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Letter from the Editor

We are excited to present to you the Winter 2021 issue of *The Contemporary Tax Journal*. Over the past few months, we worked with fellow students and tax practitioners to present you this edition. The topics covered in this issue are current and thought-provoking.

Our regular feature *Tax Enlightenment* presents an article written by an MST student summarizing a recent court case about a malpractice lawsuit settlement payment.

Next, our *Tax Feature* presents summaries written by MST students on presentations made at the 36th Annual TEI-SJSU High Tech Tax Institute held in November 2020. The topics covered in these summaries include post-pandemic tax practice, CARES Act changes, debt restructuring and other strategies for a strong future, post-election tax analysis for high tech and beyond, U.S. international tax issues and developments, and the research tax credit.

Our *Tax Maven* for this issue of our journal is Ms. Gloria Sullivan, the Director of Western Compliance Practice Area in LB&I Division at the IRS. She offers students and new tax practitioners’ knowledge from her experiences and valuable advice as a successful tax practitioner. I was honored to have a Zoom interview with her and learn about her remarkable career in the tax field. I hope her insights and experience will inspire your professional goals.

Our special section, *Fun Tax Facts*, presents interesting facts about taxation written by Tina Tan. We would like to thank Tina for this generous contribution to our journal.

Finally, *A Focus on Tax Policy* presents the analysis of three Federal tax proposals: H.R. 6787, Providing Essentials for Frontline Workers Act, by MST students Yixin Liang and Aarti Shah; S. 4319, Supporting America’s Restaurant Workers Act, by MST students and Tina Tan; and S.2697, Tariff Tax Credit Act of 2019, by MST students Hanna Shatanionak and Liubov Shilkova. These tax bills were analyzed using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.¹

I would like to thank all the contributors of this issue and fellow MST students. Also, I would like to thank Professor Annette Nellen for her continuous support, her invaluable contributions to this journal, and for being an inspiration to me. I am also grateful to student co-editor Tina Tan and to our MST coordinator and journal webmaster Catherine Dougherty. Their insights and hard work made this issue of the journal possible.

I invite you to enjoy reading our journal and hope you will consider contributing to our upcoming issues. I now present to you the Winter 2021 issue of *The Contemporary Tax Journal*.

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Regards,
Liubov (Luba) Shilkova
Student Editor
Malpractice Lawsuit Settlement Payment Is Includable

By: Sheetal Partani, MST Student

**McKenny v. U.S.,126 AFTR 2d 2020-5943(11th Cir.)**

The Eleventh Circuit Court of Appeals reversed a lower court decision and held that taxpayers must include in the income, a malpractice claim settlement award received from an accounting firm. The court agreed with the lower court’s holding concerning the denial of legal expense deductions and losses the taxpayer claimed related to transactions involving the accounting firm. A summary of the McKenny case follows.

**Basics of Deductible Business Expense versus Non-Business Expense**

IRC §162 allows a deduction for "all the ordinary and necessary business expenses paid or incurred during the taxable year in carrying on any trade or business." To be deductible under IRC §162(a) an expense must have a business origin. The characterization of legal cost as business or personal depends on the origin and character of the event that led to the expense.

**Basics of Gross Income**

Gross income is defined broadly at IRC §61 as "all income from whatever source derived." It is the total of the amount received from various sources unless expressly excluded under the tax law. When a taxpayer receives a settlement award after a claim, its treatment of inclusion or exclusion from gross income depends on the reason for which the settlement for damages was awarded.

**Background of the Case**

Mr. and Mrs. McKenny were residents of Missouri in the late 1990s. The husband (H) worked as an independent consultant, providing advisory services for a car - dealership business. He hired accounting firm, Grant Thornton for tax planning advice.

Grant Thornton suggested that H form his consulting business as an S corporation for tax purposes. This suggestion also included that the S corporation be owned by an employee stock ownership plan (ESOP), with H as the sole beneficiary of the ESOP. This plan would enable H to accumulate tax-free income in the ESOP until distributions were made to him. Following this plan, H could also defer tax on his income from the consulting business. The income earned from the company would pass through the S corporation without being subject to corporate income tax.
In 2000, Grant Thornton's advice was implemented, and Joseph McKenny Inc. ESOP was formed, with McKenny as its sole beneficiary. Following the firm’s direction in the same year, H also acquired a 25 percent stake in a GMC car dealership in Florida, with this stake held in a separate S corporation. This S corporation was wholly owned by Joseph McKenny Inc. ESOP. For tax purposes, Grant Thornton suggested H characterize the dealership's payments to the S corporation as management fees instead of partnership profit share. For numerous years, they paid little or no federal income taxes.

The IRS audited the McKenny's tax returns in 2005 and determined underpayment in their federal income taxes between 2000 and 2005. The IRS alleged that tax planning concerning the ESOP was an abusive tax shelter. The dealership's payments were improperly characterized as business expenses for tax purposes. The McKennys settled with the IRS and paid over $2.2 million in taxes, interest, and penalties. They entered into a closing agreement, which states that no amount would be allowed as an ordinary loss for the years at issue. The McKennys were not entitled to any deductions or business losses relating to the ESOP and accepted that they owed unpaid taxes.

The McKennys subsequently sued Grant Thornton. They alleged that their accounting firm was negligent and committed malpractice and held the firm responsible for their unpaid tax liabilities for the years at issue. The firm provided complex tax planning, which did not work well, and that is why the McKennys had to pay a large tax bill. In 2009, the accounting firm settled the lawsuit by paying $800,000 to the McKennys but denied any wrongdoing.

Over the consecutive three years (2009-2011), the McKennys filed tax returns with several deductions and exclusions related to their lawsuit against Grant Thornton. For the 2009 tax return, the McKennys claimed a deduction for legal fees of $419,490, which they paid to litigate the malpractice claim. They excluded the $800,000 settlement payment from gross income. They claimed an unreimbursed loss of approximately $1.4 million which was the difference between the amount they paid to the IRS ($2,235,429) and the amount they received from accounting firm as a settlement payment of $800,000. The McKennys claimed a net operating loss based on deductions and exclusions, and it was carried forward to 2010 and 2011 to reduce their tax liabilities.

After the IRS issued a notice of deficiency in 2013, the McKennys ended up paying an additional $813,407 in taxes. The notice stated that all the deductions and exclusions claimed were disallowed. The IRS recharacterized the legal expenses as a miscellaneous itemized deduction (rather than as a business deduction), subject to the two percent of adjusted gross income limitation. After the IRS denied all deductions and exclusions, the McKennys filed a lawsuit in the District Court of Florida.

The district court ruled in favor of the government on the legal fees and unreimbursed loss. It concluded that they were not deductible as business expenses because the McKennys sued the accounting firm on their personal behalf rather than the consulting business bringing the suit.
The court also mentioned that their 2007 settlement with the IRS barred McKennys from claiming any losses related to the ESOP transactions. They held in favor of McKennys that the settlement payment of $800,000 was a return of capital rather than income. Both the IRS and McKennys were not convinced with the district court's decision, and they sought reversal in the U.S. Court of Appeals for the Eleventh Circuit.

The Eleventh Circuit's Decision

The Eleventh Circuit partially reversed the lower court's decision on the settlement payment of $800,000 to be excluded from the income. It held that the settlement payment received by the McKenny's was not a return of capital but was taxable income. The Eleventh Circuit sided with lower court’s decision that the legal fees were personal expenses only deductible to the extent they exceeded two percent of AGI along with the McKenny’s other miscellaneous deductions.

Explanation of the 11th Circuit’s Holding

Exclusion of settlement payment

The McKenny's argument was based on Clark, 40 BTA 333 (1939). A settlement payment received in Clark was due to the tax adviser’s error in preparing and filing the married couples tax return. The adviser recommended the Clarks file jointly but later discovered he should have suggested filing separately. This negligence caused the Clarks to pay almost $20,000 more in taxes. Because the law does not allow an amended return to change this filing status, the Clarks ended up paying more than the minimum amount of tax owed.

The Board of Tax Appeals held that the payment received was reimbursement which constituted "compensation for a loss which impaired petitioner’s capital,” and was not taxable. The IRS acquiesced to the Clark case in Revenue Ruling 57-47.

After a discussion of the “very difficult questions” presented by Clark and similar situations and questioning if the Clark case was correctly decided, the appeals court found that the McKenny’s situation was not the same as that of the Clarks. The settlement received by the McKennys related to taxes they truly owed on the “structuring of an underlying transaction.” The court also noted that the McKennys failed to “sustain their burden of demonstrating that the $800,000 settlement was excludable.”

Treatment of Legal Fees

The McKennys contended that their legal fees were deductible as a business expense under IRC §162 because they related to McKenny's business. This argument though is not the correct one for legal fees. As addressed by the lower court, for legal fees to be a business deduction, they must have a “business origin." This is the origin of the claim doctrine laid out by the U.S. Supreme Court in United States v. Gilmore, 372 US 39 (1963). In the Gilmore case, legal fees
were incurred by Mr. Gilmore to protect his business interests, but the origin for why the legal action existed was a divorce. Thus, the origin was personal rather than business making his legal fees personal. For the McKennys, the accountants had an agreement with the McKennys, not their businesses. The appeals court therefore affirmed the district court decision on the legal expenses not being deductible as a business expense.

