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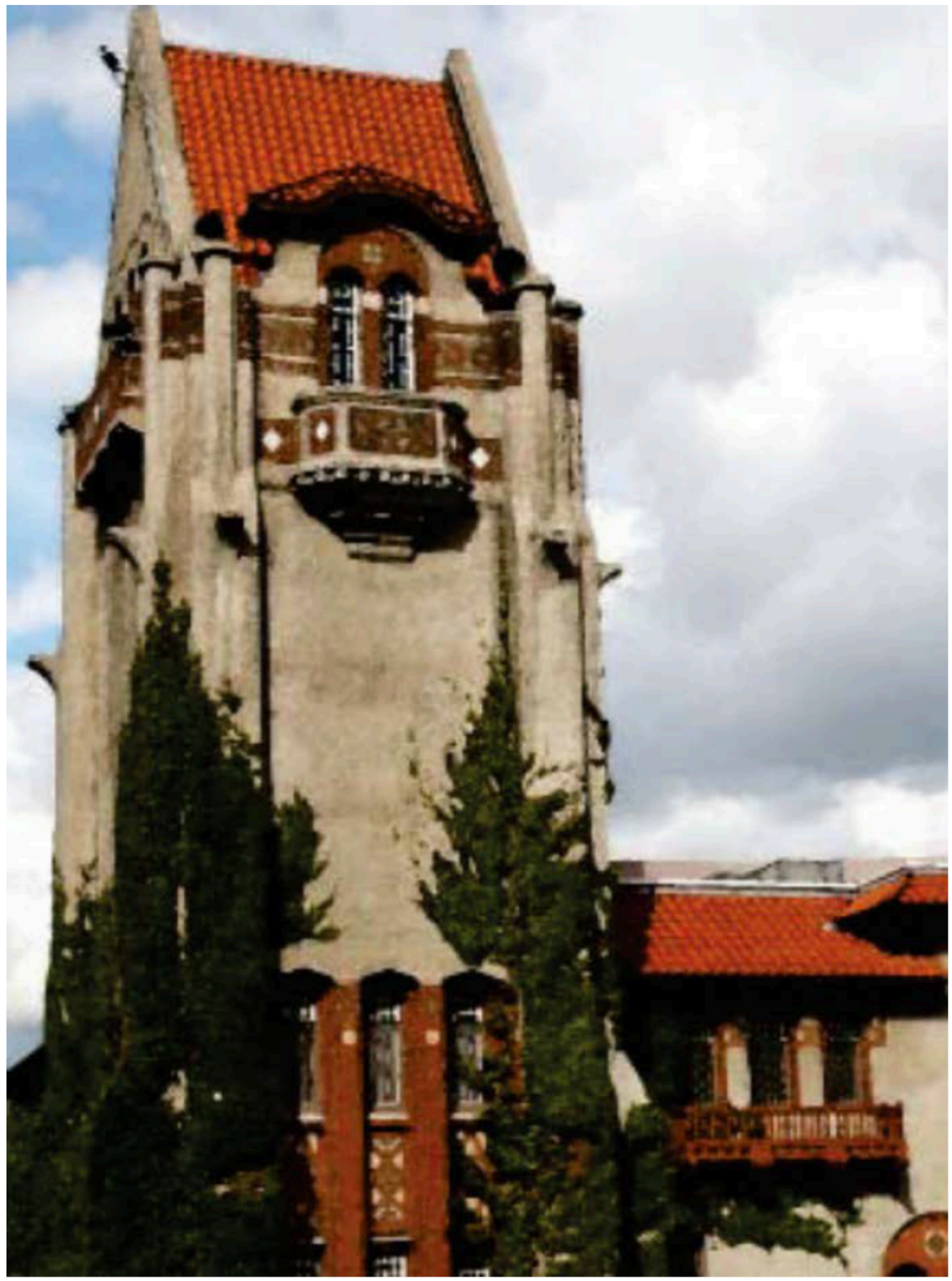

The Contemporary Tax Journal Summer 2019

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FOCUS ON TAX POLICY

Letter from the Editor

We are excited to present to you the Summer 2019 issue of *The Contemporary Tax Journal*, a publication of San Jose State University's MST Program.

In *Featured Contributors,* we have the iconic sales tax case of 2018 South Dakota v. Wayfair: Analysis and State Reactions by Mr. Andrew Wasilick and Dr. Dan L. Schisler.

Inna Ostrovsky, MST student, helps us understand Section 1400Z on the Qualified Opportunity Zones introduced by the Tax Cuts and Jobs Act, 2017 in the *Tax Enlightenment* section.

Next the *Tax Feature* section presents summaries written by my fellow MST students for selected sections of the 34th Annual TEI-SJSU High Tech Tax Institute held in November 2018 and the 7th Annual IRS SJSU Small Business Tax Institute held in May 2019. The topics covered in this section include fringe benefits, executive compensation, cryptocurrency, rental of residences and TCJA caution and reminders.

Our Tax Maven for this issue of our journal is Ms. Claudia Hill, EA, President of TaxMam Inc. for over 40 years. I was honored to have interviewed her and learn about her remarkable career and experiences. It was a fascinating experience for me, and I hope her words inspire you as well.

An interesting section, *Fun Tax Facts*, was introduced in the previous issue by Rachana Khandelwal, MST. Rachana has been very generous to contribute fun tax facts for this issue as well.

We have CPA practice questions from Roger CPA Review for all those who are preparing for the CPA exams. We thank Roger CPA for helping our CPA aspirants with practice questions.
Finally, *A Focus on Tax Policy* presents the analysis of the tax bill S. 3364, First-Time Home Buyer Credit by Langzun (Edward) Li, MST Student. The SJSU MST Program and its Tax Policy Capstone class focuses on the essence of tax rules and analysis. In the midst of understanding the new tax reform, I encourage you to assess and understand these tax policies with professionalism, objectivity, and context.

I want to thank all the contributors of this issue and fellow MST students. As my journey with the MST program is nearing an end, I want to extend a big thank you to Professor Annette Nellen for her invaluable contributions to the journal and for being an inspiration to me in numerous ways, always ensuring that her students get ready for the ever changing tax world, once they graduate from the MST program.

Now presenting to you, the Summer 2019 issue of *The Contemporary Tax Journal*.

Regards,
Surbhi Doshi
Student Editor

South Dakota v. Wayfair: Analysis and State Reaction

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Introduction

In 2018, the Supreme Court (the "Court") issued an opinion that addressed the ability of states to force out-of-state businesses to collect and remit state sales tax. The Court in *South Dakota v. Wayfair*[1] ("*Wayfair*") reanalyzed whether the "Physical Presence Test" (the "PPT") was the proper way to determine if the taxing state had nexus over the out of state business. The PPT, which was established in *National Bellas Hess, Inc. v. Department of Revenue of Ill.*,[2] ("*Bellas Hess*"), and reaffirmed in *Quill Corp. v. North Dakota*,[3] ("*Quill*") had been the test to determine nexus for over fifty years. The Court in *Wayfair* rejected the PPT, expressly overruling *Bellas Hess* and *Quill*.[4] The decision in *Wayfair* held that South Dakota's tax law was not a violation of the Commerce Clause and, therefore, could require out-of-state businesses to collect sales tax.[5]

The legal issues presented in *Wayfair* contained elements of stare decisis,[6] the Dormant Commerce Clause,[7] and tax policy implications. Many non-tax experts were also awaiting the *Wayfair* decision because the outcome would affect large businesses, small businesses, traditional "brick and mortar businesses," online businesses, and consumers. The interest in the

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* I would like to thank Kathleen DeLaney Thomas for her helpful comments and review of this paper.
[1] 138 S. Ct. 2080, 585 U.S. ___ (2018).
[2] 386 U.S. 753 (1967).
[3] 504 U.S. 298 (1992).
[4] *Wayfair*, 138 S. Ct. at 10.
[5] *Id.* at 22.
[6] Stare decisis a legal term meaning "to stand by things decided." *Stare Decisis*, LEG. INFO. INST., https://www.law.cornell.edu/wex/stare_decisis#. "Simply put, it binds courts to follow legal precedents set by previous decisions. *Stare Decisis Definition*, INVESTOPEDIA (May 9, 2019), https://www.investopedia.com/terms/s/stare_decisis.asp.
[7] The Dormant Commerce Clause is a "prohibit[ion] [on] States from discriminating against or imposing excessive burdens on interstate commerce without congressional approval . . . ." Comptroller of the Treasury of Md. v. Wynne, 135 S. Ct. 1787, 1794 (2015).

case from both experts and non-experts has brought a flurry of media reports and analysis about the impact of *Wayfair* on national commerce.[8]

This paper will proceed in three parts. Part I will address the Court's precedent pre-*Wayfair*. Part II will analyze the decision in *Wayfair*. Part III will address the implications of the new *economic activity standard* and the effects on national commerce post-*Wayfair*. This part includes the various state legislative actions in reaction to the *Wayfair* decision.

Part I: Pre-Wayfair

Under the widely accepted framework established in *Complete Auto Transit, Inc. v. Brady*,[9] a state "may tax exclusively interstate commerce so long as the tax does not create any effect forbidden by the Commerce Clause."[10] This is because the Commerce Clause, by granting power to the federal government to regulate interstate commerce, takes away or reduces that power from the states.[11] This limit, known as the Dormant Commerce Clause, prevents states from interfering with interstate commerce because only Congress has the power to regulate this activity.[12] In *Complete Auto*, a tax will be enforced if it "(1) applies to an activity with a substantial nexus with the taxing state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to services the state provides."[13] Whether a state can force an out-of-state company to collect and remit state sales tax turns on whether there is enough nexus between the out-of-state business and the taxing state.

The Court first answered the out-of-state company sales tax issue in in *Bellas Hess*.[14] In *Bellas Hess*, Illinois had passed a statute that required out-of-state retailers to collect and submit Illinois state sales tax.[15] Illinois attempted to enforce this statute on National Bellas Hess, Inc., a mail order company, "whose only connection with [the] customers in [Illinois]

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[8] *See e.g.*, Joseph Bishop-Henchman, *Supreme Court agrees to take* South Dakota v. Wayfair *Online Sales Tax Case*, Tax Found. (Jan. 12, 2018), https://taxfoundation.org/supreme-court-south-dakota-wayfair-online-sales-tax/ (describing this case as "pivotal decision" on "online retail activity"); Scott Peterson, South Dakota v. Wayfair*: What the Supreme Court Decision Means for Online Retailers*, CPA PRAC. ADVISOR (Apr. 16, 2018), https://www.cpapracticeadvisor.com/small-business/news/12408049/south-dakota-v-wayfair-what-the-supreme-court-decision-means-for-online-retailers (describing the potential impacts of the *Wayfair* decision depending on the outcome of the case). Some academics have already begun an in-depth analysis of what this case means. *See generally,* Leading Cases, *Article I—Stare Decisis for Constitutional Default Rules—Dormant Commerce Clause—* South Dakota v. Wayfair, Inc., 132 HARV. L. REV. 277 (2019) (describing the effect on the Dormant Commerce Clause).

[9] 430 U.S. 274 (1977).

[10] *Id.* at 285.

[11] *Quill*, 504 U.S. at 309.

[12] *Id.*

[13] South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2091 (2018) (citing *Complete Auto*, 430 U.S. at 279).

[14] It is important to note, that this was a separate issue from whether states could collect sales tax on goods sold in the state. It is undisputed that states have this ability.

[15] *Bellas Hess*, 386 U.S. at 754–55.

[was] by common carrier or the United States mail."[16] Bellas Hess challenged the statute as a violation of the Commerce Clause.[17]

The Court began its analysis by stating that "the Constitution required 'some definite link, some minimum connection, between a state and the person, property, or transaction it seeks to tax.'"[18] The Court stated that it is well established that, under certain circumstances, states can require out-of-state businesses to collect local taxes.[19] All of the examples from past precedent, however, involved some connection within the state itself, such as having an agent in the state or having physical presence in the state.[20]

The Court went on to state that the transaction in *Bellas Hess* was almost exclusively interstate commerce.[21] The Court followed by stating a parade-of-horribles if Illinois were allowed to impose this liability on out-of-state businesses.[22] This included the possibility of burdening interstate commerce.[23] This led the Court to conclude that the Commerce Clause was intended to prevent this type of unjustifiable local entanglement.[24] The dissent pointed out that Bellas Hess's "large-scale, systematic, continuous solicitation and exploitation of Illinois consumer market is a sufficient 'nexus' to require Bellas Hess to collect from Illinois customers and to remit the use tax."[25] Despite the dissent, the Court determined that some sort of physical presence was needed to establish nexus in order for a state to require an out-of-state business to collect its sales tax, thus creating the PPT.

In 1992, the Court decided to reexamine the PPT established in *Bellas Hess*. Despite the "tremendous social, economic, commercial, and legal innovations" since *Bellas Hess* was decided, the Court reaffirmed the PPT based on the Commerce Clause.[26] The Court in *Quill* held that a state's attempt "to require an out-of-state mail-order house that has neither outlets nor sales representatives in the State to collect and pay a use tax on goods purchased for use within the state" was a violation of the Commerce Clause.[27] The Court stated that similar to *Bellas*

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[16] *Id.* at 758.
[17] *Id.* at 757. Bellas Hess also challenged the tax on Due Process grounds. *Id.* Though this was initially held as valid, *Id.* 758, this argument was overturned in *Quill. Quill*, 504 U.S. at 307–08, 317–18.
[18] *Bellas Hess*, 386 U.S. at 756.
[19] *Id.* at 757
[20] *Id.* The Court's examples included: sales made by a local agent, mail-order business with a local retail store, and an out-of-state retailer with an instate collections agent. *Id.*
[21] *Id.* at 759.
[22] *Id.* ("For if Illinois can impose such burdens, so can every other State, and so, indeed, can every municipality, every school district, and every other political subdivision throughout the Nation with power to impose sales and use taxes.").
[23] *Id.*
[24] *Id.* at 760.
[25] *Id.* at 761–62 (Fortas, J., dissenting)
[26] Quill Corp. v. North Dakota, 504 U.S. 298, 301 (1992). Previously in *Bellas Hess*, the Court had stated that minimum contracts within the state was required by both the Commerce Clause and the Due Process Clause. *Bellas Hess*, 386 U.S. at 758. *Quill* overruled the due process holding, but reaffirmed the commerce clause PPT holding. *Quill*, 504 U.S. at 307–308.
[27] *Quill*, 504 U.S. at 301.

Hess, here the lack of physical presence prevents the completion of the "nexus" prong of the *Complete Auto* test.[28] The Court did recognize that the PPT, like all bright line rules, can be "artificial it its edges . . . [but] it encourages settled expectations and, in doing so, fosters investment by business and individuals."[29] Even though the Court believed its analysis was in line with the Commerce Clause, the Court also relied heavily on stare decisis in order to not overrule *Bellas Hess*.[30]

One important note is that the part of the *Quill* opinion that discussed the Commerce Clause—which was at issue in *Wayfair*—received only five votes on the merits. Justice Scalia, joined by Justices Kennedy and Thomas, would have upheld *Bellas Hess* on stare decisis alone.[31] Justice White, dissenting in part, argued that "there is no relationship between the physical-presence/nexus rule the Court retains and Commerce Clause considerations that allegedly justify it."[32] These two cases show that the Court created the PPT to determine nexus and reaffirmed that decision a generation later. These rulings had a substantial effect on commerce throughout the United States.

The PPT was a critical factor to the increased popularity of online commerce.[33] Unlike brick and mortar business, online businesses were not required to collect sales tax except for states in which they had a physical presence.[34] By lowering the cost related to the administration of collecting sales tax, online business could offer items and services at a lower cost.[35] This, along with the added convenience of online commerce, gave online business a

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[28] *See id.* at 310.
[29] *Id.* at 315–16.
[30] *Id.* 318.
[31] *Id.* at 320 (J. Scalia concurring).
[32] South Dakota v. Wayfair, Inc., 138 S. Ct. 2080, 2092 (2018) (quoting *Quill*, 504 U.S. at 327).
[33] Matthew C. Boch, *Way(un)fair? United States Supreme Court Decision Ends State Tax Physical Presence Nexus Test*, 53-SUM Ark. Law 18, 1 (2018).
[34] *Id.* For example, if an online company was based in North Carolina, they could be required to collect and remit North Carolina sales tax; but, they could not be required to collect and remit sales tax to any other state unless they had a physical presence in that state such as a warehouse or salesman. The Court in *Wayfair* gives the following example of the taxation of business under the *Bellas Hess* and *Quill* regime:

> "Consider, for example, two businesses that sell furniture online. The first stocks a few items of inventory in a small warehouse in North Sioux City, South Dakota. The second uses a major warehouse just across the border in South Sioux City, Nebraska, and maintains a sophisticated website with virtual showroom accessible in every State, including South Dakota. By reason of its physical presence, the first business must collect and remit a tax on all of its sales to customers of south Dakota, even though sales that have nothing to do with the warehouse. . . . But under *Quill*, the second, hypothetical seller cannot be subject to the same tax for the sales of the same items made though a pervasive Internet presence."

Wayfair, 138 S. Ct. at 2094.
[35]

> "Relatively little is known about sales tax compliance costs, but some data are available from PriceWaterhouseCoopers (2007), which estimated that sales tax compliance costs were 13.5% of tax revenues for small retailers, 5.2% for medium retailers, and 2.2% for large retailers. Bruce and Fox (2013) find the vast majority of e-commerce firms are small, suggesting significant compliance costs,

distinct advantage over brick and mortar stores. Second, since businesses were rewarded for limiting their physical presence, many businesses made a purposeful business decision not to expand to brick and mortar locations.[36] Last, since the PPT prevented states from requiring out-of-state business from collecting the sales tax, it forced in-state-purchasers themselves to self-assess and pay a use tax.[37] This method of collecting sales tax is notoriously ineffective.[38] Many states have use tax lines on their state income tax returns for individuals but rarely do individuals actually self-assess and pay the tax,[39] and states have not made a serious effort to enforce the use tax.[40]

Though the PPT was firmly established as the law of the land, as another generation passed and national commerce continued to evolve, calls for another re-examination of the PPT began.

Part II: Wayfair

PPT has been the target of criticism since its formulation.[41] Over two decades later, as the economy continued to evolve, South Dakota decided to challenge *Bellas Hess* and *Quill*. South Dakota passed a statute (the "Act") requiring out-of-state businesses to collect and remit sales tax if they: (1) deliver more than $100,000 of services or goods into the state; or (2) complete 200 or more separate transactions in the state.[42] This provision would be enforced even if a business had no physical presence in the state.

South Dakota attempted to enforce this new Act on Wayfair, Inc., Newegg, Inc. and Overstock.com, Inc., companies that had over six billion dollars of revenue last year

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> though firms with over $1 million in sales account for about 57% of business-to-consumer e-commerce. PriceWaterhouseCoopers finds that local sales taxes raise costs further, with one jurisdiction increasing costs by 38.7% and two or more adding 70.7%."

David R. Agrawal & William F. Fox, *Taxes in an E-Commerce Generation*, 24 INT. TAX. PUB. FIN. 903, 910 (2017).

[36] *See Wayfair*, 138 S. Ct. at 2094.

[37] Boch, *supra* note 33, at 1.

[38] *Id.* The low compliance rate with report the use tax is well documented. *See e.g.,* Chana Joffee-Walt, *Most people Are Supposed to Pay This Tax. Almost Nobody Actually Pays It.*, NPR (Apr. 16, 2013), https://www.npr.org/sections/money/2013/04/16/177384487/most-people-are-supposed-to-pay-this-tax ("About 1.6 percent of taxpayers . . . actually pay the use tax."); Mike Maciag, *Use Tax Revenues: How Much Are States Not Collection?,* Governing (May 1, 2012), https://www.governing.com/blogs/by-the-numbers/state-use-tax-collection-revenues.html ("States have grown accustomed to expecting paltry participation rates. In California, for example, only 0.3 percent of 2009 income tax returns reported use tax, with an average of $202 per return.");

[39] Boch, *supra* note 33, at 1.

