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Special Thanks to

Eileen Marshall
Roger CPA Review
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Letter from the Editor

I am excited to present to you the Winter 2018 issue of The Contemporary Tax Journal. Over the past few months we worked with fellow students, professors and practitioners to present you this edition.

The topics are covered in this issue are current and thought-provoking. Featured in this edition is an article on Section 195 by Professor Luis Rodriguez, Assistant Professor of Law and Taxation at Alfred University. We also present an interview with Tax Maven Eileen Marshall, partner with Wilson Sonsini Goodrich & Rosati, and member of the San Jose State University Tax Advisory Board. Ms. Marshall offers new practitioners an excellent opportunity to learn from her experiences as a successful tax practitioner. She was nominated several times to the Washington D.C., Super Lawyers list. Also, starting with this edition we introduce a Tax Fun Facts column presenting interesting tax facts from throughout history. We hope you enjoy knowing these lesser-known tax facts.

Enlightenment pieces written by MST students include topics on Section 1031 like-kind exchanges, tax treatment of hard forks, choice of entity, tax treaties, and tax implications in a short sale. Rachana Khandelwal, MST analyzed the Cryptocurrency Tax Fairness Act which intends to simplify use of cryptocurrency in day-to-day transactions. Students who attended the 2018 IRS-SJSU Small Business Tax Institute present summaries of topics covered. Roger CPA Review provides a few CPA Exam tax questions with solutions for students preparing for the exam or anyone interested in testing their tax and accounting knowledge.

My deepest gratitude goes to Professor Joel Busch, Professor Annette Nellen and Assistant Editor Surbhi Doshi, MST student, for their help and support in publishing this edition. I thank our MST coordinator Catherine Dougherty for her help in publishing this edition online. I thank Rachana Khandelwal, MST for her contributions, editing assistance, and her suggestion to add the Fun Tax Facts column. I thank Professor Luis Rodriguez, Eileen Marshall, the Roger CPA Review team and all the MST student contributors for their contributions and support.

Thank you and enjoy reading!

Best Regards,

Rani Vaishnavi Kothapalli,
Student Editor, The Contemporary Tax Journal
INTRODUCTION

Section 195, enacted in 1980 to address the tax treatment of start-up expenditures, unnecessarily complicates their tax treatment and likely encourages taxpayers to make inappropriate or sub-optimal tax decisions. Recent federal income tax filing data clearly suggest that the vast majority of new partnership and new C corporation taxpayers are not deducting and amortizing their start-up expenditures under section 195 as Congress and the Service expects. The tax implications are that these taxpayers either: (i) distort their income; (ii) increase their tax obligations; (iii) overstate their net operating losses; or, (iv) increase their federal income tax audit risks. This paper therefore suggests several statutory amendments to better align section 195 with its legislative intent, or suggests that Congress use this opportunity for real tax reform in this area and address the real question: whether start-up expenditures are capital or current expenses by analyzing their nature, with the goal of minimizing income distortion.

LEGISLATIVE AND CASE LAW HISTORY

Section 195: Pre-1980

Prior to Congress enacting section 195, start-up and investigatory expenses were deemed nondeductible capital expenses. Courts required new businesses to capitalize these expenses based on the literal language of section 162 and on the clear reflection of income doctrine, collectively known as the “pre-opening expense doctrine” as described in Richmond Television Corp. v. United States. The literal language of section 162 requires that businesses must first be “carrying on a trade or business” in order to deduct their ordinary and necessary expenses, and therefore start-up expenditures do not qualify. Under the clear reflection of income doctrine, these expenses were akin to the cost of purchasing an asset, and therefore deducting these expenses under section 162 would distort income as their benefits far outlasted a single tax year. This “future benefits test” ultimately led to the alternative proposition that many deductible expenses may create benefits that last beyond a tax year, and so the Supreme  

1 Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (hereinafter “I.R.C.”). All references and citations to regulations are to Treasury Regulations under the Internal Revenue Code of 1986, as amended, unless otherwise indicated. All references to the “Service” are to the Internal Revenue Service.
3 Madison Gas & Electric Co. v. Commissioner, 633 F.2d 512 (7th Cir. 1980).
4 345 F.2d 901 (1965).
5 Hotel Kingkade v. Commissioner, 180 F.2d 310 (10th Cir. 1950).
Court in *Commissioner v. Lincoln Savings & Loan*\(^6\) held that the controlling feature instead should be whether the expenses created or enhanced a separate and distinct additional asset, and were then capital in nature and not an expense.

Given this tax landscape, taxpayers were motivated to either claim an accelerated start date for their new business so as to fall within section 162\(^7\) or to rationalize that *Lincoln Savings & Loan* was misinterpreted and creates a test but not the test for whether an expense is ordinary or capital.\(^8\) *Richmond Television* and its progeny still provides the test most frequently used by the Service to determine the start date of a business (see Table 1), wherein the court described that date as when “the business has begun to function as a going concern and performed those activities for which it was organized.”\(^9\)

Additionally, taxpayers seeking to expand their existing business raised unique issues for the Service with respect to their start-up and investigatory expenses. Here, the issue became whether their additional business activities should be characterized as a new business requiring these expenses to be capitalized under section 263, or whether their additional business activities should instead be characterized as expanding an existing business which permits the deduction of those expenses under section 162.\(^10\) The difference in characterization generally depends on how closely the additional business activities resemble the existing business, and that distinction can be arbitrary depending on the feature the Service emphasizes.\(^11\)

### Table 1: Trade or Business Start Dates by Industry

<table>
<thead>
<tr>
<th>Business Industry</th>
<th>Relevant Start Date of a Trade or Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing</td>
<td>When production begins (not receipt of revenues);(^12) having the assets in place for production is not enough(^13)</td>
</tr>
<tr>
<td>Retail</td>
<td>When doors open and revenue is generated (cash or accrual)(^14)</td>
</tr>
<tr>
<td>Leasing</td>
<td>When doors open and revenue is generated (cash or accrual)(^15)</td>
</tr>
</tbody>
</table>

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\(^6\) 403 U.S. 345 (1971).
\(^7\) Frank v. Commissioner, 20 T.C. 511 (1953); Ellis v. Commissioner, 26 T.C.M. 450 (1967).
\(^8\) Iowa-Des Moines Nat’l Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979); Colorado Springs Nat’l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974).
\(^9\) Richmond, 345 F.2d at 907.
\(^10\) Mid-State Products Co. v. Commissioner, 21 T.C. 696 (1954).
\(^12\) McManus v. Commissioner, 54 T.C.M. 475 (1987).
\(^13\) Petrich v. Commissioner, 40 T.C.M. 303 (1980).
\(^14\) Kennedy v. Commissioner, 32 T.C.M. 52 (1973); Walsh v. Commissioner, 55 T.C.M. 994 (1988).
Distribution

| When assets and licenses are acquired, and the taxpayer begins using them (need not generate income yet)¹⁶ |
| Publishing (books, films, photographers, music) | Generally, when the work begins¹⁷ |
| Services | When doors open and services are provided or are ready to be provided¹⁸ |

**Section 195: Enacted in 1980**

Congress enacted section 195 in an effort to “encourage formation of new businesses and decrease controversy and litigation ... with respect to the proper income tax classification of start-up expenditures.”¹⁹ As originally enacted, section 195²⁰ provided that taxpayers could elect to amortize their start-up expenditures over a period of not less than 60 months beginning in the month in which the business began. Start-up expenditures were generally defined as any amount paid or incurred in (a) investigating the creation or acquisition of an active trade or business or (b) creating an active trade or business, which would be an allowable deduction if paid or incurred with the expansion of an existing business.

Daniel I. Halperin, former Deputy Assistant Secretary of the U.S. Treasury Department, testified at a hearing before the House of Representatives on April 17, 1980 in support of the bill enacting section 195 that:

> The bill is designed to reduce the disparity [emphasis added] in tax treatment between certain ordinary and necessary preopening expenses and similar expenses incurred by an existing business.... It is difficult to justify such disparate treatment for similar expenses.

It is our hope that enactment of this bill will induce taxpayers with existing businesses to elect to amortize the start-up costs of a marginally related business [emphasis added] thereby reducing the number of controversies in this area. In the unclear cases, of which there are many, taxpayers should elect to amortize [emphasis added]; if they fail to elect and the Internal Revenue Service successfully maintains that the costs must be capitalized, the election would not be available and the costs would not be recoverable through amortization. Electing to amortize these expenses over five years would appear for most taxpayers to be a more prudent decision.²¹

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¹⁶ Cabintaxi Corp. v. Commissioner, 63 F.3d 614 (7th Cir. 1995); Jackson v. Commissioner, 864 F.2d 1521 (10th Cir. 1989); Simonson v. Commissioner, 752 F.2d 341 (8th Cir. 1985).
¹⁷ Gestrich v. Commissioner, 74 T.C. 525 (1980); Snyder v. United States, 674 F.2d 1359 (10th Cir. 1982).
Eligible start-up expenditures therefore fell into two categories: (1) investigatory expenses, and (2) start-up expenses, both of which must have been allowable as a deduction by an existing trade or business when paid or incurred. Investigatory expenses are those “costs incurred in reviewing a prospective business prior to reaching a final decision”\(^\text{22}\) to acquire or to enter that business. These costs included expenses incurred in analyzing or surveying potential markets, products, labor supply, transportation facilities, etc.\(^\text{22}\) Such expenses may relate to businesses generally, or to a category of businesses, or may relate to a particular business.\(^\text{23}\) Investigatory expenses paid or incurred after reaching the final decision would be capitalized.\(^\text{24}\) Start-up expenses, on the other hand, are those expenses made or incurred after reaching a final decision in the investigatory process, but before the business begins. These expenses include advertising; salaries and wages paid to hire and train employees; travel and other expenses to secure prospective suppliers, distributors, and customers; rent; utilities; insurance; and, executive compensation.\(^\text{25}\)

Section 195 as originally enacted was problematic in that it did not mandate capitalizing those start-up expenditures for which an election to amortize was not made and therefore taxpayers were free to argue that those expenses could be deducted. Importantly, section 195 failed to reduce tax controversies as much as the Treasury Department had hoped with respect to start date disputes for new businesses and with respect to claims that the new businesses were in reality simply expansions of existing businesses.\(^\text{26}\)

**Section 195: Amended in 1984**

Congress first amended section 195 in 1984\(^\text{27}\) in an attempt to refine the original legislation and resolve its problematic provisions. This amendment was important to the extent that it clarified that taxpayers failing to elect to amortize start-up expenditures under section 195 had no choice other than to capitalize them under section 263. In addition, the amendment carved out deductions relating to interest,\(^\text{28}\) taxes,\(^\text{29}\) and research and experimentation.\(^\text{30}\)

The Service then published guidance in Rev. Rul. 99-23 on applying section 195 to investigatory expenses when acquiring an existing trade or business, as opposed to creating a new trade or business. This ruling provides that ordinary expenses that are investigatory and

\(^{22}\) House Report at 10; Senate Report at 10.
\(^{24}\) House Report at 12; Senate Report at 13.
\(^{25}\) House Report at 10-11; Senate Report at 11-12.
\(^{28}\) I.R.C. §163.
\(^{29}\) I.R.C. §164.
\(^{30}\) I.R.C. §174.
paid or incurred to determine whether to enter a new business and which new business to enter qualify as start-up expenditures under section 195; however, once a taxpayer focuses on acquiring a specific business (i.e., makes the final decision) the expenses related to that attempt qualify as capital costs under section 263 as a facilitation cost. Rev. Rul. 99-23 thus provides important and detailed guidance in a fluid decision-making process to determine when investigatory costs can no longer be treated under section 195, and section 263 instead applies.

**Section 195: Further Amended in 2004, and in 2010**

In order to encourage small business creation Congress further amended section 195 in 2004 to provide for a limited current deduction for start-up expenditures: up to $5,000, but then reduced dollar-for-dollar (but not below zero) for amounts greater than $50,000. Any start-up expenditures in excess of $5,000 are amortized over 180 months. The $5,000 and $50,000 thresholds were increased for tax year 2010 to $10,000 and $60,000 respectively, as Congress believed the increase could help encourage new business formation not requiring substantial start-up costs. Those threshold amounts then reverted back to the $5,000 and $50,000 amounts in 2011, and for subsequent tax years.

Importantly, in 2008 the Treasury Department published Treas. Reg. §1.195-1(b) which provides that taxpayers are deemed to have made the election to amortize their start-up expenditures and instead have to affirmatively elect to capitalize those expenses. Treasury couched those regulations under electronic filing initiatives acknowledging that a “vast majority” of taxpayers elect to amortize start-up expenditures, and through efforts to reduce the administrative burdens of making those elections.

In retrospect, the legislative evolution of section 195 can be viewed as an attempt at Congress and the Treasury Department inducing taxpayers to compromise – that a rational taxpayer with a marginally related business under highly fact-specific circumstances should choose to apply section 195 to their start-up expenditures rather than risk their permanent capitalization when successfully challenged upon audit, with a limited current deduction used to encourage new business creation being no more than an afterthought. Permanently capitalizing start-up expenditures has the effect of deferring the taxpayer’s cost recovery until the sale or disposition of the business, reducing any resulting gain or increasing any resulting loss under sections 1001, and 336.

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LITERATURE REVIEW

John W. Lee’s (1986) research on section 195 called the original statute (and subsequent amendment in 1984) a “deeply flawed provision and a substantial step backwards from simplicity”\(^\text{35}\) in two respects. Firstly, that Congress left section 195 as a bare-bones statute to be fleshed out by regulations using detailed guidance in the legislative history that incorporated by reference then current controversial case law that “fatally [eroded] the certainty sought by the statute.”\(^\text{36}\) Secondly, that Congress missed the opportunity for true tax reform by failing to address the fundamental concept that the purpose of differentiating capital expenses from ordinary and deductible expenses is to minimize income distortions.\(^\text{37}\)

According to Lee (1986), a deep structural analysis of start-up and business expansion costs must begin with “Congress’ fundamental policy decision to tax net income calculated annually, with minimum distortion.”\(^\text{38}\) If currently deducting an expense does not result in more than minimal income distortion, and if the burden of capitalizing and amortizing the expense is heavy, then the expense should be currently deducted.\(^\text{39}\) Minimal income distortion occurs when the expense to be deducted (a) is not substantial when compared to the taxpayer’s income for the year or has a short useful life, (b) recurs regularly or annually in roughly the same amount, with a short or uncertain future benefit, or (c) cannot be clearly associated with a tax year.\(^\text{40}\)

Lee (1986) cites *Cincinnati, New Orleans & Texas Pacific Railway v. United States*\(^\text{41}\) as the first decision that uses the distortion of income analysis to allow the current deduction of an expense that benefits future years. The court reasoned “that capitalization, depreciation, and the requirement that the taxpayer’s method of accounting clearly reflect income were all so ‘inextricably intertwined’ that the ultimate question was whether the taxpayer’s (tax) accounting method clearly reflected income, and not whether the benefits generated by the expenditures extended beyond the tax year….”\(^\text{42}\) The court heavily relied on how insubstantial the expenses were in relation to both taxable income and the taxpayer’s balance sheet, as well as the burden of capitalizing and depreciating such amounts. Lee (1986) admitted that the difficulty, of course, lies in determining what was insubstantial with respect to any given taxpayer.\(^\text{43}\)

“Managers of a growing business rarely attach much significance to labeling the growth as an expansion of the existing business or a start of a new business. The tax law, however, finds

\(^{\text{36}}\) Id.
\(^{\text{37}}\) Id. at 7-8.
\(^{\text{38}}\) Id. at 4.
\(^{\text{39}}\) Id. at 13.
\(^{\text{40}}\) Id.
\(^{\text{41}}\) 424 F.2d 563 (Ct. Cl. 1970).
\(^{\text{42}}\) Lee, supra note 35 at 16.
\(^{\text{43}}\) Id. at 17.
such labels critical.” So begins Glenn Walberg’s (2010) examination of how the investigatory expenses of an existing business are treated under section 195. Walberg (2010) noted that taxpayers, their advisors, and the Service have “devoted substantial resources” to determining and contesting whether an activity rises to the level of a new business activity or whether it is an extension of an existing business activity, which unfortunately subjects taxpayers to “considerable uncertainty” as taxpayers generally consider business opportunities on an ongoing basis, and therefore “can drift into an investigatory phase without realizing or acknowledging its occurrence.” He argues that it is difficult to distinguish between routine investigative activities and those that trigger section 195, which adds another layer of tax complexity.

Walberg (2010) believed that taxpayers are ill-equipped to determine if a business activity is a new business for tax purposes. However, in practice the Service looks to whether an average trade or business in a particular field would likely enter into that new activity. If so, then that activity is likely not a new business activity, unless “substantial amounts of new skills and expertise are required to enable the existing trade or business to include the other activity or pursuit . . . .” Walberg (2010) writes that this analysis becomes unwieldy for taxpayers, especially in a dynamic and innovative industry with diverse competitors. He therefore argues that Congress should amend section 195 to reflect that start-up expenditures should be mandatorily amortized, and that investigatory expenses for existing businesses should be fully deductible as their value quickly grows stale and loses their usefulness.

**METHODOLOGY**

This study compares the total number of new partnerships and new C corporations filing their initial federal income tax return with those new partnerships and new C corporations who utilized section 195. The Service only recently started reporting data on the number of taxpayers filing under section 195 and the gross amounts deducted; however, this data is limited to partnerships (since 2010) and C corporations (since 2008) (see Tables 2 and 3), and does not include tax filing data for S corporations or sole proprietorships.

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45 Id. at 97.
46 Id. at 99.
48 Id. at 63.
49 Id. at 108.
50 Service obtains this tax filing data using line item estimates from a sampling of data from Form 4562.
Study Results

Table 2: The table below reflects section 195 tax filing data for partnerships

<table>
<thead>
<tr>
<th>Taxable Year</th>
<th>Partnerships Initially Filing Form 1065</th>
<th>Partnerships Filing Under Section 195 (Form 4562)</th>
<th>Total Section 195 Deduction Amount (1,000s) (Form 4562)</th>
<th>Average Section 195 Deduction Amount per Form 4562</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>315,580</td>
<td>20,050</td>
<td>$ 90,401</td>
<td>$ 4,509</td>
</tr>
<tr>
<td>2011</td>
<td>311,380</td>
<td>12,166</td>
<td>$ 96,973</td>
<td>$ 7,971</td>
</tr>
<tr>
<td>2012</td>
<td>307,763</td>
<td>13,970</td>
<td>$ 49,780</td>
<td>$ 3,563</td>
</tr>
<tr>
<td>2013</td>
<td>291,132</td>
<td>16,075</td>
<td>$ 123,942</td>
<td>$ 7,710</td>
</tr>
<tr>
<td>2014</td>
<td>308,173</td>
<td>14,820</td>
<td>$ 279,278</td>
<td>$ 18,845</td>
</tr>
<tr>
<td>2015</td>
<td>339,513</td>
<td>32,307</td>
<td>$ 95,428</td>
<td>$ 2,954</td>
</tr>
</tbody>
</table>

Table 3: The table below reflects the section 195 tax filing data for C corporations

<table>
<thead>
<tr>
<th>Taxable Year</th>
<th>C Corporations Initially Filing Form 1120</th>
<th>C Corporations Filing Under Section 195 (Form 4562)</th>
<th>Total Section 195 Deduction Amount (1,000s) (Form 4562)</th>
<th>Average Section 195 Deduction Amount per Form 4562</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>106,343</td>
<td>25,816</td>
<td>$ 133,862</td>
<td>$ 5,185</td>
</tr>
<tr>
<td>2009</td>
<td>103,937</td>
<td>22,571</td>
<td>$ 71,594</td>
<td>$ 3,172</td>
</tr>
<tr>
<td>2010</td>
<td>90,196</td>
<td>22,721</td>
<td>$ 106,729</td>
<td>$ 4,697</td>
</tr>
<tr>
<td>2011</td>
<td>94,096</td>
<td>16,275</td>
<td>$ 84,572</td>
<td>$ 5,196</td>
</tr>
<tr>
<td>2012</td>
<td>96,038</td>
<td>14,944</td>
<td>$ 110,111</td>
<td>$ 7,368</td>
</tr>
<tr>
<td>2013</td>
<td>102,151</td>
<td>18,081</td>
<td>$ 136,879</td>
<td>$ 7,570</td>
</tr>
</tbody>
</table>

The tax filing data serving as the source for Tables 2 and 3 does not provide detail on business industries or geographic regions. Importantly, the Service also does not report how many tax filers elect to capitalize their start-up expenditures or their amounts. Notwithstanding these limitations, this data is still useful to the extent of what can be reasonably inferred in regard to how taxpayers are treating these expenses. This study therefore uses the total number of partnerships initially filing Form 1065 and C corporations initially filing Form 1120 as a proxy for the population of taxpayers that would generally be expected to have start-up expenditures and should have utilized section 195.