**Unreimbursed Loss Deduction**

The McKennys contended that their $1.4 million loss claimed was not related to ESOP transactions due to the accountants "failure to reimburse" them fully in the lawsuit. This deduction was denied by the IRS because their audit closing agreement clearly stated that McKennys agreed to pay tax attributable to the disallowance of any of the ESOP transactions. The Eleventh Circuit noted that it was "a distinction without a difference." The court mentioned that the McKennys did not have a position to dispute that their $2.2 million tax payment to the IRS was not related to ESOP transactions. Their settlement agreement with the IRS as per IRC §7121 blocked them from claiming any deduction based on this payment. IRC §7121(b) does not allow them to reopen matters that are agreed upon and treated as final and conclusive under the Code. Therefore, the court affirmed the lower court’s decision barring the $1.4 million loss.

**Lessons Learned**

As *Clark* is still valid authority, it helps taxpayers decide the tax malpractice settlement award issue. The holding in *McKenny*, on the other hand, has clarified the taxability issue. As a result, taxpayers facing these issues should refer to both cases and be careful in determining whether a payment from a preparer must be included in gross income.

In addition, the McKenny case reminds us of the origin of the claim test as still applicable to determine if legal fees are personal or business for tax purposes.
Post-Pandemic Tax Practice: Lessons Learned for the High-Tech Sector

By: Charlene Kliatchko, MST Student

The 36th Annual TEI-SJSU High Tech Tax Institute Conference took place on November 9th and 10th, 2020; the first time since its establishment that the conference was held virtually. This was due to the gathering restrictions of the COVID-19 pandemic. The conference featured panels with government representatives, tax practitioners, academic professionals, and industry professionals. The panel that spoke on Post-Pandemic Tax Practice: Lessons Learned for the High-Tech Sector addressed the issues and revelations that arose during the pandemic. Panel representatives were Nora Beltran, IRS Western Compliance, Territory Manager; Stephen Dunphy, Vice President of Tax Operations at Ross Stores and President of the TEI Silicon Valley Chapter; Lupita McLane, Chief People Officer at Seiler LLP; Peter Rock, IRS Western Compliance Director of Field Operations; and Jeff Swerdlow, Senior Director at Alvarez & Marsal, LLP.

Challenges for the IRS

The IRS representatives, Nora Beltran and Peter Rock, addressed the difficulties and infrastructure challenges the IRS faced at the start of the pandemic. When the COVID-19 stay at home orders were put in place, it became mandatory for businesses to require all workers to work from home. It required the IRS to switch from working full-time in the office to full-time teleworking. Ms. Beltran explained that the IRS was not ready to have its employees work remotely, which made it extremely problematic to transition to full-time teleworking. She explained that there was significant stress on the IRS system due to the volume of teleworkers using it all at the same time. The IRS had to modify their processes due to the restrictions of the pandemic. All paper files are located in the office and audit sites, but auditors had no access to audit sites. In addition, IRS audits were not as fast to adapt to web access or Zoom, as opposed to, face to face audits. As a result, substantial virtual training and great emphasis on cyber security was required. The IRS learned that although it took a great deal of time and development of processes to convert to full-time teleworking, it allowed schedule flexibility for employees. Mr. Rock went into detail about this which required employees to work the core hours of 9:30 a.m. to 2:30 p.m., but the flexibility to work any other time, up to 10 hours a day, either 4 or 5 days a week.

Challenge for Industries

Mr. Dunphy emphasized how difficult it was to transition the whole company to teleworking. Ross was not fully prepared to have their management and employees work remotely. Employees were not equipped with the resources and technology needed to work from home, so the company had to provide these to their employees. In addition, management also had to build policies on the fly. The stress and workload of preparing the company for teleworking was disruptive to the business. At the start of the pandemic, Ross Stores had to close due to the shelter-in-place orders. Gross receipts decreased by more than 50 percent. Although sales
decreased significantly, the company still wanted to continue to pay their employees. The employees were happy, and the company was allowed a tax credit. Mr. Dunphy discussed the Employee Retention Credit under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which allows the company a credit up to 50 percent on up to $10,000 of qualified wages paid per employee. This, however, was burdensome for the company to compute. It consumed a lot of their payroll employees’ time to gather sales and payroll details to substantiate the requirements for the credit.

Challenge for Tax Practitioners

Mr. Swerdlow mentioned that prior to COVID-19, Alvarez & Marsal, LLP had a meeting about transitioning the firm to teleworking and flex scheduling for employees. However, due to the abrupt restrictions of shelter-in-place orders, Mr. Swerdlow explained that instead of easing into implementing work-from-home processes, the firm had to work quickly and operate in a fast-paced and frantic style.

Ms. McLane emphasized the significance of creating a successful long-term remote work strategy for the company, and most importantly, for their employees. Ms. McLane described how important it is to keep the company culture alive, even through virtual working. She briefly discussed the effects of teleworking, including high anxiety and loneliness; and the importance of being aware of an employee’s well-being. She advised that leaders need to be available for employee support and show compassion during these uncertain times. Ms. McLane emphasized that it is crucial for employers to consider the needs of their employees in order for an organization to succeed.

Mr. Swerdlow discussed the impacts of the changed work requirements. He explained that it is hard to say what will happen after we overcome the pandemic. Mr. Swerdlow mentioned that the population may have different preferences. There will be some people who will want to go back to working in the office, while others will want to continue to telework full-time. Then, there may be some people who want the hybrid model of working, that allows split time between time working in the office and working remotely. Mr. Swerdlow described the practical considerations that need to be put in place if offices begin to open to their employees and the public. Furthermore, he explained that organizations have adapted well so far, and recommends that all should consider the future and think long-term going forward.

Conclusion

The panel of representatives shared the challenges they faced that other establishments can relate to. As a tax and accounting professional, I personally experienced the struggles of transitioning and working from home. It was a surprise to hear that other companies, even large ones, were not already prepared to telework. I learned that it is crucial that organizations establish a work-from-home culture that will last, and that is it essential to build a system and processes that work best for your business, and especially for employees. Businesses need to
consider what its people need to succeed. Organizations should embrace teleworking and allow employees the flexibility and opportunity to work where they please. It will give businesses the opportunity to empower their workforce in new ways.
Dealing with Losses: CARES Act Changes, Debt Restructuring, and Other Strategies for a Strong Future

By: Jane Lei, CPA, MST Student

The 36th Annual TEI-SJSU High Tech Tax Institute conference featured a panel of four subject matter experts tackling the timely topic of “Dealing with Losses: CARES Act Changes, Debt Restructuring, and Other Strategies for a Strong Future.” The panelists included Rob Black, Partner at PwC; Eileen Marshall, Partner at Cooley; Mark Perwien, Senior International Advisor, Enterprise Activities, at the Internal Revenue Service; and Myra Sutanto Shen, Partner at Wilson Sonsini Goodrich & Rosati.

Net Operating Losses - The CARES Act

Mr. Black kicked off the presentation by reviewing the impact of the Coronavirus Aid, Relief, and Economic Security (CARES) Act on tax provisions related to net operating losses (NOLs). To provide economic relief to businesses struggling from the impact of the pandemic, the CARES Act was signed into law in March 2020. Among other things, it amended section 172 to allow a five-year carryback of NOLs from the tax years beginning in 2018, 2019 and 2020. As a result of this change, losses generated during the three-year period from 2018 through 2020 at a 21 percent tax rate can be carried back to the preceding five-year period which was subject to the higher 35 percent tax rate. The CARES Act also temporarily removed the 80 percent taxable income limitation to allow an NOL to fully offset taxable income. The 80 percent limitation will resume after December 31, 2020.

Mr. Black further discussed the impact of the changes to the NOL rules on completed mergers and acquisitions (M&A) transactions. Specifically, corporations that have engaged in M&A transactions since the enactment of the Tax Cuts and Jobs Act (TCJA) should evaluate the potential benefits of carrying back any recent NOLs and should review the transaction agreements to determine how to allocate any tax refunds resulting from the CARES Act provisions between the parties. Ms. Marshall noted that because many companies did not contemplate the applicability of NOL carrybacks after the TCJA and prior to the CARES Act, the companies may have removed such provisions from pre-TCJA agreement templates as they were deemed inapplicable. Ms. Sutanto Shen added, however, that carryback provisions may have still been relevant in certain state and/or foreign jurisdictions, in which cases, agreements may have retained their carryback provisions.

No doubt there are many complexities associated with carrying back an NOL in an acquisition scenario, whether the NOL is generated pre-acquisition or post-acquisition. Depending on the circumstances and mechanics of the transaction, a buyer may have different options at its disposal. For example, the buyer may decide to waive the carryback period and carry forward the NOL. The election to waive the carryback period must be made no later than the timely filed return for the year that includes the NOL, with the exception of NOLs generated in 2018
and 2019, for which the election must be made no later than the timely filing of the 2020 tax return.