[40] *Id.*

[41] *Wayfair*, 138 S. Ct. at 2092 (quoting Direct Marketing Assn. v. Brohl, 814 F.3d 1129, 1148, 1150–51 (10th Cir. 2016)). The Court states other criticisms from tax experts in the opinion. *Id.*; *see also* A. LAFFER & D. ARDUIN, PRO-GROWTH TAX REFORM AND E-FAIRNESS 1, 4 (July 2013) (stating that the PPT creates an inefficient "online sales tax loophole); Hellerstein, Deconstructing the Debate Over State taxation of Electronic Commerce, 13 Harv. J.L. & Tech. 549, 553 (2000) (stating that the PPT is not necessary appropriate for a twenty-first century economy); Charles A. Rothfeld, *Quill: Confusing the Commerce Clause*, 56 Tax Notes 487, 488 (1992) (stating that the PPT is "premised on assumptions that are unfounded" and "riddled with internal inconsistencies").

[42] S. 106, 2016 Leg., 91 Sess. (S.D. 2016).

combined.[43] South Dakota filed a declaratory judgment to have the new Act enforced.[44] Wayfair and Overstock.com moved for summary judgment, arguing that the Act was unconstitutional.[45] It came as no surprise that all the lower courts granted summary judgment to the out-of-state businesses since the PPT was still the law of the land.[46] The Court granted certiorari to reconsider the PPT for a third time in fifty years.[47]

The Court delivered the opinion on June 21, 2018.[48] In a 5–4 decision, the Court decided to overrule *Bellas Hess* and *Quill*[49] and held that the Act allowed for substantial nexus.[50] The dissent stated that it would have reaffirmed *Quill* based on stare decisis. In this section the Court's opinion in *Wayfair* is analyzed specifically addressing: (1) the Court's criticism of the PPT; (2) the new standard created by the Court; and (3) the dissent's opinion.

A: Criticisms of the Physical Presence Test

Wayfair outlined three main criticisms of the PPT: (1) the PPT is not a proper measure for whether an activity has substantial nexus with a state; (2) the test creates market distortions; and (3) the test is arbitrary and formalistic, which is in tension with modern Commerce Clause precedent.[51]

For a state to be able to tax an activity, the tax must apply to an activity that has a substantial nexus with the taxing state.[52] The Court stated that modern day commerce involves a substantial amount of business that does not require physical presence within the state.[53] Companies now can reach purchasers in all fifty states with no physical presence with ease by setting up a simple website, where previously a business would need to have some physical presence, such as a sales person or store location, in every state to reach these same purchasers. Although companies have been selling remotely for decades—for example, by catalog—the ease of doing so has undoubtedly increased with the internet. Since physical presence is no longer a required in modern commerce, the Court concluded that, "[p]hysical presence is not necessary to create a substantial nexus."[54]

The Court's second criticism of the PPT is it created market distortions. As noted in *Quill*, "[i]f the Commerce Clause was intended to put businesses on an even playing field, the

[43] *Wayfair*, 138 S. Ct. at 2089.
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *See id.*
[48] *Id.* at 2087.
[49] *Id.* at 2092.
[50] *Id.* at 2099.
[51] *Id.* at 2092.
[52] *Id.* (quoting Complete Auto Transit, Inv. v. Brady, 430 US 274, 279 (1977)).
[53] *Id*. at 2093 (quoting Quill Corp. v. North Dakota, 505 U.S. 298, 308 (1992)) ("[I]t is an inescapable fact of modern commercial life that a substantial amount of business is transacted . . . [with no] need for physical presence within a State in which business is conducted.").
[54] *Id.*

[physical presence] rule is hardly a way to achieve that goal."[55] Local brick and mortar business were "at a competitive disadvantage relative to remote sellers."[56] In powerful language, the Court stated that the PPT has become "a judicially created tax shelter for businesses that decide to limit their physical presence and still sell their goods and services to a State's consumers."[57] This sentiment was also echoed by Justice Gorsuch in concurrence who quoted Justice White stating that "judges have no authority to construct a discriminatory 'tax shelter' like this."[58] The Court had created a rule that incentivizes business to avoid physical presence in multiple states, causing a lack of storefronts and employment centers that otherwise would be efficient or desirable.[59]

Last, the Court stated that since *Bellas Hess* and *Quill* were decided, the Court's Commerce Clause precedent has evolved to a case-by-case analysis, using a fact heavy approach to determine the outcome of a dispute, rather than arbitrary or formal test.[60] The Court demonstrated that the PPT arbitrarily treats two economically equal companies differently solely because one has a store front and one does not, which "makes no sense."[61] The modern Commerce Clause jurisprudents is grounded in "functional, marketplace dynamics."[62] Since the Commerce Clause no longer follows a strict arbitrary analysis, the Court indicates that states should be allowed to consider the realities of the modern day economy when enacting and enforcing its tax laws.[63]

These "market dynamics" are addressed throughout the opinion. The Court emphasizes that the modern economy is not tied to physical presence.[64] The internet allows retailers to be closer to customers, regardless if there is a storefront.[65] This artificial distinction has caused states to lose an estimated loss of up to thirty-three billion dollars a year in tax revenue.[66] As more customers shop online the amount of lost revenue is likely to increase. The amount of the lost revenue has already increased since *Quill* was decided, when states were losing only about three billion dollars per year.[67] Based on these three criticisms, the Court concluded that this

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[55] Quill Corp. v. North Dakota, 505 U.S. 298, 329 (1992).
[56] *Wayfair*, 138 S. Ct. at 2094.
[57] *Id.*
[58] *Id*. at 2100 (J. Gorsuch concurring) (quoting *Quill*, 505 U.S. at 329 (J. White concurring in part and dissenting in part)).
[59] *Id.* 2094 (majority opinion).
[60] *Id.*
[61] *Id.* ("Consider, for example, two businesses that sell furniture online. The first stocks a few items of inventory in a small warehouse in North Sioux City, South Dakota. The second uses a major warehouse just across the border in South Sioux City, Nebraska, and maintains a sophisticated website with a virtual showroom accessible in every State. including South Dakota, even those sales that have nothing to do with the warehouse. But under *Quill*, the second, hypothetical seller cannot be subject to the same tax for the sales of the same items made through a pervasive Internet presence. *This distinction simply makes no sense*." (emphasis added) (citations omitted)).
[62] *Id.*
[63] *Id.*
[64] *Id.*
[65] *Id.* at 2095.
[66] *Id.* at 2088.
[67] *Id.* at 2097.

hard to apply test[68] was no longer functional.[69] The Court explicitly overruled *Quill* and *Bellas Hess* because the PPT was "unsound" and based on incorrect interpretation of the Commerce Clause.[70]

B: The New Standard

With the PPT now overruled, the Court shifted its analysis to determine if the Act was a tax that applied to an activity that had a substantial nexus with the taxing state. The Court, in conclusory fashion, stated that based on economic and virtual contacts with the state, "nexus was *clearly* sufficient."[71] The Court thus created an "economy activity standard." The Court did not give a specific test, but rather stated that the Act is sufficient to establish nexus because in order for it to apply, an out-of-state business needs to sell over $100,000 of goods or services in South Dakota or engage in 200 or more separate transactions in South Dakota. By having this level of economic activity within South Dakota, the seller was conducting business in South Dakota, even if there was no physical presence in the state.[72]

Last, the Court indicated that several factors helped determine that the Act was not a violation of the Commerce Clause. First, the Court indicated that the Act itself provided safe harbors for those who only have limited transactions in South Dakota, preventing an out-of-state business from being subject to the Act for a single transaction. Second, South Dakota's sales tax structure is simple and straight forward.[73] The Court stated that since the South Dakota tax system would cause only a simple administrative burden, it would not be enough to negatively affect interstate commerce.[74]

The dissent, written by Chief Justice Roberts,[75] did not disagree with the reasoning of the majority.[76] Despite this, the dissent argued that *Quill* should not be overruled because of stare decisis principles.[77] The dissent stated that it is Congress, not the Court, that should be regulating this area of the law.[78] However, the dissenting justices never addressed that it was the Court itself that created the PPT. Despite the dissent's pleas, the majority replaced the PPT with a new economic activity standard.

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[68] The Court discusses briefly how this test at creation was supposed to be easy to apply, but it is now unworkable. *See id.*
[69] *See id* at 2099.
[70] *Id.*
[71] *Id.* (emphasis added).
[72] *Id.* ("This quantity of business could not have occurred unless the seller availed itself of the substantial privilege of carrying on business in South Dakota.").
[73] *See id.*
[74] *See id.*
[75] Justices Breyer, Sotomayor, and Kagan joined Chief Justice Roberts in dissent.
[76] *Wayfair*, 139 S. Ct. at 2101 (J. Roberts dissent) ("I agree that *Bellas Hess* was wrongly decided, for many of the reasons given by the Court.").
[77] *Id.* at 2102–03.
[78] *Id.* at 2104.

Part III: Implications

Since *Wayfair* was decided only recently, it is hard to determine what the concrete effects will be on national commerce. There are, however, several outcomes have either happened or probably with happen.

First, there is a likelihood that states will be able to increase their tax revenue. As indicated by the majority, states were losing up to thirty-three billion dollars every year because of the PPT.[79] By overruling the PPT, the Court intended for states to no longer be deprived of billions of dollars of tax revenue. This goal, however, may be harder to accomplish than the Court may have hoped.

While the PPT was used to determine if out-of-state business were required to collect and submit sales taxes, this did not mean that those transactions were never taxed. As stated above, if the out-of-state company could not be required to collect these taxes, the state could require the individual taxpayers within the state to pay a use tax. The Court noted that there are several practical issues with this collection process.[80] More importantly, the Court noted that compliance rates for this process are "notoriously low," even as low as four percent.[81]

The Court does not indicate that compliance rates will be much better without the PPT. Easy to find "super online companies," such as Amazon, were already paying state sales tax on items they sell directly because they already had a physical presence in many states.[82] In fact nineteen of the twenty largest online retailers already collected and submitted state sales tax.[83] These top ten retailers account for sixty-four percentage of online sales.[84] These facts indicate that states who pass new collection laws similar to South Dakota are going to have to enforce these provisions on smaller, out-of-state companies. For large online companies like Wayfair Inc., it will be easier for states to find and enforce the new provisions. It will be difficult, however, to find and enforce these statutes on businesses that are just over the statutory threshold. Despite these challenges, the United States Government Accountability Office estimated that states will be able to gain a total of $8–$13 billion from the expanded authority.[85] This indicates that states are not going to be able to recover all of their lost revenue, but they will likely be able to collect at least part of it.

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[79] *Id.* at 2088 (majority opinion).

[80] National Geographic Soc. v. California Bd. of Equalization, 430 U.S. 551, 55 (1977).

[81] *Wayfair*, 138 S. Ct. at 2088.

[82] Eugene Kim, *Why Amazon is the Winner of the Supreme Court Sales Tax Ruling*, CNBC (June 21, 2018), https://www.cnbc.com/2018/06/21/why-amazon-wins-with-supreme-court-sales-tax-ruling.html.

[83] Katherine Thibadeau & Simon Bord, *LII Supreme Court Bulletin:* South Dakota v. Wayfair, Inc. *Dormant Commerce Clause Sales Tax E-commerce Stare Decisis*, Cornell Law School (last visited November 15, 2018) https://www.law.cornell.edu/supct/cert/17-494#.

[84] *Id.*

[85] GAO Rpt No.18-114 (Nov. 2017).

Second, both the majority and dissenting opinions discussed the effect that *Wayfair* will have on interstate commerce. The majority opinion focused on how the PPT has negatively affected several types of business. The majority indicated that the PPT placed local business and interstate businesses that maintain a physical presence in multiple states at a disadvantage compared to remote businesses.[86] This is because out-of-state businesses are not required to submit sales tax, and therefore are able to offer lower prices.[87] The majority believed that this was a "judicially created tax shelter" for online businesses.[88] Justice Gorsuch in concurrence, quoting Justice White, stated "judges have no authority to construct a discriminatory 'tax shelter' like this."[89] Though tax incentives are not necessarily a bad thing, the Court implies that it should be Congress, not the Court, that create these tax incentives. The dissent seems to also agree with this point, but believes that this is the exact reason why the Court should not overrule the PPT.[90] The dissent believes that due to Congress's ability to approach this issue through a variety of ways it is better suited to handle this question, rather than the judiciary.[91]

Unlike the majority, the dissent describes the negative impact that will be created for online retailers as the basis for why the Court is not the correct branch of government to get rid of the PPT. The dissent, stating that the Constitution gives Congress the power to regulate commerce among the states, should allow Congress to determine if the PPT, a test that has "governed this area for half a century," should be disregarded.[92] While the majority focuses on what businesses were hurt by the PPT, the dissent indicated that PPT test has allowed e-commerce to thrive and become an important factor in the national commerce. The dissent pointed out that getting rid of the PPT rule will impose severe compliance costs on online retailers.[93] These compliance costs would fall to small businesses who would then have to navigate several thousand tax jurisdictions.[94]

The dissent stated several times the effect this decision will have on small businesses, at one-point stating that startup companies would fail if they have to navigate the tax code.[95] The dissent appears to gloss over that the majority strongly indicated that if the economic threshold required by a state's tax law begins requiring out-of-state businesses to collect sales tax is too low, it will be a violation of the Dormant Commerce Clause. This is because there will be no

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[86] *Wayfair*, 138 S. Ct. at 2093–94.
[87] *Id.* at 2094.
[88] *See id.* at 2100 (J. Gorsuch concurring).
[89] *Id.*
[90] *Id.* at 2104 (J. Roberts dissent).
[91] *Id.* ("A good reason to leave these matters to Congress is that legislatures may more directly consider the competing interests at stake. Unlike this Court, Congress has the flexibility to address these questions in a wide variety of ways. As we have said in other cases, Congress 'has the capacity to investigate and analyze facts beyond anything the Judiciary could match.").
[92] *Id.*
[93] *Id.* at 2103.
[94] *Id.* at 2104.
[95] *Id.*

substantial nexus with the taxing state on the activity being taxed.[96] The small startup that the dissent is concerned about would not have to worry about being taxed in a foreign jurisdiction unless they have constant sales to that area.

This leads into the next implication of *Wayfair*—how have states reacted? Many states are quickly moving to implement a statutory regime that will allow them to require out-of-state retailers to collect and submit sales tax.[97] Some states are implementing the same statutes as South Dakota, while others are implementing similar statutes, but with different economic thresholds.[98] Table 1 is a summary of the states' legislative enactment as of May 2019. Each individual state is listed in the Appendix.

Table 1
Summary of State Legislation
As of June 20, 2019

Sales $100,000 or 200 or more transactions (Same as South Dakota in *Wayfair)*	25 States
Sales Greater than $250,000 or 200 or more transactions	9 States
No Sales Tax	5 States
No Guidance	2 States
Other (five with Sales > $100,000)	10 States

As of June 20, 2019, twenty-five states have enacted sales tax standards exactly like the Act—$100,000 in Sales or over 200 transactions. That still leaves twenty-three states and Washington D.C. with a standard that differs from the Act. *Wayfair* did not give any principles for lower courts to rely on when analyzing if state statutes are only taxing activity in which an out-of-state business has substantial nexus with the taxing state. This unknown potential could create large levels of litigation for the states not conforming to the *Wayfair* standard. There are only five states that have enacted statutes with standards below the Act—$100,000 or 200 transaction— so, as of now, it appears that most states are taking the conservative approach by following *Wayfair* to the letter.

There is also a likelihood that some states will simplify their tax code. The Court indicated that a factor for finding sufficient nexus was that South Dakota's tax regime was a simplified structure with uniform rules.[99] Some states, however, do not have a simplified structure in place. This may require those states to simplify their tax structure for out-of-state businesses. Louisiana, for example, created the Louisiana Sales and Use Tax Commission for

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[96] *Id.* at 2099 (majority opinion) ("South Dakota's tax system includes several features that appear designed to prevent discrimination against or undue burdens upon interstate commerce.").
[97] Boch, *supra* note 33, at 2.
[98] *Id.*
[99] *Wayfair*, 138 S. Ct. at 2100.

Remote Sellers, which administers a simplified tax system for out-of-state sellers.[100] Louisiana businesses, however, continue to face the state's notoriously complex state and local sales tax system.[101]

Interestingly, both the majority and dissent indicate that states will take advantage of this newly granted power by enforcing statutes under the new economic activity standard. This assumption is made despite states notoriously under enforcing its use tax provisions in the past. One reason for this belief is if states are going through the trouble to enact new statutes that mirror South Dakota's Act or are creating new tax regimes, it would indicate that states are no longer going to under enforce these provisions like they have in the past. States, however, did, at one point, also go through the trouble of enacting its current under enforced provision so the same could hold true in this case. The Court's assumption, therefore, can only be based on the belief that since there are fewer businesses that would be subject to these new statutes, it will be easier to enforce them.

While states are creating these statutes, another question arises as to whether Congress will step in and regulate interstate commerce. As stated by Justice Gorsuch, Congress can regulate interstate commerce and "Article III courts may not invalidate state laws that offend no congressional statute."[102] Congress is still able to create a national rule for when states are able to force out-of-state retailers to collect and remit sales tax. A national rule created by Congress could ease the administrative burdens for small businesses that the dissent was worried about.

As noted by the Court, however, Congress has been unable to, or has chosen not to act in this area for over fifty years. The dissent gives several examples of recent pending legislation[103] and fears it will no longer be considered as a result of *Wayfair*. As noted by Justice Gorsuch, Congress is able to regulate interstate commerce. This legislation is still able to go into effect if it is the will of Congress. Overruling the judicially created PPT does not change this fact. It is true, however, that state officials are likely to focus on enacting a new tax structure that can raise state revenue from out-of-state businesses, rather than work with Congress on a national solution.[104] It may be an overstatement, however, to believe that Congressional

[100] Boch, *supra* note 33, at 2.
[101] *Id*. Louisiana has numerous exemptions and sales tax rates for different assets sold. *See generally, Taxable Rate of Transactions for Exemptions and Exclusions*, Louisiana Dept. Rev., http://revenue.louisiana.gov/Publications/R-1002(07-18).pdf. For example, Nonprofit electrical co-ops are subject to a 1% tax, while purchases for electric power and energy are subject to a 2% tax. *Id.* For an extensive list of exemptions and rates, see, id.
[102] *Wayfair*, 138 S. Ct. at 2100 (J. Gorusch concurring).
[103] Some of these are the Marketplace Fairness Act of 2017; Remote Transactions Parity Act of 2017; and No Regulation Without Representation Act
[104] *Wayfair*, 138 S. Ct. at 2103 (J. Roberts dissenting).

legislation is right around the corner when Congress has failed to act, or chosen not to act, for fifty years,[105] though nothing, including *Wayfair*, is preventing Congress from doing so.[106]

Last, there still remains the unanswered question about how third parties selling on an online retail platform are affected by *Wayfair*. For example, prior to this ruling, Amazon had not been required to collect sales tax from third party sellers, even though they use Amazon as a platform to sell products. Most of those sellers have not been required to collect and remit sales tax to other states. After *Wayfair*, it is unclear what the effect on these third parties will be going forward. It is not clear if the platform itself, like Amazon, could be required by states to collect and remit sales tax, even if the sale occurred through a third party. Several states including California have enacted marketplace facilitator rules that will require Amazon and similar facilitators to collect on behalf of the vendors whose products they sell.[107] Future litigation or federal legislation will likely be the only way to answer this question.