As section 195 amounts are amortized over 180 months, one expectation for this study was that the number of partnerships and C corporations filing under section 195 in any given tax year would be much greater than the number of those taxpayers initially filing their federal income tax returns, which were expected to fluctuate for any given tax year. Another expectation was that the section 195 deduction amounts would also increase over time due to the cumulative nature of amortization. This pattern was generally expected to follow the tax
filing data for 15-year (180 months) property depreciated amounts for partnerships and C corporations (see Tables 4 and 5).

**Table 4: The table below reflects tax filing data for partnerships**

<table>
<thead>
<tr>
<th>Year</th>
<th># of Returns Filed for 15-year Property</th>
<th>15-Year Depreciation Amounts in Thousands</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>113,986</td>
<td>1,280,679</td>
</tr>
<tr>
<td>2011</td>
<td>56,313</td>
<td>1,205,622</td>
</tr>
<tr>
<td>2012</td>
<td>166,141</td>
<td>1,543,617</td>
</tr>
<tr>
<td>2013</td>
<td>156,730</td>
<td>1,888,800</td>
</tr>
<tr>
<td>2014</td>
<td>166,482</td>
<td>2,150,967</td>
</tr>
<tr>
<td>2015</td>
<td>150,822</td>
<td>2,288,944</td>
</tr>
</tbody>
</table>

**Table 5: The table below reflects tax filing data for C corporations**

<table>
<thead>
<tr>
<th>Year</th>
<th># of Returns Filed for 15-year Property</th>
<th>15-Year Depreciation Amounts in Thousands</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>144,147</td>
<td>2,425,850</td>
</tr>
<tr>
<td>2009</td>
<td>140,703</td>
<td>2,034,742</td>
</tr>
<tr>
<td>2010</td>
<td>113,335</td>
<td>1,483,602</td>
</tr>
<tr>
<td>2011</td>
<td>71,957</td>
<td>972,415</td>
</tr>
<tr>
<td>2012</td>
<td>150,261</td>
<td>1,504,286</td>
</tr>
<tr>
<td>2013</td>
<td>160,985</td>
<td>1,795,333</td>
</tr>
</tbody>
</table>

**DISCUSSION AND SUGGESTED SOLUTIONS**

**Discussion**

What is immediately apparent from the study results in Tables 2 and 3 is that the number of partnerships and C corporations filing under section 195 is surprisingly very small when compared to the number of partnerships initially filing (ranging from a low of 3.91 percent in 2011 to a high of 9.52 percent in 2015) and C corporations initially filing (ranging from a low of 15.6 percent in 2012 to a high of 25.2 percent in 2010), with C corporations on average 3.5 times more likely than partnerships to take a section 195 deduction. Also surprising is the almost random nature of the number of partnerships and C corporations filing under section 195 and their deduction amounts over time given the cumulative nature of section 195.

The tax filing data in Tables 2 and 3 therefore suggest that the deduction and amortization provision of section 195 is being ignored by the vast majority of new partnerships and new C corporations, which contradicts the Service’s statement that the “vast majority” of taxpayers elect to amortize their start-up expenditures and runs contrary to Congress’ stated intent. Its lack of use is problematic given the increased tax complexity section 195 has caused.

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53 Supra, note 34.
and the likely added risk of the tax treatment of start-up expenditures being challenged on tax audit; therefore, a discussion of possible reasons why start-up expenditures are not being deducted and amortized under section 195 is warranted within the context of the following four options taxpayers have in treating these expenses.

**Not Reporting Start-up Expenditures**

Failing to report these expenses reflects a lack of taxpayer familiarity with section 195 and suggests that the Service should commit to additional taxpayer outreach and to tax education consistent with their mission mandate. It is very unlikely that partnerships and C corporations of any meaningful size fail to report these expenses as these taxpayers generally have access to tax advisors keen on not wasting an opportunity to recover these expenses as quickly as possible.

**Deduct Allowable Start-up Expenditures and Amortize Any Remainder Under Section 195**

Tables 2 and 3 clearly suggest that a vast number of partnerships and C corporations initially filing their federal income tax returns are not deducting and amortizing their start-up expenditures under section 195. One of the legislative purposes of section 195 was to encourage new business creation by allowing taxpayers to immediately deduct up to $5,000. Arguably, this limited deduction is too small to be a meaningful incentive and may instead serve to encourage taxpayers to limit their due diligence costs to no more than $5,000 in an effort to immediately recover as much as possible, which may in turn increase their financial risks by self-limiting their information.54

The other legislative purpose of section 195 was to reduce tax controversies between the Service and those taxpayers with existing businesses seeking to expand into additional business activities. Where the additional business activity is clearly unrelated to the existing business, the expectation is that taxpayers will apply section 195 to related start-up expenditures. Where the additional business activity is clearly related to the existing business, then the expectation is that taxpayers will deduct those expenses under section 162. In the case of additional business activities that are neither clearly unrelated nor clearly related (“marginally related additional business activities”) and can therefore lead to tax controversies, the expectation is that rational taxpayers will apply section 195 to relevant start-up expenditures in order to mitigate their risk that upon audit these expenses will be capitalized. While the Service does not generally publish data on tax controversies, the tax filing data in Tables 2 and 3 suggest that if tax controversies have been reduced in this area, then the reduction is the result of either partnership and C corporation taxpayers refraining from expanding through unrelated or marginally related additional business activities altogether, or they have clearly resolved that their start-up expenditures stemming from additional business activities should be capitalized under section 263 or deducted under section 162—that there is no need to resort to section 195.

Arguably, the nature of the business community is such that it is unlikely that those with existing businesses have refrained from expanding through additional business activities (the great recession notwithstanding). Moreover, given the complexity and fact specific nature of deciding whether their additional business activities are unrelated, marginally related, or clearly related to an existing business activity, it seems likely that partnerships and C Corporations would have a fair number of business activities whereby section 195 would apply, possibly triggering tax controversies. And yet, Tables 2 and 3 reflect that few partnerships and C Corporations initially filing their federal income tax return avail themselves of the deduction and amortization provisions in section 195. Instead, the vast majority of these taxpayers clearly must then be availing themselves of one or more of the other options discussed in this section.

**Elect to Capitalize Start-up Expenditures Under Section 263**

Tables 2 and 3 suggest that some partnerships and C corporations initially filing their federal income tax returns may have elected to capitalize their start-up expenditures under Treas. Reg. §1.195-1. While the Service does not provide tax filing data on the number of taxpayers making this election, or their amounts, capitalizing these expenses unnecessarily delays recovering these amounts until the business is sold or otherwise disposed and thus distorts taxpayer income. Those taxpayers affirmatively making this election are no better off than pre-section 195 when taxpayers were required to capitalize their start-up and investigatory expenses, in which case section 195 has needlessly increased the complexity of the tax code in this area by adding an underutilized tax provision.

**Deduct Start-up Expenditure Amounts Under Section 162, 248, or 709**

Tables 2 and 3 suggest that some partnerships and C corporations initially filing their income tax returns may be deducting their start-up expenditures under section 162. Outside the context of expanding an existing business with clearly related business activities, these taxpayers may be at audit risk caused by misapplying section 162; however, the availability of an immediate deduction of up to $5,000 under section 195 may provide a partial safe harbor for these taxpayers. This immediate deduction not so much makes the case to motivate taxpayers to create new business (which was poorly supported by data) rather than make the case that the immediate deduction partially minimizes income distortion and should be extended by allowing a full deduction of all start-up expenditures. Importantly, the tax data does not support that a material number of partnerships and C corporations initially filing their federal income tax returns may be treating start-up expenditures as organizational costs under section 709 for partnerships or section 248 for C corporations.

**Suggested Solutions**

If the original legislative intent of section 195 to encourage new business creation and reduce tax litigation and controversies still has merit, then increasing the immediate deduction, decreasing the amortization period, and excluding the investigatory expenses of existing businesses from the definition of start-up expenditures as Walberg (2010) suggests might
individually or collectively make section 195 relevant to taxpayers. All of these options have merit to the extent that they promote minimizing the distortion of income, which is consist with GAAP which also seeks to minimize income distortions. While GAAP is not determinative for tax purposes, Lee (1986) admits that both financial and tax accounting seek to match income with associated costs, and therefore broad accounting concepts are useful in implementing tax policy.

According to Lee (1986), in enacting section 195 Congress missed the opportunity for framing the conversation beneficially: the question should have been whether start-up expenditures are capital or current expenses by analyzing their nature, with the goal of minimizing income distortions. Lee (1986) writes that a mechanical test such as section 195 will most likely fail in making this distinction in all but the most obvious of cases. He believed in currently deducting start-up expenditures that do not result in more than minimal income distortion where the burden of capitalizing and amortizing such expense is heavy. The clear reflection of income test, which is the financial accounting standard and to which section 446 gives preference, may be a good tool to use in this analysis. Lower courts have held that “where a taxpayer has consistently treated certain expenditures in a manner that clearly reflects net income and that also comports with generally accepted accounting principles, the taxpayer’s accounting practice should be allowed to dictate tax treatment despite the contrary result arguably required by section 263.”

Importantly, Table 6 illustrates the results of a recent PwC survey whereby the United States is in the clear minority of countries (approximately 7 percent) where start-up expenses for corporations are either amortized for a period of greater than 5 years or must be capitalized, with approximately 56 percent of the countries included in the survey either permitting full deduction or amortization of these expenses within five years. This survey implies that the United States might want to rethink its position in this tax area.

55 Walberg, supra, note 44.
56 ASC 720-15; ASC 835-20; ASC360-20; ASC970-10; ASC805.
57 Lee, supra note 35 at 24.
58 Id. at 8.
59 Id. at 13.
61 Id. at 635-6.
62 Any data classified as “Unclear” may be better classified under relevant and regional GAAP principles; PwC, Worldwide Tax Summaries, Corporate Taxes 2018/9 (1, 2018), https://www.pwc.com/gx/en/services/tax/worldwide-tax-summaries.html#pdf.
Table 6: The table below reflects a PwC survey of how various countries treat start-up expenses

<table>
<thead>
<tr>
<th></th>
<th>Africa</th>
<th>Asia Pacific</th>
<th>Central America &amp; Caribbean</th>
<th>Central Asia &amp; Eastern Europe</th>
<th>Europe</th>
<th>Middle East</th>
<th>North America</th>
<th>South America</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fully Deductible</td>
<td>14</td>
<td>9</td>
<td>3</td>
<td>11</td>
<td>22</td>
<td>4</td>
<td>0</td>
<td>4</td>
<td>67</td>
</tr>
<tr>
<td>Amortized ≤5 years</td>
<td>6</td>
<td>4</td>
<td>3</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>0</td>
<td>4</td>
<td>21</td>
</tr>
<tr>
<td>Amortized &gt;5 years</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Fully Capitalized</td>
<td>0</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Unclear</td>
<td>10</td>
<td>7</td>
<td>11</td>
<td>9</td>
<td>13</td>
<td>5</td>
<td>2</td>
<td>2</td>
<td>59</td>
</tr>
</tbody>
</table>

CONCLUSION

Section 195 was enacted to provide a tax incentive to create new businesses, as well as reduce tax controversy and litigation with respect to start-up expenditures. By those measures, section 195 successfully meets its mandate only when used. After several decades and subsequent statutory amendments, the tax filing data suggest that section 195 is largely being ignored by partnerships and C corporations, which is problematic given the increased complexity this tax provision has caused, and the added risk that the taxpayer’s tax treatment of their start-up expenditures will be challenged on tax audit by the Service. This paper suggests amendments that can better align section 195 with its legislative intent, but further suggests that Congress revisit the discussion of fully deducting all start-up expenditures rather than try to fix a flawed tax provision that may encourage taxpayers to make inappropriate or sub-optimal tax decisions with respect to those expenses. This paper further suggests that the Service engage in more comprehensive data gathering on this issue to better direct tax policy efforts.
**Tax Enlightenment: Section 1031 Like-Kind Exchange**

- Daniel Currie, MST Student

**Definition and Popularity**

A popular strategy used by taxpayers to defer capital gain taxes on the sale of business or investment property is to use a like-kind exchange (also known as a “1031 exchange”). No gain or loss is recognized on the exchange provided that such property is exchanged solely for property of a *like kind* which is to be held either for use in a trade or business or for investment.\(^1\)

In general, if a taxpayer transfers property to another party in a like-kind exchange during the current tax year, the taxpayer defers the gain (or loss) on the exchange and must file IRS Form 8824 with their tax return for that tax year.\(^2\) This filing requirement is one which includes taxpayers that are either an individual, a corporation, or a partnership.

The frequency of Form 8824 being filed is illustrated in the chart below which was prepared using statistical data provided by the IRS.\(^3\) The dollar amount indicates the amount of gains deferred as reported on Form 8824. According to this data, individuals reported deferred gains from years 2009 through 2013 of $26.85 billion. In that same five-year span corporations reported $154.51 billions of deferred gain and partnerships reported $62.02 billions of deferred gains on Form 8824. Although this most recently published data does not include the most recently completed four calendar years (2014-2017), this information clearly demonstrates that many taxpayers are taking advantage of Section 1031 for significant tax deferral.

<table>
<thead>
<tr>
<th>Form 8824*</th>
<th>Individuals</th>
<th>Corporations</th>
<th>Partnerships</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Frequency</td>
<td>Amount**</td>
<td>Frequency</td>
</tr>
<tr>
<td>2013</td>
<td>216,581</td>
<td>$7,863,355</td>
<td>87,921</td>
</tr>
<tr>
<td>2012</td>
<td>174,580</td>
<td>$7,834,355</td>
<td>79,454</td>
</tr>
<tr>
<td>2011</td>
<td>156,930</td>
<td>$3,871,938</td>
<td>76,479</td>
</tr>
<tr>
<td>2010</td>
<td>146,526</td>
<td>$2,723,076</td>
<td>60,883</td>
</tr>
<tr>
<td>2009</td>
<td>129,907</td>
<td>$4,562,209</td>
<td>56,022</td>
</tr>
<tr>
<td>Total</td>
<td>824,524</td>
<td>$26,854,933</td>
<td>360,759</td>
</tr>
</tbody>
</table>

*All data are estimates based on samples; some companies file multiple Forms 8824.

\(^1\) IRC §1031(a)(1).
**From 8824, line 24, Realized gain (or loss); all amounts are in thousands of dollars.**

### The Details of Sec. 1031 (Pre-TCJA)

A like-kind exchange does not meet the non-recognition rules if one kind or class of property is exchanged for another kind or class. This means that a taxpayer, under the rules before the TCJA, could (although it was not elective) use the non-recognition rules in an exchange if, for example, the taxpayer exchanged certain real property for like-kind real property or certain personal property for like-kind personal property. If, however, the exchange satisfied the requirements for non-recognition treatment as being an exchange of like-kind and the taxpayer also transferred (or received) property that was not like-kind, the exchange could still potentially qualify as tax-free (or partially tax-free). In other words, a taxpayer that transfers property, where a gain is realized, could avoid a current taxable event by exchanging solely in property that is like-kind, but if the exchange is not solely for property of like kind, then the transaction may not potentially qualify as tax-free. If non-like-kind property (“boot”) is received by the taxpayer, then gain is recognized based on the lesser of the realized gain or the value of the boot received. On the other hand, if boot is given to the other party and (1) the only boot given is in the form of cash, then no gain is recognized, or (2) if non-cash boot is given to the other party, then gain is potentially recognized based on the difference between the non-cash boot’s fair market value and the taxpayer’s basis in the property right before the exchange – if the fair market value exceeds the basis. While not common, in realized loss situations, losses cannot be recognized if boot is received, but losses can potentially be recognized if non-cash boot is given to the other party and the property’s fair market value is less than the taxpayer’s basis in the property.

Under the Sec. 1031 rules before the TCJA, there were three different classes of property to determine whether an exchange of property satisfies the requirement for being a reciprocal exchange: (1) depreciable tangible personal property, (2) intangible and non-depreciable personal property, and (3) real property. A transaction would not meet the like-kind exchange requirement if, for example, a taxpayer exchanged equipment (depreciable tangible personal property) for a vacant lot of land (real property).

There were additional requirements for depreciable tangible personal property in a like-kind exchange. An exchange of depreciable tangible personal property for other depreciable tangible personal property must have been within the same general asset class or within the same product class to be considered like-kind.

There were also additional requirements for intangible personal property or non-depreciable personal property in a like-kind exchange. For an exchange of intangible (or non-depreciable) personal property for other intangible (or non-depreciable) personal property to meet the like-kind requirement generally depends on the nature and character of the rights involved and also on the nature or character of the underlying property to which the intangible (or non-depreciable) personal property relates.

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4 Reg. §1.1031(a)-1(a)(2).
5 Reg. §1.1031(a)-2(b).
6 Reg. §1.1031(a)-2(c).
The like-kind requirements were more liberal in an exchange of real property than other property. The grade or quality, such as improved real estate or unimproved real estate, is not a factor as to whether real property qualifies as like kind. In other words, a vacant lot of land exchanged for a commercial building would generally meet the like-kind requirement in a section 1031 exchange.

Changes Made to Sec. 1031 by the TCJA

For exchanges completed after December 31, 2017, personal property no longer qualifies for tax-deferral under Section 1031 under P.L. 115-97, the law known as the Tax Cuts and Jobs Act (TCJA). To meet the requirements of section 1031 for tax-deferral, an exchange completed after December 31, 2017 must be for like-kind real property that is not held primarily for sale. If an exchange of real property completed after December 31, 2017 includes personal property, the receipt of the personal property will be considered the receipt of “other property” or boot.

Many qualified 1031-exchanges do not occur simultaneously. In a reverse exchange, the replacement (new) property is received first and the old (relinquished) property is later given to the other party. On the other hand, in a forward exchange, the old property is relinquished first with the replacement property received at a later date. Under the “transition rule,” in a situation where the non-simultaneous exchange straddles tax years, the effective date for determining whether the exchange is subject to the changes made by P.L. 115-97, is based on whether or not the replacement property (in a reverse exchange) is received or the relinquished property (in a forward exchange) is given up on or before December 31, 2017. If either scenario applies, then the pre-TCJA rules apply. If the effective date of the exchange is after December 31, 2017, the exchange is subject to the new law and thus personal property would not qualify as like-kind property. Of course, this transition rule regarding when the new real property limitation for transactions involving a Sec. 1031 would apply for non-simultaneous exchanges, is still subject to the identification and relinquishment / replacement time periods (to be discussed later).

Real Property vs Personal Property

An essential question for exchanges completed after December 31, 2017 then becomes: Is the property classified as real property or personal property? This question must be answered for both the relinquished property and the replacement property, to determine whether the exchange satisfies the real property limitation.

State law creates legal interests and rights of property and separates property into these two broad categories of real or personalty. In California, personal property is considered “movable” and real property is considered “immovable”. Furthermore, land and anything that is affixed to

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7 Reg. §1.1031(a)-1(b).
8 Committee Report 10,311.00089, PL 115-97, 12/22/2017.
9 P.L. 115-97, Section 13303.
10 Morgan vs. Commissioner, 60 S. Ct. 424 (1940).
land is real property. California further defines personal property as every kind of property that is not real property.

State law characterizations of property is a factor, but not the sole determinative factor for purposes of section 1031. In the Tax Court case of *Peabody Natural Resources Co. vs. Commissioner*, 126 T.C. 261 (2006), the court held that coal supply contracts, which were a part of a section 1031 like-kind exchange of gold mines for coal mines, did not constitute personal property (boot) in the exchange even though the supply contracts were also a contract for the sale of goods under New Mexico law. Instead, the court considered the state law classification to be less significant than factors bearing on the nature and character to which the bundle of rights relate, which in this case is the ownership of realty made up of mine land coal reserves.

An example provided in IRS Chief Counsel Advice 201238027 demonstrates further that an exchange of two natural gas pipelines, one in State A classified as personal property and the other in State B classified as real property are, in fact, like-kind for the purposes of section 1031 since the basic nature and character of the property is a significant factor, rather than simply being overridden by a state law classification.

Furthermore, although property classifications, such as those by the state law, are an important consideration for the like-kind determination of section 1031, there are other considerations such as whether the property is an inherently permanent structure affixed to real property and whether the property is transferred as part of the land. Additionally, consideration should be given to the respective interests in the properties, including the duration of such interests, the rights involved, including whether the nature of such rights is merely ancillary, the nature of the title conveyed, and any other factor bearing to the nature and character of the properties.

Although the distinction between section 1245 and section 1250 property is needed for depreciation purposes, it is not necessarily determinative for section 1031 purposes. In other words, the facts and circumstances that bear to the nature and character of the property will still triumph the property classification that was assigned for depreciation purposes.