In the case of a buyer that is part of a consolidated group that generates a post-acquisition consolidated NOL (CNOL), the group may make an irrevocable election to waive the entire carryback period with respect to the CNOL. In this case, the election would be applicable to the entire group and none of the CNOL may be carried back. An alternative option known as the “split-waiver election” is available, whereby a buyer consolidated group may make an irrevocable election to waive all CNOLs attributable to an acquired company for the portion of the carryback period during which the acquiree was a member of a different consolidated group. A split-waiver election must generally be filed with the buyer consolidated group’s timely filed original return for the year in which the corporation became a member. Because of the amendments to NOL rules from the CARES Act, the IRS issued temporary regulations to effectively allow a buyer consolidated group to file a late amended split-waiver election by November 30, 2020.

**Section 382(h)**

Next, Ms. Sutanto Shen covered the proposed regulations under section 382. Section 382 imposes limitations on NOL carryforwards and certain built-in losses following an ownership change. The annual limitation is based on the fair market value of the corporation’s stock prior to the ownership change multiplied by the applicable federal long-term tax-exempt rate, which is currently a low 0.89 percent.

If a loss corporation\(^1\) has a net unrealized built-in gain (NUBIG) at the time of the ownership change, then it may increase its section 382 limitations by its recognized built-in gain (RBIG). Conversely, if a loss corporation has net unrealized built-in loss (NUBIL) at the time of the ownership change, then it may decrease its section 382 limitations by its recognized built-in loss (RBIL). NUBIG and NUBIL are calculated by comparing the fair market value of the loss corporation’s assets to its tax basis in those assets at the time of the ownership change.

In 2003, the IRS released Notice 2003-65, which provides two methods for identifying RBIG and RBIL. Under the section 1374 approach, RBIG and RBIL are determined as the amount of gain or loss recognized on the sale of an asset during the recognition period, meaning there would be no increase in the section 382 limitation unless the asset is sold. The second approach under section 338 allows a corporation to determine RBIG and RBIL by comparing actual items of income, gain, deduction and losses with those items that would have resulted from a hypothetical sale of its assets.

In September 2019, the IRS introduced proposed regulations which included a number of changes, most notably eliminating the more favorable section 338 approach and instead

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\(^1\) Section 382 defines the term “loss corporation” as a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs.
applying the section 1374 approach with the rationale that the latter is more consistent with
the text and purpose of section 382 and simplifies tax administration. Also among the
amendments were provisions related to conformity with the TCJA, changes to the treatment of
contingent liabilities, deferred deductions and cancellation of debt (COD) income.

Under the 2019 proposed regulations, the final regulations would have been effective on their
date of publication. In January 2020, the IRS released additional proposed regulations which
provided taxpayers with some relief. Firstly, the new proposed regulations delayed the effective
date to 30 days after the publication date of final regulations. Further, corporations that
undergo an ownership change may continue to apply Notice 2003-65 through the delayed
effective date, or indefinitely for ownership changes after the delayed effective date subject to
the following conditions:

- A binding agreement in effect on or before the delayed effective date
- Transaction that has been publicly announced or described in a filing with the Securities
  and Exchange Commission on or before the delayed effective date
- Bankruptcy court order on or before the delayed effective date
- Transaction that has been described in a private letter ruling request submitted to the
  IRS on or before the delayed effective date

NOL Poison Pills

Ms. Sutanto Shen also discussed the concept of NOL poison pills, a mechanism to disincentivize
acquisitions of significant amounts of stock. NOL poison pills result in significant dilution of both
economic and voting interest to the third-party acquirer and are commonly structured as rights
provided to stockholders to purchase shares of a company’s stock at a discount in a triggering
event, for example, the acquisition of 4.99 percent or more of company’s stock by a third party
without Board approval, or the announcement of a tender or exchange offer that would result
in a third party acquiring 4.99 percent or more of company’s stock. Such rights are designed to
give the company’s board an opportunity to consider and respond to an acquisition attempt by
a third party that would negatively affect the value of the Company’s NOLs.

Ms. Sutanto Shen shared recent market data collected by Wilson Sonsini Goodrich & Rosati.
According to the data, 132 companies have implemented NOL poison pills in the past ten years
with 72 of these arrangements still in effect today. A comparison of year-over-year data shows
that at the beginning of the COVID-19 pandemic, there was a significant increase in the number
of companies implementing NOL poison pills; i.e., 25 companies implemented NOL poison pills
during the period from March through August of 2020 compared to 11 companies during the
same period in 2019. Further, a significant number of transactions involving poison pills can be
observed during the March to April 2020 timeframe, which coincides with the March 23, 2020
low of the S&P 500 index.
Section 163(j) Limitation on Business Interest Expense

The next item on the agenda for the panel was the section 163(j) limitation on business interest expense. Under the TCJA, the deductibility of business interest expense for any tax year after December 31, 2017 was limited to:

- 30 percent of adjusted taxable income, plus
- business interest income (BII), plus
- floor plan financing interest for the taxable year

Any amounts disallowed may be carried forward as business interest expense indefinitely. Certain businesses, including “small businesses” with average annual gross receipts of $26 million or less over the preceding three-year period are exempt from the limitation. The CARES Act made a number of temporary but meaningful changes to section 163(j). Firstly, it increased the limitation to 50 percent of adjusted taxable income for tax years beginning in 2019 and 2020. Taxpayers, however, can elect not to apply the 50 percent limitation in 2019 or 2020 if taking the deduction for those years would increase the taxpayer’s NOL. The utilization of the NOLs would be subject to the 80 percent of taxable income limitation, whereas a disallowed business interest expense carryforward is not subject to such limitation. Rev. Proc. 2020-22 provides guidance on how to make this election. The CARES Act further allowed taxpayers to elect to calculate the 50 percent limit for 2020 based on its adjusted taxable income in 2019, which could provide a bigger deduction for businesses that expect to have a lower taxable income in 2020 due to the impact of the pandemic. Ms. Marshall highlighted that in a section 381 transaction, if an acquiring corporation makes this election, the acquiree company’s 2019 adjusted taxable income is not included in determining the limitation per the proposed regulation. The proposed regulation also included clarifications on situations involving other complexities, for example, an acquiring company and its target company having different tax years.

Final regulations issued in 2020 under section 163(j) included a refined definition of interest, which sets forth four broad categories of items that are treated as interest under section 163(j), including an anti-avoidance rule. The anti-avoidance rule states that any expense or loss “economically equivalent” to interest is treated as interest expense if one of the principal purposes of structuring is to reduce amounts that otherwise would have been treated as interest under the other categories. Ms. Marshall and Mr. Perwien discussed specific provisions of the anti-avoidance rule to highlight the changes brought about by the final regulation.

Conclusion
This article only attempts to touch on some of the presentation’s highlights in addressing a topic as broad and complex as the tax treatment of business losses. The recent changes effected by the CARES Act and the inevitably evolving regulatory landscape add to its complexity. In order to seize any available tax savings and cash flow opportunities from business losses, tax professionals will require not only in-depth knowledge of the applicable rules but also a holistic understanding of the taxpayer’s unique circumstances.
Post-Election Tax Analysis for High Tech and Beyond

By: Hanna Shatanionak, CPA, MST student

Ray Beeman, Principal and Co-Leader of the Washington Council at Ernst & Young, and former congressional tax staff for the U.S. House Committee on Ways and Means and the Joint Committee on Taxation, was the keynote speaker for the TEI-SJSU High Tech Tax Institute Virtual Conference held in November 2020. In his presentation “Post-Election Tax Analysis for High Tech and Beyond,” Mr. Beeman discussed how the outcome of the U.S. presidential election may shape tax policy. He opened by analyzing the post-election changes in Washington and discussing 2020 Presidential and Senate race highlights. He briefly discussed the first major pieces of legislation recent presidents had enacted after taking office. He also observed that no prior U.S. president was re-elected if there had been a recession within two years before a bid.

Mr. Beeman then shared his 2021 policy outlook and process considerations, including a divided government scenario and potential areas for bipartisan deals. He concluded by addressing issues related to expiring tax provisions in the Tax Cuts and Jobs Act (TCJA) and the international digitization project implemented by the Organization for Economic Co-operation and Development (OECD). At the time of this presentation, the presidential election results had not been finalized. On November 7, 2020, former Vice President Joe Biden was declared the winner of the presidential race, but control of the Senate was still unknown.

Mr. Beeman addressed the common question that many had in mind, whether Congress will consider tax increase as a solution to the huge federal deficit caused by the coronavirus pandemic. The Congressional Budget Office projects a federal budget deficit of $3.3 trillion in 2020, more than triple the shortfall recorded in 2019 and the $1.8 trillion projected in 2021.¹ Pre-COVID, the deficit was projected to be $1 trillion each year. Due to the government response to the pandemic, the debt-to-GDP ratio is projected to exceed the 100% mark 10 years sooner than previously projected. Economists had for years considered the 100% mark to be the ceiling, but many have increased this assessment by 50%, as the bond market has not reacted, and interest rates have remained low. Mr. Beeman confirmed that at this point neither party is showing particular interest in using tax increases to compensate for this debt spike. He is certain that the Republicans would not sign up for tax increases strictly to reduce the deficit and that President Biden’s proposed tax increases were not intended, at least during the campaign, to be enacted as a standalone package but to be combined as revenue sources for his major priorities.