Conclusion

The Court decided to reexamine a fifty-year-old rule to determine if it still applicable in the modern economy. The Court determined that this archaic rule was outdated and decided to overrule the PPT. Rather than basing nexus on physical presence, the Court, looking at the economic activity required by the Act, assumed that 200 transactions or over $100,000 of goods or services sold was clearly enough to establish nexus with South Dakota. While *Wayfair* rids the Court's precedent of an out-of-date rule, it leaves little guiding principle for lower courts, states, and businesses to use when evaluating this holding.

The effects of this holding will have implications for national commerce. This will place out-of-state retailers on a level playing field with brick and mortar businesses, as well as small in state businesses. It will add compliance costs to mid-sized or large online retailers but will not affect small businesses that are under the economic thresholds set by states. Future litigation and legislation on both the federal and state level should be expected going forward to more fully develop this new economic activity standard set by the Court in *Wayfair*.

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[105] It should be noted that Congressional inaction may not be a sign of Congress not being able to pass legislation, but rather could be a sign of Congress agreeing with *Quill* and therefore has not needed to pass any legislation.
[106] One reason that may push Congress to Act is these large online retailers, along with small online retailers, may gain enough influence as the popularity of e-commerce continues to grow to lobby for a national standard to lower their compliance costs.
[107] *See e.g.,* Sophia Bollag, *New California Law Requires Amazon to Collect Sales Tax for Small Online Retailers*, SACRAMENTO BEE (Apr. 25, 2019), https://www.sacbee.com/news/politics-government/capitol-alert/article229699444.html.

Appendix
States and Sales Tax Rules**

	Rule	Effective
Alabama	Sales>$250,000	Oct. 1, 2018
Alaska	No State Sales Tax – State Level	n/a
Arizona	Transfer Privilege Tax Sales > $200,000	Oct. 1, 2019
Arkansas	Sales>$100,000 200 Transactions	July 1, 2019
California	Sales>$500,000	April 1, 2019
Colorado	Sales>$100,000	Dec 31, 2018 Grace Period 05/30/19
Connecticut	Sales>$250,000 200 Transactions	Dec 1, 2018
Delaware	No State Sales Tax	n/a
District of Colombia	Sales>$100,000 200 Transactions	Jan 1, 2019
Florida	No Guidance	No Guidance
Georgia	Sales>$250,000 200 Transactions ($100,000 as of Jan. 2020)	June 1, 2019
Hawaii	Sales>100,000 200 Transactions	July 1, 2018
Idaho	Sales > $100,000	July 1, 2018
Illinois	Sales>$100,000 200 Transactions	Oct 1, 2018
Indiana	Sales>100,000 200 Transactions	July 1, 2019
Iowa	Sales>$100,000 200 Transactions	Jan 1, 2019
Kansas	No Guidance	No Guidance
Kentucky	Sales>$100,000 200 Transactions	July 1, 2018
Louisiana	Sales>$100,000 200 Transactions	Jan 1, 2019
Maine	Sales>$100,000 200 Transactions	July 1, 2018
Maryland	Sales>$100,000 200 Transactions	Oct. 1, 2018
Massachusetts	Preceding year sales>$500,000 100 Transactions	Oct 1, 2017

Michigan	Sales>$100,000 200 Transactions	Oct 1, 2018
Minnesota	>100 sales shipped to MI ≥10 sales shipped to MI totaling >$100,000	Oct 1, 2018
Mississippi	Sales>$250,000	Sept 1, 2018
Missouri	Sales>$100,000 & 200 Transactions	Jan 1, 2020
Montana	No State Sales Tax	n/a
Nebraska	Sales>$100,000 200 Transactions	Jan 1, 2019
Nevada	Sales>$100,000 200 Transactions	Oct 1, 2018
New Hampshire	No State Sales Tax	n/a
New Jersey	Sales>$100,000 200 Transactions	Nov 1, 2018
New Mexico	Sales > $100,000	July 1, 2019
New York	Sales>$300,000 100 Transactions	June 1, 2019
North Carolina	Sales>$100,000 200 Transactions	Nov 1, 2018
North Dakota	Sales>$100,000 200 Transactions	Oct 1, 2018
Ohio	Sales>$500,000 was the threshold before Wayfair	Haven't offered any new guidance since Wayfair decision.
Oklahoma	Sales>$100,000	Nov. 1, 2019
Oregon	No State Sales Tax	n/a
Pennsylvania	Sales>$100,000	July 1, 2019
Rhode Island	Sales>$100,000 200 Transactions	July 1, 2019
South Carolina	Sales>$100,00	Nov 1, 2018
South Dakota	Sales>$100,000 200 Transactions	Nov 1, 2018
Tennessee	Sales > $500,000	Oct. 1, 2019
Texas	Sales>$500,000	Oct 1, 2019
Utah	Sales>$100,000 200 Transactions	Jan 1, 2019
Vermont	Sales>$100,000 200 Transactions	July 1, 2019
Virginia	Sales>$100,00 200 Transactions	July 1, 2019
Washington	Sales>$100,000	Oct. 1, 2018
West Virginia	Sales>$100,000 200 Transactions	Jan 1, 2019
Wisconsin	Sales>$100,000	Oct 1, 2018

	200 Transactions	
Wyoming	Sales>$100,000 200 Transactions	Feb. 1, 2019

** Source: Individual States' Department of Revenue website. Updated June 20, 2019.

Tax Enlightenment
Section 1400Z-2 - Special Rules for Capital Gains Invested in Opportunity Zones

By: Inna Ostrovsky, *MST Student*

Introduction

Occasionally, the U.S. government launches programs to stimulate the economy in high poverty, significant unemployment, and low-income areas through tax incentives. For example, the Omnibus Budget Reconciliation Act of 1993 introduced the Empowerment Zones and Enterprise Communities, and the Community Renewal Tax Relief Act of 2000 established the New Markets Tax Credit Program. A similar measure – The Opportunity Zone tax incentive – was introduced by the Tax Cut and Jobs Act of 2017 (TCJA) which added Sections 1400Z-1 and 1400Z-2. Section 1400Z-1 describes the designation of the opportunity zones while Section 1400Z-2 is the tax incentive rule, and it governs the treatment of the capital gains reinvested in the zones. The Opportunity Zone program provides benefit through the favorable treatment of capital gains. In general, if a taxpayer reinvests his capital gain in a business located in one of the specially designated economically-distressed areas, he may defer the recognition of that gain and eliminate a portion of that gain if a specific holding period requirement is met. Additionally, if the opportunity zone investment is held for more than ten years and then sold, the taxpayer can exclude the capital gain that represents the appreciation of the initial investment.

Although the general rule of Section 1400Z-2 can be summarized in a few sentences, it contains many details and nuances. As this paper is intended to summarize and explain the main rules related to the opportunity zone tax incentive, the Code sections and the proposed regulations will be used. However, note that the first set of proposed regulations were issued in 2018 and not yet finalized at the time this article was prepared.[1]

Explaining the General Rules and Definitions

As mentioned in the introduction, Section 1400Z-2 provides tax benefits through the favorable treatment of capital gains. Particularly, if a taxpayer has a capital gain (such as the gain from the sale of stock or real estate) and reinvests the proceeds within 180 days in a business located in special zones, she can defer the gain and exclude up to 15 percent of that capital gain (depending on the holding period). The election to defer the gain is made on Form 8949, Sales and Other Dispositions of Capital Assets, in the year the gain would otherwise be recognized. The deferred gain is eventually included in the income on either the date of the sale of interest or December 31, 2026, if not sold before that date. The reinvestment period is 180 days, the special zones are called qualified opportunity zones, and the qualified investment

[1] This article was written before the issuance of the second set of QOZ regulations on May 1, 2019 - REG-120186-18 (5/1/19).

is described as a qualified opportunity fund. These and other definitions are considered separately below.

- ***Eligible Taxpayer***: Section 1400Z-2 applies to individuals, C corporations, S corporations, partnerships, trusts, and estates. Prop. Reg. 1.1400Z2(a)-1 states that generally any taxpayer who can recognize a capital gain can use this special deferral rule.

- ***Eligible Gain***: Generally, any gain that is treated as capital gain for federal tax purposes is an eligible gain. However, there are three requirements. First, the gain would be recognized before January 1, 2027 in absence of Section 1400Z-2. Thus, the gain cannot be deferred under other sections on a date later than January 1, 2027 period.[2] Second, the eligible gain is not a gain generated by the transaction with a related party.[3] Under the rules of this section, related parties are the following: family members,[4] individual or corporation or individual and partnership with 20 percent interest in the corporation/partnership, two corporations which are members of the same controlled group, two partnerships in which the same persons directly or indirectly own more than 20 percent of the capital interest or profit, certain grantors and fiduciaries described in Section 267(a)(4)-(8), a person or organization to which Section 501 applies and which is controlled by this person or his family member, S corporation and S corporation (or S corporation and C corporation) with common ownership of more than 20 percent in value of outstanding stock, executor and beneficiary of the same estate.[5] The third requirement of the gain is that it should not have been already deferred under Sec.1400Z-2.[6] Thus, the same proceeds cannot be deferred twice. Also, in case the section was applied only to a portion of the qualified gain, only the remaining gain reinvested can be deferred.

  There is a special rule for Section 1256 contracts.[7] The eligible gain from these contracts is the net income amount calculated at the end of each tax year on an aggregate basis.[8] Thus, all gains and losses from Section 1256 contracts are netted at the end of the year, and the net amount is the eligible gain for deferral under Section 1400Z-2. The 180-day reinvestment period for Section 1256 contracts starts at the end of the tax year (The reinvestment period requirements will also be covered in a section below.) The gain from Section 1256 contracts is not eligible for deferral if during a taxable year any of the contracts were part of an offsetting-position transaction.[9] Under Prop. Reg. 1.1400Z2(a)-1(b)(2)(iv), "an offsetting-positions transaction is a transaction in which a taxpayer has substantially diminished the taxpayer's risk of loss from holding one position with respect to personal property by holding one or more other positions with respect to personal property (whether or not of the same kind)". For

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[2] Prop. Reg. 1.1400Z2(a)-1(b)(2).
[3] Section 1400Z-2(e)(2).
[4] Section 267(c)(4): The family of an individual shall include only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants.
[5] Section 267(b) and Section 707(b)(1).
[6] Prop. Reg. 1.1400Z2(a)-1(b)(2)(ii).
[7] Sec. 1256 contracts are any regulated future contracts, foreign currency contracts, dealer equity and nonequity options, dealer securities futures contracts that are treated as sold at its fair market value at the end of the tax year.
[8] Prop. Reg. 1.1400Z2(a)-1(b)(2)(iii).
[9] Prop. Reg. 1.1400Z2(a)-1(b)(2)(iii)(B).

example, a straddle transaction is a type of offsetting-position transaction for which the deferral of gain under Section 1400Z-2 is unavailable.

- ***Qualified Opportunity Funds and Qualified Opportunity Zone Property*: ** A Qualified Opportunity Fund (QOF) is a corporation or partnership organized for the purpose of investing in the qualified opportunity zone property (QOZP). An LLC may also be organized as a QOF if it chooses to be treated either as a partnership or corporation for federal tax purposes. To qualify as a QOF, the fund must contain 90 percent or more of its assets in QOZP calculated as an average percentage measured on the 6th and 12th months of the taxable year.[10] If a QOF fails to meet the 90 percent requirement, it will pay a penalty for each failed month in the amount equal to:

  *[(90% of assets - the amount of QOZP held by the fund) * underpayment rate for these months]*[11]

  If a QOF is a partnership, the penalty is distributed among partners in proportion to their interests in the partnership.[12] However, Section 1400Z-2(f)(3) forgives the penalty for companies if reasonable cause exists. Also, the proposed regulation requires that the entity must be organized in the United States to qualify as a QOF.[13] The entity, however, can be organized within any U.S. territory (thus, potentially outside of the 51 states), but in this case it must be organized as a company investing in QOZP that is located in the same U.S territory.

  There are three types of qualified opportunity zone property (QOZP): qualified opportunity zone stock, qualified opportunity zone partnership interest, and qualified opportunity zone business property.[14]

  a. *Qualified opportunity zone stock* is any stock in a domestic corporation that was acquired in exchange for cash by a QOF after December 31, 2017 at its original issue from a corporation which qualified as a QOZ business at the acquisition and during the entire holding period;
  b. *Qualified opportunity zone partnership* interest is any capital or profits interest in a domestic partnership that was acquired in exchange for cash by a QOF after December 31, 2017 at its original issue from a corporation which qualified as a QOZ business at the acquisition and during the entire holding period;
  c. *Qualified opportunity zone business property* (QOZBP) is any tangible property used in the trade or business of a QOF that was purchased after December 31, 2017 from an unrelated person. The newly acquired business property must be used in the trade or business of the QOF or the QOF must substantially improve the property during the entire holding period, and substantially all of the use of this property must be within a qualified

[10] Section 1400Z-2(d)(1).
[11] Section 1400Z-2(f)(1). Monthly underpayment rate is established by Sec. 6621(a)(2).
[12] Section 1400Z-2(f)(2).
[13] Prop. Reg. 1.1400Z2(d)-1(e).
[14] Section 1400Z-2(d)(2).

opportunity zone. For the property to be "substantially improved" for the purpose of Section 1400Z-2(d)(2)(D), the additions to the basis of the property must exceed its basis at the beginning of the 30-month period during any 30-month period beginning after the property was acquired That is, the improvement to the property must preponderate the asset's basis. If an asset that was previously claimed as a QOZBP fails to meet the definition of such property, it continues to be treated as a QOZBP for the lesser of (i) 5 years after the date the asset fails to meet the definition, or (ii) the date when the qualified opportunity zone business disposes of the asset.[15]

- ***Reinvestment Period***: In general, the 180-day period during which taxpayers have to reinvest their eligible capital gain in a qualified opportunity fund to qualify for Section 1400Z-2 treatment begins on the date of the sale (or exchange) that gives rise to that gain. Also, the proposed regulation adds that, "the 180-day period […] with respect to any eligible gain (180-day period) begins on the day on which the gain would be recognized for federal income tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of the gain".[16] For example, for sold stock, the 180-day period starts on the trade date, for dividends received by the RIC or REIT[17] shareholder the reinvestment period begins on the date the dividend is paid, and for deemed gains (such as undistributed capital gains that are required to be added in the shareholder's capital gains) the 180-day period starts on the last day of the taxable year of the company.[18] For partnership, S-corporation, trust, and estate, the 180-day period starts on the last day of the partnership's taxable year. However, if a partnership does not elect to defer its eligible gain, the partners may elect to defer their distributive share of that gain and treat their 180-day period the same as the period of the partnership. Alternatively, the partner's 180-day reinvestment period begins on the last day of the partnership's tax year.[19] For gains from Section 1256 contracts, the reinvestment period begins on the last day of the taxable year.[20] Additionally, under Prop. Reg. 1.1400Z2(a)-1(b)(4)(ii)(D), if a taxpayer defers a capital gain under Sec. 1400Z-2 but then later disposes of the entire interest, he may continue to defer the original gain if the new proceeds are reinvested in the same or another qualified opportunity fund during the 180-day period. Thus, the additional deferral of previously deferred gains is allowed.

- ***Basis Adjustments***: As mentioned above, the deferred gains are included in income on the earlier of December 31, 2026 or the date of the sale of the interest in a qualified opportunity fund. However, the law provides additional tax benefits related to the gain recognition in the case of an extended holding period of the interest. In particular, there are three possible tax incentives: interest's basis step-up for investments held for more than five years, more than seven years, or more than ten years.

[15] Section 1400Z-2(d)(3)(B).
[16] Prop. Reg. 1.1400Z2(a)-1(b)(4).
[17] RIC - Regulated Investment Company; REIT – Real Estate Investment Trust.
[18] Prop. Reg. 1.1400Z2(a)-1(b)(4)(ii), examples 1, 2 and 3.
[19] Prop. Reg. 1.1400Z-2(a)-1(c)(2)(iii).
[20] Prop. Reg. 1.1400Z2(a)-1(b)(2)(iii).

a. *For investments held for more than 5 years*, a taxpayer may adjust the basis of the interest by 10 percent.[21] This will reduce the gain of the taxpayer by 10 percent at the time the gain is included on the taxpayer's tax return. Note that due to the expiration of the opportunity fund tax incentive, to get the benefit of the 10 percent basis increase, the investment must be made no later than December 31, 2021.
b. *If the investment is held for more than 7 years,* the taxpayer may increase the basis in the investment by a total of 15 percent (thus, an additional 5 percent after the 5-year holding period adjustment).[22] Note that in order to be able to increase the basis by 15 percent, the qualified opportunity fund interest must be acquired no later than December 31, 2019.
c. *The basis of investment that is held for more than 10 years* is equal to the fair market value of the investment at the date it was sold (exchanged).[23] That is, if an investment is held for more than ten years, capital gain on the appreciation of the QOF investment is permanently excluded. For example, a taxpayer generates a capital gain but decides to defer its recognition under Section 1400Z-2. He reinvests the gain by acquiring the interest in a qualified opportunity fund within the 180-day period in 2019 and holds the interest for ten years. On December 31, 2026, despite still possessing the interest, the taxpayer recognizes the gain but may increase the basis in the interest by 15 percent as the holding period is seven years. However, if the taxpayer sells the interest in 2029 meeting the 10-year holding period requirement, he has no additional tax liability related to the sale (or exchange) of the interest. So, the appreciation in the value of the interest after 2026 becomes tax-free.

Example: Jane has stock with basis of $20 and she sells it for $100 realizing an $80 gain. In June of 2019, within 180 days of selling the stock, she reinvests the $80 gain in a QOF and does not pay tax on the gain as she elects to defer it under the QOF rules. Her initial basis in the investment is $0. In June 2024, after holding the investment for five years, Jane's basis in the investment is increased to $8 (10% x $80 of the deferred gain). By June 2026, she has held the investment for at least seven years, so her basis in the investment is increased to $12 (additional 5 percent increase). On December 31, 2026 she still holds the investment, but she must recognize the gain at that time. Since her basis increased to $12, she recognizes a gain of $68 rather than $80, and her basis in the investment becomes $80. If Jane sells the investment in July 2029 for $200 after holding it for more than ten years, she owes no additional federal income tax.

- ***Gain recognition***: As mentioned above, previously deferred gain reinvested in a qualified opportunity fund must be recognized on the earlier of December 31, 2026 or the date of sale or exchange of the investment. The amount that must be included in the tax return at this point is governed by Section 1400Z-2(b)(2)(A). According to this section, if the amount of the gain deferred is more than the fair market value of the investment, a taxpayer recognizes the

[21] Section 1400Z-2(b)(2)(B)(iii).
[22] Section 1400Z-2(b)(2)(B)(iv).
[23] Section 1400Z-2(c). See also Prop. Reg. 1.1400Z2(c)-1: Investments held for at least 10 years.

gain equal to the difference between the fair market value of the investment and the adjusted basis of the investment. In the case the amount of the deferred gain is less than its fair market value, the amount to be recognized is equal to the amount of the deferred gain minus the adjusted basis of the investment (the adjusted basis of the investment is the subject to the step-up adjustment described earlier if the interest was held for more than five or seven years and acquired by the dates specified above to qualify for the 10 percent and 15 percent exclusions).

Special cases

- ***Rules for Partnerships***: Either the partnership or the partners may make an election to defer the qualified and re-invested gain in a qualified opportunity fund. The rules, however, are different for the two cases. If a partnership makes an election to defer, then the gain is not included in the partner's distributive share of the partnership income, and the partner's basis in the partnership is not increased. When the deferral period ends, the partnership includes the deferred gain in its gross income and in the partner's share of the income, and at this point, the partner's basis is increased accordingly.[24] If a partnership does not make an election to defer the eligible gain, it is included in the partner's distributive share of the partnership income. The partner can then make the election. In this situation, the 180-day period within which to make the election to defer starts on the last day of the partnership taxable year. Alternatively, the partner may treat his 180-day period the same as the period of the partnership.[25] For that to occur though, the partnership will need to provide that information to the partners in a timely manner.