### Additional Fundamentals of Sec. 1031

The non-recognition of gain or loss applies if certain requirements under section 1031 are met. One of the “exchange” requirements is that like-kind property must be both given up as relinquished property and received as replacement property. The transfer of property is normally made using a qualified intermediary (QI), also known as an Accommodator or a Facilitator, who in most circumstances is the one required to initially acquire and transfer the relinquished property and replacement property between the two parties.

In regard to the basis of like-kind property received in a like-kind exchange, the replacement property has a carryover tax basis if no gain or loss is deferred in the transaction. In situations

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14 126 T.C. at 278.
15 CCA 201238027, April 17, 2012.
16 IRC §1031.
17 Treas. Reg. §1.1031(k)-1(g)(4).
where there is a deferral, the basis in the replacement property is generally the value of the replacement property less the deferred gain (or plus any deferred loss). Other factors that could be involved in the basis calculation include any liability assumed, liability relieved, non-like-kind property assumed, or non-like-kind property given up.

In a deferred forward exchange, in order for section 1031 to apply, the potential replacement property must be identified (with certain requirements) on or before the 45th day after the transfer of the relinquished property. This 45-day period is known as the “identification period”. Additionally, in a deferred forward exchange, the replacement property must be received after the earlier of 180 days succeeding the transfer of the relinquished property or the due date of the taxpayer’s tax return. This 180-day period is also known as the “exchange period”. The exchange period is determined with a properly filed extension which means that if the exchange period is expected to extend beyond the original due date of the tax return, the taxpayer must have a properly filed extension for the property to have the full 180-day exchange period. A properly filed extension is one that must be granted.

Both the identification (45-day) and the exchange (180-day) periods are set by the statute and therefore, are not eligible for any type of extension, except in situations where the exchange is impacted by a Presidentially Declared Disaster.

For reverse exchanges, sometimes known as reverse “Starker” transactions, where the transfer of the replacement property is completed before the transfer of the relinquished property, the IRS has issued a safe harbor rule under Rev. Proc. 2000-37. The safe harbor provides that the IRS will not challenge either the qualification of the replacement property (or the relinquished property), or the treatment of the exchange accommodation titleholder (EAT) as the beneficial owner of the property so long as the property is held in a “qualified exchange accommodation arrangement” (QEAA). In these transactions, property is “parked” with the accommodation party under a permissible agreement, and although not required to follow the rules under section 1031(a)(3), there still must be genuine intent of a like-kind exchange and must accomplish such transaction within a short period of time. The safe harbor under Rev. Proc. 2000-37 will not apply if the taxpayer receives the replacement property before initiating a QEAA.

Considerations for Sec. 1031 with Personal Property: Years 2018 and Later

Although the new tax law will undoubtedly create some questions by tax practitioners dealing with their clients’ like-kind exchanges completed in 2018 or planned to be completed in 2018 or later, the concept for determining whether the properties meet the real property limitation will depend on the facts and circumstances.

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18 IRC §1031(a)(3)(A).
19 Treas. Reg. §1.1031(k)-1(b)(1)(ii).
20 IRC §1031(a)(3)(B).
21 Treas. Reg. §1.1031(k)-1(b)(1)(ii).
In a multi-asset exchange that meets the requirements of an exchange of real property, but which also includes what may be classified as personal property, such as for either state law purposes or for federal depreciation purposes, proper planning should address which properties specifically qualify under section 1031 and which ones will be boot. Although the rules for exchanges of multiple properties under Treas. Regulation §1.1031(j)-1 have not been amended to reflect the changes made under P.L. 115-97, real property in a multiple property exchange would presumably be included in one exchange group. The receipt of property that is not classified as real property will therefore not be included in the exchange group, and not permitted to be transferred without the recognition of gain or loss. In other words, the party that receives property that is not like-kind will be deemed to have received boot in an amount equal to its fair market value, and the party that gives up the other property may either recognize gain to the extent the boot’s fair market value exceeds the adjusted basis, or loss to the extent that the adjusted basis exceeds the fair market value.25

Many taxpayers have been and will continue using cost segregation studies to classify certain property as section 1245 (personal property) assets to utilize shorter useful lives for depreciation purposes. In situations where these taxpayers later exchange real property that qualifies for section 1031, there may be multiple assets involved, some of those being section 1245 assets, which although classified as such for depreciation purposes, may or may not meet the real property classification for section 1031 purposes. Proper planning should be made in these situations to identify which properties are considered as meeting the like-kind requirements under section 1031(a).

The popular strategy of tax-deferred exchanges should be expected to continue despite the new real property limitations. Although further guidance to better clarify the definition of real versus property in the context of these transactions may be needed, it will remain important for taxpayers and those involved with these arrangements to carefully review the like-kind exchange rules and then interpret how these rules should apply to their unique set of facts and circumstances.

25 Treas. Reg. §1.1031(d)-1(e).
Background on Cryptocurrency

Cryptocurrency (CC) is a digital, decentralized, open source asset with its value entirely driven by market forces. CC holds no intrinsic value due to an absence of any asset backing. CCs such as bitcoin and altcoins (Ethereum, Dash, Monero, Zcash, etc.) are significantly different from traditional currencies such as the Euro and U.S. dollar. Traditional currency is a legal tender with a central bank backing and is generally globally accepted as a medium of exchange.

Transactions in cryptocurrency are recorded in a distributed ledger through a series of cryptographical blocks called Blockchain, a robust technology which makes it impossible to alter any recorded transaction.

CCs are stored in digital wallets and can be used to buy/sell via transactions over a peer to peer network. When an exchange takes place over a peer to peer network, the record of transactions is maintained between user addresses and not the actual users. A bitcoin address is an alphanumeric code called a ‘public key’. Each public key has a corresponding private key, which needs to be protected and stored safely by the user. The public key is used to receive bitcoin while the private key is to send bitcoin. When a user’s wallet is hosted on a third-party platform such as an exchange, the user doesn’t have any control over the wallet since the private key of the wallet is held by the exchange. However, this does not imply that the exchange is manipulating the user’s fund. The exchange manages the user’s wallet and executes the transactions only when it receives the authorization from the user.

CCs such as bitcoin and Ethereum are primarily obtained through ‘mining’, which involves solving complex mathematical algorithms on powerful computers. Once in circulation, it can be purchased from dedicated exchanges such as Coinbase and GDAX, or can be received as a payment for goods or services.

Cryptocurrency also comes into existence through an Initial Coin Offering (ICO) or through a hard fork.

What is a Hard Fork?

As per the Safe Harbor for Taxpayers with Forked Assets Act of 2018 “hard fork means, with respect to any convertible virtual currency, any material change in the shared digital ledger which is used to verify by consensus transactions in such currency if such change results in the maintenance of independent shared digital ledgers with respect to such currency.”

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1 ICO is funded by investors to develop a blockchain, digital tokens or a currency. According to the Bitcoin Market Journal, August 6, 2018, ICOs’ raised $13 billion; https://www.bitcoinmarketjournal.com/biggest-icos-roi/.

In general, a hard fork (also known as a chain split) occurs when a blockchain network protocol is permanently upgraded by implementing major changes to the existing protocol, thereby creating a separate blockchain with a new cryptocurrency. Such a change in the protocol is not backward compatible and hence all the future transactions are operated with a different set of rules under the new protocol.

Source: Rachana Khandelwal

Usually, a hard fork takes place when the blockchain network participants (miners) arrive at a consensus that the software needs to be upgraded for reasons such as to increase the scalability of a block size, make the blockchain more efficient, lower the transaction costs or make the blockchain robust and immune from potential security breaches.

The new blockchain retains the pre-forked transaction history of the owners of the coins. However, due to incompatibility in the software, a transaction that is accepted by the new protocol is rendered invalid on the old one and is not accepted by the non-upgraded nodes in the network.

In 2016, Ethereum went into a hard fork in Ethereum Classic (old) and Ethereum (new) to improve their broken blockchain network. The old blockchain was subject to hacking and resulted in the financial loss of $64 million. This led to a launch of new improved software which tightened the security to prevent such losses in the future.

Bitcoin has undergone several hard forks such as Bitcoin XT (December 2014), Bitcoin Classic (February 2016), and Bitcoin Cash (August 2017). So far, the most successful bitcoin blockchain

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split is the Bitcoin Cash owing to its wide acceptance by the cryptocurrency users and ranked fourth largest by market capitalization of approximately $9 billion.⁵

**Tax Treatment**

In March 2014, the IRS provided general guidance through Notice 2014-21⁶ to treat cryptocurrency as ‘property’ for federal tax purposes. Thus, the tax rules applicable to a property transaction are also applicable to the transactions undertaken using CC. However, since 2014 there has been a significant transformation in the use and operation of cryptocurrency, which was originally viewed as an asset obtained by mining or purchased from a dedicated exchange.

In 2017, the hard fork of bitcoin into Bitcoin Cash presented an altogether a new challenge in the tax treatment of a newly obtained currency via chain split. The IRS has been silent on the tax treatment of a hard fork, perhaps because of the subtleties involved in determining the point of taxation for such events. As mentioned above the valuation of the forked coin may be a challenging aspect given the unpredictable frequency of a hard fork. In addition, the nature and newness of a hard fork has no existing counterpart in existing transactions to aid in identifying any obvious tax treatment.

**Character of Income**

**A. Hard Fork as Ordinary Income**

Per IRC section 61(a), under general tax principles, gross income includes “all income from whatever source derived,” except as otherwise provided.⁷ Treasury Regulations §1.61-1(a) further explains it to include income realized in any form such as money, property or services.

In *Commissioner v. Glenshaw Glass*, the U.S. Supreme Court further broadened the interpretation of IRC 61(a) and explained, income as a “taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it.”⁸ The Court emphasized that the determinative factors of gross income include- a) undeniable accession to the wealth, b) clearly realized, and c) complete dominion over such income.

Application of these three factors to a hard fork, produces the following analysis.

a) Undeniable accession to the wealth

In *Haverly v. U.S.* ⁹, the court determined that the taxpayer’s receipt of unsolicited textbooks, and subsequent claiming of a charitable tax deduction upon donation of such textbooks constituted an accession to wealth. In the case of a hard fork, the forked coin is an economic gain to the taxpayer because of the taxpayer’s holding of the original coin. The taxpayer generally receives an equal number of forked coins as the original coins held in their wallet at no cost. In substance, the taxpayer is in receipt of free property representing an increase

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⁵ Top 100 cryptocurrencies by market capitalization available at [https://coinmarketcap.com/coins/](https://coinmarketcap.com/coins/) (as of August 22, 2018).


⁷ Code Section 61(a).


⁹ 513 F. 2d 224 (7th Cir., 1975).
in the wealth of the taxpayer. However, the value of such property at the time of hard fork may not be determined and might be viewed as no value at the time of creation. In addition, the new coin can also be viewed similarly to a stock split (although the new coin is different), in that the coin emerges from the existing coin.

The hard fork of bitcoin resulting in the split of bitcoin and creation of a new forked coin called Bitcoin Cash. This represented unsolicited property bestowed upon the holder of a bitcoin. Arguably, the fact that the Bitcoin Cash is freely available for use by the taxpayer satisfies the factor of ‘undeniable accession to the wealth’. While a market might emerge for the coin, arguably, at the moment of its creation, it had no value separate from the original coin.

b) Clearly realized
Taxpayers’ entitlement to the forked coin reflects their ability to enter into a transaction using the forked coin. The income is said to be clearly realized when it is actually or constructively received. The doctrine of constructive receipt is explained under Treasury Reg. §1.451-2(a). The regulation stipulates that income is realized when the taxpayer has control over that income whether or not it is actually received by the taxpayer. However, in the case of a hard fork, this may or may not be satisfied due to two categories of wallet—custodial and non-custodial.

i) Custodial Wallet
A user owning cryptocurrency in a custodial wallet, such as an exchange, may not be able to claim the forked coin unless the exchange recognizes and supports it. In August 2017, prior to the bitcoin hard fork, Coinbase, a cryptocurrency exchange notified its bitcoin customers that it would not support Bitcoin Cash and the users would not be able to access Bitcoin Cash from their wallet.¹⁰ In such a case, the income received was substantially restricted and legally controlled by the custodian of the wallet and it might not be construed as a constructively received unless the exchange allows the user to access it.

ii) Non-custodial wallet
A non-custodial wallet does not involve any third party, and the user exercises complete control over the wallet. Thus, the user is said to constructively receive income as soon as the forked coin appears in his wallet. Hence, the unconditional and unrestrictive access to forked coins such as Bitcoin Cash or Ethereum received by the taxpayer as a virtue of being an owner of bitcoin or Ethereum Classic, might be viewed as a realization of income at the time of the hard fork. However, as noted earlier, the coin might have a value of zero at that time.

c) Complete dominion

A taxpayer is said to have complete dominion over income when the taxpayer is able to exercise legal control over it. A cryptocurrency user holding a custodial wallet hosted on a third-party platform such as Coinbase establishes legal control over the forked coin only when unconditional and unrestricted access is allowed. On the other hand, a user holding cryptocurrencies in a non-custodial wallet might be considered as having complete dominion as soon as the forked coins appear in the wallet. Again though, there remains the issue as to the value of the forked coin and whether the wallet holder has done anything to exercise control over the new coin.

The above three-factor analysis is crucial in determining whether the forked coin obtained is income. However, there are significant practical challenges when a user’s wallet is hosted by a third-party platform such as Coinbase. In August 2017, Coinbase was apprehensive of treating Bitcoin Cash as a legitimate currency due to the security risks to digital assets. At this time, the private key of a user’s wallet was held with Coinbase and therefore the user could not access Bitcoin Cash unless Coinbase allowed them to do so. This brings a severe restriction on the user along with the uncertainty based on the third party’s decision. In such situation, a realization event is delayed, and the price may not be accurately assessed due to a highly volatile cryptocurrency market.

B. Hard fork treated as a growth in an investment

Can the forked coin be viewed as a dividend paid on the original coin, which is treated as property per Notice 2014-21? In *Eisner v Macomber*, the Supreme Court held that a stock distributed as a dividend is not income. The Court observed that a “stock dividend is nothing, but a piece of paper received by the stockholder of the company and the stockholder has received nothing out of company’s assets for its separate use and profit.” Further, the Court emphasized that “the stockholder is subject to the business risks of the company which may result in wiping out the entire investment of the stockholder.”

Applying this analogy to a hard fork, the forked coin can be construed as a stock dividend received by the user resulting in an increase in the number of coins, but not an increase in value. In addition, the original coin is subject to operational and security risks like the business risks of a company distributing stock as a dividend.

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11 “When will Coinbase exchange Accept Bitcoin Cash,” BitcoinExchangeGuide available at 


13 Samson Mow, “The Bitcoin Cash Fork Was a Dangerous Trick,” fortune.com available at
C. Valuation of the forked coin

Assigning a value to the new currency is crucial and the most challenging aspect in the taxation of a hard fork. If the IRS decides to treat the forked coin as ordinary income, then the basis possibly could be the price at the time of launch, i.e. the opening price.

In its comment letter (May 2018) to the IRS, the AICPA suggested that the price discovery at the time of a fork can be considered as near zero and therefore for tax purposes, it should have a zero basis and result in no income at that time.\(^{14}\) A similar position was offered by the American Bar Association's (ABA) Section of Taxation in its comment letter (March 2018) to the IRS suggesting the valuation and the tax treatment of forked coin.\(^{15}\)

The rationale behind assigning a zero value is the uncertainty in the survival of the new coin and the high volatility of the cryptocurrency market. Also, as discussed in the previous section, factors such as third-party support for custodial wallets delays the (constructive) receipt of the new coin.

Other countries on the hard fork

Australia

The Australian Tax Office (ATO) issued a guideline that taxpayers do not derive any ordinary income or capital gain when they obtain a new cryptocurrency as a result of the hard fork in the existing blockchain. Further, if the taxpayer held the cryptocurrency as an investment, the basis for the new cryptocurrency would be zero for the purpose of computing capital gain. If a cryptocurrency is held for a sale or exchange in a business, the new cryptocurrency obtained during a hard fork would be treated as a trading stock, and it must be accounted as income at the end of the financial year.\(^{16}\)

United Kingdom

Her Majesty's Revenue and Customs (HMRC) treats cryptocurrency as an asset and therefore a gain on the sale or use of cryptocurrency is a capital gain. HMRC has specified in its internal manual on Capital Gains that the basis of the new cryptocurrency arising as a result of a chain split should be traced to the cost of the original asset. Thus, the acquisition cost of the old


cryptocurrency would be apportioned between the old and the new cryptocurrency obtained in the course of a hard fork.\textsuperscript{17}

**Germany**

In a Cryptotax seminar hosted by the Frankfurt School of Finance & Management in March 2018, the school suggested treating a hard fork similar to stock splits and consider the market value at the time of the split as a cost of acquisition of the new cryptocurrency.\textsuperscript{18}

**Conclusion**

The evolution of blockchain technology and the cryptocurrency market has given rise to an increase in tax complexities. There are diverse interpretations of a chain split around the world and as a consequence, the tax treatment of hard fork varies between countries. Not many countries have issued guidelines on chain splits and such an event needs to be interpreted based on the particular facts and circumstances and that country’s tax law.

As more and more currencies come into existence through hard forks, it is going to be challenging for the tax authorities in understanding, designing and regulating the tax treatment.

The character, timing and the amount of income are difficult to identify and define within the tax framework. Therefore, these aspects need to be carefully evaluated to make a tax law for a complex subject like a hard fork. Specific guidance is also needed to better ensure consistency of how owners experience a hard fork of CC treat it for tax purposes.

**Acknowledgement**

I would like to express my deep gratitude to **Professor Annette Nellen** for her expert guidance and helpful critique.


\textsuperscript{18} Norbert Gehrke, German Income Tax on Virtual Currencies, Medium.com, March 11, 2018 available at https://medium.com/@norbert.gehrke/german-income-tax-on-virtual-currencies-18bc35990457.
Tax Enlightenment: Tax Treaties and Special Considerations for Unemployment Income, Foreign Students, and Academic Employees

-Inna Ostrovsky, MST Student

Overview of Tax Treaties

When two countries impose taxes on the same earnings, capital, investments or other forms of wealth, double taxation occurs. It is usually the country of a taxpayer’s residence and the country of the income source that claim the rights to tax the same income. To make the international tax system harmonized, many countries have adopted bilateral tax treaties – the agreements between two countries that define the rights and rules on taxation in such situations. Treaties can potentially supersede domestic law, and the US Constitution calls them “the supreme law of the land”. Section §7852(d) equalizes treaties and the Code while Section §894(a) states that application of the Code should always consider treaty obligations. Based on non-statutory law, with some exceptions, if there is a conflict between the regular U.S. domestic applicable law and the tax treaty, the one that was enacted on the same issue most recently is the applicable law in play for the transaction.

Tax treaties play an important role for international trade and commerce and generally benefit both sides: taxpayers and countries. First, they often allow companies to avoid double taxation and minimize their tax expense. Treaties are a powerful tool for countries trying to increase the inflow of investments by promoting a more favorable tax structure. Knowing that a country’s withholding tax or the double-taxation effect will be eliminated by applying a treaty, companies are more interested in expanding their businesses in the countries with favorable tax treaties. Tax treaties are also applicable to individuals. They may provide significant benefits by implementing a lower tax rate or eliminating taxes or fees completely to residents of other countries. Also, in the absence of treaties, traveling could become very problematic and disadvantageous for individuals and devastating for tourism-oriented countries. For example, anticipating complexity and double-taxation effect in one country, travelers would choose the destinations with tax treaties, and this would impact the economy of the countries that heavily rely on tourism but have no tax treaties.

Although the general benefits and purpose of tax treaties are clear, there might be some nuances under which treaties are not helpful for tax reduction or elimination of the double-taxation problem. An example of this is unemployment income of a nonresident alien under the United States-Canada tax treaty. Under this treaty there is no section that specifically mentions this type of income. In a recent case of Guo v. Commissioner, which is discussed in more detail

1 US Constitution, Article VI, § 2.
2 Reid v Covert, 354 US 1 (1954), 77 S Ct 1222.
later, the court held that unemployment benefits were taxable in the United States by a Canadian citizen.\(^4\) On the other hand, students’ income, awards, and benefits are generally, non-taxable in the United States. The purpose of this article is to explore the treatment of the unemployment income and the income received by students or professors under the U.S. treaties with Canada, China, France, India, Russia and U.K.