Mr. Beeman discussed scenarios for how certain policy issues could play out under a Democratic or Republican Senate. If Democrats win control of the Senate, major priorities like stimulus, climate change, health care, education, and housing may be passed in the House and Senate, some or all of which might be financed with tax increases. Still, the vote margin will be

tight, and Democrats would have to negotiate with some Senate Republicans in order to achieve the 60-vote threshold necessary to move most legislation through the Senate. Another option that Democrats most likely would consider is to employ a budget reconciliation process that allows certain legislation to pass with 51 votes. However, each reconciliation bill is limited as it cannot increase the deficit outside the 10-year budget window and has other restrictions as to what can be included in such a bill. Overall, Biden’s comprehensive tax plan would add up to about 4 trillion U. S. dollars on the business side, which is an increase of about 2 trillion dollars mainly due to three provisions: an increase in corporate rate to 28%, 15% minimum tax on book income, and the first round of tightening up the GILTI rules. There is also a second round of tightening the GILTI rules as part of Biden’s “Made in America” plan to address offshoring.

Types of tax increases that Biden supported during the campaign would not be included as part of initial stimulus legislation but would instead be used to offset the cost of changes in permanent policies. Biden campaigned with a promise that tax increases would not affect individuals earning less than $400,000 annually. There are indicators that tax increases could be delayed at least until 2022.

Calling Biden’s plan “a menu of revenue proposals,” Mr. Beeman cautioned against thinking about it as an actual tax plan because it would still have to go through Congress as a standalone tax bill, much like the TCJA. At this point, Biden’s plan is a series of proposed sources of revenue to help offset the cost of other non-tax projects that the Biden administration would want to pursue healthcare, housing, climate. President Biden’s major tax proposals are unlikely to get through the Senate in the divided government scenario. If Republicans retain Senate control, the Majority Leader Mitch McConnell (R-KY) will decide which bills are brought up in the Senate and can block Democratic priority bills that are financed with tax increases. Mr. Beeman reviewed some of the key measures and ideas President Biden will continue to propose as part of the Treasury Greenbook, and reasons these proposals are not expected to be approved by the Senate. For example, Mr. Beeman does not expect the proposal of 15% minimum tax on book income over $100 million to be enacted due to the complications that would arise in implementing this change and also due to its impact on financial accounting. Also, any changes favoring the trillions-of-dollars Green New Deal on energy is likely to be dismissed by Republicans. According to Mr. Beeman, Republicans are very committed to maintaining the 21% corporate tax rate and are unlikely to increase it, even with the current economic situation. Also, if the Democrats are not in control of the Senate, Republicans are not going to participate in any legislation that involves raising rates on an individual’s top earners for at least the next two years. Many members of the Finance Committee are up for re-election in 2022 and, if the Senate flips, the tax rate increase will be easier for Democrats to achieve.

In his 2021 policy outlook, Mr. Beeman noted that even in a divided government scenario, there are some areas of potential bipartisan deals, such as infrastructure, retirement savings, changes scheduled under the TCJA and health care. Both parties have a strong desire for significant infrastructure investment. The main issue has always been the funding, which
potentially could be solved by Biden’s proposal to raise the corporate income tax. Another area of bipartisan support with regard to President Biden’s “Made in America” initiative is the incentivizing of domestic production activity. As a result of the pandemic, Biden also has an intense focus on supply chains and offshoring. There are several proposed solutions on the table in Washington, including offshoring tax penalties and tax credits as an incentive for investment and manufacturing in the U.S. Republicans have their own solution, such as tax incentives for onshoring. Nevertheless, there are signs that both parties can work together on these areas.

Mr. Beeman also suggested that legislation could include incentives for research and development, such as an increase in the research tax credit, investment tax credits, and advanced research credits. Both parties may also consider a repeal of the R&D amortization provision, enacted as part of the TCJA but not effective until 2022. So, it is possible that proposals seen as rebuilding the economy and creating jobs without raising taxes could attract support among Republicans in the Senate.

Mr. Beeman also mentioned that Biden and McConnell worked together for many of Biden’s 30 years in the Senate. The Obama administration would often send Biden to negotiate deals with McConnell. For example, they negotiated a resolution to the 2012 “fiscal cliff” slate of tax increases. With a divided government scenario, this history may help in areas that have potential for bipartisan consensus. However, a significant challenge for Democrats when attempting to cut a deal is that Republicans have already emphasized that they will focus more on the budget deficit going forward.

The primary focus of the tax committee in the next Congress, especially if Republicans control the Senate, continues to be the TCJA. Mr. Beeman noted that they will be interested in finding a way to make the TCJA permanent or to extend provisions that are expiring. There is also a real interest in looking at some of the delayed effective date provisions and their impact on companies. Congress is planning to apply the experience from the past two years to closely analyze the technical aspect of GILTI and whether it has any unintended consequences. Mr. Beeman did not expect any major changes in the near future but he mentioned that the tax committees had an interest in understanding what changes in GILTI rules would benefit companies. The TCJA was the first draft of international tax reform, which is still a work in progress, particularly with some of the more global OECD shifts on international tax. Mr. Beeman suggested that a fresh interest on the Hill in TCJA refinement is worth paying attention to, even though it wasn’t a big part of the campaign. Biden’s proposal will affect some factors that would take the GILTI rate up to 21% and subsequently adopt a jurisdiction-by-jurisdiction approach to GILTI, as opposed to the current worldwide basis of GILTI measurement.

Mr. Beeman emphasized that the TCJA has a built-in tax increase that will automatically be triggered by the phase-out of the expensing provisions regardless of inaction in a divided government scenario. He discussed the dynamics of some of the main provisions to consider. First, starting in 2022, the TCJA will require companies to amortize their R&D costs over five
years instead of deducting them immediately each year. This change will increase the cost of investment, which can unfavorably impact R&D and reduce the level of economic output.

Second, after 2021, the measure for 30% limitation on the interest expense deduction will change from Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) to Earnings Before Interest and Taxes (EBIT). According to Mr. Beeman, there is also discussion to extend the temporary 2020 increase in income threshold from 30% to 50% enacted by the congressional CARES Act, which will otherwise expire in 2020. Also, he mentioned that he expects a fair amount of lobbying to delay or repeal these changes in the TCJA. There is already a bipartisan bill in both the House and the Senate to repeal the R&D amortization provision. Mr. Beeman observed that, if any changes are made to the TCJA, the R&D amortization provision has a high chance of being repealed as the government has a strong interest to address it.

Third, at the end of 2025, the whole individual side of TCJA, including Section 199A and the SALT deduction limitation, will expire and make an impact as well. Mr. Beeman does not expect Congress to address all these provisions any time soon, although he suggested that they could end up delaying some of them. He explained that the costs of repealing the conversion to EBIT and the R&D amortization are much more significant than if they were delayed for a couple of years. A delay may result in a 2025 “fiscal cliff” similar to but much more significant than the one that had been set to occur in 2012, because that “fiscal cliff” only involved individual tax rates, while the 2025 “fiscal cliff” would involve tax rates and tax base. Mr. Beeman noted that it is not clear at this point how the government can work out a solution with bipartisan agreement. Despite the nearness of expiration dates, he thinks a solution will not be achieved even in the term of the next president. Most likely, Congress will address all these issues only in the following term.

To conclude, regardless of the outcome of the Georgia Senate runoff election, even if the Democrats are able to take control of the Senate, there will still be progressive and moderate groups within the party. It is unlikely that the government will be able to achieve major changes to the tax code whether Democrats or Republicans control the Senate. Bipartisan deals could be possible in a divided Congress, including potential compromise tax legislation in which Republicans presumably negotiate to keep or fix some of their priorities from the TCJA in exchange for the Democrats’ priorities.
U.S. International Tax Issues and Developments Summary

By: Liubov (Luba) Shilkova, MST Student

The 36th Annual TEI-SJSU High Tech Tax Institute conference held on November 9-10, 2020 via Zoom, was honored to have Jim Fuller once again present on various international tax issues and developments such as the final Global Intangible Low Tax Income (GILTI) regulations, new IRC §163(j) regulations, and final regulations on sale of partnership interests. Mr. Fuller is a partner at Fenwick & West LLP. He has been named one of the world’s top 25 tax advisers by Euromoney multiple times, most recently in 2019. He is the only U.S. tax adviser to receive a Star Performer rating (higher than first tier) in Chambers USA (2020); Chambers Global ranks him tier one in corporate and international tax (2020). He is also one of the three “most highly regarded” U.S. tax practitioners according to Who’s Who Legal (Law & Business Research). Legal 500 has included Mr. Fuller in its “Halls of Fame” for both Corporate Tax and International Tax. This article summarizes some of Mr. Fuller’s points and concerns as it relates to the finalized and new regulations.

Final Regulations: Source of Income from Sales of Property

Mr. Fuller briefly discussed final regulations dealing with the source of income derived from certain sales of personal property. These regulations retain the overall approach of the proposed regulations, with certain revisions.

Under IRC §863(b)(2), income from the sale of inventory produced (in whole or in part) by the taxpayer in the U.S. and sold outside the U.S., or vice-versa, is allocated and apportioned between the U.S. and foreign sources solely based on the production activities with respect to the property. Before the TCJA, IRC §863(b)(2) sourced income from these transactions as partly U.S. and partly foreign but did not specify a method for determining the amount sourced as foreign or U.S. The TCJA amended IRC §863 regarding special rules for determining the source of income, including income partly from within and partly from without the U.S.