- ***Mixed Funds Investment***: If a taxpayer re-invested the capital gain but added some other funds, this type of investment is considered as two separate investments. Thus, the first investment is the one made with the previously generated capital gain and for which the deferral election under Section 1400Z-2 is timely made. The second investment is the one that is made with the additional funds.[26] Also, if the investment is held for more than ten years, Section 1400Z-2(c) can only apply to the portion of the investment made with a qualified capital gain and for which the deferral was elected.[27]

- ***Selling a Portion of the Investment***: If a taxpayer acquired an interest in a QOF in several transactions but later, prior to December 31, 2026, sells a portion of his total interest, then the FIFO method is used to identify which interest was sold.[28] It is possible that what has been sold is a portion of one of several acquisition transactions that occurred on the same day, and attributes of the acquired interests are different (for example, one part of the interest acquired with a short-term gain while another is with a long-term gain). In this case, two transactions that occurred on the same date are treated as one, and the pro-rata method

[24] Prop. Reg. 1.1400Z2(a)-1(c)(1).
[25] Prop. Reg. 1.1400Z2(a)-1(c)(2).
[26] Section 1400Z-2(e)(1).
[27] Prop. Reg. 1.1400Z2(c)-1(a).
[28] Prop. Reg. 1.1400Z2(a)-1(b)(6).

should be applied to identify the attributes of the disposed interest. For example, in 2019 an investor generates and invests $1,000 of his short-term gain in a QOF in exchange for 1000 QOF shares. In 2020, he invests $400 of his long-term gain in exchange for 400 shares. He timely makes an election to defer the gain under Sec. 1400Z-2. In 2021, he sells 500 QOF shares. As per Prop. Reg. 1.1400Z2(a)-1(b)(6), the sold portion is half of the interest that was acquired in 2019 with the short-term gain. Since the attributes of the deferred gains are preserved (Prop. Reg. 1.1400Z2(a)-1(b)(5)), the investor must include in his income $500 of the short-term gain in 2021. A different example would be, if in 2019, the investor has $1,000 of the short-term gain and $500 of the long-term gain. One day in 2019, he invests in a QOF the total gain ($1,400) in exchange for 1,400 shares and makes the timely gain deferral election. In 2021, when he sells 700 of his 1,400 shares, he first applies the FIFO method to identify the interest that has been sold. Since two investments with different attributes were made on the same day, the pro-rata method must be used to identify the characteristics of the investment sold in 2021. Under the pro-rata method, in 2021 the investor must include in his income $500 of the short-term gain ((700/1,400) x $1,000) and $200 of the long-term gain ((700/1,400) x $400)).

Summary and Critics

As seen from the definitions and operating rules explained above, the overall rule of the gain deferral under Section 1400Z-2 is complex with many details and nuances. However, with the understanding and correct application of the law, and diligent analysis of potential investments prior to investing, it can be a powerful tax-planning tool in the hands of investors.

Indeed, the idea of stimulating struggling areas through the transfer of money from successful regions and projects to indigent areas is important. If this incentive is successful, it should be a win-win for everybody. Thus, investors, seeking significant tax planning, can get a significant deferral and even a permanent exclusion of a portion of their gains. On the other hand, low-income areas can get new businesses, infrastructure improvements, and local economic growth. But for now, since this law is relatively new, it is hard to estimate and conclude whether the program will bring a positive impact to the designated zones. In addition, the critics surrounding the law suggest that the program may not be as successful as was planned or expected.

First of all, it can be challenging to find the right investment. Since the designated zones are mapped as economically struggling, it might be difficult to find a business that would be profitable and alluring as an investment. The law, of course, can bring new businesses and property to the identified low-income communities. However, there are 8,764 opportunity zones in the United States,[29] and with this number of opportunities for the investors throughout the country, the impact to a particular community might be negligible.

[29] Notice 2018-48.

Secondly, the program might benefit the investors, not the communities. For example, there is a requirement for a QOF to hold at least 90 percent of the assets in a QOZ property. However, there is no requirement that this property or business should benefit the communities and somehow be evaluated by local government or businesses themselves. Thus, investors would likely pursue their own financial interests rather than focus on local infrastructure or the unemployment rate. That is, there is nothing in the law that could stop investors from abandoning the construction of an affordable housing project in an area after all anticipated tax benefits from an investment are received. In addition, Rebecca Lester, an accounting professor and researcher at Stanford University, stated in her analysis of opportunity zones implications,"… because Opportunity Zone investments are not required to demonstrate specific benefits to the existing local population, investors may select projects based solely on their financial return, with little local social impact. While this could result in an improvement of local economic conditions, it could raise prices such that existing residents would be forced to relocate".[30] Thus, the opportunity zones program may even bring adverse results to the communities.

Thirdly, it looks like the law does not provide enough time for investors to execute the full benefit of the basis step-up adjustment. In particular, in order to be able to increase the basis in the investment by 15 percent, the investment and appropriate election must be made no later than December 31, 2019. Currently, there are only a few months left to find a good investment and make the election. Given that time is needed to sufficiently evaluate possible investments, and, for a meticulous investor, it can take a long time to find the right one, it might be a good idea to start the process as soon as possible. Another challenge is that proposed regulations have not yet been finalized as of the end of June 2019.

Despite all the critics, the opportunity zone tax incentive program is still a powerful idea, and many areas that need an economic boost have been waiting for such an idea to bring funds to their area. The law is new, and the regulations have not yet been finalized. As for any new bold proposal, it will take some time to finalize the rules and guidance while taking into consideration the suggestions and critique from tax experts. In addition, the statistics and analytics should be available in a few years, so we can evaluate the effectiveness of the incentive. However, for now, along with the critics, there are people who are very optimistic about the new provision, and there are some already gaining the advantages of the program.

Attachment:
Flowchart on basics of the Qualified Opportunity Zone rules.

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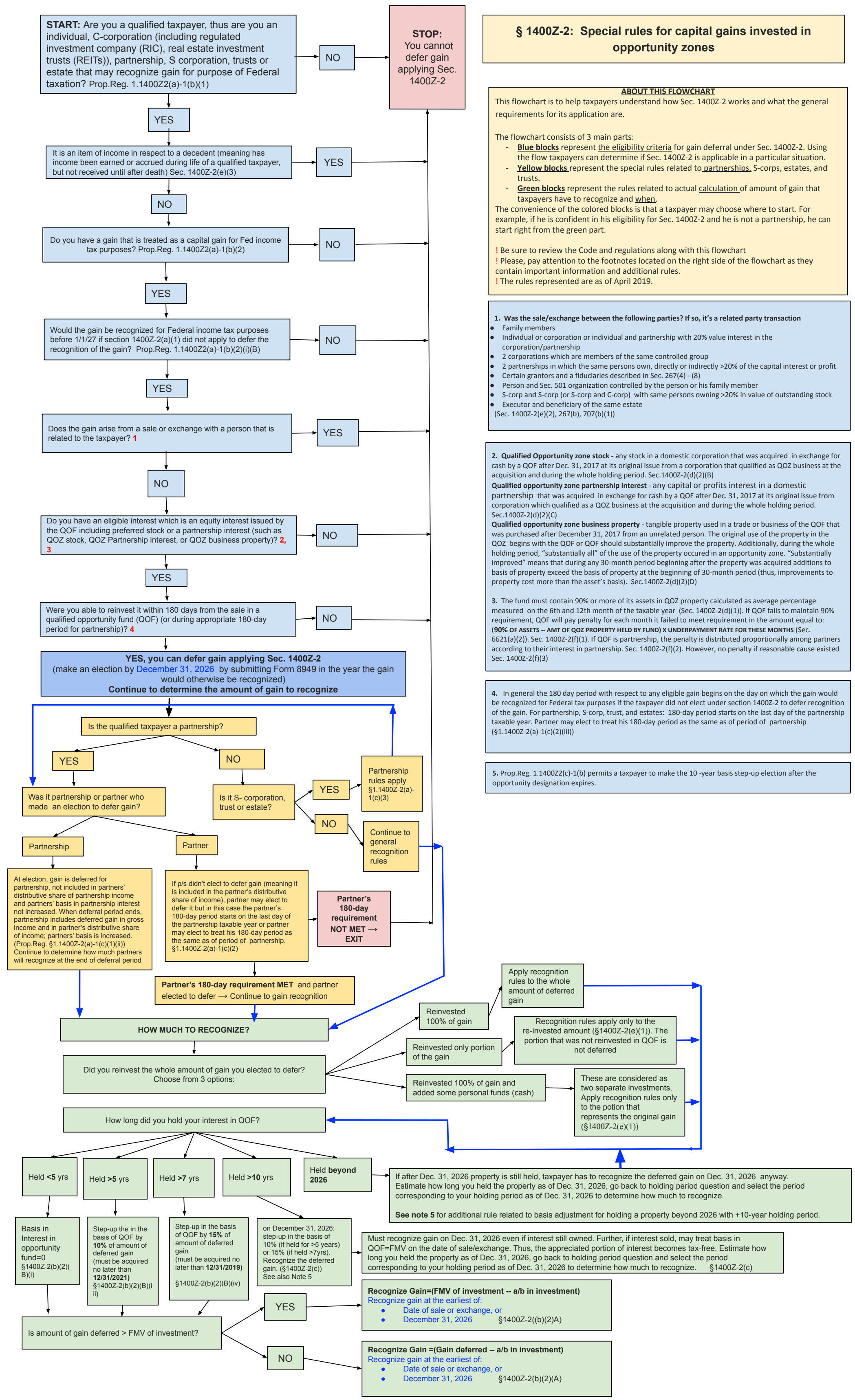
[30] R. Lester, C. Evans, and Hanna Tian, *Opportunity Zones: An Analysis of the Policy's Implications for Investors, Policymakers, and Constituents,* June 2018, available at http://opportunityzones.stanford.edu/docs/Opportunity-Zones-Analysis-of-Policy-Implications-6_29_18.pdf.


START: Are you a qualified taxpayer, thus are you an individual, C-corporation (including regulated investment company (RIC), real estate investment trusts (REITs)), partnership, S corporation, trusts or estate that may recognize gain for purpose of Federal taxation? Prop.Reg. 1.1400Z2(a)-1(b)(1)
NO
STOP: You cannot defer gain applying Sec. 1400Z-2
YES
It is an item of income in respect to a decedent (meaning has income been earned or accrued during life of a qualified taxpayer, but not received until after death) Sec. 1400Z-2(e)(3)
YES
NO
Do you have a gain that is treated as a capital gain for Fed income tax purposes? Prop.Reg. 1.1400Z2(a)-1(b)(2)
NO
YES
Would the gain be recognized for Federal income tax purposes before 1/1/27 if section 1400Z-2(a)(1) did not apply to defer the recognition of the gain? Prop.Reg. 1.1400Z2(a)-1(b)(2)(i)(B)
NO
YES
Does the gain arise from a sale or exchange with a person that is related to the taxpayer? 1
YES
NO
Do you have an eligible interest which is an equity interest issued by the QOF including preferred stock or a partnership interest (such as QOZ stock, QOZ Partnership interest, or QOZ business property)? 2, 3
NO
YES
Were you able to reinvest it within 180 days from the sale in a qualified opportunity fund (QOF) (or during appropriate 180-day period for partnership)? 4
NO
YES, you can defer gain applying Sec. 1400Z-2
(make an election by December 31, 2026 by submitting Form 8949 in the year the gain would otherwise be recognized)
Continue to determine the amount of gain to recognize
Is the qualified taxpayer a partnership?
YES
NO
Was it partnership or partner who made an election to defer gain?
Is it S- corporation, trust or estate?
YES
Partnership rules apply §1.1400Z-2(a)-1(c)(3)
NO
Continue to general recognition rules
Partnership
Partner
At election, gain is deferred for partnership, not included in partners' distributive share of partnership income and partners' basis in partnership interest not increased. When deferral period ends, partnership includes deferred gain in gross income and in partner's distributive share of income; partners' basis is increased. (Prop.Reg. §1.1400Z-2(a)-1(c)(1)(ii)) Continue to determine how much partners will recognize at the end of deferral period
If p/s didn't elect to defer gain (meaning it is included in the partner's distributive share of income), partner may elect to defer it but in this case the partner's 180-day period starts on the last day of the partnership taxable year or partner may elect to treat his 180-day period as the same as of period of partnership. §1.1400Z-2(a)-1(c)(2)
Partner's 180-day requirement NOT MET → EXIT
Partner's 180-day requirement MET and partner elected to defer → Continue to gain recognition
HOW MUCH TO RECOGNIZE?
Did you reinvest the whole amount of gain you elected to defer? Choose from 3 options:
Reinvested 100% of gain
Apply recognition rules to the whole amount of deferred gain
Reinvested only portion of the gain
Recognition rules apply only to the re-invested amount (§1400Z-2(e)(1)). The portion that was not reinvested in QOF is not deferred
Reinvested 100% of gain and added some personal funds (cash)
These are considered as two separate investments. Apply recognition rules only to the potion that represents the original gain (§1400Z-2(e)(1))
How long did you hold your interest in QOF?
Held <5 yrs
Held >5 yrs
Held >7 yrs
Held >10 yrs
Held beyond 2026
If after Dec. 31, 2026 property is still held, taxpayer has to recognize the deferred gain on Dec. 31, 2026 anyway. Estimate how long you held the property as of Dec. 31, 2026, go back to holding period question and select the period corresponding to your holding period as of Dec. 31, 2026 to determine how much to recognize.
See note 5 for additional rule related to basis adjustment for holding a property beyond 2026 with +10-year holding period.
Basis in Interest in opportunity fund=0 §1400Z-2(b)(2)(B)(i)
Step-up the in the basis of QOF by 10% of amount of deferred gain (must be acquired no later than 12/31/2021) §1400Z-2(b)(2)(B)(iii)
Step-up in the basis of QOF by 15% of amount of deferred gain (must be acquired no later than 12/31/2019) §1400Z-2(b)(2)(B)(iv)
on December 31, 2026: step-up in the basis of 10% (if held for >5 years) or 15% (if held >7yrs). Recognize the deferred gain. (§1400Z-2(c)) See also Note 5
Must recognize gain on Dec. 31, 2026 even if interest still owned. Further, if interest sold, may treat basis in QOF=FMV on the date of sale/exchange. Thus, the appreciated portion of interest becomes tax-free. Estimate how long you held the property as of Dec. 31, 2026, go back to holding period question and select the period corresponding to your holding period as of Dec. 31, 2026 to determine how much to recognize. §1400Z-2(c)
Is amount of gain deferred > FMV of investment?
YES
Recognize Gain=(FMV of investment -- a/b in investment)
Recognize gain at the earliest of:
• Date of sale or exchange, or
• December 31, 2026 §1400Z-2((b)(2)A)
NO
Recognize Gain =(Gain deferred -- a/b in investment)
Recognize gain at the earliest of:
• Date of sale or exchange, or
• December 31, 2026 §1400Z-2(b)(2)(A)
§ 1400Z-2: Special rules for capital gains invested in opportunity zones
ABOUT THIS FLOWCHART
This flowchart is to help taxpayers understand how Sec. 1400Z-2 works and what the general requirements for its application are.
The flowchart consists of 3 main parts:
- Blue blocks represent the eligibility criteria for gain deferral under Sec. 1400Z-2. Using the flow taxpayers can determine if Sec. 1400Z-2 is applicable in a particular situation.
- Yellow blocks represent the special rules related to partnerships, S-corps, estates, and trusts.
- Green blocks represent the rules related to actual calculation of amount of gain that taxpayers have to recognize and when.
The convenience of the colored blocks is that a taxpayer may choose where to start. For example, if he is confident in his eligibility for Sec. 1400Z-2 and he is not a partnership, he can start right from the green part.
! Be sure to review the Code and regulations along with this flowchart
! Please, pay attention to the footnotes located on the right side of the flowchart as they contain important information and additional rules.
! The rules represented are as of April 2019.
1. Was the sale/exchange between the following parties? If so, it's a related party transaction
• Family members
• Individual or corporation or individual and partnership with 20% value interest in the corporation/partnership
• 2 corporations which are members of the same controlled group
• 2 partnerships in which the same persons own, directly or indirectly >20% of the capital interest or profit
• Certain grantors and a fiduciaries described in Sec. 267(4) - (8)
• Person and Sec. 501 organization controlled by the person or his family member
• S-corp and S-corp (or S-corp and C-corp) with same persons owning >20% in value of outstanding stock
• Executor and beneficiary of the same estate
(Sec. 1400Z-2(e)(2), 267(b), 707(b)(1))
2. Qualified Opportunity zone stock - any stock in a domestic corporation that was acquired in exchange for cash by a QOF after Dec. 31, 2017 at its original issue from a corporation that qualified as QOZ business at the acquisition and during the whole holding period. Sec.1400Z-2(d)(2)(B)
Qualified opportunity zone partnership interest - any capital or profits interest in a domestic partnership that was acquired in exchange for cash by a QOF after Dec. 31, 2017 at its original issue from corporation which qualified as a QOZ business at the acquisition and during the whole holding period. Sec.1400Z-2(d)(2)(C)
Qualified opportunity zone business property - tangible property used in a trade or business of the QOF that was purchased after December 31, 2017 from an unrelated person. The original use of the property in the QOZ begins with the QOF or QOF should substantially improve the property. Additionally, during the whole holding period, "substantially all" of the use of the property occured in an opportunity zone. "Substantially improved" means that during any 30-month period beginning after the property was acquired additions to basis of property exceed the basis of property at the beginning of 30-month period (thus, improvements to property cost more than the asset's basis). Sec.1400Z-2(d)(2)(D)
3. The fund must contain 90% or more of its assets in QOZ property calculated as average percentage measured on the 6th and 12th month of the taxable year (Sec. 1400Z-2(d)(1)). If QOF fails to maintain 90% requirement, QOF will pay penalty for each month it failed to meet requirement in the amount equal to: (90% OF ASSETS -- AMT OF QOZ PROPERTY HELD BY FUND) X UNDERPAYMENT RATE FOR THESE MONTHS (Sec. 6621(a)(2)). Sec. 1400Z-2(f)(1). If QOF is partnership, the penalty is distributed proportionally among partners according to their interest in partnership. Sec. 1400Z-2(f)(2). However, no penalty if reasonable cause existed Sec. 1400Z-2(f)(3)
4. In general the 180 day period with respect to any eligible gain begins on the day on which the gain would be recognized for Federal tax purposes if the taxpayer did not elect under section 1400Z-2 to defer recognition of the gain. For partnership, S-corp, trust, and estates: 180-day period starts on the last day of the partnership taxable year. Partner may elect to treat his 180-day period as the same as of period of partnership (§1.1400Z-2(a)-1(c)(2)(iii))
5. Prop.Reg. 1.1400Z2(c)-1(b) permits a taxpayer to make the 10 -year basis step-up election after the opportunity designation expires.

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Summaries of the 7th Annual IRS SJSU Small Business Tax Institute Rental of Residences in the Modern World

By: Chen Chen, *MST Student*

At the 7th Annual IRS/SJSU Small Business Tax Institute on May 30, 2019, Claudia Hill, EA, MBA, President of TaxMam, Inc., and Annette Nellen, CPA, CGMA, Esq, Professor at San Jose State University, presented on the topic rental of residences and the changes after the Tax Cuts and Jobs Act (TCJA).

During the presentation, Ms. Hill highlighted three main rental issues in the modern world for tax purposes- rental to family members at less than fair market value, variations on vacation rentals, and qualified business income deduction on real estate rental activities.