**Unemployment Income Under U.S. – Canada Treaty**

In *Guo*, Pei Fang Guo, a Canadian citizen, came to the United States in 2010 to work at the University of Cincinnati, Ohio, as a post-doctoral fellow. Her employment with the university ended in November 2011, and not being able to find another job, she returned to Canada. In 2012, she applied for and received unemployment compensation from the state of Ohio. For 2012, she filed tax returns in both Canada and the United States but paid no taxes on the unemployment income that she received (while reported on her Canadian tax return, after applicable deductions and credits and no tax was ultimately due). Guo claimed that she owed no taxes to the United States on this income because Article XV\(^5\) of the U.S. – Canada tax treaty applied, but the IRS disagreed by stating that in her situation Article XXII\(^6\) of the treaty should apply instead.

Article XV covers wages, salaries, and other remuneration related to an employment earned by a resident. According to this article, only Canada can tax the Guo’s income if she, a resident of Canada, earned income in Canada. However, if Guo earned income in the United States, the article grants the United States the right to tax it as well. Under the paragraph 2, only Canada can tax the income if it was less than $10,000 or if Guo was not physically present in the United States for more than 183 days or her employer was not a U.S. resident. Article XXII covers the types of income not covered by other articles of that convention. It states that income earned by a resident of one country in another country may be taxed by both jurisdictions.

The court determined that Article XV did not apply to Guo since her income was not wages or any type of remuneration associated with employment. However, even if it was such remuneration, Article XV directly gives the right to the United States to tax it because the employment occurred in the United States, the amount was greater than $10,000 and her employer was a U.S. resident. The court further agreed with the Commissioner that Article XXII should be used rather than XV.

This case shows what has to be considered when a resident of another country claims unemployment benefits earned from the United States. A person can become qualified for such income in the United States but then leaves the country and receives that income outside of the country. It is important to remember that not being physically present in the United States does not eliminate the obligation to pay taxes on the income generated in the United States. In addition, the type of income should be taken into consideration as treaties do not apply universally on all types of income. In *Guo*, the court determined that unemployment income

\(^5\) United States – Canada Income Tax Convention, Article XV Dependent Personal Services (August 16, 1984).
\(^6\) United States – Canada Income Tax Convention, Article XXII Other Income (August 16, 1984).
should be treated under the “Other Income” article rather than as salary or wages. Finally, in some cases the residency status of employer may play a determining role. Generally, employers who are U.S residents generate U.S source income that is taxable in the United States.

**Unemployment Income Under Other U.S. Treaties**

As is the case in the U.S. - Canada convention, unemployment income is also not specifically mentioned in the U.S. treaties with China\(^7\), France\(^8\), India\(^9\), Russia\(^10\), and the United Kingdom.\(^11\) The U.S. Model Income Tax Convention that was developed in 2006 also does not cover it. However, the court in Guo determined that unemployment income was covered under the “Other Income” article (Article XXII) of the treaty. Thus, determining the correct treatment of this type of income under other treaties means to examine the article describing the “Other Income” category.

Although the wording of “Other Income” articles is very similar in the treaties mentioned above, they differ in one point. Some of the treaties only allow one country to tax income this income, and other treaties also give the right to tax it in a second country. In particular, as in the U.S. – Canada treaty, Article 23 of the U.S. – India treaty states that any income not covered in other articles “shall be taxable only in that Contracting State” but when “arising in the other Contracting State may also be taxed in that other State”.\(^12\) Thus, if a resident of India earns unemployment income in the United States, then the treaty directly allows not only India but also the United States to tax this income. On the other hand, according to the treaties between the U.S. and China, France, Russia or the United Kingdom, only taxpayer’s country of residency may tax unemployment income generated in the United States.

To summarize, unemployment income can be either taxable by two countries or only by the country of residence. For instance, if taxpayer is a resident of China, France, Russia or U.K., only these countries have the right to tax unemployment income earned from the United States. On the other hand, residents of India and Canada should remember that both the country of residence and the United States have the right to tax their unemployment income that arose in the United States.

**Treaty for Students and Professors**

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\(^9\) Tax Convention with the Republic of India (January 1, 1991).

\(^10\) Income Tax Convention with the Russian Federation (January 1, 1994).


\(^12\) Tax Convention with the Republic of India, Article 23 (January 1, 1991).
In *Guo*, the taxpayer was a post-doctoral fellow who received an unemployment income from the state of Ohio. However, if she had received income for being a student, teacher, researcher, or professor that would have turned her case in a different direction. The reason for that is that students, professors and teachers who receive a specific type of income generally have special favorable treatment in treaties. As mentioned earlier, the rules in the U.S. treaties with Canada, China, France, India, Russia, and U.K are comparable with minor variations.

The treaty between the United States and Canada, for example, does not mention teachers and professors directly.\(^\text{13}\) In fact, a teacher is treated as any other person, and his income would be considered as either an independent (under Article XIV) or a dependent personal service (under Article XV).\(^\text{14}\) According to these rules, the income from providing services and employment income can be taxed by both countries. Visiting students have a special status under Article XX. The income they receive from outside the country of their education is tax-exempt with no limit on number of years or the amount of income.

In contrast, the U.S. treaty with China contains a special provision for teachers, researchers and professors (Article 19). In it, a resident of either country who is temporarily present in another country for the purpose of “teaching, giving lectures or conducting research at a university, college, school” has tax-exempt status for three years. In other words, if a resident of China comes to the United States to work as a university professor, the income from teaching would not be taxable in the United States for a period of no more than three years. Moreover, under Article 20 of this treaty, students also receive a favorable status. According to the Article, a person who is in another country “for the purpose of his education, training or obtaining special technical experience” and who receives grants or awards from the government or any payments supporting his education or research is exempt from tax in the country of education. Additionally, students may claim up to $5,000 (or its equivalent amount in the Chinese yuan) of tax-exempt employment income. For instance, if a resident of China studies in the United States and receives a stipend from China, this income is non-taxable in the United States. Additionally, if that student works in the United States, then he may claim up to $5,000 of tax-exempt income under the treaty.

The U.S. treaty with France is very similar to the treaty with China. Here, the rules for teachers and researchers are also described in a separate article (Article 20). Under this Article, a resident of one country who is present in another country for the purpose of “teaching and engaging in research, or both” may claim an exemption from taxable income for teaching or research at a qualified institution in the non-resident country for the period of no more than two years. Important to note that under the French treaty, each person may claim this benefit only once. Under Article 21 “Students and Trainees,” students’ income that is intended to support their studies is tax-exempt for a “reasonable period” of time required to complete the education or


\(^\text{14}\) Independent Personal Services include the work performed as an independent specialist and not as an employee (for example, a doctor, a CPA, or a contractor). Dependent personal services include services performed as an employee.
training, but not more than five years. As in the treaty with China, $5,000 of income from personal services is tax-exempt.

In the U.S. – India Treaty, Article 22 “Payments Received by Professors, Teachers and Research Scholars” grants teachers and professors a tax-exempt status for two years. Article 21 says that students or business apprentice who study in another country are exempt from tax for a period of time reasonable to complete their study. However, the second paragraph also entitles the students to all existing tax benefits and deductions as available to its residents.

In the U.S.-Russia treaty, provisions related to teachers, professors, and students is very similar to the law of the U.S. - Canada treaty. Specifically, the treaty does not contain a provision of a tax-exempt status for visiting teachers and professors (although a previous version from 1973 contained it15). Visiting students, trainees and researchers, on the other hand, obtain a favorable status in Article 17 for a reasonable period of time to complete the course of study, but not exceeding five years.

Finally, the latest version of the U.S. treaty with the United Kingdom from 2001 and its provision for students is stricter than its previous version.16 For instance, Article 20 “Students”, says that full-time students’ income that arose outside the country of education is tax-exempt for a period not exceeding one year. The new treaty also eliminates the provision for visiting teachers and professors completely, thus, treating them as any other person under Article 14 “Income from Employment.”

The comparison of these six treaties shows that the rules for visitors of the United States may be different depending on the country of residency of these visitors. The completed assessment of the rules for teachers, students, and professors shows that the most generous treaties, such as with China, France and India, provide the exemption status to both - students and professors. The treaties with Canada, Russia and U.K. are less generous as they do not grant a favorable status to professors and teachers but concede for students with specific limitations. Thus, for these categories of visitors in the U.S., the original place of residence matters.

CONCLUSION

The purpose of this article is to familiarize a reader with the general concepts of tax treaty. In regard to U.S. tax treaties, there are many beneficial provisions for students and professors who come to the United States from Canada, China, France, India, Russia or U.K. The article considers the Guo court case in analyzing a treaty. There are also many provisions applicable to students and professors in the U.S. in its bilateral treaties with Canada, China, France, India, Russia, and the United Kingdom. Although treaties are comparable in many aspects and approaches to

15Income Tax Convention with the Russian Federation, pg. 3 (January 1, 1994).
eliminate double taxation for taxpayers, it is not rare to have differences among treaties with different countries.

Applying the found similarities and differences to the Guo case, it might be concluded that if Guo, a post-doctoral fellow, was a resident of China, France, Russia or the United Kingdom, her unemployment income would have been taxed only in the country of her residence. On the other hand, if she was from India, the unemployment income would have been taxable in the United States as well. If she worked as a professor from China, France or India, her employment income would have been tax-exempt for two to three years, but she wouldn’t have been able to claim an exemption if she was a professor from Canada, Russia or U.K. And, finally, if she was a student from any of the examined countries, Guo’s income for studying would have been tax-exempt for a period from one to five years. As demonstrated above, tax treaties are complex in application and require special considerations in regard to taxpayer’s country of residence, income source, duration of temporary residence, and type of income. With all these variables, the effect of tax treaty may be different, so taxpayers considering applying a specific treaty should check on all the factors that may affect the result of applying the treaty.
Short Sales and Cancellation of Debt Income

-Rani Vaishnavi Kothapalli, MST Student

Are they two different transactions or a single transaction? Let us find out with the Simonsens1.

This is a classic case which provides guidance to taxpayers and practitioners on how to calculate gain or loss on short sale of property and treatment of cancellation of indebtedness income in such instances. It provides answers to: Whether a property sold in a short sale is always going to have a cancellation of debt income, subject to tax? More specifically, in a short sale is there one or two separate transactions between the sale of the property to a third party the lender’s acceptance of less than the total amount owed to them from the net proceeds of the sale? Does the fact that a mortgage on real property is a recourse or non-recourse debt?

The Simonsens were California residents who bought a townhouse in San Jose, California for $695,000 in July 2005, paying 20% down and they borrowed the rest from Wells Fargo Bank (Bank) as a nonrecourse debt (mortgage). The mortgage had an adjustable interest rate note which was secured by a deed of trust. This townhouse was their principal residence at the time of purchase. Subsequent to their purchase, they made improvements to the townhouse. In September 2010, they moved and rented out their townhouse after failing to make mortgage payments during the great recession. At that time, they converted their personal residence into a rental property. In November 2011, the Simonsens negotiated a short sale for $363,000 with the Bank and a third-party buyer. All of the sales proceeds went to the bank towards the remaining mortgage balance of $555,960 and closing costs of $26,310. In January 2012, the Bank sent the Simonsens a Form 1099-C showing that it cancelled the remaining mortgage balance of $219,270. The Simonsens also received a Form 1099-S from First America Title Company showing the sale of the house to the buyer in the amount of $363,000 with a closing date November 18, 2011.

The Simonsens prepared and properly filed their tax return for 2011 which reported a sales price of $363,000. They also reported cancellation of indebtedness (COI) income of $219,270,2 but the they excluded the COI income, applying the Mortgage Forgiveness Debt Relief Act of 20073 which modified Section 108 to provide for a new COI income exclusion for discharged qualified principal residence indebtedness.4 They took the position on the COI exclusion on the fact that the property was still eligible for the principal residence gain exclusion provisions of IRC §121 based on the amount of time the property was their principal residence prior to its sale. They reported a capital loss of $216,495 which was calculated as the difference

1 K.F. Simonsen v Commr, 150 TC, No. 8 (2018)
2 Cancellation of Indebtedness Income ($219,270) = Bank Loan ($555,960) + Closing Costs ($26,310) – Cash Proceeds ($363,000)
4 IRC §108(a)(1)(E)
between the adjusted basis of the townhouse of $579,495 at the time of sale and the sale proceeds from the short sale of $363,000.

In October 2014, the Commissioner sent a notice of deficiency, which included an accuracy-related penalty under Section 6662(a),\(^5\) concluding that the short sale and the cancellation of indebtedness were both part of an integrated, single transaction. The Simonsens disagreed, claiming the sale and the COI they were separate events and properly filed a petition with the U.S. Tax Court.

**Gross Income**

Gross income means all income from whatever source derived, including income from discharge of indebtedness.\(^6\) However, an exclusion from gross income includes any amount of specified, qualifying debt that is discharged if it is related to a qualified principal residence.\(^7\) Not all mortgages on principal residences are considered qualifying indebtedness for purposes of this exclusion. Qualifying indebtedness on a principal residence generally only includes only acquisition indebtedness used to acquire, construct, or substantially improve a qualified principal residence of the taxpayer, and the debt must be secured by such residence.\(^8\)

**Recourse vs. Nonrecourse Debt**

Indebtedness is classified as “nonrecourse” if the debtor is not personally liable on the debt and the creditor has rights towards only specified collateral for the debt, but not to all the debtor’s assets as a whole. Great Plains Gasification\(^9\) case by citing Raphan case.\(^10\) The meaning of a “qualified principal residence” is governed by IRC §121, which generally provides that gross income (up to $250,000 - $500,000 for jointly filed returns) shall not include gain from the sale of a primary residence if the taxpayer has owned and used that property as their principal residence for at least two out the five years prior to the sale. However, this provision does not answer the Commissioner’s question as to whether the townhouse was the Simonsen’s principal residence at the time of sale. However, as detailed later on, this issue ultimately was a moot point.

As mentioned previously, the Simonsens believed that there were two transactions - one causing a capital loss of $216,495 on the sale (based on the price paid by the buyer less their basis in the property at the time of the sale) of the townhouse and other resulting in COI income of $219,270, albeit exempted from taxable income under the qualified principal residence.

\(^5\) IRC Section 6662(a) Imposition of penalty: If this section applies to any portion of an underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to 20 percent of the portion of the underpayment to which this section applies.

\(^6\) IRC §61(a)

\(^7\) IRC §108(a)(1)(E)

\(^8\) IRC §108(h)(2)


\(^10\) Raphan - Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985))
indebtedness exclusion. Citing the Briarpark\textsuperscript{11} case, the Tax Court determined that the sale of townhouse and cancellation of debt was one integrated transaction. In Briarpark, a partnership firm defaulted on their nonrecourse mortgage that was secured solely by their office building that was subject to the loan. The taxpayer found a third-party to purchase the property at a price lower than their outstanding loan amount. The bank agreed to forgive the entire remaining loan balance if the third-party purchased the property. The court held that the discharge of the loan simply represented an additional amount realized on the sale of the property, under the fundamental concepts contained in IRC §1001(b).

**Computing the Gain or Loss from the Disposition of Property with Liabilities**

The amount of recognized gain or loss from disposition of property is generally provided for in IRC §1001. IRC §1001(a) provides that on the sale or disposition of property the recognized gain is normally the excess of the amount realized on the sale over the asset’s adjusted basis, with a recognized loss occurring if the adjusted basis exceeds the amount realized. IRC §1001(b) generally provides that the amount realized from the sale or disposition of property is the sum of any money received – including the fair market value of any non-cash property received on the sale, except for any amounts attributable to property taxes that are legally imposed on the buyer. From here it is critical to know if liabilities attached to a sold property is included in the amount realized on a sale.

In sales where seller’s debt on the sold property is forgiven, the amount realized includes the amount of debt forgiven from such a sale or disposition.\textsuperscript{12} The court referred to this concept in the holding in *Commissioner v. Tufts*\textsuperscript{13} in which the Supreme Court held, as was noted in this case, that “when a taxpayer sells or disposes of property encumbered by a nonrecourse obligation the Commissioner properly requires him to include” in the amount realized the remaining outstanding amount of the loan at the time of sale. As such, a short sale and any cancellation of nonrecourse debt are considered part of a single transaction within a sale of property. Therefore, the Tax Court in the present case held that the debt forgiven by Wells Fargo must be added to the amount realized that is used for computing the gain or loss on the disposition of property and should not be treated as a transaction separate from the sale and reported as income from cancellation of indebtedness. Therefore, the total amount realized by the Simonsens on their short sale their townhouse was $555,960.\textsuperscript{14}

**What is the Adjusted Basis of the Property for the Simonsens?**

The adjusted basis for the gain/loss computation on a sale of the type of property sold in the present case is generally defined under IRC §1011 as the original cost basis in property, adjusted upwards for any capital improvements and downwards for any applicable depreciation as provided under IRC §1016. The Simonsens purchased their townhouse for $695,000 and

\begin{align*}
\text{Amount realized ($555,960) = Cash ($363,000) + Debt Forgiven ($192,960)}
\end{align*}

\textsuperscript{11} 2925 Briarpark, Ltd. v. Commissioner, T.C. Memo. 1997- 298
\textsuperscript{12} Treas. Reg. § 1.1001-2
\textsuperscript{13} Commissioner v. Tufts, 461 U.S. 300, 317 (1983)
\textsuperscript{14} Amount realized ($555,960) = Cash ($363,000) + Debt Forgiven ($192,960)
made improvements to it. They, and the Tax Court, believed that their adjusted basis in the property was (before a relatively small amount of applicable depreciation) at or above $695,000 right before it was converted to a rental property, with its fair market value being $495,000 at the time of the rental conversation in September 2010. The adjusted basis of a property converted to a rental, in the case of loss on its subsequent sale, is calculated as the lower of: (1) the fair market value of the property or (2) the adjusted basis at the time of conversion. Accordingly, the adjusted basis in the property for loss computation purposes for the Simonsens was $495,000, which was the lower of its adjusted basis or fair market value before at the time of conversion. However, for gain recognition purposes, the lower of fair market value or adjusted basis rule does not apply, so their basis in the property in this situation was approximately $695,000.

**Computation of Gain or Loss (if any) on a Sale of a Rental Conversion Property**

As stated previously, the Simonsen’s gain basis in the townhome was determined to be $695,000, but their loss basis was only $495,000. Also, as previously detailed, the amount realized on the short sale was $555,960. Since this was more than the loss basis, but less than the gain basis, no recognized gain or loss was applicable on its sale.

To understand the best way to compute gain in this case, the Court referred to how the adjusted basis is determined when a person gifts property to another. Section 1015(a) provides that the basis of the gift to the done is the generally same as that of the donors. However, if the fair market value of such gift is lower than the donor’s basis at the time the gift is made, Treas. Reg. §1.1015(a)(1) provides that the basis to the done in case of a loss is based on the property’s the fair market value. When the amount realized on the sale by the donee is higher than the loss basis, but less than the gain basis, neither gain nor loss is recognized, with the adjusted basis considered to the same amount as the amount realized. Therefore, with the same gain/loss basis rules for gifts and rental conversion properties, and with the amount realized for the Simonsens of $555,960 which was between the loss basis of $495,000 and the gain basis of $695,000, there was neither loss nor gain for them in this transaction.

**The Accuracy Related Penalty**

A penalty under IRC §6662(a) is issued when the taxpayer understates their tax by an amount exceeding the greater of $5,000 or 10% of the tax required to be shown on the tax return. The correct tax liability for Simonsens was $76,000 as determined by the Court and they reported only $7,000. Hence, the Simonsens were issued a 20% accuracy related penalty under IRC §6662(a). However, the burden of proof is on the Commissioner who has to prove that the penalty was approved in writing by the examiner’s supervisor no later than the date of notice of

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15 Treas. Reg. §1.165-9(b)(2).
16 IRC §7491(c)
deficiency.\textsuperscript{17} Fortunately for the Simonsens, the Commissioner was unable to provide such evidence.

Even if the Commissioner proved that the examiner’s supervisor approved the notice of deficiency on or before the date of notice of deficiency, the Simonsens could have potentially avoided the accuracy related penalty by proving that they acted with reasonable cause and in good faith in their reporting of the transaction.\textsuperscript{18} Treas. Reg. §1.6664-4(a) lists the rules to help determine if the taxpayer acted in good faith. Such factors take into consideration the applicable facts and circumstances of the situation – including the education and experience of the taxpayer - and, with specific provisions for the reliance on an opinion or advice of a tax professional. The Simonsens could have, if needed, argued that this short sale was the first time they had to deal with such a transaction and they relied on IRS Publications 4681 and 523, as well as language included in the instructions to the Form 1099-S information return that was sent to them on the sale of the property, that could have been read to support their original tax filing position.