Under final Reg. §1.863-3(c)(2)(i) (as redesignated), where the taxpayer’s production assets are located both within and outside the U.S., the amount of income from sources outside the U.S. is determined by multiplying all the income attributable to the taxpayer’s production activities by a fraction:

- the numerator of the fraction is the average adjusted basis of production assets that are located outside the U.S.
- the denominator is the average adjusted basis of all the production assets located within and outside the U.S.

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1 Section 863(b)(2).
2 Reg. 1.863-3(c)(2)(i).

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The final regulations make a noteworthy change to one of the rules under §865(e)(2). The proposed regulations provided that sales of inventory property produced outside the U.S. and sold through an office maintained by a nonresident in the U.S. must be sourced in the U.S. at least in part. Mr. Fuller mentioned that the final regulations generally retain the rules in the proposed regulations and clarified that Reg. §1.865-3 applies only if a nonresident maintains an office or other fixed place of business in the U.S. to which a sale of personal property is attributable. The final regulations also reorder and revise parts of Reg. §1.865-3 in a non-substantive manner.

The proposed regulations provided rules for determining the portion of gross income from sales (sourced in the U.S.) and production activities (sourced according to the rules of §863(b)). Under the proposed rules, the default method would allocate 50 percent of gross income to each category (“50/50 method”), but nonresidents could elect to use their books and records to make the allocation (“books and records method”) if they met certain requirements. The final regulations added additional requirements with respect to the books and records method: an election to apply the books and records method continues until revoked and may not be revoked without IRS consent for any tax year beginning within 48 months of the end of the taxable year in which the election was made. An election, or revocation of an election, to apply the books and records method is made by attaching the required statement to an original timely filed U.S. tax return (including extensions). Therefore, taxpayers should assess whether or not to elect the books and records method given that the final regulations would prevent a taxpayer from revoking such election if the use of the 50/50 method could provide better tax results in that year.

The final regulations also revised Reg. §1.864-5 to clarify the interaction with §865(e)(2) and (3) and the promulgation of Reg. §1.865-3. Gross income, gain, or loss from the sale of personal property treated as from sources within the U.S. under Reg. §1.865-3 will generally be effectively connected with the conduct of a trade or business in the U.S. to the extent provided in §864(c), other than §864(c)(4) or (5).

**Final Regulations: Foreign Tax Credits and Related Matters**

There were some changes made by the TCJA which impacted the foreign tax credit and some related areas. Despite the fact that certain provisions in the foreign tax credit and expense allocation rules that were proposed in December 2019 along with rules addressing certain hybrid issues that were proposed in April 2020 were adopted by the final regulations without substantive change, there are areas where the final regulations clarify or depart from the proposed regulations. These areas include the allocation and apportionment of stewardship expenses, the allocation and apportionment of research and experimental (R&E) deductions, and foreign tax redeterminations. The final regulations also revised guidance on adjustments to hybrid deduction accounts, conduit financing arrangements, and branch loss and dual consolidated loss recapture rules.
Stewardship Expenses

The 2019 proposed regulations provided that stewardship expenses are to be allocated to inclusions under §951 and §951A, §78 gross-up dividends, and amounts included under the passive foreign investment company regime, in addition to dividends received or to be received. The proposed rule specified that stewardship expenses are considered definitely related and allocable to “dividends and inclusions received or accrued, or to be received or accrued” from a related corporation (as opposed to “dividends received, or to be received” under the previous regulations). In addition, the proposed regulations provided that, once allocated, stewardship expenses are apportioned based upon the relative values of a taxpayer’s stock assets, in the same manner as used for apportioning interest.

The final regulations revised the proposed rules and make important clarifications in certain areas. The pre-existing definition of stewardship expenses as a “duplicative activity” or activities that preserve a shareholder’s capital investment or facilitate compliance with reporting, regulatory, or legal requirements remains the same. Also, the final regulations provided that stewardship expenses incurred with regard to oversight of “business entities” (i.e. disregarded entities, partnerships, and corporations) are subject to allocation and apportionment rules.3 However, the rules do not extend the definition of stewardship expenses to include oversight expenses incurred with respect to an unincorporated branch of the taxpayer, since the branch’s income is income of the taxpayer itself, not income of a separate entity in which the taxpayer is protecting its investment.

The final regulations provide that stewardship expenses can be allocated and apportioned to income and assets of all affiliated and consolidated group members, and that the affiliated group rules in Reg. §1.861-14 are not applied for purposes of allocating and apportioning stewardship expenses.4 Stewardship expenses incurred by one member of an affiliated group to oversee the activities of another member are allocated and apportioned by the investor taxpayer on a separate entity basis, with reference to the investor’s stock in the affiliated member. Also, for purposes of determining the value of an entity, the final regulations provide that the value of the stock in an affiliated corporation is characterized as if the corporation were not affiliated.5 In addition, the stock is characterized by the taxpayer in the same ratios in which the affiliate’s assets are characterized for purposes of allocating and apportioning the group’s interest expense.

Since stewardship activities are not fungible, the final regulations provide that, at the allocation step (but before applying the apportionment rules), only the gross income which is derived from entities to which the taxpayer’s stewardship expense has a factual connection is included.6 The regulations also provide a guidance in other areas, including guidance on

4 Id.
5 Reg. 1.861-8(e)(4)(ii)(C).
determining the tax book value of a taxpayer’s investment in a disregarded entity, clarification that the exempt income and asset rules do not apply for purposes of apportioning stewardship expenses, and specific guidance on the application of the other rules.

This article summarizes only some of Mr. Fuller’s wide range of international tax topics and developments. While the IRS and Treasury issue clear technical guidance, many areas of the international tax law are subject to additional interpretations by tax practitioners. Also, it is important to be aware of all changes in international tax law in order provide clients with professional advice and help them build appropriate tax strategies.

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**Hold the Date**

37th Annual TEI-SJSU High Tech Tax Institute
November 8 and 9, 2021
Expected live in Palo Alto with a virtual option too.

[https://www.sjsu.edu/taxinstitute/](https://www.sjsu.edu/taxinstitute/)
Research Tax Credit

By: Xiaoyue Tan, MST student

The research tax credit (R&D credit), which is provided for increasing research activities, can benefit taxpayers suffering from the coronavirus pandemic. However, some companies lack knowledge about the research tax credit.

A panel of five tax experts provided an update on the research credit at the High-Tech Tax Institute held on November 9 and 10, 2020. They are Matt Normington, Partner at Deloitte; Travis Riley, Partner at Moss Adams; Dan Mennel, Partner at Grant Thornton; Michael Washburn, Large Business and International (LB&I) Office of Chief Counsel at the Internal Revenue Service (IRS); and Cheryl Teifer, Director of Field Operation, Eastern Compliance Practice Area at the IRS.

The panel analyzed recent court cases involving research tax credit issues in the LB&I Division’s compliance campaign, state R&D tax credit updates, and the impact of the Tax Cuts and Jobs Act (TCJA).

What is the R&D Credit?

The R&D credit allows businesses to claim a credit based on a percentage of qualified research expenses during the taxable year. Qualify activity involves technological experimentation used in the development of a new or improved business. The research must significantly enhance a new or improved function, performance, reliability, or quality. Qualified research is divided into in-house research and contract research. In-house research includes taxable wages for employees who perform or directly supervise or support qualified activities, and cost of supplies used in qualified activities. Qualified research includes 65% of contract research expenses that are attribute to qualified activities, and rental costs of computers used in qualified activities. Certain activities are excluded. For example, software designed primarily for internal use, and not for qualified research or a production process, does not qualify as research activity. Research in the social sciences, arts, or humanities; research funded by any grant, contract, or otherwise by another person; and research conducted outside the United States do not qualify as research activity.¹

If companies incur qualified research expenses during the taxable year, they can claim research credit equal to the sum of 20 percent of the excess qualified research expenses over the base amount, 20 percent of the basic research payments, and 20 percent of the amounts paid or incurred to an energy research consortium for energy research.

Recent Court Cases

¹ IRC § 41(b) - Credit for increasing research activities
Mr. Washburn first discussed recent research credit opinions that came out from District court, Tax court, and California office of Appeals cases. He emphasized that the research credit has variety elements that require diverse set of evidence. It is important for taxpayers to think through what support documents they need case by case.

The government claimed that the taxpayer could not meet the burden of proof because the taxpayer calculated the fixed base using start-up company rule, however, the taxpayer could not demonstrate it was a start-up company. *United States v. Quebe*, Dkt. No. 3:15-cv-294 (S.D. Ohio Jan. 17, 2019), 2019 WL 250602 (granting Government’s MSJ and holding that taxpayer failed to prove it qualified to calculate credits using I.R.C. § 41(c)(3)(B) applicable to start-up companies).

*Siemer Milling Co. v. Commissioner*, T.C. Memo. 2019-37 (taxpayer failed to prove it conducted qualified research on certain business components by failing to establish that it satisfied the process of experimentation requirement with respect to any of its projects; in addition, taxpayer failed to establish that some of its projects met the section 174, business component, and/or technological information tests).