Under Section 162(a)(3), a deduction is allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including… rental or other payments required to be made as a condition to the continued use or possession". However, when the lessor and the lessee are related, the terms of the lease must be structured carefully to avoid the implication that the arrangement is just a way to transfer funds and avoid taxes. When the rent payments are determined to be unreasonable, a portion of the lessee's rent deduction, in excess of the rental income of the lessor, is disallowed. The IRS determines if the taxpayers do not earn a profit in at least three of the prior five years, the business might be considered a hobby.[1] Therefore, running a rental business with large losses year after year might trigger an IRS audit. In addition, when there is disposition of the passive activity to a related party, any suspended loss incurred in the transaction remains with the original seller.[2]

In general, the tax treatment of a vacation home depends on the mix of personal and rental use. If the taxpayer rents out the residence for less than 15 days during the taxable year, any income from the rental is excluded from gross income and any deductions from the rental are disallowed.[3] However, interest expense and property tax may be deductible on Form 1040, Schedule A. If the home is rented out for 15 days or more, the rental income will be reported on Schedule E, and the prorated rental expenses can be deducted, but may be limited to the gross rental income limitation.[4] When the home is considered a residence of the taxpayer and it is used for personal purposes for more than the greater of 14 days or 10 percent of the total numbers of days the home has been rented out at fair rental value, the rental expense cannot exceed the rental income,[5] but the additional expenses can be carried forward and a personal portion of mortgage interest, and property taxes may still be claimed on Schedule A.

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[1] Section 183.
[2] Section 469(g)(1)(B).
[3] Section 280A(g).
[4] Section 280A(b) and (c)(5).
[5] Section 280(e).

Conversely, if the home is not also used as a residence, the expenses in excess of rental income can be deducted. However, the loss will be limited by the passive-activity loss limitation rules of Section 469.

For clarification of the operation of the limitations of Section 280A(b) and (c)(5) after the TCJA, the IRS issued Program Manager Technical Advice 2019-01, to advise about the interplay between the $10,000 limit on the state and local tax (SALT) deduction,[6] and the amounts that are permissible as a deduction for expenses in connection with business use of a home under Section 280A. The PMTA concludes that if a taxpayer exceeds the SALT limitation, or opts to take the standard deduction, then none of the taxpayer's SALT relating to the taxpayer's business use of home are included as expenses under Section 280A(b).[7] On the other hand, if the amount of taxpayer's SALT is less than $10,000 limitation and they choose to itemize deductions, then the taxpayer can include as an expense under Section 280A(b) the business portion of the SALT up to the difference between the $10,000 limitation and the amount of the SALT the taxpayer actually deducted under Section 164.

Nowadays, renting homes or spare rooms on third-party platforms, like Airbnb or VRBO, is a quick way to earn extra cash and offset living expenses. However, it is also a hot-button issue that the IRS has been paying attention to and has recently launched a sharing economy tax center website given how prevalent the sharing economy has become. Taxpayers who offer their properties for rent through third-party platforms, are subject to the income tax rules for residential rental property and may receive Form 1099-K if they receive gross payments via the platform company website that exceed $20,000 and more than 200 transactions. However, regardless of whether the Form 1099-K is received, the taxpayer is obligated to report the taxable income on his income tax return. Short-term rental activities can be classified into three categories: Schedule E rentals under Section 469[8] Schedule C rentals such as for a bed-and-breakfast operation, and non-taxable rentals of less than 15 days.

A rental activity generally falls into the category of Schedule E rental when a host does not provide substantial services for the convenience of guests; otherwise, it can be classified as a Schedule C business activity and subject to self-employment taxes if substantial personal services are provided to guests. The substantial services include, but are not limited to, cleaning of the rental portion of the property, concierge exercises, guest tours and outings, meals and entertainment, transportation and other hotel-like services. When the property was used primarily as a personal residence and rented out less than 15 days at fair rental value, Section 280A(g) applies. Furthermore, as Professor Nellen reminded attendees, taxpayers with positive

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[6] Section 164.

[7] Section 280A(b).

[8] Section 469 (c): the rental activity is treated as passive activity, in which the taxpayer does not materially participated in the conduct of trade or business. If the rental is a trade or business such as because the average rental period is seven days or less and the owner materially participates, the activity is still reported on Schedule E unless significant personal services are offered such that the income is subject to self-employment taxes under Section 1402, in which case it is reported on Schedule C.

taxable income from the sharing economy activities may also be subject to state and local taxes, such as transient occupancy taxes, business license tax and personal property taxes. The Tax Cuts and Jobs Act gave us the most significant and dramatic changes to the Internal Revenue Code. One of the biggest changes was the addition of Section 199A, which allows certain business owners to claim up to 20 percent deduction on the profits of their business. However, determining whether a rental activity is an investment or business activity is crucial, because the Section 199A deduction is not available if the rental activity is not a qualified trade or business.

So, what if the taxpayers are regularly renting out their homes for profit motive,[9] but not actively participating in the activities?[10] Will it still be a qualified business? These questions have not been adequately answered by the Congress in the Tax Code. But, as Professor Nellen mentioned, throughout the past years, several court opinions have shown to be in favor of treating the rental activities as a business. Even so, in an effort to help provide clarity and guidance on this issue, the IRS released Notice 2019-07. It contains a proposed Revenue Procedure providing a safe harbor for treating a rental real estate as a business for purpose of the Section 199A deduction. To qualify for the safe harbor, a total of at least 250 hours of documented rental services must be provided by the taxpayer or others during the year. Taxpayers who do not meet the safe harbor requirement may still qualify as a business if they can prove the rental meets the definition of a trade or business under case law, and the judgement will be made on a case-by-case basis on a good faith effort.

Furthermore, another concern that has surfaced is about losses. Even if a rental produces a loss, the taxpayer must still determine if it is a trade or business because if it is, the loss reduces qualified business income from other businesses in computing the Section 199A deduction. If there are no other businesses, the loss carries forward to reduce future income from the rental business. There are lot of uncertainties that still need to be resolved because of the changes in the tax law.

While the tax laws are still evolving, as tax professionals, we must exercise due diligence to make sure clients are in compliance with the current tax rules as well as consider planning to alleviate any undue tax burden.

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[9] *Groetzinger*, 480 U.S. 23, 35 (1987) has pointed that “to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer’s primary purpose for engaging the activity must be for profit”.

[10] Section 469 (c)(7)(B): in order to treat the rental activities to be non-passive activity, the taxpayer must materially participate in the activity which is equivalent to more than 750 hours of the services during the taxable year.

Helping Employers Serve Their Multicultural Workforce

By: Liwei Bi, *MST Student*

At the 7th Annual IRS-SJSU Small Business Tax Institute held on May 30, 2019 at the Biltmore Hotel in Santa Clara, Mr. Carlos Lopez, EA of Lopez Tax Service, and Mr. Carlos Zepeda, of the IRS LB&I Withholding & International Individual Compliance Office, addressed the importance and necessity of identifying the tax status of workers. It is not uncommon to find nonresident alien employees working alongside U.S. citizens. From an employer perspective, correct determination of an employee's residency status is critical in determining the federal and state withholding taxes, Social Security tax, as well as the employer's federal unemployment tax (FUTA).

The first step in determining the withholding and reporting requirements for an employer is to determine whether the employee is a U.S. citizen, resident alien or a nonresident alien. If the employee is a U.S. citizen or a resident alien with a green card, the employer must comply with the usual withholding rules. In addition, a nonresident alien that meets the "substantial presence test" is generally defined as having a physical presence in the U.S. for more than 31 days in the current taxable year and more than 183 days during the previous three years. To calculate the number of substantial presence days for the current year, count all the days; for the prior year, count one-third of the days; and second prior year, count one-sixth of the days.

If the test is met, then even a nonresident alien is subject to the usual withholding rules with certain exceptions for any foreign government related individual, teachers or trainees under the J, U visas, students under the F, J, M or Q visas, and professional athletes in the U.S. competing in a charitable event. Form 1042-S is for non-residents who conduct some form of business within the United States. The form is sent to the non-resident by the bank or corporation that handles the transaction.

Once an employee is determined to be a resident alien, there may be one other exemption. If the employee is a tax resident from a country that has a treaty with the U.S. to exempt them from withholding. For income tax purposes, a U.S. resident alien is taxed on their worldwide income. A nonresident alien will be taxed on all income earned in the U.S., and any other income effectively connected with a trade or business or passive income that is considered fixed, determinable annual, periodic (FDAP) income from sources within the U.S.

For Social Security tax purposes, the employer must pay the tax regardless of citizenship or residency of the employees except if they have a F, J, N, or Q visa including for all income related to work performed outside of the U.S. for resident aliens but not for nonresident aliens.

Finally, for the federal unemployment tax (FUTA), the employer must pay the tax for resident and nonresident aliens except for wages paid to students, railroad workers and agricultural workers. Mr. Zepeda noted that helpful IRS publications for these rules include Circular A, Circular E, and Publications 54, 514, 519, and 901.

TCJA Cautions and Reminders

By: Surbhi Doshi, *MST Student*

The 7th Annual IRS/SJSU Small Business Tax Institute was held on May 30th, 2019 at the Biltmore Hotel in Santa Clara. A panel of seven experts spoke about the challenges faced and important things to remember after the Tax Cuts and Jobs Acts of 2017 (TCJA). The panel consisted of Claudia Hill, EA, MBA, President of TaxMam Inc.; Carlos Zepeda, Withholding and International Individual Compliance Office IRS LB&I; Ericka Shuper, CPA, Senior Manager in Tax at Squar Milner; Joel Busch, CPA, Esq. Professor at San Jose State University; Vicki Mulak, EA, CFP; Annette Nellen, CPA, Esq., Director and Professor of the MST Program, San Jose State University; and Chris Grindy , VP of Grindy Tax Services, Inc. The panel spoke about the queries experienced during the first filing season after the TCJA, a few international tax changes, the disallowance of certain expenditures and NOLs and the extent of California's conformity to federal changes.

Ms. Claudia Hill began the presentation with issues faced and the ambiguities about the new laws and regulations passed by the TCJA and their applicability during this filing season. The IRS issued guidance throughout the filing season and the software providers integrated it into the software. One of the major concerns was that, while the tax returns for 2018 were filed to the best interpretation of the guidance available then, will the interpretation and hence the treatment of certain items change when more IRS guidance is issued? Will this trigger any of the automatic accuracy related penalties and the preparer penalties by the IRS? This is followed by the concerns among the clients about the differences of treatment of certain items in 2018 versus the 2019 tax return.

Tax laws affect the behavior of people and what trends it sets in the society. At a conference in USC where she recently spoke, she asked the audience about the effects of the change of law regarding mortgage interest, Schedule A property taxes and the state and local tax (SALT) limitation. One of the consequences is that there may be less ownership of principal residences and more of corporate owned homes because of REIT benefits. The limit on home acquisition debt of $750,000 and disallowance on property tax deduction have resulted in a change in people's attitude towards home ownership in Silicon Valley where the property prices are one of the highest in the country. It affects the attitude of the newer generation who might want to spend more now rather than saving for buying a house due to the reduced tax incentives. Tax practitioners must continuously watch out for new regulations and other guidance coming out to ensure that the client returns are filed to the best interpretation of the law at the time.

Mr. Carlos Zepeda briefly covered some international changes introduced by the TCJA. He believed that the tax reform has brought learning opportunities to tax practitioners as well as the IRS. The IRS is facing challenges in issuing the publications and other guidance relating to the changes. The major areas of change in the international area impacting taxpayers in control of foreign corporations include Section 951A – Global Intangible Low Taxed Income (GILTI). U.S. shareholders now have to include income from such Controlled Foreign Corporations (CFCs) on an annual basis as opposed to reporting on a receipt basis. To reduce the harsh effects of GILTI, TCJA introduced Section 250, available to corporations, a 50 percent reduction of the income that is reported under GILTI. Section 962 allows individuals to make an election to be treated as a corporation and claim the Section 250 deduction on the GILTI inclusion amount. If not for this deduction, individuals could be taxed at 37 percent on the GILTI inclusion in their income. Section 951 also changed the definition of the U.S. shareholder as any U.S. person who owns 10 percent or more of the total value (earlier it was voting power) of shares of all classes of stock of a foreign corporation. The TCJA made changes to the sourcing rules of produced goods under Section 863(b) where anything produced in the U.S. will be treated as U.S. sales, not foreign sales. Tax reform changed Section 904 and added a GILTI tax basket wherein no carryback or carryforward is allowed for the GILTI tax credit that cannot be used in the tax year in question.

Ms. Ericka Shuper spoke about the changes brought in by TCJA regarding bonus depreciation for qualified improvement property. The Congress intended to make qualified improvement property have a recovery period of 15 years and thus eligible for bonus depreciation. But the Internal Revenue Code was not changed, and qualified improvement property has a recovery period of 39 years so it not eligible for bonus depreciation. In expectation of a technical correction on this from the Congress, many extensions for tax returns have been filed. She added that it is crucial to have proper communications with clients and document them properly to ensure that no important information is missed.

Professor Joel Busch spoke about the excess business loss limitation and the business interest deduction. The excess business loss rules apply to tax years beginning after December 31, 2017 and ending before January 1, 2026. The maximum loss allowed is $250,000 (2018)/ $255,000 for (2019) of the total net business losses to be deducted on the individual's tax return for the year. Taxpayers filing jointly have double the above referenced limits - $500,000 for 2018 and $510000 for 2019. Any excess loss is treated as an NOL carryforward and is subject to the new 80 percent of modified taxable income limitation. Taxpayers are required to file Form 461 to report excess business loss. As California has static conformity, the excess business loss deduction limitation does not apply for the California income tax.

Professor Busch also spoke about the business interest deduction limitation of Section 163(j). This is an entity level business interest deduction limitation which applies to most business-related interest expenses in tax years beginning after December 31, 2017. The limitation does not apply to small businesses having average annual gross receipts over the prior three years of $25 million or less. Taxpayers can deduct interest expense up to a maximum of 30 percent of adjusted taxable income plus any business interest income. Adjusted taxable income doesn't include the NOL deduction, business interest income and expenses and most cost recovery deductions like depreciation or amortization. Form 8990 is required to be filed if Section 163(j) applies and there is any current year business interest expense or any disallowed business interest expense carryforward. Lastly, due to the static conformity rules, California doesn't conform to this new business interest deduction limitation.

Ms. Vicki Mulak focused on California's non-conformity to the federal rules relating to home acquisition indebtedness where interest can be deducted on debts up to $750,000 while the threshold for California remains at $1 million. She highlighted the complexities of Form 8829 for the federal home office deduction. The property taxes for home office deduction are impacted by the SALT limitation and interest on acquisition indebtedness which is limited on Schedule A both are required to be reported on Form 8829. Lastly, she spoke about the complexities of the new postcard-size Form 1040, which was actually designed to make it simpler, and clients' unfavorable reactions to it.

Professor Annette Nellen emphasized that the effective date of regulations that basically state something in the statute is really the effective date of the related statute. She briefly spoke about the *Argo Sales* case (*Argo Sales Company v. Comm'r.*, 105 TC 86 (1995)) where the court held that the "absence of regulations does not relieve us of the duty of interpreting our tax laws." The case involved a built-in gain issue and the S corporation did not include its Section 481(a) adjustment in the gain. The court agreed with the IRS that the taxpayer should include the Section 481(a) adjustment although the regulation stating that the built-in gain included the 481(a) adjustment were effective after the return was filed. The court said this interpretation was in the statute and thus its effective date controlled. Professor Nellen also reminded attendees that the small business definition of Section 448(c) was changed to include businesses having average annual gross receipts over the prior three years of $25 million or less. This amount is adjusted for inflation to $26 million for 2019. One thing to be cautious about is that the small business exception doesn't apply to a tax shelter as defined in Section 448 regardless of the entity's gross receipts level.

To conclude, Chris Grindy offered some tips about work-life balance and managing client expectations for tax practitioners. He highlighted the fact that it is important to not be afraid to say no to new clients when you don't have capacity to help them and to not compromise on the services to existing clients. In the end, he emphasized that tax practitioners should try to strike a healthy balance between both.

Summary

In a nutshell, all the speakers highlighted the importance of staying current with the TCJA changes and guidance and communicating with clients. Also, practitioners should discuss planning opportunities with clients and take the right steps to implement them.

Summaries from the 34th Annual High Tech Tax Institute
Say Goodbye? Executive Compensation & Fringe Benefits Planning

By: Amy Yue, *CPA, MST Student*

The Tax Cuts and Jobs Act (TCJA) was enacted on December 22, 2017 (Public Law 115-97). The new law significantly changed tax deductibility for certain employee compensation and benefits for tax years beginning after December 31, 2017. At the 34th Annual TEI-SJSU High Tech Tax Institute conference, held on November 5, 2018, a panel of tax experts comprised of Anne G. Batter, Partner at Baker & McKenzie LLP, Jennifer George, Partner at PwC, and Rick Berge, Executive Director at EY, addressed updates and insights on this topic. The panel discussed the tax changes regarding compensation limits for covered employees, qualified equity grants, and fringe benefits.

Compensation Limit for Covered Employees

Section 162(m) limits the deduction related to remuneration of covered employees to $1 million. Applicable remuneration paid to covered employees exceeding $1 million is not tax deductible. Prior to the TCJA, Section 162(m) applied only to publicly traded corporations. TCJA extended the limitation to those corporations who are required to file a registration statement for debt or equity securities under the Securities Act of 1933 but are not publicly traded. Therefore, more taxpayers are subjected to the Section 162(m) limitation after TCJA.

In addition, the new law includes more employees as covered employees. It defines a covered employee as a CEO and a CFO at any time during tax year, and the other three highest compensated officers. If an individual is a covered employee in any tax year beginning after December 31, 2016, the individual remains a covered employee for all future years, even if the employment is terminated.

TCJA eliminates the exception for performance-based compensation and commissions. Under the new law, performance-based compensation and commissions are subject to the $1 million limit, while prior law excluded such compensation as applicable employee remuneration. The new law broadens the tax base by applying the limit to more corporations, broadening the definition of covered employees and including additional types of compensation.

Qualified Equity Grants

TCJA added Section 83(i) to provide favorable tax treatment to certain employees with qualified equity grants. Employees from private companies can elect to defer taxes related to equity awards such as restricted stock units (RSUs), stock options and employee stock purchase plans for up to five years.

Generally, under the new law, qualified employees can recognize the income at the earlier of the date when stock becomes transferable or the date the stock is publicly traded. Prior to

TCJA, taxpayers were required to include amounts in revenue when fully vested RSUs were received or non-statutory stock options were exercised.

Employee Qualifications
The Section 83(i) tax deferral is not available for the following individuals:
- Independent contractors
- Non-employee directors
- CEO and CFO
- Shareholders holding stock of 1 percent or more in the preceding 10 years
- Any of the four highest-compensated officers for the current or preceding 10 years

Eligible Corporation
To be eligible for Section 83(i), a corporation cannot have stock that is readily tradable on the securities market during any preceding years. Stock options or RSUs must be granted to more than 80 percent of all employees with the same rights and privileges.

Making the election
The election must be made within thirty days after shares or options are issued in the manner similar to a Section 83(b) election.

Fringe Benefits

a. Transit and Commuting

Employers lose the deduction of certain transit and commuting benefits provided to employees. Prior to TCJA, those benefits were excluded from employees' income for both federal income and FICA taxes and were deductible business expenses for employers. The following table compares the changes under the new law, which mostly affect employers, not employees.