The \textit{Simonsen} case is a classic case to be referred by a taxpayer when they have short sale. It helps provide solutions to complex situations such as how different types of mortgages (recourse versus nonrecourse) and a conversion of a former primary residence to a rental come into play in the gain or loss calculation – including situations where there may be a no gain or loss situation. It also gives insight on how taxpayers can avoid the accuracy-related penalty under IRC §6662(a).

\begin{itemize}
\item \textsuperscript{17} IRC §6751(b)(1)
\item \textsuperscript{18} Treas. Reg. §1.6664-4(a)
\end{itemize}
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and
High Tech Tax Institute

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Summaries for the 2018 IRS-SJSU Small Business Tax Institute

Held on May 23, 2018 at the Biltmore Hotel, Santa Clara, California

Authors: Daniel Currie, Ruchi Chopra, Chen Chen, Sara Yaqin Sun, Surbhi Doshi, Tina Tran
A New Due Diligence Checklist:
Let’s Not Overlook Any New Tax Rules
- Daniel Currie, EA, MST Student

Last December, many Americans found themselves scrambling at the last minute to make their final tax planning decisions before it may have been too late! It was interesting how the year ended for Enrolled Agents (EAs), CPAs, attorneys as well as other accountants and tax preparers as different versions of tax reform bills were released as to which one would pass and make a significant overhaul to the U.S. tax code that would affect millions of taxpayers, primarily businesses and individuals. The House and the Senate passed the Tax Cuts and Jobs Act (TCJA), which was later signed into law by President Trump on December 22, 2017 (P.L. 115-97). Most of the changes under the TCJA, both temporary (primarily for individuals) and permanent (primarily for businesses), are for tax years beginning after December 31, 2017. Despite what seemed to be a rollercoaster of a ride this tax season, learning the new rules surrounding tax reform is now front-and-center and practitioners can now digest more of these new tax rules, but where do we begin? Who do we ask for help? How will all of these tax changes affect individuals, corporations, partnerships, other businesses and foreign entities? And what about the fact that some of these new rules are still unclear and need further clarification by the Internal Revenue Service?

The Tax Institute at San Jose State University is working hard to help deliver some of these answers. On May 23, 2018, the IRS-SJSU 6th annual Small Business Tax Institute was held at the Biltmore Hotel in Santa Clara, California. There were several distinguished speakers who helped navigate the attendees through some of the changes made by the TCJA. The first section was presented by P. Evan Stephens, CPA, MT and Bill Abel, EA, MST, both from Sensiba San Filippo, LLP. Their presentation was titled, “A New Due Diligence Checklist: Let’s Not Overlook Any New Tax Rules.” One of their opening comments was a good reminder that when we last saw major changes like this during the Tax Reform Act of 1986, it took nearly two years for clear and thorough guidance to come out from the IRS. Although they are expecting to see guidance to be issued sooner this time around, it could take longer for more complete and thorough guidance to be issued and for tax practitioners to digest the information.

For 2018 there are seven federal tax brackets for individuals, but at slightly lower rates and adjusted income ranges as compared to 2017. The old graduated federal tax rates for corporations are gone, and instead corporations will be taxed at a flat 21% rate. However, be on the lookout for your fiscal-year corporate clients, as their 2017 fiscal year will require that both the old and the new tax rates be used to determine their 2017 tax liability, based on the number of days their fiscal year falls in calendar-year 2017 (using the old rates) and in 2018 (using the flat 21% rate). This is referred to as a blending of the rates. Also for 2018, they explained that for individuals the regular tax and the alternative minimum tax (AMT) is to

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1 IRC §§1(a) – 1(d).
2 IRC §11(b).
3 Treas. Reg. §1.15-1.
function more like a “hybrid system” between the two, but the TCJA outright repealed the AMT for corporations.

While C corporations get the benefit of a significant reduction from its effective top federal tax rate from 35% to this new flat 21% rate, it only made sense that the TCJA would provide some equity and fairness for other types of business entities to keep pace. This was handled through the newly-created §199A which provides for a qualified business income (QBI) deduction of up to 20%⁴ for individuals and estate/trust owners of pass through business entities (such as partnerships, S corporations and sole proprietorships), so long as they meet the definition of a qualified trade or business.⁵ The QBI deduction rules are extremely complex and will likely need extensive clarification. While the QBI deduction is a great news for many businesses for 2018, a significant repeal in the TCJA was made for the Domestic Production Activities Deduction (DPAD) under IRC Section 199 which allowed for a potential 9% tax deduction for certain domestic income manufacturers, producers, and growers.⁶ Perhaps the QBI deduction and lower individual rates will offset the loss of DPAD.

The DPAD is not the only deduction going away for businesses. Taxpayers will no longer be able to deduct entertainment expenses related to business, such as those expenses for sporting, for amounts paid or incurred after December 31, 2017.⁷ Employer-provided meals at an employer’s dining facility that are treated as a tax-free fringe benefit, which were 100% deductible, are now 50% deductible through 2025, and then nondeductible thereafter.⁸ Also highlighted in the presentation were modifications to net operating loss deductions (NOLs). Effective for tax years beginning after December 31, 2017, NOL deductions are limited to 80% of the taxpayer’s pre-NOL taxable income.⁹ In addition, for tax years ending after December 31, 2017, NOL deductions will no longer be carried back 2 years, but instead will be carryforward indefinitely,¹⁰ except for farming-related NOLs.¹¹

For individuals, the mortgage interest deduction is limited to the first $750,000 of qualified mortgage interest ($375,000 for married filing separate) for most debt incurred after December 31, 2017.¹² The additional deduction for home mortgage interest for home equity debt of up to $100,000 is no longer deductible for taxable years beginning after December 31, 2017.¹³ With these changes there may be more incentive for taxpayers to take a closer look at the interest-tracing rules to see if there is any interest allocated to a trade or business expenditure by looking at the uses of mortgage loan disbursements as those attributable to a trade or business are not subject to these particular limitations.¹⁴

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⁴ IRC §199A(a).
⁵ IRC §199A(d).
⁶ P.L. 115-97, Sec. 13305(a).
⁷ IRC §274(a)(1).
⁸ IRC §274(e)(1).
⁹ IRC §172(a).
¹⁰ IRC §172(b).
¹¹ IRC §172(b)(1)(B).
¹² IRC §163(h)(3)(F).
¹⁴ Treas. Reg. §1.163-8T.
For taxpayers looking to defer gain and qualify for a like-kind exchange under IRC Section 1031, they should be aware that under the TCJA, property other than real property will no longer qualify for this deferral for federal tax purposes, effective for exchanges completed after December 31, 2017.\(^\text{15}\) For those taxpayers with heavy machinery that may have been subject to accelerated depreciation, and would have normally received the benefit of a 1031 exchange for replacement new machinery under the old rules, now they have to pay federal tax on the gain, even in a non-cash exchange. Like-kind exchanges of real property still qualify for deferral if the property being exchanged is held for productive use in a trade or business or for investment. There are no changes to the identification period (45 days) and completion period (normally 180 days) of the replacement property.\(^\text{16}\)

An interesting discussion was made towards the end of the presentation relating to the limitation of state and local income tax deductions for individuals (also known as the SALT deduction) of $10,000 for taxable years beginning after December 31, 2017, and before January 1, 2026.\(^\text{17}\) The issue is that high-tax states, such as California, may be facing increasing budget pressures due to the fact that individual taxpayers will no longer be as incentivized to earn income and pay tax in these states due to the overall $10,000 limit for state and local taxes for individuals on their personal tax returns as an itemized deduction. One idea that has been floated around is could taxpayers potentially characterize payments for their state and local tax liabilities as deductible charitable contributions? Interestingly, the same day of this discussion at the IRS-SJSU Small Business Institute, there was an issuance of the IRS Notice 2018-54 which explained that “substance-over-form will continue to govern the federal tax treatment of state and local tax liability payments” and that the IRS plans to issue proposed regulations which will address the issue of states that pursue providing state tax credits to their residents for amounts paid to state-chartered purported charitable funds, but in substance it is merely an attempted circumvention of the new federal SALT deduction limitation.\(^\text{18}\)

These were a few important highlights of the new tax rules during the first presentation at this year’s IRS-SJSU Small Business Tax Institute. While there are more questions and a need for further guidance on some of the provisions of the TCJA, there are learning opportunities to help clients with these changes to suit their unique circumstances.

\(^\text{15}\) P.L. 115-97, Sec. 13303(a).
\(^\text{16}\) IRC §1031(a)(3).
\(^\text{17}\) IRC §164(b)(6)(B).
New Favorable Methods for Small Businesses

- Ruchi Chopra, CPA

The 6th annual IRS/SJSU Small Business Tax institute conference on, “Successfully Navigating the TCJA (Tax Cuts and Jobs Act) for Small Business Clients” was held on May 23, 2018. Professor Annette Nellen, CPA, CGMA, Esq., Professor and Director of the MST Program at San Jose State University, gave her presentation on the topic “New Favorable Methods for Small Businesses” and discussed how the method changes under the TCJA to Sections 448, 460(e), 471 and 263A apply to small businesses. During her presentation Professor Nellen also threw some light on the term tax shelter and its relevance to these favorable rules and talked about how to change the method of accounting under the TCJA provisions.

Professor Nellen commenced the discussion with an overview of the term method of accounting and pointed that a method of accounting involves timing and answers the ‘when’ question and not the ‘whether’ question about the reporting of an income or expense item. What helped to understand the concept was the question, ‘When is an item included in income?’ as this is a question that deals with method of accounting matters. When it is only a timing recognition matter, the issue does not affect lifetime income of the taxpayer. In Rev Proc. 2015-13, the IRS defines method as a consistent and correct application of procedure in one or more tax returns. Rev. Proc. 2015-13 further provides rules for both automatic and non-automatic method changes and provides that a change in facts or a simply correction of an error is not a change in method of accounting. A change in method of accounting almost always involves filing Form 3115 (Application for Change in Accounting Method) with the IRS rather than filing an amended return.

The TCJA provides four favorable provisions on method changes for small businesses, but before delving further into the discussion, Professor Nellen helped the audience understand what a ‘small business’ is under the TCJA provisions - highlighting the annual gross receipts test of §448(c) as modified by the TCJA. Under the TCJA provisions, a business (1) with average annual gross receipts in the prior 3-year period of $25 million (previously $5 million) or less and (2) that is not a tax shelter per §448(d)(3), is considered a small business. Professor Nellen then discussed the four favorable provisions for small businesses, as provided by the TCJA.

One of the new provisions covers §448 that, prior to the TCJA, generally required use of the accrual method for most C corporations and partnerships with one or more C corporation partners, now provides that small businesses that are either a C corporation or partnership with a C corporation partner, are not required to use accrual method and now may use the cash method for tax years beginning after December 31, 2017. The second provision under the new TCJA rules, provides a new exception under §471(c) and highlights that small businesses with inventory are not required to account for inventory, unless the small business is a tax shelter. The third provision covers §263A and provides a new exception that small businesses are not subject to any part of the §263A UNICAP rules, unless the entity is a tax shelter. The fourth and the final provision covers §460(e) that provides an exception for having to use the percentage of completion method for certain construction contracts that previously applied for contractors with a prior three-year average annual gross receipts threshold of $10 million under the pre-
TCJA provisions. Under the TCJA provisions, the threshold is now $25 million and will allow these contractors to use the completed contract method on certain constructions contracts entered into after December 31, 2017.

Professor Nellen shared some examples to explain the term tax shelters under §448 and reiterated that the TCJA favorable provisions, as discussed earlier, are not applicable for businesses classified as tax shelters. Section 448 refers to §461(i)(3) to define tax shelters to include (a) enterprises (other than a C corporation) that have offered interests for sale where the offering is required to be registered with any Federal or State agency, (b) a syndicate within the meaning of §1256(e)(3)(B) (i.e., any entity (other than a C corporation) with more than 35% of losses in a year allocable to limited partners or limited entrepreneurs) or (c) any tax shelter, as defined in §6662(d)(2)(c)(ii), which generally is any plan or arrangement where a significant purpose of the plan is tax avoidance or evasion.

Professor Nellen further elaborated on §471(c), as amended under the TCJA, that now provides two alternatives for small businesses with inventory to report inventory. The two options include either (a) treating inventory as non-incidental materials and supplies, or (b) conforming to such entity’s method of accounting as reflected in its applicable financial statements or if the taxpayer does not have an applicable financial statement, then according to the books and records of the taxpayer prepared in accordance with taxpayer’s accounting procedures. Rev. Proc. 2001-10 provides that under the cash method, the cost of inventoriable items treated as non-incidental materials and supplies are deductible only in the year sold to a customer, or in the year in which the entity actually pays for the items, whichever is later.

The TCJA provides guidance on method changes for small business and points out that generally, these method changes are treated for purposes of §481 as initiated by the taxpayer and approved by the IRS. Also, the §460(e) changes to recognizing income for construction contractors does not involve a §481 adjustment, as it is made using the cut-off method.

To conclude, Professor Nellen, advised us to watch for further IRS guidance on how to make method changes for small businesses. There are a few additional items that tax practitioners need to know such as if a Form 3115 will be required, and if so, which lines can be skipped, or whether the cut-off option will be available with no §481(a) adjustment. In the case of §481(a) adjustments, another area to look out for is whether the adjustments are netted into a single figure or reported separately. Also, Rev. Proc. 2018-31 replaces most of the provisions of Rev. Proc. 2017-30 and provides a new list of automatic method changes. However, certain sections of Rev. Proc. 2018-31 do not include the TCJA changes in automatic method changes (those which do not require advance consent from the IRS), hence it is advised to wait for later guidance from the IRS. Professor Nellen also advised about keeping accurate 2018 records assuming the taxpayer wants to adopt a new method of accounting. And last but not least, make sure to determine if the taxpayer is a tax shelter.

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1 Subsequent to the May 2018 IRS-SJSU Small Business Tax Institute, the IRS issued Rev. Proc. 2018-40 on how to make the method changes for small businesses.
Federal and California Considerations for Choice of Entity Consideration

-Chen Chen, MST Student

During the 6th annual IRS-SJSU Small Business Tax Institute on May 23, 2018, Steven Walker, Esq., of the Law Offices of Steven L. Walker, a former IRS trial attorney and an adjunct professor at the University of San Francisco School of Law, and Professor Joel Busch, Esq., CPA, of San Jose State University, presented on Federal and California choice of entity considerations under the Tax Cuts and Job Act (TCJA).

According to Mr. Walker, many business owners have considered changing their business entity type to benefit from the new lower corporate tax rate of 21% or the new provision of a potential 20% deduction on the qualified business income of non-C corporation entities. Both changes become effective in 2018 under the TCJA. As tax professionals, it is important to thoroughly understand each type of business entity and how they may fit based on each taxpayer’s facts and circumstances.

The presenters laid out the advantages and disadvantages of each type of business entity, tax and non-tax issues surrounding entity conversion, and finally, provided examples that illustrate the tax consequences on each choice of entity according to each taxpayer’s facts and circumstances.

Choice of Entity

**Sole Proprietorship:** This is a type of business entity which is not legally separate from its owner and is the simplest and the most common structure chosen to start a business. The proprietor personally holds all the business assets and runs the business with no legal or tax distinctions between the business and the owner. The individual can choose to operate the business under his/her own name or a fictitious name by which the taxpayer can segregate business legally without creating a formal legal entity.

**Advantages:** It is easy to set up a sole proprietorship with nominal costs and the owner has complete control of the business. The income and the losses are directly reported on the Schedule C (Form 1040) of the proprietor.

**Disadvantages:** The individual owner is held personally liable for debts and obligations of the business. Creditors of the business can claim his/her personal assets, such as houses and vehicles. Also, it is hard to raise capital because the sole proprietorship cannot sell interests and not being legally incorporated generally limits investor opportunities.

**General and Limited Partnerships:** A partnership is an association of two or more taxpayers to carry on as co-owners of a business for profit. Typically, all partners in a general partnership are jointly and severally liable for partnership obligations. In limited partnerships, there is a

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2 §11(b).
3 §199A.
4 Reg. §301.7701-2(c).
potential liability shelter that shields the limited partners, but not the general partners, from partnership debts as long as such limited partners are primarily passive investors.

**Advantages:** A partnership is not subject to federal income tax. Instead, partnership income, gains, losses and credits are passed through to the partners at the partner level.

**Disadvantages:** A general partner is fully liable for the partnership debts and obligations.

**C Corporations:** This is a legal entity (a corporation), that is separate from its shareholders. It must file Articles of Incorporation with the Secretary of State in one of the states and draft by-laws to govern the corporation’s operations. Generally, shareholders appoint and elect a specified number of directors for the board to carry out fiduciary duties for the company, and the board of directors elect certain officers to manage the corporation’s affairs. The board of directors conduct meetings of both themselves and required annual shareholder meetings.

**Advantages:** The corporate form provides limited personal liability to the shareholders. There are no limitations on the number of shareholders. If a shareholder no longer wants to hold his/her ownership interest in the company, it is normally easier to transfer the ownership by selling the stock (as compared to an interest in another entity type). Moreover, the entity will not cease to exist because of retirement, death or resignation of the shareholders. Also, due to the TCJA, the corporate federal income tax has been reduced to 21% flat rate.

**Disadvantages:** A C corporation’s earnings are subject to double taxation. The profit earned by the corporation is taxed at the corporate level first, then the earnings distributed to the shareholders in the form of dividends are taxed again at the shareholder level.

**S Corporations:** An S corporation files an election to allow it to pass corporate income, losses, deduction and credits to the shareholders for tax purposes similar to what a partnership does.

**Advantages:** The shareholders will normally be shielded from personal liability as the entity is a corporation, and the taxable income (or losses) are passed through to the shareholders and taxed at a single (shareholder) level.

**Disadvantages:** There are several criteria that must be met in order to qualify as an S corporation under §1361(b). They include: ① the entity must be a domestic corporation; ② shareholders cannot be a partnership, corporation or a non-resident alien; ③ there is only one class of stock; ④ there are not more than 100 shareholders (with certain limited exceptions for certain family members); and ⑤ the entity cannot be an ineligible corporation, such as certain financial institutions and insurance companies. ⑥ Despite no federal income tax at the entity level, a 1.5% tax rate (for most S corporations) is imposed at the entity level by the State of California.

**Limited Liability Company:** This is an unincorporated entity formed by one (or more) taxpayer(s). It is a hybrid entity combining the most attractive features of corporations and partnerships (and for single-member LLCs, sole proprietorships). Depending on elections made by the LLC and its members, the entity can be either treated as a partnership (the default for

5 §1361(c)(1)(B).
6 R&T §23802.
multi-member LLCs), or as a disregarded entity with only one member, or it can elect to be treated as a corporation.

**Advantages:** Usually, no member is responsible for the liability of the entity unless it is specifically stated in the operating agreement of the LLC. The income and losses are passed through to the member(s) under the conduit principal and taxed at the owner level. There are a few restrictions on ownership and operations compared to an S corporation, and it is not bound by the same rigid rules of corporations, such as annual meetings, extensive corporate records, and other corporate formalities.

**Disadvantages:** For California tax purposes, under R&T §17942, the LLC is potentially subject to an annual fee which can be as high as almost $12,000 per year based on its total gross income “from all sources derived from or attributable to California” starting at $250,000 of gross annual income.\(^7\) In addition to a potential LLC fee, there is an annual tax of $800 (although C corporations, S corporations, LPs and LLPs have an annual $800 California tax as well).

Besides considering the above advantages and disadvantages of each of the listed entities, Mr. Walker and Professor Busch reminded us that taxpayers should consider other important non-tax factors when it comes to choosing the right entity for their business.

**Illustration in Chart\(^8\):**

<table>
<thead>
<tr>
<th></th>
<th>Sole Proprietorship</th>
<th>General and Limited Partnership</th>
<th>C Corporation</th>
<th>S Corporation</th>
<th>Limited Liability Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal Status</strong></td>
<td>Same entity as owner</td>
<td>Separate entity from owner</td>
<td>Separate entity from owner</td>
<td>Separate entity from owner</td>
<td>Separate entity from owner; not adopted by all states</td>
</tr>
<tr>
<td><strong>Separate Taxable Entity</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Depends on tax status</td>
</tr>
<tr>
<td><strong>Ease of Formation</strong></td>
<td>Very easy</td>
<td>Partnership agreement is helpful; state law must be followed to create a limited partnership</td>
<td>Articles of Incorporation generally required</td>
<td>Articles of Incorporation generally required</td>
<td>Operating agreement is helpful</td>
</tr>
</tbody>
</table>

\(^7\) For California gross receipts of $250,000 - $499,999, the LLC fee is $900; $500,000-$999,999, fee: $2,500; $1,000,000-$4,999,999, fee: $6,000; $5,000,000 or more, fee: $11,790.