*Swat-Fame, Inc.* 2020-OTA-046P (March 22, 2019) (Cal.Off.Tax App.), 2019 WL 9050584 (taxpayer failed to prove substantially all of its activities were part of a process of experimentation for a qualified purpose; among other things, it did not prove it conducted methodical processes of experimentation rather than simple trial and error).

Order, *Populous Holdings v. Commissioner*, (T.C. Dkt. No. 405-17) (Dec. 6, 2019) (granting taxpayer’s MSJ and holding that research was not funded as (1) taxpayer bore financial risk of research’s failure under fixed-price contracts and (2) taxpayer retained substantial rights as there were no provisions that prevented it from using the research or that required it to pay to do so).

*Audio Technica v. United States*, 963 F.3d 569 (6th Cir. 2020) (government not barred by settlements of prior year claims from arguing fixed-base percentage was incorrect).

**LB&I Compliance Campaign**

LB&I compliance campaigns were launched on January 31, 2017. One of the purposes of LB&I is to address significant compliance risk. Mr. Washburn analyzed some cases about compliance issue of research tax credit in recent years. In *Siemer Milling Co. v. Commissioner*, T.C. Memo. 2019-37, taxpayer failed to prove it conducted qualified research on certain business components by failing to establish that it satisfied the process of experimentation requirement with respect to any of its projects. In *United States v. Quebe*, 123 AFTR 2d 2019-543, taxpayer failed to prove it qualified to calculate credits using IRC §41(c)(3)(B) applicable to start-up companies. These court cases reflect high compliance risk about research issues. On February 27, 2020, the IRS announced a new LB&I compliance campaign, Research Issues.
Mrs. Teifer, the Director of Field Operations Engineering of LB&I Organization, explained that the research issues campaign (RIC) will address issues involving the research credit and research and experimental expenditures under IRC §41 and IRC §174, which are some of the most prevalent LB&I tax issues that utilize significant examination and taxpayer resources. The campaign will employ various treatment streams, including issue-based examinations, form updates, and requests for guidance. The goals of the RIC are to conduct issue-based examinations using filtering techniques to identify high-risk returns; to promote consistency of examinations and voluntary compliance through proper issue development; and, based on information gathered from examinations, to request additional guidance and/or form updates to assist with reporting and auditing of research issues.

**State R&D Tax Credit Updates**

Some states also offer the R&D tax credit. They generally comply with federal regulations and IRS guidance, but some of them do not. For example, the R&D credit rate in California is 15 percent, as opposed to the federal rate of 20 percent with the regular calculation method. Another difference is that unused California research credits can be carried forward indefinitely, unlike federal credits, which can be carried back one year and carried forward twenty years. Mr. Normington provided the following updates for the R&D tax credit in each state.

**Arizona**
- Credit rate tiers set to decrease for tax years ending on or after 12/31/2030:
  - <$2.5M Incremental qualified research expenses (QREs) = 24% vs 20%
  - >$2.5M Incremental QREs = $600K + 15% vs $500K + 11%

**Louisiana**
- Sunset date extended to 12/31/2025 (was 12/31/2021)

**Maryland**
- Online application due no later than 11/15/2020
- Funding cap applies (typically 10% - 11% of requested amount)
- Approval certificate must be received by 2/15/2021
- Because certificate comes after return is filed, taxpayers may either amend or utilize the credit in any of the 7 taxable years after the taxable year that generated the credit
- Certificate must be attached to the return when utilized
- This is helpful for taxpayers who do not want to amend

**New Jersey**
- Mandatory combined filing requirement
- Method used for federal and New Jersey must be consistent (i.e., if use ASC for federal it must be used for New Jersey)

**North Dakota**
1. For tax years 2019 and after, a taxpayer may elect to use the ASC method
2. Credit equals 17.5% of the first $100K incremental credits + 5.6% of the amount >$100K
3. $2M credit cap

Ohio

- Increasing audit activity
- Requirement to compute credit on calendar year basis (complexity for fiscal year taxpayers)

Texas

- Increasing audit activity
- Major focus on auditing on a project-by-project basis
- Limited flexibility with respect to project documentation (i.e., must prove 100% of all R&D projects meet 4-part test, regardless of materiality)
- Software, especially internal use software, continues to be an area of focus for exam

Impact of the TCJA

Before the TCJA, R&D expenses could be deducted immediately or charged to a capital account for no less than five years. However, starting in 2022, companies will not be able to immediately expense research costs. Instead, they will be required to charge US-based research expenses to a capital account and deduct them over a five-year period, or a fifteen-year period for research performed outside of the United States. Therefore, time value analysis should be performed to assess how much the value of credits may have reduced. Intense lobbying to eliminate or prolong this provision is expected in the coming years.

Under the TCJA, the maximum tax rate was decreased to 21 percent, and net credit was made equal to 79 percent of gross credit instead of 65 percent. The lower corporate tax rate has led to increased credits, which has benefited taxpayers.

Corporate taxpayers’ alternative minimum tax rate of 20 percent was repealed by the TCJA. Individual exemptions and phase-outs for alternative minimum tax was increased from the $200,000 to $500,000 range. As a result, corporate and individual taxpayers have been able to use more of their research credit currently rather than having to carry it forward.

Conclusion

Taxpayers should consult their tax advisors to make the greatest use of federal and state R&D tax provision. Most states offer a research tax credit and most adopt rules similar to those of the federal R&D credit. State credits are even more generous than the federal credit in some cases. Some states require taxpayers to file an application other than tax return. The amortization period for foreign research expenditures (15 years) is longer than for United States-based research expenditures (5 years). It is important for taxpayers to re-consider the
location of future R&D activities once this TCJA change goes into effect. Taxpayers would benefit from tracking R&D tax credit updates and planning accordingly. Taxpayers also need to be careful about the risk of claiming the R&D credit. It is possible the IRS would examine and disallow some or all the R&D credits. A penalty may occur if the credit was either claimed through negligence or results in a substantial understatement of income tax.
Tax Maven

The Contemporary Tax Journal's Interview with Ms. Gloria Sullivan

By: Liubov (Luba) Shilkova, MST Student

Gloria Sullivan is the Director of Western Compliance Practice Area in Large Business & International (LB&I) Division at the Internal Revenue Service (IRS). In this position, she oversees tax administration activities for C and S corporations and partnerships with assets greater than $10 million within a geographic area that includes eighteen states. The Western Compliance Practice Area is also responsible for the Computer Audit Specialist program in LB&I.

Ms. Sullivan received a Bachelor of Science Degree in Accounting from the University of Montana and is a Certified Public Accountant (CPA) in the state of California. She has been with the IRS for 37 years. She has long-time connections with the San Jose State University (SJSU) Tax Advisory Board. Ms. Sullivan also regularly attends and participates in the TEI-SJSU High Tech Tax Institute conference.

I had the pleasure to interview Ms. Sullivan on October 28 via Zoom. Beyond her exceptional reputation and professional achievements, I found Ms. Sullivan approachable and gregarious. She believes that if you enjoy what you do, you will definitely succeed. Ms. Sullivan was kind enough to share her career experiences and thoughts with The Contemporary Tax Journal.

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

I think I was always meant for a career in income tax. As early as high school, I gave a civics class speech on “How to complete a Form 1040A.” I began volunteering for VITA in college. When I was a junior in college, the IRS recruited on my campus for interns – which was our “tax auditor coop program” at that time. I was selected for the Missoula office in Montana. It was an incredible experience. We got the in-depth IRS tax training in San Francisco (which was quite an education by itself at that time) and then actually got to audit 1040 tax returns. I really felt the weight of that responsibility, as I had some pretty interesting cases and was only 20 years old. When I was preparing to graduate, I hoped to stay with the IRS if possible, because I really liked the challenge of auditing, and was learning so much. It worked out and I was able to convert to full-time Revenue Agent status in Seattle right after graduation.

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

As I reflect back, it’s so interesting what does stand out. After several years as a revenue agent, I had the opportunity to become an “industry specialist” in the forest products industry and the
environmental issues area, where I served as a consultant to the large corporate audits around
the country in those specialty areas. This was a career changer for me, since it really broadened
my IRS and external perspective as well as my network. This was sort of pre-IRS-Internet, so the
way I maintained my network was to host periodic national meetings. In 2000, I hosted a
national Environmental Issues meeting in Seattle, where over 250 people attended including
several external stakeholders. It was widely appreciated for advancing our understanding of
several issues and led to a national strategy on a Sec. 1341 issue, and ultimately to IRS success
in the courts on this issue. I felt I made a lasting contribution to tax administration.

Much later, as an LB&I Executive in the Enterprise Practice Area, the Tax Cuts and Jobs Act
(TCJA) was enacted almost at year-end, and I became responsible for the implementation of
many domestic corporate provisions. This was a huge task, but we had many partners in
counsel as well as the other operating divisions who we were coordinating with, including Tax
Forms & Pubs and IT. I learned so much about what it takes to successfully prepare for filing
season with that experience, and although not all the guidance was published by the time
taxpayers had to file, we were able to get a lot of interim guidance, new forms and instructions
done in time. We all took pride in that.