	Employee Includable in Income		**Employer tax deductible**	
	Prior Law	TCJA	Prior Law	TCJA
Commuter shuttles/vans	Exclude from income	Exclude from income	Tax Deductible	Not Deductible
Transit passes	Exclude from income	Exclude from income	Tax Deductible	Not Deductible
Qualified parking	Exclude from income	Exclude from income	Tax Deductible	Not Deductible
Qualified bicycle commuting reimbursement	Exclude from income	Include in income	Tax Deductible	Tax Deductible

b. Moving Expenses

Moving expenses paid by the employer on behalf of an employee, either through reimbursements or by direct payments, are now included in the income of the employee, except for members of the Armed Forces on active duty. Moving expenses continue to be deductible for employers as a business expense.

c. Meals and Entertainment

The expenses related to entertainment, amusement, or recreation are no longer tax deductible after the new law. However, employers can continue to deduct 50 percent of business meals if the expense is not lavish and the taxpayer or an employee of the taxpayer is present at the meal. Business meal means food and beverage provided to customers, clients, consultants or other similar business partners in carrying on a trade or business.

Before TCJA, food and beverage provided to employees for the convenience of the employer were fully deductible. Under TCJA, such meals are 50 percent deductible for 2018 through 2025 and are nondeductible after 2025. These meals remain non-taxable to the employees.
In sum, while corporations enjoy the tax rate cut, they as well as non-corporate employers lose certain deductions related to employee compensation and benefits, resulting from expanding the tax base. A comprehensive analysis is necessary to determine the overall tax effects to any employer.

Cryptocurrency, ICO and Whatever Else is New
By- Langzun Li, *MST student*

At the 34th Annual TEI-SJSU High Tech Tax Institute conference held on November 5-6, 2018 in Palo Alto, a panel of tax experts provided an overview of blockchain, ICOs (initial coin offerings) and cryptocurrency. The panelists were Rob Massey with Deloitte, Brian Rowbotham with Crowe LLP, David Forst with Fenwick & West LLP, and Dawn Rhea with Moss Adams. The panel walked the attendees through multiple topics such as the evolution in commerce, the innovation empowered by blockchain, the definition of virtual currency, and different tax considerations of cryptocurrency.

Evolution in Commerce

Throughout human history, technology has the most significant impact on moving society forward. From the commerce landscape, it started in the caves. The cavemen started the earliest transactions which were barter transactions. A barter transaction is exchanging goods without the use of a monetary medium. To the cavemen, a barter transaction can be trading a cub for meat. As technology progressed, people started using mail, common courier and live services in commerce. Soon after the internet was introduced in the 1990s, Software as a Service (SaaS) and cloud service were also introduced and became an invaluable part of the world of commerce. Now, new technology such as blockchain is introduced, and it has the essential characteristics as barter transaction which does not have fiat currently involved in this process.

Cryptocurrency is one of the products that operates using blockchain technology. Cryptocurrency can be highly volatile. The price of the cryptocurrency can vary significantly within short time periods within a couple of hours. It can be challenging for people to keep track of their basis in this asset, because a cryptocurrency coin can be divided into multiple smaller fractions. For example, a cryptocurrency coin worth $1,000 can be divided into ten pieces of $100 or a hundred pieces of $10. The options regarding splitting coins into smaller values are unlimited.

Furthermore, a barter transaction[1] involving cryptocurrency also triggers gain or loss when holders of the virtual currency use them to purchase goods or services. For example, a taxpayer acquired cryptocurrency early in 2010 for $200. By 2018, the value of his cryptocurrency had increased to $120,000. If he decides to use his cryptocurrency to purchase a Tesla Model S which costs around $75,000, he has a capital gain of $74,875 which is subject to capital gain tax after the barter transaction.[2] This capital gain tax can be a heavy burden to the taxpayer if he

[1] In Notice 2014-21, 2014-16 I.R.B. 938, the IRS held that convertible virtual currency should be treated as property for tax purposes. Thus, when someone uses virtual currency, such as bitcoin to purchase something, a barter transaction occurs.
[2] Calculated as $75,000-($200 x $75,000/$120,000) = $74,875.

decides to make the purchase with his cryptocurrency rather than using cash. He needs to be sure he has sufficient cash to pay the tax on the capital gain.

Enabling Innovation

Even though transactions with cryptocurrency can present challenges, it is only one of the products derived from blockchain technology. The blockchain helps solve many problems. For example, it has always been difficult to protect music rights because people can quickly and illegally download a song and misuse it. However, blockchain can convert song rights into tokens and only people who purchase these tokens have access to the songs. The owner of the song can use blockchain to keep track of who has paid to access the songs.

Another example given by the panel is smart contracts. The agricultural industry relies on the weather. To mitigate the damages due to undesirable weather, farmers usually have crop insurance. If crop insurance is converted into smart contracts, it can minimize human intervention and tremendously improve the efficiency of the payment process. For example, in the smart contracts, the number of days of rain can be verified from third party sources and per specified conditions, the blockchain can enable smart contracts to be executed automatically, and payment will be sent to farmers, as specified in the insurance contract.

Furthermore, each panelist shared examples they encountered in their work. They included IBM setting up blockchain to enable business ledger for customers, entrepreneurs wanting to set up blockchain platforms to trade tokens to mirror U.S. stock exchanges, selling a fraction of a house by tokenizing real estate, and the government using blockchain technology to prevent Value Added Tax (VAT) fraud.

The Definition of Virtual Currency

There is not much authoritative guidance regarding the definition of virtual currency. The only guidance that directly addresses this issue is IRS Notice 2014-21.[3] According to this notice, virtual currency(cryptocurrency) is not considered a currency but is considered a property. Within the definition of property, it can be sub-categorized as investment, trade or business property, commodity, security, and cash equivalent.

If individuals use virtual currency in exchange for goods or services or to acquire other virtual currency, a realization event occurs based on the fair market value of the virtual currency at that time less its basis. When virtual currency is acquired via mining, it is taxable as ordinary income. If it is used by employers to pay their employees, it is considered compensation subject to withholding and reporting requirements. Finally, the notice also states that whether the character of the virtual currency is considered as capital assets or ordinary asset is determined by how taxpayers hold and use it.

[3] Notice 2014-21, 2014-16 I.R.B. 938.

Tax Considerations of Cryptocurrency

For domestic tax considerations, enterprises should pay attention to areas such as revenue recognition and compensation when they use cryptocurrency. The panel also stated that taxpayers should be careful about the tax accounting methods of cryptocurrency. Because there is different basis for different coins, it can be difficult to keep track of the basis of each of the coins. Therefore, they recommend having thorough and proper documentation to record the basis.

As for international tax considerations, enterprises should focus on areas such as VAT considerations, Intellectual Property (IP) migration, Subpart F and Global Intangible Low Tax Income (GILTI).

Conclusion

The creation of blockchain and cryptocurrency has and will have a significant impact on every industry. It creates efficiency and enables innovation to solve many challenging problems. It also presents many challenges and tax considerations like tracking the basis of the cryptocurrencies. However, if tax professionals understand the essence of these transactions involving cryptocurrency, they can still appropriately address the tax treatment.

Locating Intangibles - Generating and Using Foreign Derived Intangible Income (“FDII”)

By: Rachana Khandelwal, *MST*

A panel of four experts from the international tax field presented at the High Tech Tax Institute held on November 5-6, 2018 in Palo Alto. They discussed the new tax rule, Foreign Derived Intangible Income (FDII), introduced by the Tax Cuts and Jobs Act (TCJA), P.L. 115-97. The panelists were Sanjay Agarwal from MGO LLP, Lisa Felix from Armanino LLP, Ken Harvey from Moss Adams LLP and Allan Smith from Grant Thornton LLP.

The panel discussed briefly the sweeping changes brought by the TCJA in the taxation of intellectual property (IP) by creating new tax laws such as the Base Erosion and Anti-abuse Tax (BEAT), Foreign-Derived Intangible Income (FDII) and Global Intangible Low Taxed Income (GILTI). These new rules will significantly impact high-technology companies with cross-border operations involving intangibles located outside of the U.S. In addition, the change from the worldwide tax system to a quasi-territorial system and reduction in the corporate tax rate to 21 percent is viewed as an incentive for corporations to structure their operations in the U.S. rather than in low tax jurisdictions.

The panel went through the concept and the factors involved in the calculation of FDII, its rate structure, effective tax rate for corporations and briefly explained the interaction between FDII and GILTI.

Foreign Derived Intangible Income (FDII)

The introduction of Section 250 is essentially an attempt to make corporates rethink their earlier tax planning strategy of locating intellectual property (IP) in low-cost jurisdictions. However, the panel noted that corporations need to evaluate costs and benefits of shifting IP back to the U.S. or from the U.S. considering factors such as onshore and offshore operational volumes, political uncertainty, and international laws.

Section 250 allows a domestic C corporation to take a deduction based on the foreign income derived by such corporation. The FDII is defined as income derived by U.S. taxpayer’s selling or licensing property, including IP or providing services to its foreign clients. This income from export activities is divided into deemed earned income from tangible assets which is subject to 21 percent and the remaining income is deemed to be from intangible assets (FDII).

Calculation of FDII

The FDII deduction involves multi-step calculations as follows:

1. Deduction Eligible Income (DEI) The starting point in calculating FDII is gross income of a domestic C corporation, reduced by subpart F income, GILTI income, foreign branch

income, domestic oil and gas extraction income and dividend from a controlled foreign corporation (CFC). These items of income are further reduced by properly allocable expenses. This will yield deduction eligible income.

2. Qualified Business Asset Investment (QBAI) This is the average of the basis based on the quarter end amounts in the tangible property used in the trade or business. The adjusted basis is determined using the alternative depreciation system such as straight-line method or pre-determined recovery period (class life). The QBAI does not include assets that do not produce DEI.

3. Deemed Intangible Income (DII)- This amount is arrived at by reducing DEI by 10 percent of QBAI. Formula: DII = DEI less 10% x QBAI.

4. Foreign Derived Deduction Eligible Income (FDDEI) This includes direct and related party foreign sales and services reduced by allocable deductions. However, it does not include foreign branch sales.

5. $$\text{FDII} = \text{Deemed Intangible Income (DII)} \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income (DEI)}}$$

The amount of FDII computed above is 37.5 percent deductible from the taxable income, thereby yielding an effective tax rate of 13.125 percent.

Rate Structure

The new regime allows a domestic corporation to take an additional deduction based on the amount of such corporation's FDII.

Tax Year	% Deduction of FDII	Effective tax rate
Beginning 2018 through 2025	37.5%	13.125%
Beginning after 2025	21.875%	16.406%

FDII Income and Deductions

The panel discussed the intricacies of the new law with respect to the nuances and interpretations involved in determining the FDII. A corporation needs to carefully interpret definitions and rules set out in Section 250 to compute the FDII income. The key concepts under Section 250 include foreign-derived deduction eligible income, foreign use of property or services, related party transactions.

The panel then briefly discussed how the cost of goods can be allocated with respect to the above-mentioned income derived. The panel suggested that the allocation of the cost of goods sold can be done using a reasonable method provided in Treasury Reg. 1.199-4. Further, for deductions other than the cost of goods sold, the panel indicated that before the final version of Section 250, the Senate version provided that deductions should be properly allocable applying the rules similar to the rules under Section 954(b)(5).

State and Local Taxation

The introduction of Section 250 is a conformity consideration for states, and the extent to which they conform to the federal law is an important factor in determining the overall effective tax rate for a corporate taxpayer. The key issues involved are the definition of taxable income and the deductions by the state for the purpose of computing FDII. The number of variations can be a major factor influencing the corporation's decision to shift operations to its foreign entity.

Interaction of FDII and Global Intangible Low Taxed Income (GILTI)[1]

The tax rate under GILTI is 10.5 percent on the income derived from IP outside the U.S., while the effective tax rate under FDII is 13.125 percent. The rate under FDII would increase to 16.406 percent after 2025. Currently, guidance on the new law lacks clarity. A taxpayer needs more guidance to ensure the expected benefits involved in bringing back the IP from offshore. The uncertain political climate might lower the benefits in the long run which might impede the operational growth of corporations. A taxpayer also needs to take into consideration the effects of GILTI and other provisions in bringing back the IP which might trigger additional tax liabilities.

The panel anticipated clearer guidance for determining the costs and benefits of shifting IP to the U.S. given the attractive benefits such as FDII currently offered by the TCJA.

[1] See Section 951A. GILTI imposes a tax on foreign earnings of US taxpayers earned through Controlled Foreign Corporations (CFCs) in excess of a 10 percent return on CFC's tangible assets.

U.S. International Tax Issues and Developments

By: Nam Nguyen, *MST Student*

The 34th Annual TEI-SJSU High Tech Tax Institute was honored to have Mr. James P. Fuller lead a comprehensive discussion on various international tax developments and issues. His topics, which were meticulously detailed in a 250-page outline,[1] covered a wide range of international tax developments such as Section 965 and related guidance, comments concerning Global Intangible Low Tax Income (GILTI) inclusion, foreign tax credit implications, and the Section 59A base erosion and anti-abuse minimum tax ("BEAT"). Mr. Fuller is a long-time tax partner at Fenwick & West LLP and is considered one of the world's most leading authorities in corporate and international taxation. According to *Chambers Global* (2018), Mr. Fuller is the only U.S. tax advisor to receive top honors in both corporate and international tax categories and has been inducted in the *Legal 500*'s Tax "Hall of Fame."[2] This article summarizes some of Mr. Fuller's key points and concerns as it relates to the Tax Cuts and Job Act (TCJA), new regulations, and recent court decisions.

Disallowance of FTC for Foreign Taxes Paid on Previously Taxed E&P

Mr. Fuller spoke of Prop. Reg. §1.965-5(c)(1)(ii) and how it will significantly impact foreign tax planning for years to come. This proposed regulation explicitly disallows the foreign tax credit, under Section 901 or deduction for foreign income taxes paid or accrued with respect to any amount for which a Section 965(c) deduction is allowed. In addition, neither a credit nor a deduction is allowed for foreign income taxes attributable, as it relates to previously taxed earnings and profits ("E&P") under Section 965(a) and Section 965(b). In plain English, the new tax law reduces the foreign tax credit that can be used against the Section 965 income inclusion.[3] It also disallows the credit for foreign taxes paid by the foreign corporation on income distributed to its U.S. corporate shareholders. Before getting into details of this specific provision, let's break down key concepts of Section 965.

As a result of the TCJA, a controlled foreign corporation ("CFC") must increase its Subpart F income by its accumulated deferred foreign income. This means the CFC's U.S. shareholders must include in their taxable income their pro rata shares of that Subpart F income now increased by this deferred foreign income, which Section 965(a) further defines as accumulated post-1986 E&P. This is hereafter called the mandatory inclusion and applies to CFCs having tax year beginning before January 1, 2018. But of course, not all foreign corporations will have

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[1] Available online at: http://www.sjsu.edu/taxinstitute/about/history/2018materials /(under International High Technology U.S. Tax Current Developments).

[2] James P. Fuller biography; https://www.fenwick.com/professionals/pages/jimfuller.aspx; May 7, 2019 from Fenwick & West LLP.

[3] SKL Tax, "The Grind down of Foreign Tax Credits and the Code Section 965 Inclusion," https://skltax.com/grind-foreign-tax-credits-code-section-965-inclusion/; May 5, 2019.

positive accumulated post-1986 E&P—there are some CFCs with a foreign E&P *deficit*. This is where Section 965(b) comes into play.

Section 965(b) provides that in certain cases where a U.S. shareholder owns at least one foreign corporation with positive accumulated E&P (called a DFIC) and at least one E&P *deficit* foreign corporation, the post-1986 E&Ps used to calculate the mandatory inclusion is reduced by the U.S. shareholder's aggregate foreign E&P deficits. Because it is used to calculate the mandatory inclusion amount, both Section 965(a) and Section 965(b) are taken into consideration when calculating previously taxed income ("PTI").

Mr. Fuller mentioned that Prop. Treas. Reg. §1.965-5 is especially concerning because the foreign tax credit under Section 901 is disallowed for the applicable percentage of any foreign income taxes for the portion of the Section 965(a) previously taxed E&P reduced by allocable E&P deficit pursuant to Section 965(b). He provided us with a simple example to illustrate this issue:

Suppose a U.S. shareholder owns CFC1 which has $100 of accumulated E&P and CFC2 which has an E&P *deficit* of $25. According to Section965(b), the U.S. shareholder can use the E&P deficit of $25 from CFC2 against the $100 of accumulated E&P from CFC1 to have an inclusion of only $75 as income. Any foreign tax credits associated with the $75 of income inclusion can be used. However, the remaining $25 of E&P that was left in the positive CFC1 was not included as income under Section 965, but instead becomes previously taxed income under Section 965(b). Any foreign tax credits associated with this $25 of PTI which is related to the positive CFC1, will be disallowed and lost forever. Mr. Fuller was of the view that taxpayers should be entitled to a foreign tax credit for this $25 of PTI and that the IRS and the Treasury should rectify this soon because it "does not seem right or supportable under the statute."

Mr. Fuller emphasized that the preamble to Prop. Treas. Reg. §1.965-5 states that Section 960(a)(3) only allows a credit for foreign income taxes when it is imposed on an upper-tier foreign corporation on distributions of Section 965(a) or Section 965(b) previously taxed E&P from lower-tier foreign corporations. This is illustrated through an example detailed in the preamble, summarized next.

> If a lower-tier CFC distributes PTI to an upper-tier CFC, and the upper-tier CFC pays a foreign withholding tax on it, such withholding tax would be creditable under Section 960(a)(3) upon distribution by the upper-tier CFC to an eligible domestic corporation. However, the domestic corporation cannot bring up the foreign tax credit for the applicable percentage of that withholding tax.[4]

[4] Disallowance of foreign tax credit or deduction for foreign income taxes paid with respect to amount for which Section 965(c) deduction is allowed. (Jan. 1, 2019). *Federal Tax Coordinator (RIA),* https://riacheckpoint.com.

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Foreign Currency Gain or Loss with Respect to Distributions of Previously Taxed E&P

Although Section 986(c) is not a new regulation, Mr. Fuller emphasized that this section will impact a lot of companies with respect to distribution of PTI from their respective CFCs. According to the proposed regulation, when a CFC makes distributions of Section 965(a) PTI, the U.S. shareholder must recognize foreign currency gain or loss based on the movements in the exchange rate between December 31, 2017 and the time the distributions were actually made. This foreign currency gain or loss will be treated as ordinary income or loss from the same source as the associated income inclusion.

Initially, it was thought that the entire Section 956 inclusion would be considered PTI. In other words, all of a company's deferred foreign earnings since 1986 is going to be one big PTI account. For instance, suppose a CFC has $1 billion of PTI and there was a 10 percent change in currency rate. That would be $100 million of currency gain or loss if that PTI was distributed in cash. This would result in significant recognition of foreign currency gain or loss for CFCs with PTI. Fortunately, Section 986(c) and the subsequently issued Notice 2018-7[5] provided clarification stating that not all of the Section 965 inclusion amount will be used to calculate foreign currency gain or loss. The calculation of foreign currency gain or loss is only on the distributions of Section 965(a) previously taxed E&P that is reduced in the same proportion as the reductions by a Section 965(c) deduction amount. Indeed, this is welcome news for those with foreign currency gains. However, if the CFC had foreign currency loss, there is currently no authority or statute to dictate this circumstance.[6]

Subpart F High-Taxed Income Exclusion as it Relates to GILTI

Another high point of Mr. Fuller's discussion corresponded to Subpart F and whether to elect the high-tax income exclusion under Section 954(b)(4) as it pertains to GILTI and maximizing of foreign tax credits. In general, U.S. shareholders of CFCs must include their pro rata share of the CFC's Subpart F income which comprises foreign base company income ("FBCI") and is subject to U.S. tax minus applicable foreign tax credits. However, there are certain types of income which are excluded from FBCI. Under Section 954(b)(4), a high-tax exception is any income taxed at more than 90 percent of the highest U.S. corporate tax rate and, if elected, is excluded from Subpart F income.