\(^8\) Excerpted from 2010 National Association of Tax Professionals.
<table>
<thead>
<tr>
<th>Number of Owners</th>
<th>One</th>
<th>More than two</th>
<th>Unlimited</th>
<th>100</th>
<th>Depends on tax status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eligible Owners</td>
<td>Individuals</td>
<td>Unlimited</td>
<td>Unlimited</td>
<td>Some limitations</td>
<td>Depends on tax status</td>
</tr>
<tr>
<td>Owner Liability</td>
<td>Unlimited exposure</td>
<td>Unlimited if general partner; limited to investment if limited partner</td>
<td>Limited to investment, except for personal service</td>
<td>Limited to investment, except for personal service</td>
<td>Limited to investment, except for personal service</td>
</tr>
<tr>
<td>Ability to Raise Capital</td>
<td>Limited to owner assets and borrowing ability</td>
<td>Limited to owner asset and borrowing ability; can sell interests to raise capital</td>
<td>Limited to owners’ contributions and borrowing ability; can sell interest to raise capital</td>
<td>Limited to owners’ contributions and borrowing ability; can sell interest to raise capital</td>
<td>Limited to owners’ contribution and LLC’s borrowing ability; and can sell interest to raise capital</td>
</tr>
<tr>
<td>Management</td>
<td>Owner</td>
<td>May be divided among partners</td>
<td>Board of Directors</td>
<td>Board of Directors</td>
<td>Per articles of organization</td>
</tr>
<tr>
<td>Transferability of ownership</td>
<td>Only by sale of entire business or creating a different entity</td>
<td>Can sell all or portion of partnership interest</td>
<td>Can sell all or portion of stock</td>
<td>Can sell all or portion of stock; but must follow the restrictions on number and type of shareholders</td>
<td>Per articles of organization; commonly have some limitations</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>Marginal tax rate at individual level</td>
<td>Pass through and marginal tax rate at individual level</td>
<td>21% by TCJA</td>
<td>Pass through and marginal tax rate at individual level</td>
<td>Depends on tax status</td>
</tr>
</tbody>
</table>

**Other Important Tax Issues on Conversion of Business Entities**

Due to different tax treatments for different entities, such as double taxation for a C corporation, and the “pass through” of income for a LLC, partnership or S corporation, taxpayers...
should evaluate thoroughly, the potential entity conversion issues under the various federal and state tax laws because it can lead to different tax consequences. For instance, under the TCJA, Congress reduced the corporate rate to 21%, but, in case of business other than a C corporation, the owner(s) of such business types may enjoy the potential 20% deduction on their qualified business income. So, it depends on “crunching the numbers!” said Mr. Walker, to approve whether converting a pre-existing business to another form of entity would be ideal and in the best interest of the owners. Furthermore, converting an entity may raise numerous other issues such as: a change of tax identification numbers, other tax impacts, such as payroll tax, sales/use tax, property tax, and gross receipts tax under the various tax jurisdictions in which it conducts business.

**Other Important Non-Tax Issues on Conversion**

Besides the tax issues on entity conversion, Professor Busch also mentioned important non-tax issues, such as business licenses, contracts, worker’s compensation, other insurance matters, title transfers of assets, and other matters that can come into play in the conversion process.

In addition, Professor Busch stressed that only attorneys who work for law firms are legally allowed to undertake the non-tax aspects of business entity formations or other entity-related legal tasks, such drafting a partnership agreement. Hence, he highly suggested that the non-attorney tax practitioner work with an experienced tax/business attorney to have a full picture on the choice of business entity matters for a client.

**Examples**

Lastly, the presenters provided two examples which illustrate that an entity choice comes with performing a great many numerical tax calculations on a case-by-case basis.

In their first set of examples, by putting the taxpayer in a variety of entity forms, within the consideration of a 21% corporate rate and an eligible Section 199A deduction for non-C corporation entities, the most beneficial choice of entity for the taxpayer, based on total taxes paid by both the entity and/or owners was an S corporation, followed by a C corporation and then a sole proprietorship.

In their second example with a different scenario where the taxpayer was not eligible for the Section 199A deduction, the best choice of the entity was as a C corporation, followed by an S corporation and then a sole proprietorship.

**Conclusion:**

Since the TCJA, many business owners are considering whether they should convert their entities to a better one which can potentially save taxes. However, it is always easier said than done. Hence, as tax professionals, our job is to step into each taxpayer’s shoes, fully understand their business and needs in order to do the math, and work with a tax/business attorney to choose the best entity for the taxpayer within a big picture scenario.
Ethics, Due Diligence, and Changes to Penalty Provisions

- Sara Yaqin Sun, MST Student

At the 6th annual IRS-SJSU Small Business Tax Institute, a presentation on Ethics was given by Ms. Claudia Hill, EA, MBA, President of Tax Mam, Inc. Ms. Hill mentioned there are multiple sources that tax practitioners have to abide by when filing returns, consulting with clients, and representing taxpayers before the IRS through a power of attorney.

Ethics and Due Diligence Standards

Due diligence standards are codified primarily in the Internal Revenue Code (IRC), and all “tax return preparers”¹ are subject to these provisions. Practitioners who are EAs, CPAs, and attorneys are also covered by Circular 230² which requires them to meet due diligence requirements and provides for penalties for a wide variety of unethical behavior, including making false and misleading representations to the IRS. Moreover, there are standards to be followed outside of the IRC and Circular 230 depending on the type of compliance or other work the practitioner is involved with, such as state Board of Accountancy Codes of Conduct, the AICPA’s Statements on Standards for Tax Services, and industry professional standards. According to Ms. Hill these professional standards provide more guidance than Circular 230 because they are more situational. However, practitioners should be familiar with both because they often have to rely on each other and reference each other in terms of interpreting the codes and penalty provisions.

Penalty Provisions Amended by the TCJA - IRC §6695(g)

Talking about the changes made by the TCJA, Ms. Hill pointed out one due diligence codified penalty provision that is going to have to a broad impact is §6695(g) imposing a $500 penalty (subject to inflation) on a tax return preparer who fails to be diligent in determining eligibility for certain tax benefits. This specific provision previously covered claiming the Child Tax Credit, the American Opportunity Tax Credit, and the Earned Income Tax Credit. The TCJA added the Head of Household filing status and codified the provision into IRC 6695(g)(1). The “IRS is watching you” set of rules demand that tax return preparers complete their due diligence by asking questions of taxpayers and completing the required questionnaires, learning as much about their client’s personal situation as applicable to these credits and the Head of Household status, and considering what rules and regulations apply to their circumstances.

More importantly, tax return preparers are required to confirm on the Form 8867 due diligence checklist indicating that they have asked all the questions of their client to determine whether the taxpayer qualifies for the specified tax benefits they are claiming on their return. They need to document all required worksheets and forms and keep them in their records for generally at least three years from the original due date of the return or when it was filed. The issue brought

¹ Tax return preparer is defined in IRC 7701(a)(36) (A) as “any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title.”

by Ms. Hill was that when technology steps in, many of the tax software platforms automatically pre-fill/complete the due diligence process for return preparers, but it could be wrong.

By giving examples (in a slightly different context), she illustrated how tax preparation software could cause taxpayers to make mistakes or make the return preparer fail to be duly diligent. One of the examples involved simply using the data contained on Form 1099-B for sales of stock related to the exercise of stock options. Tax software can pull the 1099 numbers automatically and created a Form 8949, but it does not have the substantively correct cost basis figures for same-day option sales. Another example was that one provider experienced problems with sending in certain first quarter estimated taxes to California, and at the time of the presentation, they were still in the process of notifying preparers that those e-payments were not made. Sometimes, tax preparers were tripped up by these software or online filling platforms. She emphasized that we cannot trust technology 100 percent and that we still have to do our due diligence to make sure the conclusions the software draws are correct.

**Penalty on Unreasonable Positions - IRC §6694(a)**

There is another kind of penalty that may come up when dealing with returns that are challenged by the IRS under exam. It is a penalty on the preparer of record on the return if they have taken an unreasonable position. However, this penalty does not happen every time a return is examined and a client owes tax. IRC §6694(a) provides that if a return preparer prepares a return or claim for refund with an understatement of liability due to an “unreasonable position” and the preparer knew (or should have known) that the position taken was unreasonable, then a penalty can be imposed if there is an understatement of tax liability as a result of the unreasonable position. A “reasonable basis” standard / penalty exclusion applies if the position is adequately disclosed in the return or in a statement attached to the return. To make sure of an adequate disclosure, refer to Rev. Proc. 2018-11 for guidance for purpose of meeting the standards, as well as Form 8275 Disclosure Statement. There is even a Form 8275-R if a practitioner chooses to not follow a regulation, but can justify the reason for departure.

**Conclusion**

To get to the level of a reasonable basis on transactions while filing returns for clients, practitioners need to pay attention to the primary sources of law for guidance on these issues. These primary sources include the IRC, Treasury Regulations, Revenue Rulings and Revenue Procedures. Judicial sources like court cases are also primary sources, but we are not going to see any cases on the new laws in these areas anytime soon. Other documents, like IRS publications, are not legal authority that can be relied upon in taking positions on tax returns.

Ms. Hill ended her presentation emphasizing that when practitioners take on the obligation to prepare a tax return they must prepare the tax return substantially correct to the best of their ability and that practitioners should bear in mind that they have to meet the due diligence requirements when they interview their clients.
Section 199A’s Qualified Business Income Deduction

- Surbhi Doshi, MST Student

One of the biggest changes brought by the Tax Cuts and Jobs Act of 2017 is the §199A qualified business income deduction. In the 6th annual IRS/SJSU Small Business Tax Institute conference held on May 23, 2018, Gary McBride CPA, J.D., LL.M, Professor Emeritus at California State University, East Bay, and Rico J. Delodovici, EA, owner of Tax and Business Consulting, shed some light on the newly enacted section 199A deduction.

What is the Section 199A Deduction?

For tax years beginning after December 31, 2017, a deduction of up to 20 percent of the taxpayer’s combined qualified business income (which is generally comprised of the business net operating income – details to follow below) with respect to a (or multiple) qualified trade(s) or business(es) will be allowed to non-corporate taxpayers (i.e., individuals, estates and trusts). The section 199A deduction is a from-AGI deduction (i.e., below the line) and is available to both itemizers and non-itemizers. In addition to having this deduction apply to qualified business income, it also applies (separately) to qualified REIT dividends (QRD), and qualified traded partnership income (QPTPI) received by non-corporate taxpayers (for the examples below we will assume no REIT dividends or publicly traded partnership income is applicable).

Qualified Business Income (QBI):

§199A(c) defines QBI to include the net amount of income, gains, deduction and loss with respect to any qualified trade or business (subject to the exclusions noted below). In case of a net loss from a qualified traded or business, the applicable portion of the loss is carried forward to the succeeding taxable year as a potential reduction of the QBI deduction in that year.

The definition of QBI excludes:

a. Any capital gains, dividends, dividend equivalent, interest income (unless allocable to the trade or business), annuity income and other specified types of non-operating income.

b. Any wage compensation received by the taxpayer from the qualifying trade or business of the taxpayer for services rendered.

c. Any guaranteed payments made to a partner/member for services rendered by him with respect to the trade or business.¹

Qualified REIT Dividends: Per §199A(e)(3), it includes any dividend received from a real estate investment trust during the taxable year, but excludes capital gain dividends and any qualified dividend income.

Qualified Publicly Traded Partnership Income: Per §199A(e)(4), from any qualified trade or business, this is the sum of the taxpayer’s allocable share of income, gain, deduction or loss from a publicly traded partnership that is not treated as a corporation, and any gain recognized by the

¹ IRC §199A(c)(3)(B).
taxpayer upon disposition of its interest in the partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under §751(a).

**Eligible Taxpayers and Forms of Business:** The section 199A deduction is available to individuals, trusts and estates from QBI derived from sole proprietorships, partnerships, S corporations, limited liability companies (LLCs) and co-operatives (so long as they are not taxed as C corporations for federal tax purposes). To be clear, the deduction is available to owners of S corporations, partnerships and LLCs at the *shareholder/partner/member* level – not at the business entity level. This deduction is not available to C corporations.

**How to Calculate the Deduction?**

For many eligible taxpayers (subject to the additional limitations below for certain high-income taxpayers) the QBI deduction from income derived from non-specified service businesses (SSBs – to be discussed later) is the lesser of the amount determined under A or B below:

A. The taxpayer’s combined qualified business income (CQBI), or

B. 20% of the taxable income of the taxpayer for the year, minus net long-term capital gain and qualified dividends (“modified taxable income”).

Taxable income, per Step A above, is calculated *before* considering the §199A deduction. The determination of the combined qualified business income amount (CQBIA) is a complicated one. § 199A(b) explains CQBIA, which is the sum of the amounts calculated per items a and b below for each trade/business and then combined together.

When the taxpayer’s modified taxable income exceeds $157,500 (non-MFJ filing status) or $315,000 (MFJ), the qualified wages (or the qualified wages plus the unadjusted basis of qualified property limitations) of the qualified business comes into play when determining the potential QBI deduction. Subject to the modified taxable income limitation (as noted above), the amount applicable for the QBI deduction for any qualified trade or business is the *lesser of:*

a. 20% of the taxpayer’s qualified business income with respect to the qualified trade or business or

b. The *greater of:*
   i. 50% of the qualifying W-2 wages with respect to each qualified trade or business, or
   ii. The sum of 25% of the qualifying W-2 wages with respect to the qualified trade or business, *plus 2.5% of the unadjusted basis* immediately after the acquisition (UBIA) of all qualified property,

plus (if applicable):

c. 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the year [see chart 1 below].

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2 Qualifying W-2 wages are generally the total amount of W-2 taxable wages paid to employees, plus any elective employee deferrals under most retirement plan contributions.
§199A does not define unadjusted basis, but it defines qualified property as any tangible property subject to depreciation that is held and available for use by the qualifying business at the end of the year, was used at any point during the year in the production of QBI, and the depreciable period for the asset has not ended before the close of the year (or if later, 10 years after the asset was placed in service).³

The UBIA and W-2 wage limits are phased-in proportionately when the taxpayer’s modified taxable income exceeds $157,500 (non-MFJ) or $315,000 (MFJ) – up to $207,500 (non-MFJ) or $415,000 (MFJ).

If modified taxable income does not exceed the $157,500/$315,000 threshold amounts, then the taxpayer has complete relief from the W-2 (or W-2 plus UBIA) potential limitations.

If modified taxable income exceeds $415,000 (MFJ) or $207,500 (other filing statuses), then the W-2 (or W-2 plus UBIA) potential limitations fully apply.

**Qualified Trade or Business (QTB):** A qualified trade or business is any business other than a specified service trade or business (SSB) or, the trade or business of performing services as an employee.⁴

**Specified Service Business (SSB):** This is defined as “[a]ny trade or business involving performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities.”⁵ ⁶

Generally, specified service businesses are not considered a qualified trade or business. However, IRC 199A(d)(3) provides an exception which allows income generated by specified service business to be included in qualified business income. If the entity is a SSB, and the owner’s modified taxable income is below $157,500 or $315,000 (MFJ), the taxpayer qualifies for the (up to) 20% qualified business income deduction. However, if the taxpayer’s modified taxable income is greater than the above thresholds, but less than $207,500 or $415,000 (MFJ), the taxpayer will still be eligible for partial QBI deduction (see example #2 below). If modified taxable income exceeds the $207,500/$415,000 amounts, then no deduction is allowed.

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³ IRC §199A(b)(6).
⁴ IRC §199A(d)(1).
⁵ IRC §199A(d)(2).
⁶ Note that subsequent to this presentation, the IRS has limited the skill or reputation factor for a potential SSB classification to essentially only endorsement activities – Treas. Reg. §1.199A-5(b)(2)(xiv).
Chart 1: Calculation of the Section 199A Deduction for Owners of Non-SSBs – for Very High-Income Taxpayers

*If modified taxable income is less than $157,500 or $315,000 (MFJ) then:

- The above wage and UBIA limitations do not apply;
- The SSB status of trade and business is ignored; and
- The aggregate of all qualified trade or business income is considered.

Gary McBride explained some of the complex QBI deduction calculations with the help of examples.

**Example 1:** A married couple owns rental real estate (a non-SSB) that constitutes a qualified trade or business and earns a net profit (QBI) of $200,000. The couple files a joint return. The modified taxable income of the couple is $420,000 (pre-§199A). The unadjusted basis in the real property is $2,000,000. No wages are paid in the business.

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7 Those with modified taxable income of $207,500 or more ($415,000 or more for MFJ filers) in 2018.
The §199A deduction is the lesser of 20% of (1) the couple’s modified taxable income or (2) CQBI as calculated below (a and b):

a. 20% of QBI (i.e. 20% of $200,000) = $40,000
b. CQBI is sum of the 20% of the Qualified REIT and QPTP (which is 0 in the above case) and the lesser of:
   i. W-2+UBIA limit: (A) greater of 50% of W-2 wages = $0
      OR
      25% of W-2 wages + 2.5% of unadjusted basis (UBIA) = $0 + 2.5% of $2,000,000 = $50,000
   ii. 20% of modified taxable income (i.e. 20% of $420,000 = $84,000).

The potential QBI limitation figure of $50,000, which is calculated above as a percentage of wage and unadjusted basis, is higher than the straight 20% of QBI (or $40,000). In addition, 20% of the couple’s modified taxable income is $84,000. Hence, the section 199A deduction is $40,000 which is lesser of $40,000 (CQBIA), $50,000 (the W-2 + UBIA limitation), and $84,000 (20% of $420,000 (modified TI)).

In the above example, if we change the unadjusted basis of the building from 2,000,000 to $640,000 then, the W-2 + UBIA amount will be 25% of W-2 wages ($0) + 2.5% of $640,000 = $16,000.

Therefore, everything else remaining constant, the new §199A deduction is $16,000, which is lesser of $16,000 (CQBIA), $84,000 (20% of $420,000 modified TI) and $40,000 (20% of QBI).

**Example 2: Calculation for an SSB.**

S1, who is married, is the sole proprietor of a law practice (an SSB) that earns a net profit (QBI) of $200,000. The couple files a joint return. The couple’s modified taxable income is $340,000. Regardless of the amount of qualified wages or property of the business, the maximum potential QBI deduction applicable to this taxpayer related to this business is $30,000. This is because the couple’s modified taxable income is 25% into the phase-out range of the QBI deduction (i.e., $25,000 (out of $100,000) over the beginning phase-out threshold of $315,000). This 25% reduction of applicable QBI results in an applicable QBI of only $150,000. 20% of $150,000 applicable QBI is $30,000.

**Other things to Remember:**

Here are some important pointers to keep in mind for the §199A deduction:

- First, the §199A deduction is not allowed for self-employment tax purposes, but is available for AMT purposes.
- Second, the W-2 + UBIA limit does not apply to qualified REIT dividends, qualified publicly traded partnership income and qualified cooperative dividends.
- Third, if the qualified business income for any year is less than zero, then it will be treated as a loss from the qualified trade or business and will be carried forward to the
next succeeding year. This will potentially reduce the subsequent year’s §199A deduction which is a reduction in the deduction.

- §199A(g) applies to “specified agriculture or horticulture cooperatives” and their patrons who receive qualified payments from the cooperatives. Recent changes in the QBI guidance eliminates the provision that allows patrons a 20% deduction based upon gross sales (not gross income) to cooperatives.

Planning Considerations:

Mr. Delodovici focused on how important it is to examine your client base before suggesting some planning strategies so that clients are eligible for the deduction and to maximize their potential deduction. One of his illustrations was about a single, sole proprietor of an SSB. His modified taxable income for 2018 was more than $207,500, which makes him ineligible for the §199A deduction. However, there are ways in which the client could legitimately lower his taxable income. The taxpayer could buy some furniture or equipment he needs for the business, or donate to some charity if he has a charitable intent, which will bring his income level below $207,500 and hence potentially qualify him for the deduction. Now is the time to make such planning decisions and advise the clients so that they do not lose the §199A deduction.

Another example was where the taxpayer had no qualified business income. A single taxpayer is in a rental business (which happens to constitute a qualified business) with gross rents of about $80,000. She also incurs about $80,000 in expenses on the rental, of which $35,000 amounts to mortgage interest. If the taxpayer can make the interest amount disappear, such as paying off the mortgage (if feasible), she could have a QBI of $35,000 and a §199A deduction of up to $7,000. Emphasis was also laid out on shifting of income in some cases. For instance, suppose we have a partnership with equal partners who receive guaranteed payments, where there is little or no QBI, as guaranteed payments do not generate QBI for the partners and are an ordinary deduction for partnership. To help mitigate this problem, the partners could reassess their partnership agreement and move money from their guaranteed payments to distributive shares. This simple shifting of income will provide a significant tax benefit by increasing QBI of the partnership through lower deductions (without the guaranteed payment deductions).