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

Since I was heavily involved with TCJA implementation, I was fortunate enough to have had a
front row seat to a lot of the law changes and guidance items that followed that significant law
change. I also attend regular online training sessions (both IRS and external events); I read the
daily tax press, and I check the IRS TCJA website regularly for new items that may impact our
taxpayer base in the Western Compliance Practice Area. I also attend or speak at numerous
external stakeholder events, including the SJSU-TEI High Tech Tax Institute, as well as the Pacific
Rim conference, that provide great technical updates every year. Also, I’ve seen the need to re-
invigorate our Industry Specialization program area to get greater expertise in certain industries
that are prevalent in Western, such as high tech and the petroleum industries, so I selected new
full time industry specialists for those industries. I participate in their regular events, to better
understand the economics, business models, and generally increase my commercial awareness
so that I can more readily anticipate compliance risks.

4. What do you think is one key area of tax administration that could/should be
improved and why?

Following the enactment of the Taxpayer First Act, I hosted a listening event with stakeholders
in Silicon Valley to hear their feedback on “the taxpayer experience.” They spoke quite clearly
of the need for greater digitalization in tax administration. This included both short term and
longer term capabilities, including greater ability to exchange digital information over various
portals, greater ability to sign and exchange electronic documents, greater ability to
communicate through the web or portals, as opposed to phone calls and mail. Of course, many
of these short-term capabilities have come to reality because of the pandemic, and were an absolute necessity in order to keep the “lights on.” I expect many of them to become permanent. Taxpayers also spoke to us about new capabilities being tested in other tax jurisdictions, such as the ability to seamlessly report digital information to the IRS using secure platforms that could eliminate the need to compile data, report it on forms, and then have the IRS extract it. Obviously, there are many privacy, cybersecurity, cultural barriers, and other implications that would need to be worked through to get to this level of transparency. But the idea is already out there, and this kind of data exchange would totally revolutionize so many of our reporting and compliance processes and functions, including the audit function. I think the public expects this kind of efficiency from the federal tax system, and IRS will eventually be funded and positioned to make it a reality.

5. What do you wish more people understood about the IRS?

Where to begin?! Americans hold many misconceptions about the IRS!

Research has shown that most Americans are not confident about their understanding of the tax code but more than 50% believe they are over-taxed. Many also believe it’s the IRS that writes the tax laws. Research also shows that more than 50% of Americans don’t understand how tax refunds work, not realizing it’s a reimbursement for an overpayment of tax, rather than a government payment. Research also shows that some taxpayers may not understand why they are being audited or receive a piece of IRS correspondence of any kind. And it’s true that most Americans have a negative view of the IRS, but over 66% of Americans think the IRS does a good job of collecting the nation’s taxes.

Clearly the American view of income taxes and the IRS is very complicated! By a vast majority, Americans think it is a civic responsibility to pay one’s fair share of taxes, and more than 50% also connect paying taxes with their core values and sense of community. However, some Americans also perceive the tax code and system as working in favor of the very wealthy or large corporations. When people think that not everyone is paying their fair share, they justifiably view that as unpatriotic and it undercuts the perception of fairness about the tax system, and the IRS as well.

I believe that greater transparency in all phases of compliance is important toward making the system more understandable and seem fairer, and ultimately the responsibility is with the IRS to do the clarifying! But the IRS is not an amorphous bureaucracy. It’s an organization of people. After 37 years with the Service, my ultimate bottom line is that IRS employees are well trained professionals, and take a huge amount of pride in public service and in performing the mission of the IRS, and try very hard to apply the law fairly and accurately even in the face of unbelievable hurdles, such as the current pandemic. Most are more than happy to answer any question or explain the situation at hand. People should know that.

6. What advice do you have for students preparing for a career in tax?
I think it’s important to realize that there are so many areas of potential specialization in tax; and that your career can grow and evolve along any chosen path, and then change and go down a different path. There is no right starting place, and no right or wrong path. Trust your passions and strengths because they will lead you in the right direction. Then spend the time and energy to get proficient at what you are doing now, continue to work at it, learn it well, and it will provide you with the next opportunity. I have seen so many of our mid-level people worry about their next job, when they should be focused on their current job and knock it out of the park. My adage is that tomorrow will take care of itself if you do your best today. Opportunity always follows high achievement. I had no idea when I started at age 20 as a student coop at the IRS that I would eventually have 14 different IRS positions and become an executive, or that I would stay for 37 years and counting! Last bit of advice: don’t rule out public service, it’s incredibly satisfying.

Fun Questions:

7. If you could have dinner with anyone (living or not), who would it be?
This is an easy one – RBG!!! She has been on my mind for obvious reasons. I just loved her style and tenacity ---as well as her love of family and enjoyment of her own pop culture status! She seems so fun while still being incredibly smart, strategic and serious. Dinner with her would be a blast, I imagine her having great taste in food and wine; and no topic would be off limits! It would be great to hear some of the behind the scenes stories of her time on the Supreme Court! And I would definitely thank her for being the trailblazing force she was for women’s equality.

8. What is the most unusual item in your office or something in it that has special meaning to you?
I have a small stuffed raccoon in my office, that was given to me by my Mom to remind me to never give up. Several years ago, my sister and I did the Peaks to Prairie triathlon together in Montana. We had run many races together over the years and always wore some kind of costume or clothing that showed our team spirit. For this event, we wore children’s raccoon tail caps, to signify our silliness (keep us laughing so we wouldn’t cry); and the fact that we were embarking on an epic Montana adventure! This triathlon was in March and wasn’t your average triathlon. We rode our bikes 75 miles, ran 9 miles and then kayaked the Yellowstone River to the finish - about 15 miles. It took all day. It rained, the wind blew, and we were beyond exhaustion when we got the finish line. I admit to being in tears when we finished and saw our family, because it was such a tough course. A sportswriter from the Billings Gazette took our picture with our raccoon tail hats and we made the front page the next day! Not long after that, I was going through a tough personal time, and my Mom sent me the small stuffed raccoon with a red heart on it. No words were needed.
Gloria Sullivan and Liubov (Luba) Shilkova, October 28, 2020 (Zoom interview).
Fun Tax Facts – Pet Expenses

By: Xiaoyue Tan, MST Student

Cat Food Expense

In 1995 a scrap yard owner was allowed a business deduction for cat food purchased to attract wild cats to prevent snakes and rats from entering his scrap yard.¹ The court agreed that the cost of the cat food was a deductible business expense because the cat performed a task associated with the business. In contrast, one’s household cat is not qualified because it unlikely performs any service in operating a business.

Animal Foster Expenses

New York Times bestselling author, Helen Brown, wrote a blog about a rescue cat named Bono. Over 22 million people read her blog. She published Bono and inspired millions of people.²

People who foster and care for homeless animals for qualified charitable organizations can deduct out of pocket expenses. In Van Dusen v. Commissioner, foster-cat expenses qualified as unreimbursed expenditures incident to the rendition of services to a charitable organization. Van Dusen’s services were directed by a charitable organization. She thus rendered services the organization when she cared for foster cats in her home.³ It is good news for animal foster parents that they can deduct some of costs during the taxable year. It is important though that

for any donation of $250 or more that the taxpayer have a contemporaneous written
acknowledgement as required by IRC §170(f)(8).

Pet Moving Expenses

Most people may not know that the pet moving expenses are deductible under certain
circumstances. Before 2018 and after 2025, employees and self-employed individuals can
deduct the cost of transporting goods and personal effects from the old residence to the new
residence if certain distance requirements are met.\textsuperscript{4} Household pets are treated the same as
your other personal properties. If someone lost their job and relocate for a new job, the
reasonable expenses of moving their pet are tax deductible.\textsuperscript{5} However, only members of the
U.S. Armed Forces can deduct personal moving expenses from 2018 to 2025.

\textsuperscript{4} IRC Sec. 217(b).
\textsuperscript{5} Rev. Rul. 66-305.
Tax Policy Analysis

H.R. 6787 (116th Session) – Providing Essentials for Frontline Workers Act

By: Yixin Liang and Aarti Shah, MST Students

Introduction

On March 11, 2020, the World Health Organization (WHO) declared the ongoing global outbreak of the coronavirus disease 2019 (COVID-19) a global pandemic, as the disease rampaged across countries, claiming the lives of over 700,000 people.\(^1\)\(^2\) As of August 13, 2020, more than 5.1 million cases of COVID-19 have been reported in the United States.\(^3\) Across the country, business closures and shelter-in-place orders imposed to mitigate the effects of COVID-19 continue to vary by jurisdiction, yet all exempt essential service and frontline employees continue to support and meet the most basic needs of individuals and communities since the start of this pandemic.

On May 8, 2020, H.R. 6787, Providing Essentials for Frontline Workers Act, was introduced and referred to the U.S. House Committee on Ways and Means by Congresswoman Linda Teresa Sánchez (D-CA-38). The bill aims to provide relief in the form of a payroll tax credit to ease the tax liability burden on businesses, as they continue to struggle amidst the pandemic.\(^6\)

Brief Overview of Payroll Taxes

Generally, payroll taxes, as mandated by the Federal Insurance Contributions Act, are split even by the employer and the employee. One-half of the payroll taxes (7.65%) are remitted directly by employers, while the other half is withheld from workers’ paychecks. The first 12.4% of the total tax is used to fund Social Security and the remaining 2.9% funds Medicare, for a total combined rate of 15.3%.\(^4\)

Employers are required to report payroll taxes on a quarterly basis in most jurisdictions. Employers must file Form 941 - Employer’s Quarterly Federal Tax Return to report income

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\(^3\)“CDC COVID Data Tracker.” Centers for Disease Control and Prevention, Centers for Disease Control and Prevention, 2020, available at: www.cdc.gov/covid-data-tracker/#cases.

taxes, social security taxes, and/or Medicare taxes withheld from their employees’ paychecks. Due to COVID-19, significant changes have been made to provide new employment tax credits and other tax relief.