The introduction of GILTI throws a wrench into the structuring of international tax operations particularly with allocating Subpart F income and utilizing foreign tax credits. GILTI excludes Subpart F income and income that would be Subpart F income but is exempted due to the high-tax exception under Section 954(b)(4). When this high-tax exclusion election is made, the income will no longer be included as Subpart F income under both GILTI and Subpart F rules. Any foreign tax credits associated with this excluded income will remain in the CFC and will not

[5] Notice 2018-7, 2018-4 I.R.B. 317.
[6] In addition, according to Prop. Treas. Reg. §1.986(c)-1(c), §986(c) does not apply to PTI under §965(b).

be available for use. If the high-tax exception is not made under Section 954(b)(4), the income will be included as Subpart F income and subject to the U.S. shareholder's tax rate, and thus, bringing up the high foreign tax credits to be used.[7]

Before the TCJA, many U.S. multinational companies structured their international operations around Subpart F. But with the introduction of GILTI, these companies must carefully model their tax liability using both GILTI and Subpart F rules. For certain taxpayers, it might make sense to not make the high-tax income exclusion election in order to include in Subpart F income and utilize excess foreign tax credits. Mr. Fuller believes that going forward, most people will choose this strategy in order to utilize their foreign tax credits.

The *Altera* Case and Its Impact on the Arms-Length Standard

On July 24, 2018, the U.S. Court of Appeals for the Ninth Circuit ("the Ninth Circuit") initially overturned the 2015 Tax Court decision in *Altera Corp. v. Commissioner*, thus requiring the inclusion of stock-based compensation in cost sharing agreements. According to Mr. Fuller, this is a landmark decision that would have lasting impact on companies with transfer pricing issues.

The Internal Revenue Service ("IRS") brought Altera Corporation ("Altera") to Tax Court finding that the company did not follow the 2003 tax regulation (Treas. Reg. §1.482-7) that requires stock-based compensation to be included in cost sharing agreements ("the 2003 Regulation"). According to Altera, the IRS and Treasury failed to satisfy the requirements of the Administrative Procedure Act ("APA") and did not provide sufficient data to show that Altera did not satisfy the arm's-length standard under Section 482. The Tax Court ruled in favor of Altera, and as a result, many U.S. companies relied on this judicial decision and began to exclude stock-based compensation from the cost-sharing pool, basically rendering the 2003 regulation unenforceable.[8]

However, shortly after the July opinion, the Ninth Circuit withdrew the opinion and called for a rehearing. The case was re-argued before the appeals court on October 16, 2018. In early June 2019, the 9th Circuit's new decision was issued, finding as in its original decision, that the IRS was correct, thus it reversed the earlier Tax Court decision (926 F.3d 1061).

Conclusion

This article summarizes only four of Mr. Fuller's vast array of international tax topics and developments. It is important to note that while the IRS and Treasury are doing their best to issue clear technical guidance, many of these issues are still quite murky and subject to intense

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[7] Zhang, Libin. (2018). To the Frying Pan: New Virtues of Subpart F Income Over GILTI. *Tax Notes*, Volume 160, No. 1, https://www.robertsandholland.com/siteFiles/Articles/To_the_Frying_Pan.PDF.

[8] PWC Tax Insights. (2018). "Ninth Circuit reverses Tax Court in 'Altera,' requires stock-based compensation to be covered by cost sharing payments", https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-altera-ninth-cir-dec.pdf.

interpretations and comments by tax practitioners. Because of this, tax professionals should strive to obtain a complete understanding of these new tax laws and should always remember to advise their clients with utmost caution, knowing that these regulations can be replaced with newer clarifications.

Tax Maven
The Contemporary Tax Journal's Interview with Ms. Claudia Hill
By: Surbhi Doshi, *MST Student*

Claudia Hill, EA, is the founder and President of Tax Mam, Inc., in business for over 40 years. She started her career in the early 1970s after she completed her bachelor's degree in Business Administration, Management Systems. Later, she earned a Master's in Business Administration from San Jose State University and started her own business specializing in taxation. She has served as the editor-in-chief of the CCH journal *Tax Practice & Procedure* for over 20 years. Her passion for taxation along with her interest in sharing her knowledge led her to teach classes not only in the U.S. but also in some parts of Asia. She believes that if you enjoy what you do, it goes all the way along!

How did you get involved in the tax field? Was that your plan when you were in college?

My bachelor's degree is in Management Systems and that's what got me my first job in 1972. I had just started my career and got a job outside the scope of the traditional jobs that women had during that time, and then I had a baby! I was not sure if it was going to end my career which was the case for most women back in the time. The job opportunities I was offered after the child was born wouldn't have paid for the day care and so I looked around for other options and started my own business. Within a year, I enrolled for the MBA program at San Jose State, but I took all my electives in the field of taxation because I enjoyed that, and I did part of my master's work evaluating a business startup in taxation. I had to decide whether to specialize in tax or accounting and because of my interest in taxation along with the flexibility it gave me, I started my business as a tax practitioner. My business grew faster than the kids did and provided much more than I thought it would in terms of ability to support me.

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

Well, I set up my business in 1973-74, so it's been more than 40 years now. It has survived and done well for me over all these years. I had an opportunity in 1987 to serve as an advisor to Lawrence (Larry) Gibbs, Commissioner, IRS (1986-1989), on what was then the Commissioner's Advisory Group. Although I was active in my professional association beforehand, working as an advisor to Commissioner Gibbs was a boost to me as he took the people on the advisory board very seriously and invited us back to work on legislative projects and other programs. I always thought of him as a mentor in terms of how he managed client controversies. Larry told me one time that the focus of your job is to put the best face on your client's situation when representing them. Thinking of that continues to help me to this day.

I also helped found the National Association of Enrolled Agents Tax Practice Institute. I was the first woman who taught in that institute and served as dean of it for some time. I have continued to teach at their annual events on representation. Also, 20 years ago, getting selected to be the editor of the CCH *Journal of Tax Practice & Procedure* opened another avenue for me. There have been interesting opportunities to testify before the House Ways and Means Committee and the Senate Finance Committee. I have learned from and enjoyed these opportunities, and these have added greatly to my experience.

I have clients whom I have seen every year for the last thirty to forty years and I think that it is a blessing, to be so integrated in the lives of my clients. It gives a sense of satisfaction to see the clients come back year after year, and I have generations of families where I may be doing tax returns of the grandchildren from children of my original clients.

How do you keep up to date with changes in tax and new types of business transactions in the digital time?

I read all the time! One of the driving forces is that I teach classes and also because I am the editor of the Journal, I must stay current with the changes. With the Journal, I have to look out about six months ahead in terms of what kind of activities and trends I'm seeing in the industry, what topics the IRS going to be looking at, what are the tax practitioners interested in? I think it has been made harder by the significant amount of information that comes out. Thirty years ago, we did not have to worry about a daily tax report because it was delivered by paper once a week while today you can get a bunch of tax reports each day.

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

Something that should be improved at the federal level is the tendency of the Congress to starve the IRS of the budget that it needs to administer the law. The real issue goes back to the voluntary compliance system and that people have to believe that the system is fair, they have to believe that there are consequences of not following the rules. It is frustrating that the people who are administering the law aren't given the tools and the money to do. In the long term that can have bad consequences to the system itself.

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

Staying current not only with the tax law but also current with technology. I used to joke that the only thing I need to know was tax. If I understood taxes, I could do the tax return. Now it's not just tax I need to know but also how various technologies work and how to implement systems. I also have to worry about protecting data. If someone wanted to steal my client data a decade ago, they would have to steal the computer sitting at my office and it would be a physical theft. Now, we must watch out constantly for people trying to hack into your system. As tax practitioners, we are bigger targets for the hackers, as we have clients' SSNs, their bank account numbers and even driver license numbers due to the state requirements. I have my IT person running deep scans and making sure that I am trying my best to protect my client's data. It is an ethical requirement we have towards the client, too. In terms of impact on your business if you do get hacked, it's an issue of trust that can take away far more than just the cost to clean it up.

What advice do you have for students preparing their career in tax?

Tax isn't just one category; there are so many pieces to it. You should find your niche, find what you enjoy and how to make it work for your life. When you are going into the tax field, there are areas you can specialize in like individual tax or corporation tax, or litigation. If you want to work for another firm or corporation which is a 9 to 5 job, go for it. Being self-employed is not 9 to 5, but go for what you enjoy. Tax gives you a glimpse into people's lives; there is so much to learn from your client's lives, and so much to laugh about. I have never felt I have missed anything by not getting to watch soap operas because interesting lives parade through my office on a daily basis.

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

I enjoy having dinner with my grandkids because they are special people to me, and I want them to know they are special. There is so much potential in them and I want to encourage them to do everything they can.

What is the most unusual item in your office or something in it that has a special meaning to you?

Well, I have won a few awards and plaques over the years. One of the awards says the "Initial Life-Time Achievement Award" and that always seems strange to me. I mean, what did they know about how many lifetimes I am likely to have? That one always makes me smile when I see it!

Surbhi Doshi and Claudia Hill, EA; May 30, 2019

Fun Tax Facts

By: Rachana Khandelwal, *MST*

Sales Tax Token

In the 1930s, many states levied sales tax on merchandise to raise revenue to help recover from the Great Depression. Many of the items that were sold at that time were available for a dime or less. Thus, a sales tax levied at 2 percent, required two-tenth of a cent to be collected, which was a difficult task for a merchant due to the absence of a fractional cent denomination or coin. Thus, a system of sales tax tokens was born to facilitate payment of sales tax. These tokens were made of metal, plastic, fiber and cardboard, and the value was usually in "mills" (one/tenth of a cent). The twelve states that issued tokens were Alabama, Arizona, Colorado, Illinois, Kansas, Louisiana, Mississippi, Missouri, New Mexico, Oklahoma, Utah, and Washington. Sales tax tokens were not popular and were considered a nuisance to the customer, and hence by the end of World War II, many states stopped using the tax tokens.[1]

Photo by Annette Nellen of metal and plastic sales tax tokens from her private collection.

California – Vending Machine Sales Tax

Ever wonder why a fresh fruit or fruit juice in a vending machine is more expensive than in the store? In California, the in-store sale of cold items and individual hot drinks to go are exempt from sales tax. However, the same items sold through a vending machine are generally subject to 33 percent sales tax on gross receipts from vending machine sales.[2]

[1] Monte C. Dean, A Brief History of Sales Tax Token & Scrip Collecting; Malehorn, Merlin K. and Tim Davenport. *United States Sales Tax Tokens and Stamps: A History and Catalog*. Jade House Publications. 1993. American Tax Token Society Newsletter, American Tax Token Society (1975), https://nnp.wustl.edu/library/book/541896?page=21.

[2] Publication 118, Vending Machine Food Sales, California Department of Tax and Fee Administration, http://www.cdtfa.ca.gov/formspubs/pub118/#applying.

Finland's National Jealousy Day

People in Finland observe what some call National Jealousy Day on November 1 every year as Finland's Tax Administration publishes taxable income of all its citizens.[3] The data available only on paper reveals taxable income of Finnish taxpayers and is a good measure of income equality or inequality and transparency in the country. The day is informally called National Jealousy Day because people may not be happy to discover that their peers are paid more than them. However, this is contrary to the World Happiness Report of 2019 published by the United Nations which finds Finland the world's happiest country in the world.[4]

Gossip Tax

Uganda introduced a gossip (lugambo) tax on non-productive conversations, small talk and pointless jabber. The tax officially named as "Over-The-Top" (OTT) came into force on July 1, 2018 and applies to the users of social media apps such as Facebook, Skype, WhatsApp, Twitter, Snapchat, Instagram, and YouTube. A tax of 200 Shillings ($0.05) per day is required to be paid by internet users to access OTT services that offer voice and messaging services over the internet.[5]

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[3] Kate Whiting, Finland recently published everyone's taxes on 'National Jealousy Day', World Economic Forum, November 2,2018 , https://www.weforum.org/agenda/2018/11/finland-has-just-published-everyone-s-taxes-on-national-jealousy-day/.

[4] John F. Helliwell, Richard Layard and Jeffrey D. Sachs, World Happiness Report 2019, https://worldhappiness.report/ed/2019/.

[5] Juliet Nanfuka, Uganda Blocks Access to Social Media, VPNs and Dating Sites as New Tax Takes Effect, CIPESA, July 1 2018; https://cipesa.org/2018/07/uganda-blocks-access-to-social-media-vpns-and-dating-sites-as-new-tax-takes-effect/.

ROGER
CPA Review

4 Tax Questions

for SJSU MST Contemporary Tax Journal

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1. In June of Year 2, Vasilia received a state income tax refund of $500 for overpayment of state income tax in Year 1. Vasilia deducted $1,800 of state income tax on Form 1040 for Year 1, making Vasilia's itemized deductions exceed the applicable standard deduction in Year 1 by $300. What amount, if any, of the state income tax refund is taxable on Vasilia's Year 2 Form 1040?

a) $0
b) $200
c) $300
d) $500

c) **Correct!** When a taxpayer receives a refund for an amount previously claimed as a deduction, the refund is taxable in the year received to the extent that a tax benefit was derived from the deduction. Since Vasilia received a tax benefit of only $300 by itemizing deductions rather than claiming the standard deduction, only $300 of the refund is taxable in Year 2.

2. The deduction of operating losses flowing through to an individual taxpayer's return from a passive activity generally is limited by each of the following **except**

a) Basis.
b) Passive income.
c) Portfolio income.
d) Amount at-risk.

c) Correct! The deduction of operating losses flowing through to an individual taxpayer's return from a passive activity generally is limited first by the taxpayer's basis in the activity. Losses that make it past the basis limitation are then further limited by the at-risk rules (i.e., amounts considered "at-risk," such as S corporation debt basis). Any losses remaining after the at-risk rules are applied may be deducted to the extent the taxpayer has income from other passive activities. Losses from passive activities may not be deducted against portfolio or active income. Losses barred from deduction by any of these limitations in the current year are suspended until such limitations will allow.

3. Wendy, a single individual, actively participates in a 50%-owned rental real estate activity that produces an $80,000 loss in year 1. Wendy's adjusted gross income was $110,000 before considering the rental activity. What amount of the rental loss, if any, is Wendy entitled to deduct for year 1?

a) $0
b) $20,000
c) $25,000
d) $40,000

b) **Correct!** If a taxpayer actively participates in rental activities, even though they are not a "real estate person," they qualify for a deduction of up to $25,000 of rental losses against ordinary income. However, the $25,000 loss allowance is reduced by 50% of the excess of the taxpayer's (single or joint filers) modified AGI (MAGI) over $100,000. In this case, Wendy, who files as single and has MAGI of $110,000, must reduce the $25,000 allowance by $5,000 (i.e., $110,000 MAGI – $100,000 threshold = $10,000 × 50% = $5,000 reduction). Thus, Wendy may deduct $20,000 of her $40,000 loss ($80,000 × 50%) against ordinary income in Year 1. The remaining $20,000 passive loss will carry over to the next year.

4. Quanti Co., a calendar-year taxpayer, purchased small tools for $5,000 on December 21, year 1, representing the company's only purchase of tangible personal property that took place during year 1. Assume Quanti Co. does not want to take §179 or bonus depreciation on the tools. On its year 1 tax return, how many months of MACRS depreciation may Quanti Co. claim on the tools?

a) One-and-a-half months.
b) One month.
c) Six months.
d) None.

a) **Correct!** In most cases, MACRS involves applying the half-year convention, under which assets are amortized for one-half of the year in the year of acquisition and in the year of disposal. When an entity acquires at least 40% of its depreciable and amortizable assets in the final 3 months of the year, the mid-quarter convention is applied, under which depreciation is calculated for only one-half of the last quarter of the year, or 1 ½ months.

Tax Policy Analysis
First-Time Homebuyer Credit Act of 2018
S.3364 (115th Congress)

By: Langzun (Edward) Li, *MST Student*

Background

On August 22, 2018, First-Time Homebuyer Credit Act of 2018 (S.3364, 115th Congress) was introduced in the Senate by Senator Ron Wyden and was referred to the Committee on Finance. This bill aims to extend and modify the first-time homebuyer tax credit that had temporarily been in the law, expiring in 2010.

S. 3364 makes a refundable tax credit available for first-time buyers of their first principal residence in the United States. The buyer must be at least 18-years-old and not claimed as a dependent by others. This credit is calculated as 2.5 percent of the purchase price of home, but it is also subject to a three-step limitation process which includes a $10,000 limitation and limitations based on the purchase price and modified adjusted gross income. This bill also includes a recapture rule which makes first-time homebuyers liable for additional tax if they buy and dispose of their first principal residence within five years. Exceptions to this recapture rule exist such as for death, divorce, or relocation of a military duty station.

To demonstrate how this bill works, assume Tony and Jenny are a newly married couple in the state of Oregon. They are both over 18 and looking forward to purchasing their first principal residence. Their modified adjusted gross income is $170,000. They found a house in Portland and purchased it for $620,000 in 2019. In this case, Tony and Jenny can claim a tax credit of $4,000. Even though the calculation indicates that the credit is $15,500 ($620,000x 2.5% = $15,500), it is subject to the first limitation of $10,000. Next, because the purchase price exceeds $600,000, the credit is reduced by $2,000 ($10,000 x (($620,000-$600,000)/$100,000) = $2,000), leaving a credit of $8,000. For the final limitation, because their modified adjusted income exceeds $160,000, the credit is reduced by $4,000 ($8,000 x (($170,000-$160,000)/$20,000) = $4,000), leaving a credit of $4,000 which would claim on their 2019 return (if enacted).

If Tony and Jenny sell this principal residence in 2022, which is three years after they purchased it, the recapture rule applies. Tony and Jenny would need to repay $1,600 to the Treasury ($4,000 x 40% = $1,600). However, if either spouse is on active duty in the military, and is ordered to relocate to another military duty station in 2022, they will not be subject to $1,600 tax liability under the recapture rule.