Conclusion:

Section 199A is certainly one of the more complicated provisions added to the Internal Revenue Code by the Tax Cuts and Jobs Act of 2017. It offers significant tax savings for taxpayers in that it has the potential to effectively “close the gap” between non-C corporation business owners and C corporations, which are taxed at a flat 21% after the TCJA, with this potential large tax reduction.
Depreciation and Deductions for Section 1231 Assets Under the Tax Cuts and Jobs Act
- Nhi (Tina) Tran, CPA, MST Student

In the 6th annual IRS/SJSU Small Business Tax Institute conference held on May 23, 2018, a panel of experts from accounting firms collaborated and discussed the relevance of the Tax Cuts and Jobs Act (P.L. 115-97) with regards to depreciation and deductions for Section 1231 assets. The panel included Mark O’Connell from KPMG LLP, Roger Burggrabe from Moss Adams LLP, and Joel Busch, professor from the MST program at San Jose State University who joined as a moderator. The panel addressed tax changes brought by the Tax Cuts and Jobs Act (TCJA), relevant tax rules that remain unchanged, and some considerations in practice. This article will mainly focus on the details of the new law and its application.

New Tax Changes under TCJA

Mr. O’Connell and Mr. Burggrabe started off their presentation with the changes brought by TCJA with respect to depreciation deductions as summarized below:

<table>
<thead>
<tr>
<th>Topics</th>
<th>Pre-TCJA</th>
<th>Post-TCJA</th>
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<tbody>
<tr>
<td><strong>Section 179</strong></td>
<td>Dollar limitation was $510,000 in 2017</td>
<td>Dollar limitation: increased to $1,000,000</td>
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<td></td>
<td>The beginning phase-out threshold (for Section 179 assets placed in service): $2,030,000 in 2017</td>
<td>The beginning phase-out threshold is increased to $2,500,000</td>
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<td>Definition of section 179 property was very limited in regard to assets other than tangible personal property</td>
<td>Definition of section 179 property is expanded to include:</td>
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<td></td>
<td>- Qualified improvement property (QIP)</td>
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<td></td>
<td></td>
<td>- Nonresidential real property improvements such as roofs, HVAC, fire protection systems, alarm systems, and security systems</td>
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<tr>
<td></td>
<td></td>
<td>- Personal property used predominantly in lodging</td>
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<tr>
<td><strong>Bonus Depreciation</strong></td>
<td>50% first-year bonus deduction for qualified assets placed in service</td>
<td>100% first-year bonus depreciation deduction for qualified assets acquired and placed in service between September 28, 2017 and December 31, 2022</td>
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<tr>
<td></td>
<td>Bonus depreciation was only applied to new or original-use property to the taxpayer</td>
<td>100% bonus depreciation is allowed for not only new but also used property acquired from an unrelated party in an arm’s-length transaction</td>
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</tbody>
</table>
| Qualifying property included: | - Tangible property with a recovery life of 20 years or less  
- Computer software  
- Water utility property  
- Qualified improvement property with 39-year life  
- The reference of 39-year qualified improvement property is removed  
- 100% bonus depreciation is now also available for a “qualified film or television production” placed in service on or after September 28, 2017  
- Qualified property that is not required to use the ADS method of depreciation, includes:  
  - Foreign-use property  
  - Property leased to a tax-exempt entity  
- 100% bonus depreciation is now also allowed for certain building property owned by an “electing real property trade or business” or “electing farming business” as defined in section 163(j)  
- For qualified property acquired before September 28, 2017, bonus depreciation was scheduled to be reduced by 10% each year for 2018 and 2019, and would be completely phased out by December 31, 2019  
- For qualified property acquired after September 27, 2017, bonus depreciation is scheduled to be reduced 20% each year beginning in 2023, and will be fully eliminated in 2027  
| Passenger Automobile | Maximum deduction in 2017 for passenger cars or light duty trucks was:  
- $3,160 for the year the vehicle is placed in service ($11,160 if first-year bonus depreciation is elected)  
- $5,100 for the second year  
- $3,050 for the third year  
- $1,875 for the fourth and later years in the recovery period  
- Maximum deduction for passenger cars or light duty trucks placed in service after December 31, 2017:  
  - $10,000 for the year the vehicle is placed in service ($18,000 if first-year bonus depreciation is elected)  
  - $16,000 for the second year  
  - $9,600 for the third year  
  - $5,760 for the fourth and later years in the recovery period  
| Listed Property | Computers and peripheral equipment was used to be under “listed property” category, and required to be depreciated using the straight-line method if qualified business use falls below 50%  
| Computer and peripheral equipment is no longer considered “listed property” |
With regard to qualified improvement property, Mr. O’Connell emphasized that the Act consolidated the various improvement categories into one category – qualified improvement property. It consists of the former qualified leasehold improvements, qualified retail improvement property, and qualified restaurant property. Initially, the Act intended to provide a significant federal tax benefit to taxpayers by having this newly redefined QIP category to be classified as a 15-year depreciation life property and being eligible for both section 179 expensing and bonus depreciation. Due to a drafting error, that provision was ultimately taken out in the new tax bill; as a result, QIP acquired and placed in service after September 27, 2017 remains having 39-year recovery life, and no bonus depreciation is allowed for such property. The American Institute of CPAs (AICPA) has called for a technical correction to address the issue. Until the correction is made, QIP will remain as stated in the IRC.

**Considerations in Practice**

The panel additionally illustrated the application of new tax changes in practice. They provided examples on how to take advantage of the tax benefits derived from the changes by utilizing a cost segregation analysis. In general, a cost segregation study is the practice of accelerating depreciation deductions by allocating part of the capitalized costs real property which has either a 39-year life (nonresidential real property) or 27.5-year life (residential rental property) to any applicable amounts of tangible personal property with shorter class-lives, such as 5, 7, or 15-year lives. Tangible personal property, also known as “§1245 property,” has a shorter recovery period and is also eligible for section 179 deduction and/or bonus depreciation. Consequently, the segregation will normally accelerate depreciation deductions and benefit taxpayers with immediate increases in cash flow.²

For illustration purposes, the panel prepared some facts and circumstances on an office remodel. The construction started after 9/27/2017 and was completed before 12/31/2018. The aggregate cost of the remodel is $3,000,000, of which $2,700,000 million is allocated to all interior structures (except for roof and HVAC) and $300,000 is for additional office furniture.

- Without the application of cost segregation practice, where there was only one asset for the entire remodel, the total remodeling cost, after section 179 deduction consideration,
would be most likely to be bundled and classified as a 39-year qualified improvement property depreciated on straight-line basis and no bonus depreciation is available because due to the TCJA. In this case, the section 179 deduction would apply, but be reduced from the normal $1M amount to only $500,000 because the total cost exceeds the beginning phase-out threshold of $2,500,000 by $500,000. The remaining remodeling cost of $2,500,000 million will be depreciated over a 39-year life.

- However, if the cost segregation study comes into play, the remodeling cost will be reclassified into section 179 property, tangible personal property, and qualified improvement property. In this scenario, the allocated cost to tangible personal property is qualified for the 100% bonus depreciation under the TCJA. As a consequence, the depreciation deduction is accelerated. Below is the cost break-down chart in this example.

<table>
<thead>
<tr>
<th>Section 179</th>
<th>5-Year &amp; 7-Year Tangible Personal Property</th>
<th>39-Year Qualified Improvement Property</th>
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<tbody>
<tr>
<td>$150,000 of roof work</td>
<td>$300,000 of office furniture</td>
<td>$1,600,000 of interior real property improvements</td>
</tr>
<tr>
<td>$250,000 of HVAC RTU</td>
<td>$270,000 office casework, removable finishes</td>
<td></td>
</tr>
<tr>
<td>$100,000 of Fire Sprinkler</td>
<td>$330,000 of business related electrical and plumbing</td>
<td></td>
</tr>
<tr>
<td>$500,000</td>
<td>$900,000</td>
<td>$1,600,000</td>
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</tbody>
</table>

**Conclusion**

The release of the 2017 Tax Cuts and Jobs Act has provided significantly generous tax breaks to taxpayers with respect to depreciation deduction of Section 1231 assets. Tax practitioners and advisors should get comfortable with the relevant new rules in order to make the best use of such potential tax benefits in their practice. It is also important to keep up-to-date with additional IRS guidance and publications as it relates to these significant changes.
Tax Maven

The Contemporary Tax Journal’s Interview with Eileen Marshall

- Rani Vaishnavi Kothapalli, MST Student

Eileen Marshall is a partner in the tax practice at Wilson Sonsini Goodrich & Rosati. She graduated Juris Doctor (J.D.) from Yale Law School in 1996 and Bachelor of Arts (B.A.) from University of Pennsylvania in 1989 with the Summa Cum Laude (highest distinction). Eileen practices all aspects of domestic and cross-border mergers, acquisitions, divestitures, restructurings, tax-free reorganizations, taxable and tax-free spin-offs, incorporations, and partnership formations from Washington, D.C., and Palo Alto offices.

Eileen was selected to be included in the 2012, 2013, 2014 and 2015 editions of Washington D.C. Super Lawyers. She speaks regularly on panels for the District of Columbia Bar Taxation Section and the American Bar Association Taxation Section. She also spoke at the Practicing Law Institute, New York University Annual Institute on Federal Taxation, and Tax Executives Institute.


She is a Committee Officer, Corporate Tax Committee, American Bar Association Taxation Section; Former Chair, Financial Transactions Committee, American Bar Association Taxation Section; Former Chair, Financial Products Committee, District of Columbia Bar Association Tax Section; Member, District of Columbia Bar Taxation Section; Member, American Bar Association Taxation Section.
1. How did you get involved in the tax field? Was that your plan when you started law school?

I began my legal career as a corporate lawyer, but I became interested in tax early on in the late 1990s when I had a very small role as a second or third year associate at WSGR working on the Disney InfoSeek combination. It was a fascinating deal in many respects, but to me the most interesting aspects of it were tax-related. After that deal, when I imagined the future of my career, I did not see myself continuing to practice as a corporate lawyer, even though most people would have thought the corporate negotiations were the best part! Tax professionals in that respect are a distinctly self-selecting group; you don’t wind up as a tax lawyer by accident. I immediately took the initiative to switch my practice to tax, which first required me to break the news to the corporate lawyers for whom I worked, and next to convince the head of the tax department that it was a good idea to hire me. Luckily, everyone at WSGR was very supportive of my career aspirations and professional development, and I was allowed to make the move a few months later, just after I returned to work after my first maternity leave.

It was not my aim when I started law school to become a tax lawyer. I went to Yale, which at the time did not have quite the broad array of tax courses that it has today, although I took individual income tax with Michael Graetz, who is of course a luminary in the field and gave me an abiding appreciation for tax policy. When I entered law school, I thought I wanted to be a divorce lawyer!

2. What stands out as one or two of your most significant accomplishments in your career?

To be perfectly frank, I think that all of my best accomplishments are ahead of me! That said, I have worked on many merger transactions between technology companies that mattered, both to the parties involved and to the marketplace; too many to name and the most interesting and impactful of which might not have been the ones reported in the Wall Street Journal. I have also been involved in structuring many financial instruments issued by technology companies, and wrote an article on one of these trades that practitioners have found useful. I have had a hand in helping my clients achieve their business goals, and that is very satisfying. To date, the professional accomplishment that I am most proud of relate to the relationships I have formed and the network that I have built over the last 20 years. I have been active in tax sections of the American Bar Association, the DC bar and some private tax clubs. Most importantly, I have been closely involved in the management and operations of WSGR, as a leader of the tax group and member at various times of the compensation committee, board nominating committee and board of directors. The opportunity to have a voice in shaping the strategic direction of my firm has been one of the things that has kept me engaged and oriented toward the future.

3. How do you keep up to date with the changes in tax law and the ever-changing technology of the Silicon Valley tech companies?

The most important thing that I do in order to stay abreast of current developments is to read a lot! I try to make it my practice to read the relevant tax publications and news first thing in the morning, and failing that, last thing before I leave the office every day. I try not to worry about
whether the publications are directly relevant to my own practice, because you really never know how some new developments or the commentary of a smart tax practitioner might be useful. It’s a little bit like basic science, in that it is not necessarily pursued with a particular aim of producing something, there is good in simply exposing yourself to as much information as possible; just read, think and see what you find.

4. **What do you think is one key area of our federal or state tax system that could/should be improved and why?**

An invaluable improvement to tax administration would be to establish and adequately fund the processes necessary to more regularly provide published guidance to taxpayers. The dearth of widely applicable guidance, such as revenue rulings and final regulations, has hindered the efficient delivery of tax advice by practitioners, and has caused taxpayers to incur undue costs and delays in executing business-motivated transactions. The government’s relatively consistent private letter ruling practice has provided some useful insight into its positions on a wide variety of issues, but private letter rulings cannot be relied on by other taxpayers.

5. **What do you think is the biggest challenge facing tax professionals today?**

In my experience, the biggest challenge for tax professional is the fact that technologies have made it almost impossible to disconnect from work, which is both a blessing and a curse. The pace of change in the legal landscape and deal environment is extremely fast, so it is important to stay in step. Technology makes it possible to do so even if you are not in the office. On the other hand, some of my best thinking has been done while walking in the Marin headlands or on Bethany Beach or even on the sidelines at a kid’s soccer game. Work/life balance is a constant challenge that is important to take seriously as a goal.

6. **What advice do you have for students preparing for a career in tax?**

In terms of advice for the next generation, I have a sign in my office that says, “Work hard and be nice,” which really are words to live by. Although legal work is by nature adversarial, the lawyers on both sides by necessity must work together to get the deal done, so maintaining an open professional demeanor is key. I would add: Stay curious and keep yourself in learning mode all the time. Some of my most interesting learning experiences have come at unexpected moments, in particular where I had fallen into a sense of complacency about my expertise in a particular area of the law. Often a person with less experience and more fresh thinking has something to say about a particular issue, so stay humble and keep an open mind, but in any case, work hard and be nice.

7. **If you could have dinner with anyone, who would it be?**

Far and away my top choice for dinner would be Jane Austen, whose novels have transported me to a bucolic, but somehow intellectually rich and satisfying, place and time. Escapist fantasy, doubtless, but in so many ways perfection!
8. What is the most unusual item in your office or something in it that has special meaning to you?

I have a framed poster in my office from The Facebook Analog Research Laboratory that says, “WHAT WOULD YOU DO IF YOU WEREN’T AFRAID?” in orange capital letters. I originally got the poster from a client when I admired it in his office, tacked on his bulletin board. He immediately took it down, rolled it up, and handed it to me. A few weeks later, a close colleague and friend was struggling with a decision about whether to accept a new professional opportunity as general counsel of a public company. He was really agonizing over the decision of whether to leave the firm. I gave him the poster, and he took the job. A little while later, the client called and asked to meet with me urgently in the lobby of our building; I hurried downstairs and, unexpectedly, he presented me with another copy of the same poster, having learned that I had passed the first one along in the spirit of paying it forward. It has been a mainstay in my office ever since.
Fun Tax Facts
- Rachana Khandelwal, MST Student

As famously quoted by Benjamin Franklin: “In this world, nothing is certain except death and taxes.”\(^1\) Taxes are inevitable and an obligation to pay taxes has been considered as oppressive since the origin of mankind. Historical documents, old architecture, and artifacts reveal the impact of taxes on society over a period of time. Following are a few interesting facts about taxes discussed briefly.

### Hearth Tax (1662-1688)

In 1662, King Charles II introduced the hearth tax\(^2\) to raise revenue for the government. The hearth tax tied to the number of hearths, fireplaces or stoves in the house. Also, known as chimney money, the hearth tax was considered one of the first progressive taxes in England. It was a form of property tax on the wealth of the family living in the house rather than on the individual's income. The wealthier people paid more hearth tax because of large houses and therefore a greater number of hearths in the house. Poor people exempt from paying local taxes to the church, and hospitals were exempt from this tax. People started evading taxes by demolishing their chimneys and thus avoiding or reducing the tax. This innovative way of evading taxes became a concern for assessors in collecting adequate revenue for the government. Further, the resentment of the people on the assessors and collectors entering the house to count the number of hearths and invading their privacy led to the repeal of the hearth tax.

### Window Tax (1696-1851)

One of the reasons the hearth tax was repealed was the invasion of taxpayer’s privacy. Thus, as a result, a window tax\(^3\) was introduced which didn’t require the assessor to enter the taxpayer’s house. The tax was levied based on the number of windows in the house. Like the hearth tax, people who were exempt from paying local taxes to churches and hospitals were exempt from paying the window tax. However, the practice of tax evasion started by brickling up the window (as seen in the picture) to avoid the tax. Sometimes, the windows were temporarily bricked before the assessment and opened again after the assessment was completed.

A British architecture depicting the tax evasion of window tax Brighton Street, Edinburgh, Credit: Kim Traynor\(^4\)

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\(^4\) Wikimedia Commons, [CC BY-SA 3.0 (https://creativecommons.org/licenses/by-sa/3.0)].
This lack of light and air resulted in poor health of the people and thus resulted in the repeal of the window tax in 1851 (almost after 150 years of being in effect).

**Hair Powder Tax (1795-1869)**

William Pitt, the Younger, introduced the hair powder tax\(^5\) to raise funds for the war with France. Back then, men used to wear wigs and women used to wear extensions as a fashion statement. Both men and women used to color their hair with hair powder, men preferably used white powder and women used to color the hair grey or blueish. The use of hair powder was taken as evidence of affordability to pay this tax. Every person using hair powder was required to register his name at the office of the stamp commissioner, and obtain an annual certificate, paying one guinea.

Though, this tax initially generated revenue for the government and lasted for 74 years, the decline in the number of taxpayers using hair powder led to a decline in revenue. Thus, it became unproductive and as a result, the tax was repealed.

**Rosetta Stone (196 BCE)**

The Rosetta Stone\(^6\) placed in the British Museum is a marble-like rock, which bears an inscription of ancient Egyptian history in Egyptian, Greek, hieroglyphic\(^7\) and demotic.\(^8\) The inscriptions on the stone serve as a record of one of the earliest tax systems in human history. The records reveal the story of Egyptian civilization, the types of taxes, and who and what was taxed. At the time of inscription, Egypt was embroiled in a civil war started by its soldiers who returned from a military campaign in the east and were met with a new tax burden. In order to bring peace, Ptolemy V, the king, agreed on certain terms by granting amnesty to the soldiers and signed the “Proclamation of Peace.” According to historians, the interpretation of the civil war could also be a result of high taxation, tax debts and grants of tax immunity to the priests which made them rich, thus creating strife.\(^9\)

Credit- Hans Hillewaert\(^10\)

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4 Tax Questions

*for SJSU MST Contemporary Tax Journal*

Written By:

Roger Philipp, CPA, CGMA
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1. Collins, a single taxpayer, is a 30% shareholder in an S corporation. For the current year, the S corporation reports the following:

- Qualified business income (QBI) - $200,000
- W-2 wages - $65,000
- Unadjusted basis of qualified property - $25,000

Assume Collins has no other taxable income or deductions. The Section 199A threshold amount for the year is $157,500. What is the QBI deduction for Collins' share of the S corporation QBI?

a) $5,500  
b) $9,750  
c) $12,000  
d) $40,000

c) Correct! Normally, the deductible QBI is equal to 20% of the business’s QBI, determined at the shareholder level; however, the QBI deduction may be subject to a wage/property limitation (i.e., greater of 50% of W-2 wages; or 25% of W-2 wages + 2.5% of unadjusted basis of qualified property) starting at the Section 199A threshold amount of $157,500 for single taxpayers (multiply that by 2 for married taxpayers). Since Collins’ $60,000 taxable QBI (i.e., her 30% share of the $200,000 QBI) does not exceed the $157,500 threshold, the wage/property limitation does not apply. Thus, Collins' QBI deduction is $12,000 (20% x $60,000).
2. Calyx Corp. is a C corporation that began operations in Year 1. Calyx Corp’s Year 1 through Year 3 taxable earnings and profits, prior to the distribution described below, are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>E&amp;P</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(5,000)</td>
</tr>
<tr>
<td>2</td>
<td>10,000</td>
</tr>
<tr>
<td>3</td>
<td>20,000</td>
</tr>
</tbody>
</table>

On the last day of Year 3, Calyx Corp. makes a distribution to its sole shareholder, Melver, in the form of property with an adjusted basis to Calyx of $30,000 and a fair market value of $40,000. Assuming Melver has sufficient basis in the Calyx stock investment, what amount of the property distribution to Melver is a nontaxable return of capital?

a) $20,000  
b) $15,000  
c) $30,000  
d) $5,000  

**d) Correct!** Corporate distributions are measured on the basis of the amount of cash and the fair value of property distributed. Thus, Calyx’s distribution will be in the amount of $40,000, the fair market value of the property distributed. Since the amount is greater than the basis in the property, the $10,000 difference will be treated as if the entity had sold the property at a gain, increasing current earnings and profits from $20,000 to $30,000. Calyx’s accumulated earnings and profits were $5,000. Therefore, the distribution will be taxed as a dividend to the extent of the current period’s earnings and profits of $30,000 and the accumulated earnings and profits of $5,000, for a total of $35,000, leaving a $5,000 return of capital.
3. In a qualifying reorganization, Currant Corp. exchanges $700,000 of its own stock and $50,000 of Pear Corp. stock with a basis of $35,000 for all of the assets of Raisin Corp., which have a value of $900,000 and a basis of $600,000. Raisin Corp. retains the stock in Pear Corp., which is a party unrelated to the reorganization. What amount of gain or loss, if any, will Raisin Corp. recognize as a result of this reorganization?

a) $50,000 gain  

b) Neither gain nor loss  

c) $15,000 gain  

d) $150,000 gain  

a) Correct! When an acquired entity receives boot (i.e., unlike property) in an exchange, whether or not gain is recognized depends on the disposition of the boot. If it is distributed to shareholders, no gain or loss is recognized by the entity. If it is retained, however, gain is recognized. Since Raisin is exchanging assets with a basis of $600,000 for Currant stock with a value of $700,000 and Pear stock with a value of $50,000, the realized gain is $150,000. However, gain will be recognized only to the extent of boot received and retained—i.e., the value of the Pear stock received, $50,000.
4. Dale and Hillary were divorced in 2014. The divorce decree provides that Hillary pay alimony of $10,000 per year, to be reduced by 20% on their child’s 18th birthday. During 2019, Hillary paid $7,000 directly to Dale and $3,000 to the state university for tuition for their child, who turned 18 during 2018. What amount of these payments should be reported as income in Dale’s 2019 income tax return?

a) $0  
b) $5,600  
c) $8,000  
d) $10,000

c) Correct! Hillary made a total of $10,000 in payments during 2019, including the $7,000 paid directly to Dale and the $3,000 paid for their child’s tuition. Alimony would have been reduced by 20%, from $10,000 to $8,000, in the year when the child turned 18. As a result, $8,000 of the payments made by Hillary would be considered alimony and would be taxable to Dale. The remainder would be considered child support. NOTE: Alimony is not deductible for divorces/separations executed after 2018. Alimony payments attributable to divorce/separation agreements finalized prior to 2019 remain deductible by the payer and includible in the recipient’s income.
Focus on Tax Policy

The following article was written by a student of the Tax Policy Capstone Summer 2018 class of the MST Program at San Jose State University.
What is a cryptocurrency?