Next, S 3364 is analyzed using the twelve principles set out in the AICPA's *Guiding principles of good tax policy: A framework for evaluating tax proposals*.[1]

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

Principles of Good Tax Policy Worksheet

Criteria	Does the proposal satisfy the criteria? (explain)	Result
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer's income for different income levels of taxpayers.	U.S taxpayers with similar income but who purchase their first principal residences in different locations will receive a different homebuyer's credit because the amount of the tax credit is based on the prices of the homes, which vary significantly throughout the U.S. For example, assume there are three taxpayers with the same modified adjusted gross income which doesn't exceed the threshold based on modified adjusted gross income, but one lives in Oregon, one lives in California, and one lives in Missouri. The average home prices in Oregon, California, and Missouri are $338,300, $544,900 and $155,700 respectively.[2] If each purchase their first principal residences at the average home prices in their locations, the taxpayer in Oregon will receive a tax credit of $8,458 ($338,300 x 2.5%), the taxpayer in California will receive the maximum tax credit of $10,000 ($554,900 x 2.5%=$136223) and the taxpayer in Missouri will receive a tax credit of $3,893 ($155,700 x 2.5%). Based on the calculations above, taxpayers with the same taxable income but who live in different locations can receive significantly different tax credits. Therefore, this tax policy does not meet the principle of horizontal equity. If there are two taxpayers who live in California with different modified adjusted gross income buying their first principal residence at the average price mentioned previously, both taxpayers need to pay $108,980 ($544,900 x 20% = $108,980) as down payments based on the conventional 20 percent down payment.[3] If the taxpayer's modified adjusted gross income doesn't exceed the threshold limitation, he can get the maximum first-time homebuyer credit. However, for this taxpayer, this credit does not solve his urgent need which is making a 20 percent down payment of $108,980. Also, he receives the credit	+/-

[2] The data of the average home prices is from Zillow, https://www.zillow.com/.
[3]The data of conventional down payment percentage is from Zillow, https://www.zillow.com/mortgage-learning/down-payments/.

	after he first makes the down payment (after he files his tax return for that year). For the taxpayer with modified adjusted gross income above the threshold of the third limitation, he receives a tax credit which is less than $10,000. It is less difficult for him to pay $108,980 and he has a tax saving on his tax return. However, in this case, a taxpayer with a lower modified adjusted gross income receives a higher tax credit, and a taxpayer with a higher modified adjusted gross income receives a smaller tax credit. Therefore, the bill meets the principle of vertical equity. This bill meets the principle of vertical equity but fails to meet the principle of horizontal equity.	
Certainty – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that they have applied the rule correctly?	This bill clearly states that taxpayers can claim a credit on their tax returns when they purchase their first principal residence and meet the other requirements. The bill includes a three-step limitation process to determine the credit available for taxpayers to claim. It also includes a recapture rule and some exceptions to this recapture rule, which are clearly explained. Therefore, this bill meets the principle of certainty.	+
Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor?	This bill does not add an extra burden on taxpayers to pay their taxes because it only involves additional credits on their tax returns which does not affect the date they pay their taxes and the methods they use for paying taxes. However, the credit is not available at the time that the homebuyer most needs it – when they buy the home. Consideration should be given to whether there is a way to provide an advance credit at the time of purchase. Otherwise, this bill meets the principle of convenience of payment.	+
Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?	There are two main concerns regarding this bill which can hinder the effectiveness of tax administration. The first one is that the IRS needs to update multiple tax return forms which can be time-consuming. The second one is that because of the recapture rule, the IRS needs to keep track of taxpayers' addresses to stop people from abusing this tax credit. It is even more	+

	challenging than the first concern because it involves updating the IRS's current information systems and keeping track of those taxpayers who claimed this credit and disposed of their residence in less than five years after claiming the credit. However, based on a calculation from the National Association of Home Builders (NAHB), an average home buyer is expected to stay in a home for 13 years.[4] Therefore, the IRS should assume that only a small number of taxpayers will be subject to this recapture rule. The burden of keeping track of the addresses of those taxpayers should not be heavy. Therefore, this bill meets the principle of effective tax administration.	
Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	There are specific reporting requirements for taxpayers to receive this credit. They must provide their social security number, street address, the purchase price of the principal residence, the date of purchase of the primary residence and the closing disclosure relating to the purchase. Social security and street address are standard information reported on tax returns. Purchase price and purchase date of the principal residence are also public information. The closing disclosure relating to the purchase is confidential information. However, it is unlikely the information is misused due to unintended and improper disclosure. Therefore, this bill meets the principle of information security.	+
Simplicity - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner?	The calculation of the credit amount can be complicated because it involves a three-step process to determine the tax credit which includes a limitation on the dollar amount, purchase price of the principal residence and modified adjusted gross income. Furthermore, it includes a recapture rule which makes it more difficult for taxpayers to understand the rule. Therefore, this bill does not meet the principle of simplicity.	-
Neutrality – Is the rule unlikely to change taxpayer behavior?	The bill intends to encourage people to purchase their first principal home. However, based on a report in 2017 from the National Association of Realtors, "35% of all home buyers are first-time home buyers. The main reason for	

[4] Latest Calculations Show Average Buyer Expected to Stay in a Home 13 Years by National Association of Home Builders; http://nahbclassic.org/generic.aspx?GenericContentID=194717.

	first-time home buyers to purchase their homes is the desire to own a home of their own".[5] Therefore, this tax credit is not the primary motivation for people to purchase their first principal homes. Therefore, this bill meets the principle of neutrality in that it won't affect decision making of all buyers but will help more to afford a first home.	+
Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy?	Homeownership is a central part of national ethos, in which the American dream is achieved. Homeownership is good for economic growth. However, according to the report by the United States Census Bureau, homeownership rates for all age group were lower in 2017 than in 2006, the year before the Great Recession (2007-2009)".[6] The clear intention of this bill is to increase the homeownership in the U.S. For most Americans; they usually own more than one home in their lifetime. "Homeowners typically sell their starter home and trade up after 7-to-10 years".[7] Homeownership can contribute to economic growth and job creation because there are many expenditures related to home ownership such as a mortgage, remodeling, moving, lawn improving all of which generally requires professionals to help. Therefore, this bill meets the principle of economic growth and efficiency.	+
Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	Realtors and brokers will become active in promoting this tax credit because they consider it is beneficial to their business. They will let the first-time home buyers know their purchases can provide additional tax benefits. However, the complicated three-step limitation process makes it difficult for taxpayers to understand how this tax	-

[5]Home Buyer and Seller Generational Trends Report 2017 by National Association of Realtors, https://www.nar.realtor/sites/default/files/reports/2017/2017-home-buyer-and-seller-generational-trends-03-07-2017.pdf.

[6] Derick Moore, "Homeownership Remains Below 2006 Levels for All Age Group" United States Census Bureau, Aug 13, 2018 https://www.census.gov/library/stories/2018/08/homeownership-by-age.html.

[7] Lawrence Yun "Why Homeownership Matters", Forbes, Aug,12, 2016. https://www.frbsf.org/community-development/publications/community-development-investment-review/2016/august/homeownership-and-the-stability-of-middle-neighborhoods/.

	credit benefits them, and they are likely not to be aware of the existence of the recapture rule of this credit. Therefore, the bill does not meet the principle of transparency.	
Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	One concern regarding noncompliance tied to this tax credit is whether people will ignore the recapture rule and not pay their tax liability when they sell their first principal home within five years after they claimed the credit. The report from the National Association of Home Builders (NAHB) indicates that the average home buyer keeps his residence for 13 years. Therefore, it is only a small number of people who will be subject to the recapture rule, and it is only a fraction of those people will push their luck to not paying their tax liabilities when they sell their first principal residence within five years. Another concern is that some buyers may claim the credit even though it is not their first residence as defined in the bill. However, the IRS is likely to catch these problems. Therefore, the bill meets the principal of minimum tax gap.	+
Accountability to taxpayers – Will taxpayers know the purpose of the rule, why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?	This bill has a strong intention to encourage people to purchase their first principal home. However, one of the biggest challenges for people to purchase their homes is the down payment. Taxpayers receive this credit only after they purchased their homes and pay the down payment. Therefore, it does not relieve the burden of those taxpayers in the first place. Alternatives such as providing an affordable mortgage with a low percentage of down payment should be considered because it directly addresses the main concern of those taxpayers. Therefore, the bill does not meet the principal of Accountability.	-

Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?	The government has data from agencies such as the United States Census Bureau and U.S. Department of Housing and Urban Development. The government can produce a reasonable estimate on the number of first-time homebuyers who can claim the credit, and the amount of tax credit returned because of the recapture rule. Therefore, the bill meets the principle of appropriate government revenues.	+

Conclusion

S.3364 (115th Congress) mostly meets the principles of good tax policy as it meets eight out of the twelve principles. It is considered neutral in one principle, and it fails the principle of simplicity, transparency, and accountability. The failure in the principles of simplicity, transparency, and accountability can be improved by modifying the threshold on the dollar amount limitation and eliminating certain limitations. Because this credit reduces government revenue, it is crucial for the government to consider an alternative to mitigate the shortfall. A thorough study should be done as to whether there is a suitable provision such as reducing the mortgage interest deduction. The government should consider enacting this bill because the advantages of this bill outweigh the disadvantages.

Suggestions for improvement:

1. Consider reducing the threshold of the limitation on the purchase price. Instead of setting the limitation on purchase price of a residence over $600,000, change the amount to be closer to the average home price for each state (or particular regions in the states) to better meet the principle of horizontal equity.
2. The combination of the three-step limitation process and the recapture rule can be complicated. Consideration should be given to keeping the dollar limitation but eliminating the last two steps in the three-step limitation process to simplify the calculation of the tax credit so that it is easier for taxpayers to understand and comply with the rules.

Tax Policy Analysis

H.R. 285 (116th Congress) - The Mortgage Debt Tax Forgiveness Act of 2018

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IRC Section 61(a)(11) specifies that a debt that is forgiven or canceled by a lender is considered taxable income to the debtor in the year discharged. Section 108 describes circumstances under which income from discharge of indebtedness can be excluded from gross income. The debt does not have to be included in taxpayer's gross income if it meets a specified exclusion(s). The main exclusions: debt cancelled in a bankruptcy proceeding or when the person is insolvent. The taxpayer is also allowed to exclude a certain amount from gross income if the discharged debt is associated with the primary residence; but only if the discharge occurs before January 1, 2018.[1]

In order to meet the qualified as principal residence requirement, the debt must be acquisition indebtedness within Section 163(h)(3)(B), and the home must be used only as a principal residence as defined at Section 121. An owner of a residence with this qualified discharged debt can exclude up to $2 million (or $1 million if married and filing separate returns) of cancellation debt income.

The tax exclusion under Section 108(a)(1)(E) and (h) expired on December 31, 2017. However, on January 8, 2019, the proposal to make permanent the exclusion from gross income of discharge of qualified principal residence indebtedness was introduced in the House of Representatives by Representative Brownley of California (D-CA). The proposal was referred to the House Committee on Ways and Means.

Application of Principles of Good Tax Policy

This section analyzes H.R. 285, the Mortgage Debt Forgiveness Act, using the twelve principles set out in the AICPA's *Guiding principles of good tax policy: A framework for evaluating tax proposals*.[2]

[1] Section 108(a)(1)(E).
[2] American Institute of Certified Public Accountants (AICPA) Tax Division. (January 2017). *Tax Policy Concept Statement 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*; available at https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf.

Criteria	Does the proposal satisfy the criteria? (explain)	+/-
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual's income level and where they live.	There are two types of equity that should be considered. Horizontal equity is met when similarly situated taxpayers are treated similarly for tax purposes. This principle is not met in the proposal. For two individuals with the same level of income, the benefit of the exclusion depends on the amount of the mortgage. For one person, the discharged amount not included in the gross income could be $100,000 whereas another person can exclude the whole $2 million. Moreover, neighbors living side by side in a similarly valued homes might not be treated similarly. For example, two neighbors acquire their principal residences utilizing debts in the same amounts and of the same terms. One neighbor pays the mortgage over the full term of the loan and the other defaults on his/her mortgage and is able to bear no consequences of his/her actions. Finally, a single taxpayer can exclude the same amount of qualified debt as a married couple, so taxpayers are not treated similarly based on their marital status. Vertical equity stands for situations when a person with the greater ability to pay should pay more tax. There is no phase out for higher earning taxpayers. In addition, only homeowners benefit from the exclusion and there is no similar proposal to help financially strapped renters. Thus, vertical equity is also not met. Neither horizontal nor vertical equity principle is met and making the law permanent will not change this.	-
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?	The amount excluded from income tax needs to be entered on the federal tax return. H.R. 285 clearly states the definition of qualified home indebtedness and the definitions of primary residence and acquisition debt. Reporting is also clear: Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, needs to be attached to a taxpayer's federal income tax return to report the excluded cancellation of debt income amount.	+

Convenience of payment – is the tax due at a time that is convenient for the payor?	The benefit of the exclusion will not be received until the taxpayer files his/her federal income tax return. The form is filed at the same time the federal return is filed.	+
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.	The Section 108 rule for excluding certain residence debt that is forgiven was put in place in 2007 and it has been renewed a few times. The change to a permanent exclusion would not be too onerous on the IRS since the tax forms in the past already included the field for entering this exclusion. There is also guidance from the IRS on how to ensure compliance with the rule when it was enacted as a temporary provision and there is no need to issue new guidance if the rule becomes permanent. Making the law permanent might actually reduce costs to the IRS as the forms will not need to be updated as was the case when the law was extended from year to year.	+
Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	Cancellation of mortgage debt is normally reported to the borrower and the IRS by the lender using Form 1099-C, Cancellation of Debt, or Form 1099-A, Acquisition or Abandonment of Secured Property. There have been issues with the form being sent to the primary residence after the owners were forced to move, which caused privacy concerns and data security issues, as well as reporting issues when the taxpayer doesn't receive the tax form. Making the exclusion permanent will not improve this issue as there is nothing in the proposal about lenders having to find the current address of the borrower or being required to use a truncated social security number for the borrower on the reporting form provided to the borrower.	-
Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?	Form 982 needs to be attached to the taxpayer's return. The form is complex, and a lot of taxpayers do not know that they need to fill it out. Making the law permanent will not solve this issue. In addition, many people are unaware that they qualify for a gross income exclusion if they are insolvent or in bankruptcy. As long as they receive a 1099 Form from the lender about the discharge of indebtedness, they generally feel obligated to enter the amount on their Form 1040 as taxable income.	-

Neutrality - 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.	The proposal might encourage some individuals buying a primary residence to borrow more than they would otherwise have done or buy a property that is too expensive for their income level. If they end up not being able to make mortgage payments they know that they might be able to have their mortgage debt canceled, without tax consequences. In addition, they might decide to invest using leverage in their residence rather than other types of investments (like stocks or bonds) because they will be less risk associated with the residence investment. Thus, the proposal could affect a taxpayer's decision making. On the other hand, a "typical" home buyer wants to own a house based on their existing level of income, preferable size and/or location. Losing jobs and becoming insolvent is something that generally, households don't plan or anticipate when they buy a home. Moreover, defaulting on a debt can affect a person's credit status, so it is a situation that people usually avoid. A typical homeowner does not want to make an investment to try to game the tax system. Thus, the existence of the exclusion should not affect the decision making for most homeowners.	**-/+**
Economic growth and efficiency – will the tax unduly impede or reduce the productive capacity of the economy?	The proposal might unduly impede the productive capacity of the economy. Taxpayers may take on more risk because they are not fully responsible financially for the consequences of their actions due to the exclusion for the cancelation of home indebtedness if permanent. This represents the idea of a moral hazard. Making the law permanent might incentivize taxpayers to take on even more risk since there is no sunset to the provision. Moreover, the forgiven mortgage results in costs to banks, other borrowers, and the government. While one particular discharge of indebtedness would not destroy the financial health of a lender, mass discharge due to the economic downturn can. Also, every time an individual excludes the discharged income from his gross income, the government loses revenue.	**-**

Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	Taxpayers might not know that discharged debt might be taxable and that there are exclusions to the rule. In addition, taxpayers may not be aware that the exclusion expired as well as whether it has been restored. Moreover, temporary proposals that become active and non-active from time to time make it difficult for an average taxpayer to track. People might be confused whether this exclusion exists this year or not because they, for example, heard it expired last year. Making the law permanent would improve transparency, especially if certain steps to inform people are made. To improve transparency even further taxpayers could be educated on this tax rule. Currently, the instructions for Form 1099-A only warn taxpayers that the amounts reported on the form could be included in gross income and taxable. Adding a note that the amounts might be excludible from gross income in specified circumstances and referring recipients of the reporting form to Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (For Individuals),* for more details would make more people aware of the law and how it works. Another way to improve transparency would be to provide information when borrowers sign the home closing and mortgage documents. Then, they could be informed about the law before they decide on a home purchase using debt. To summarize, an overview of the law on the loan documents and/or a note on the Form 1099-A would be a good way to inform and educate borrowers and improve transparency.	+
Minimum tax gap – 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?	If the exclusion becomes permanent, it would generally improve compliance. Tracking if the exclusion is in effect or not during a specific year is generally difficult for taxpayers. As a result, people might unintentionally include or exclude their discharged debt from the gross income. Making the law permanent would give more certainty to taxpayers. As was discussed in the Transparency section, Form 1099-A, *Acquisition or Abandonment of Secured Property*, could include a separate section with an advice to taxpayers about the possibility of exclusion. This should help the proposal to better meet principles of transparency and minimum tax gap simultaneously.	+

Accountability to taxpayers – Do taxpayers have access to information on tax laws and their development, modification and purpose; is the information visible?	Although the IRS tries to post on its website a good deal of tax information, taxpayers generally do not know about the modifications and development of the tax law.[3] The publications and instructions are posted by the IRS, but those do not reveal *why* the rules were enacted and why they were temporary. Is this legislation needed? Congress passed the legislation initially in 2007 and it was good for three years. It was then extended several times. In 2007 the economy entered a mortgage crisis which lasted for an extended period of time, and it threatened the economic recovery in the country. Now the mortgage crisis is mostly behind us, so there is less need to support homeowners who face financial troubles beyond the existing and permanent exclusions for individuals who are insolvent or in bankruptcy. In addition, it is a generous provision as most homes in the U.S. are worth well below $2 million. According to the U.S. Census Bureau website, the median home price in the United States is $308,000 and for southern California (where the representative sponsoring the bill is from) the median price is $518,000.[4]	-
Appropriate government revenues – will the government be able to determine how much tax revenue will likely be collected and when?	The proposal meets the principle of appropriate government revenues as the government could estimate the budget effect of modification of discharge of indebtedness on a principal residence excluded from gross income of individuals, as was done in the report presented for the Tax Relief Extension Act of 2015.[5] This means that the government has the ability to estimate the effect of the proposal. Making the exclusion permanent will lower revenues for the government. The economic situation in the country, however, could shift the trends in claiming the exclusion, but the government should be able to adjust the estimates accordingly.	+

[3] In fact, many people likely were not aware when the exclusion for discharge of qualified principal residence debt was enacted.

[4] Median and Average Sales Prices of New Homes Sold in United States, Census.gov; accessed July 17, 2019; https://www.census.gov/construction/nrs/pdf/uspricemon.pdf.

[5] Joint Committee on Taxation, "A Report to the Congressional Budget Office of the Macroeconomic Effects of the "Tax Relief Extension Act of 2015", Aug. 4, 2015, p. 4; accessed July 17, 2019; www.jct.gov/publications.html?func=download&id=4807&chk=4807&no_html=1.

Summary

In conclusion, the proposal does not meet all of the twelve principles for good tax policy. The analysis helps to discover the strengths and weaknesses of the proposal, and it reveals that there are more weaknesses than strengths. Although it might sound like a good proposal aiming to help people going through financial difficulties, making it permanent could create additional problems. In particular, as the analysis shows, the equity principle is not satisfied, so taxpayers may be frustrated that the exclusion might be limited for married individuals or those whose forgiven debt exceeds an allowed amount. If the exclusion becomes permanent, so the attitude about the exclusion will become lasting.

Another problem with the proposal is that it would reduce the revenue collection for the government. Improving the simplicity and transparency would most likely decrease the revenues for the government as the compliance and appropriateness in claiming of the exclusion would improve. The principle of neutrality is satisfied for typical homebuyers who do not plan for debt relief when they borrow, but the proposal may affect the decision making of investors who could try to abuse the exclusion.

Furthermore, making the exclusion permanent might lead to adverse economic effects such as over-investment in residential real estate using debt versus other investment vehicles (stocks, bonds, etc.). Over-investment might lead to another housing financial crisis. The provision, if made permanent, might incentivize taxpayers to take unusual risks because there are no adverse tax consequences associated with defaulting on a mortgage. The tax system should not be used to subsidize and encourage one particular type of risk. Based on these factors, the proposal would not be a good idea. In addition, borrowers who find themselves in unexpected financial problems resulting in foreclosure might qualify for the permanent exclusions for insolvency or bankruptcy.

Something that can improve the proposal is to adjust the exclusion amount for the areas with lower and higher real estate prices. Also, adding a phase-out for higher income taxpayers would address the issue of vertical equity. If the IRS includes information about the Section 108 exclusions on Forms 1099-A and 1099-C, taxpayers' awareness of the tax rules on cancellation of debt income and possible exclusions would greatly improve and compliance would be better. In this case, taxpayers would be more informed, and the principle of transparency would be met.