A cryptocurrency such as bitcoin or alternative coins ("alt-coins" such as Ethereum, Dash, Monero, Zcash etc.) are digital, decentralized, open source assets and their value is entirely driven by market forces. Cryptocurrency holds no intrinsic value due to an absence of any asset backing. Cryptocurrency is significantly different from traditional or fiat currency such as US Dollar and Euros. Traditional currency is a legal tender with a central bank backing and is globally accepted as a medium of exchange.

Generally, cryptocurrency can be exchanged for goods and services or it can be held as an investment. These assets have gained popularity among users because of ease of transfer, low transaction costs, and some anonymity as they might be usable without disclosing the user’s information. However, a cryptocurrency also has some significant downside such as price volatility, potential vulnerability to hacking and fraud, and in some situations, an absence of a paper trail.

How does a cryptocurrency transaction work?

A bitcoin\(^1\) transaction takes place in a bitcoin wallet and all the transactions are recorded in a distributed ledger called the blockchain. When an exchange takes place over a peer to peer network,\(^2\) the record of transactions is maintained between user addresses and not the actual users. A bitcoin address is an alphanumeric code called a ‘public key.’ Each public key has a corresponding private key, which needs to be protected and stored safely by the user. The public key is used to receive bitcoin while the private key is used to send bitcoin. A bitcoin can be purchased or used in fractions equivalent to cash amount smaller than $1.

When a buyer decides to purchase, say a cup of coffee using bitcoin, he/she needs to transfer bitcoin equivalent to the cash value of the coffee into the seller’s bitcoin wallet. The seller shares his bitcoin address (public key) with the buyer and thereafter, the buyer using his private key

\(^1\) For the purpose of this article, Bitcoin is used as an example owing to its popularity and the highest market capitalization as compared to other cryptocurrencies floating in the cryptocurrency exchange.

\(^2\) Investopedia defines peer-to-peer network as the “exchange or sharing of information, data, or assets between parties without the involvement of a central authority. Peer-to-peer, or P2P, takes a decentralized approach to interactions between individuals and groups. P2P refers to the exchange of currencies that are not created by a central banking authority, and an especially common application is with cryptocurrency exchange networks such as Bitcoin.” Peer- To- Peer (Virtual Currency), available at https://www.investopedia.com/terms/p/ptop.asp.
transfers bitcoin into the seller’s wallet. The bitcoin miners\(^3\) verify and validate the transaction between buyer and seller to avoid double-spending\(^4\) of a bitcoin. A bitcoin wallet is not linked to personal details and the identity of the user can remain hidden.

**Tax treatment of cryptocurrency**

In March 2014, the IRS provided general guidance through Notice 2014-21\(^5\) to treat cryptocurrency as property for U.S. federal tax purposes. Thus, a taxpayer using cryptocurrency is required to calculate gain or loss based on the fair market value of cryptocurrency on the transaction date and the taxpayer’s basis in the currency. In the case of multiple transactions in a day, tracking fair market value on each cryptocurrency transaction and reporting gain can be burdensome for the taxpayer. Although, software such as Libra and Cointracking exist to help cryptocurrency users calculate gains/losses, simplifying the tax code by addressing common tax issues could be a helpful solution in the long term.

At present, a taxpayer purchasing goods and services using cryptocurrency is required to keep track of gains and losses and report them to the IRS. For example, every time a taxpayer buys a cup of coffee using a cryptocurrency, they need to calculate gain based on the fair market value as on that date and basis and report that gain or loss (assuming held for investment or business use) on Schedule D of Form 1040. This means a taxpayer using cryptocurrency for everyday transactions may have to complete many pages of Schedule D when filing their return.

Also, the current tax treatment of cryptocurrency allows taxpayers the flexibility to alter between an investor and a buyer holding cryptocurrency for personal use. Example: John bought 10 bitcoins with an initial intent to use for them for personal shopping, and subsequently bitcoin lost value. John decides to treat the purchase of bitcoins as an investment. If John sells these bitcoins at a loss, then John will get an advantage of deducting a capital loss on the tax return to the extent of capital gains and up to $3,000 of ordinary income. On the other hand, if John uses bitcoin for personal purpose, John won't get a deduction for the losses incurred, but gains are reportable.

\(3\) Bitcoin mining is a process of solving a mathematical algorithm to verify user transactions using specialized software on a powerful computer. The miner is rewarded with bitcoin as an incentive to approve the transaction and prevent double spending. Mining brings into circulation new bitcoins; thus, it can also be construed as a form of minting new bitcoins.

\(4\) Double spending arises when a digital currency is spent more than once. This risk is inherent to digital currency because it is easy to replicate a digital file and potentially re-use it for executing different transactions. Also see Sean Ross, “How does a blockchain prevent double-spending of Bitcoins?,” Investopedia available at https://www.investopedia.com/ask/answers/061915/how-does-block-chain-prevent-doublespending-bitcoins.asp.

Why there's a need to add an exception to the current law

In 2016, the IRS issued a John Doe summons\(^6\) to Coinbase Inc. seeking information on about 500,000 U.S. taxpayers, who had transactions in cryptocurrency during the period from 2013 through 2015. The IRS stated in the summons that Coinbase Inc. served 5.9 million customers in the U.S. with $6 billion in transactions and only 800 to 900 taxpayers reported bitcoin gains on their tax return, thus, implying that a substantial number of taxpayers failed to report or under-reported their income.

Initially, Coinbase Inc. resisted sharing a large volume of data in order to protect the privacy rights of its customers. However, after further negotiations and litigation, the IRS narrowed the summons to specific types of information about accounts “with at least the equivalent of $20,000 in any one transaction type (buy, sell, send, or receive) in any one year during the 2013-2015 period.”

On February 2018, Coinbase Inc.\(^7\) notified 13,000 customers about sharing their details with the IRS. It’s interesting to observe that, out of 500,000 Coinbase Inc.’s customers only 13,000 customers had aggregate transactions of $20,000 in a year and therefore, a reasonable assumption can be made that most of the users may not be undertaking high-value transactions. Thus, the requirement of the IRS to report gain for every transaction is burdensome for many taxpayers and may result in small gains and losses.

The Proposed Law Change

“The Cryptocurrency Tax Fairness Act”\(^8\) (H.R.3708) introduced by Rep. Jared Polis and Rep. David Schweikert on September 7, 2017, proposes to exclude from gross income de minimis gains on sale or exchange of cryptocurrency transactions below $600 for other than cash or cash equivalents. The sales or exchanges which are part of the same transaction or a series of related transactions is to be treated as one sale or exchange. The proposal also mentions that the dollar amount of gain to be excluded would be adjusted annually for inflation.

This bill aims to encourage the use of new cryptocurrency technology in small day to day transactions by providing relief to taxpayers from reporting requirements of any gain or loss on such transactions.

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Principles of Good Tax Policy

The following section analyzes H.R. 3708 using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.9

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
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<tbody>
<tr>
<td><em>Equity and Fairness</em> – Are similarly situated taxpayers taxed similarly? Also, consider any different effects based on an individual's income level and where they live.</td>
<td>This proposal is fair for the users of cryptocurrency because the amount of exclusion is not based on the taxpayer’s income level. However, a high-income taxpayer may get a greater benefit than a low-income taxpayer because of the likelihood of owning more cryptocurrency.</td>
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<td><em>Horizontal Equity</em> - It establishes the principle that taxpayers with equal ability to pay will pay the same amount of tax.</td>
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<td>In Notice 2014-2110, the IRS has stated that cryptocurrency is a ‘property’ and therefore any gain/loss arising on the use of cryptocurrency as an investment or for a personal purpose shall be treated as a capital gain/loss. Cryptocurrency can serve as a medium of exchange if a seller and buyer agree to accept cryptocurrency in lieu of a traditional currency such as US dollar.</td>
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<td>This proposal treats the users of a cryptocurrency irrespective of their income level by allowing the exclusion of gains on sale or exchange transaction below $600.</td>
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<td><em>Vertical Equity</em> - It establishes the principle that taxpayers with greater ability to pay will pay more tax.</td>
<td>Its more likely that a low-income taxpayer owns a lesser amount of cryptocurrency than a high-income taxpayer. Excluding gains on cryptocurrency transactions below $600 as per this proposal would be beneficial for a low-income taxpayer as it will reduce the tax compliance burden for these taxpayers.</td>
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In case of a high-income taxpayer, this proposal would be less burdensome as they invariably fall under the mandatory tax compliance category. Thus, this proposal satisfies the equity and fairness principle by considering an individual’s income level and by treating similarly situated taxpayer similarly.

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<tr>
<th>Certainty — Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?</th>
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<tr>
<td>The proposal clearly states to exclude from the gross income, gains from sale or exchange transactions of cryptocurrency below $600 for other than cash or cash equivalents. It further states that all sales or exchanges which are part of same transaction (or a series of related transactions) would be treated as one sale or exchange. A taxpayer entering into a sale or exchange of transaction involving a cryptocurrency can reasonably estimate the tax liability they might owe by excluding transactions below $600. Also, this proposal does not impact the timing and the method of tax payment. Hence, the proposal meets all the aspects of the principle of certainty.</td>
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<th>The convenience of payment — is the tax due at a time that is convenient for the payor?</th>
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<tr>
<td>This proposal allows a taxpayer using cryptocurrency in a sale or exchange transaction to plan their tax liability by allowing them to restrict the amount involved in each transaction in a taxable year. Taxpayer entering into transactions below $600 will not pay any tax. This proposal makes it convenient for the taxpayer to control their tax liability and gives them an opportunity for tax planning. Thus, it meets the principle of the convenience of payment.</td>
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<tr>
<th>Effective Tax Administration — Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also, consider the time needed to implement this tax or change.</th>
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<tr>
<td>For the IRS, implementing this proposal would eliminate the cost of policing taxpayers failing to report or under-reporting gains on sale or exchange of cryptocurrency transaction below $600 for other than cash or cash equivalents. It also allows the IRS to divert its resources on tracing cryptocurrency transactions involving large amount. For a taxpayer using cryptocurrency, this proposal would eliminate the requirement of tracking gains every time they enter into a micro transaction such as buying a bedsheets or a cup of coffee. Thus, implementing this proposal will satisfy the effective tax administration principle, costs of administration for</td>
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</table>
government and minimize the cost of compliance for taxpayers using cryptocurrency.

| Information Security – Will taxpayer’s information be protected from both unintended and improper disclosure? | Using a cryptocurrency has inherent risks of hacking because of its digital nature. The private key controls a user’s wallet and if the private key is leaked or lost, the cryptocurrency in the user’s wallet is gone forever resulting in financial loss to the user. A user can store cryptocurrency in a wallet hosted by a third party such as exchange or on the user’s computer. If the user’s wallet is hosted by an exchange, the private key is stored with the exchange and can be vulnerable to hacking. However, storing the private keys on the user’s own computer does not necessarily protect the private key from hacking as it can be easily stolen if the computer is not secured. Storing codes on one’s own computer has additional risks such as poor memory, loss of private key or technical glitch in the hard drive. Once the taxpayer’s wallet is compromised, it cannot be compensated or blocked, unlike credit cards.

This proposal does not require a taxpayer to report any sensitive information subject to information security risks such as their private key. Hence, this proposal does not have any effect on the principle of information security. |
| Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner? | Taxpayers using cryptocurrency for a day to day purchases will not have to bother reporting taxable gains on sale or exchange transactions below $600, which is simple and easy to understand the rule.

However, the proposal also states that all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange. The proposal, however, has not defined the meaning of a ‘related transaction’. This makes it unclear as to what can be construed as a related transaction. For example- X bought two pieces of furniture using cryptocurrency worth $ 599 each from Overstock.com on the same day but at different point of time, so would that count as one single related transaction or two separate transactions? The proposal is ambiguous and therefore |

the taxpayer may have to maintain a detailed record for each transaction involving cryptocurrency. Thus, this proposal lacks clarity and violates the principle of simplicity to a certain extent.

<table>
<thead>
<tr>
<th><strong>Neutrality</strong> - The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</th>
<th>The proposed law would influence a taxpayer’s decision of using cryptocurrency over a credit card or debit card. Credit cards involve third-party authorization such as banks, and personal information such as users name, address and credit card number are required to be shared with third parties to process transactions. These third parties also tend to sell users personal data to companies involved in push marketing. Cryptocurrency transactions involve sharing of alphanumeric codes, which are recorded on an encrypted robust network called the blockchain. The buyer and seller transact using wallet address without disclosing any personal details. This proposal will encourage taxpayers with highly appreciated cryptocurrency to use it for the purchases and proactively restrict the transaction amount to $600 in a tax year. Hence, implementing this proposal will have a significant impact on the taxpayer’s decision and behavior.</th>
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<tr>
<th><strong>Economic growth and efficiency</strong> – will the tax unduly impede or reduce the productive capacity of the economy?</th>
<th>This proposal will satisfy the economic growth and efficiency principle. Taxpayers willing to pay for goods and services using cryptocurrency will encourage small businesses to accept cryptocurrency. It will help them cut down credit card transaction processing fees, thereby boosting profits. The increased liquidity would encourage small businesses to grow or diversify their businesses.</th>
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<tr>
<th><strong>Transparency and Visibility</strong> – Will taxpayers know that the tax exists and how and when it is applied?</th>
<th>This proposal satisfies the transparency and visibility principle. Currently, cryptocurrency exchange such as Coinbase Inc.(^\text{12}) is spreading awareness and educating taxpayer</th>
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<tr>
<th>Question</th>
<th>Answer</th>
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<tr>
<td>imposed upon them and others?</td>
<td>about the current tax treatment of cryptocurrency by the IRS. The proposed law will also be visible to the users of a cryptocurrency through media platforms such as blogs, dedicated cryptocurrency websites such as coindesk.com.</td>
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<td><strong>Minimum tax gap</strong> – is the likelihood of intentional and unintentional non-compliance likely to be low? Is there any way people may intentionally or unintentionally avoid or evade this tax or rule?</td>
<td>The current law treats cryptocurrency as a property, and any gain made on the personal transaction using cryptocurrency is taxable as a capital gain. To calculate gain, a user must keep track of the basis of cryptocurrency and report income on Form 1040. This is a time-consuming activity especially when a taxpayer enters into multiple small transactions in a year. Also, it may be possible that an existing taxpayer using cryptocurrency in small transactions has not been reporting the gains on their Form 1040. This was the main concern of the IRS at the time of issuing a John Doe summons(^\text{13}) when only 800-900 people reported gains on cryptocurrency between 2013-2015. Taxpayers using cryptocurrency for small transactions will be able to do tax planning and minimize their tax liability by ensuring that the sale or exchange transaction amount remains below $600. This is a favorable proposal for the people who intentionally or unintentionally avoid paying tax.</td>
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<tr>
<td><strong>Accountability to taxpayers</strong> – Do taxpayers have access to information on tax laws and their development, modification, and purpose; is the information visible?</td>
<td>Cryptocurrency is an internet currency, and because of its growing popularity and price volatility, it has attracted the attention of media and news channels across the globe. Taxpayers are made aware of the tax consequences of bitcoin transactions by the exchanges such as Coinbase Inc., industry experts, and think tanks. Thus, educating taxpayers about the proposed law should be easy and effortless.</td>
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<tr>
<td><strong>Appropriate government revenues</strong> – will the government be able to determine how much tax</td>
<td>The proposed law allows to exclude from gross income <em>de minimis</em> gains on sale or exchange of cryptocurrency transactions below $600 for other than cash or cash equivalents as compared to the current tax law of imposing a tax on every penny gain on the cryptocurrency whether or not used for personal purpose. The</td>
</tr>
</tbody>
</table>

revenue will likely be collected and when?
government will lose revenue if this proposal is to be implemented.
Currently, cryptocurrency as an alternate payment method is still at a nascent stage. The government can possibly estimate the loss to the revenue with the help of advanced technology. The IRS has contracted with Chainalysis Inc. to provide a cryptocurrency tracking software. This software is intended to analyze transactions in a digital wallet, identify money laundering activities and expose tax evaders.
Similar software could be of value to determine the impact of this proposal on the revenue figures by tracking user spending on cryptocurrency transactions.
Thus, estimating the loss to the revenue could be a challenge given the fact that cryptocurrency is still at an evolving stage as an alternate method of payment.

Summary
H.R.3708 (115th Congress) satisfies eight out of twelve principles of good tax policy. It is simple and easy to understand without involving any complex calculations. At present, recordkeeping and calculating gains on every cryptocurrency transaction can be burdensome for a taxpayer. Further, reporting these everyday transactions on Schedule D of Form 1040 is a time-consuming task. This proposal will reduce the taxpayer’s compliance costs and ensure that the taxpayer does not have to worry about taxes when buying a bedsheet or a cup of coffee.

This proposal would equally benefit the IRS in terms of policing taxpayers evading taxes or under-reporting income. The IRS will be able to focus its resources more efficiently to other high-value cryptocurrency transactions.

However, lawmakers also need to take into consideration the intention of a taxpayer in buying a cryptocurrency. It may happen that a taxpayer bought cryptocurrency with an initial intention of investment but subsequently decides to use it for personal purposes. In such a case, the taxpayer would prefer to keep the sale or exchange transactions amount below $600, rather than pay tax on the gains after selling the cryptocurrency on an exchange and reporting it as ordinary income.

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Considering the price volatility of bitcoin, the intention of a taxpayer plays a crucial role in ensuring that a cryptocurrency user does not use this proposal as a tax avoidance mechanism. The AICPA and cryptocurrency experts have consistently mentioned in their articles and comment that the IRS needs to provide a de minimis provision to facilitate taxpayers using cryptocurrency.

H.R.3708 supports taxpayers who wish to use cryptocurrency in lieu of a traditional currency for personal consumption purposes. By providing a de minimis exemption to exclude capital gains from gross income on sale or exchange transaction not exceeding $600 would highly benefit taxpayer in terms of time and costs in maintaining records and reporting it to the IRS. This bill also supports new technology and innovation, and it can also be viewed as a tool to promote economic growth and efficiency.

Acknowledgement

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15 The price of bitcoin is highly volatile and has fluctuated from 7 cents on August 16, 2010, to $19343 on December 16, 2017. See Bitcoin Price History Chart available at https://www.buyBitcoinworldwide.com/price/.