**Overview of H.R. 6787 - Providing Essentials for Frontline Workers Act**

The Act aims to provide a payroll tax credit against employment taxes equal to a percentage of certain pandemic-related employee benefit expenses paid by employers between March 12, 2020, and January 1, 2021. The amount of the credit is 50% of pandemic-related expenses of essential employees and 30% for all other employees. The amount of qualified pandemic-related employee benefit expenses with respect to any employee may not exceed $5,000 for any calendar quarter.

Credits are usually applied against income taxes; however, to ensure employers get immediate relief, this credit is applied against employment taxes, which are generally reported on a quarterly basis. If the amount of the allowable credit exceeds the applicable employment taxes on wages paid of the employees, the excess is treated as an overpayment and will be refunded back to the employer.

Per the bill, the term “qualified pandemic-related employee benefit expenses” refers to the amounts paid to an employee that are excludable from gross income as disaster relief payments (§139) related to COVID-19 and that the employee has elected to treat as a pandemic-related expense. Per §139(b)(1), a “qualified disaster relief payment” is defined as an amount paid to the benefit of an individual to reimburse or pay reasonable or necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster. Congresswoman Sánchez notes examples of such expenses in her press release such as “temporary housing at hotels for those employees who are sheltering elsewhere to avoid exposing family members, meals, laundry service for uniforms, or child care expenses.”

Per the bill, the term “essential employee” refers to any employee who performs a substantial portion of services that constitute “essential work” for the employer. The term “essential work” is yet to be defined upon passage of the bill. Should the bill become enacted, within 30 days of

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7Internal Revenue Code §139(b)(1).

the Act’s enactment, the Director of Cybersecurity and Infrastructure Security Agency (CISA) is instructed, as per the provisions of the bill, to issue a definition of “essential work”, taking into consideration its April 17th “Advisory Memorandum on Identification of Essential Critical Infrastructure Workers During COVID-10 Response” and solicit public input in arriving to a definition.

Per the aforementioned memorandum, CISA provided an advisory list that identified workers who performed services that are deemed essential to continued critical infrastructure viability and who support crucial supply chains in states and communities. To elucidate, the industries, and respectively, specifically defined workers under these industries, identified in this report include, but are not limited to: medical and healthcare; food and agriculture; water and wastewater; law enforcement; and transportation and logistics.9 The bill also outlines special rules taking aim at abuse and exploitation of the credit. Employers are denied the credit if the qualified pandemic-related employee benefit expenses provided by the employer to employees discriminate in favor of highly-compensated individuals. It also denies the credit if the taxpayer has claimed a different deduction or credit against these expenses, preventing the taxpayer from receiving a double benefit.

The credit is not permitted to be taken by the federal government nor its agencies, with exception to tax-exempt organizations.

The Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund (collectively, the Social Security Trust Fund or Trust Funds) are trust funds that provide for payment of Social Security (Old-Age, Survivors, and Disability Insurance; OASDI) benefits administered by the United States Social Security Administration. With a credit against employment taxes, a smaller portion of taxes will be collected to fund OASDI benefits. To address this, paragraph (j) provides that funds from the general fund are to be appropriated to the Social Security Trust Fund to account for the expenditures of this bill that result in the reduction in revenues to the Treasury for OASDI benefits.

Penalties will be waived under IRC §6656 if an employer fails to make a deposit of applicable employment taxes if the Secretary determines that the failure was due to anticipation of the credit defined in this bill. The Secretary is also instructed to prescribe regulations for guidance related to advance payment of the credit and such reconciliation and adjustment steps that need to be taken due to receiving an advance payment of the credit.

Application of Principles of Good Tax Policy


### Principles of Good Tax Policy

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<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
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<td>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.</td>
<td><strong>Vertical Equity:</strong> The vertical equity principle is satisfied when taxpayers with higher income pay more tax than taxpayers with lower income. The direct benefit of this credit would be received by companies that can afford to support their employees through the pandemic to compensate for some of the economic hardships. Larger corporations, who generally employ more workers, are likely to be able to do so, thereby benefiting over small businesses and receiving large tax cuts (this is because the credit is limited to $5,000 per employee). Illustration: If an essential employee incurs a qualified pandemic-related benefit expense for $1,530, for which his or her employer reimburses her for that amount, the employer could in effect receive a credit of $765 (a reduction in their payroll tax liability) for which this credit was in effect. If a non-essential employee incurred the same expense, the employer would receive a credit of $459. With no phase-out rules based on quarterly net income or gross receipts, larger businesses are likely to fare better at the advantage of this credit. Moreover, companies with efficient and effective expense reimbursement recording will further benefit over small businesses that may not have as efficient records for the months already passed for which this credit can apply to (i.e. March through July). Companies that could afford to implement proper systems before or during the pandemic may have sufficient records of such qualified expenses.</td>
<td>- (vertical equity)</td>
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reimbursed to their employees and claim the credit over those companies that do not.

Furthermore, individuals with jobs and therefore, a source of income, receive the indirect benefit of having some of their expenses compensated by their employer. Moreover, this credit results in a double benefit in that the same expense results in a tax-exempt item for the employee per §139 and a credit for the employer (note, that the bill does explicitly deny the employer from receiving the credit and then taking corresponding deduction for the same expense). Individuals, who are unemployed due to the pandemic, face a double penalty - (1) loss of income and (2) loss of government funds that may have provided support to them.

**Horizontal Equity:** This type of equity holds that similarly situated taxpayers should pay the same amount of tax. This bill also violates the principle of horizontal equity because taxpayers of similar financial footing and resources can be impacted differently from the benefit of this credit. If taxpayer A is in an industry that is not classified as an essential service or does not have essential workers, it can only receive a credit for 30% of the qualified pandemic-related benefit expenses that it reimburses of its employees. On the other hand, an employer who does fall within one of the categories outlined in CISA’s memorandum has the potential to deduct up to 50% of any qualified pandemic related benefit expenses it reimburses.

**Fairness:** The bill does not provide a credit or other tax benefit to the employees or individual taxpayers, who notably bear the burden of payroll taxes in indirect forms. Employees effectively bear the burden for almost the entire payroll tax, despite the tax on the surface being split half-half amongst the employer and employee. The demand for labor - or an employers’ willingness to hire - is much more sensitive to taxes. As taxes decrease, generally speaking, employers are more likely to hire or increase wages. Vice versa, when taxes increase, employees’ wages are reduced and the demand for labor is much lower. So, while employers may be sending their portion of the tax to the
government, effectively it results in a decrease to their employees’ wages by almost the same amount.

Looking at the current economic situation, while at the face, decreasing an employer’s tax liability may stimulate the demand for labor, this effect is unlikely due to the unpredictability and instability of the economy in relation to the pandemic. Rather employers are likely to hold on to these additional tax savings as reserves that will continue to support their current footing as the pandemic pursues. Effectively, providing a payroll tax credit to the employers will not evenly re-distribute the burden, thereby violating the principle of fairness.

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<th>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?</th>
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<td>The bill creates a new payroll tax credit that allows employers to claim a refundable credit against employment taxes paid quarterly. The credit is a maximum of $5,000 per frontline worker paid after March 12, 2020, through Dec. 31, 2020. The calculation of the credit amount is relatively straightforward.</td>
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<td>However, there is no set definition of “essential work” or “essential industry”. The list of critical infrastructure sectors provided by the CISA is not a set federal directive or standard. Employers may have confusion on identification since there are no legal regulations to outline in the code currently and it is uncertain what direction CISA will take with its definitions should this bill be passed.</td>
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<td>Furthermore, there is little guidance under §139 as there have been no regulations released as the date of this article. While §139 may be straightforward for more common disasters, guidance may be needed to address the situations and circumstances specific to the COVID-19 pandemic. For example, the IRS may likely need to release a regulation to address when an employer may deduct a qualified expense, when it is entitled to this credit, or if the employer can choose the benefit it receives. In addition, the IRS may need to clarify the extent or breathe of employer’s spending in relation to this bill, and the necessity of expenses incurred due to the pandemic. Arguably, §139 could apply to an employer buying computers, software and educational</td>
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workbooks to help employees who are teaching their kids at home while schools are either closed or online.

In addition, there is no legal definition of “frontline worker”. The term itself is informal yet. While some regard frontline workers as those in serving in hospitals and healthcare facilities, having direct exposure to the virus, others regard it as those having to report directly on-site to their jobs.

Meanwhile, in the digital age, telecommuting allows industries to remain open while employees are able to maintain operation remotely from home. There is no certainty in the definition of frontline workers. Therefore, this bill does not meet the principle of certainty.

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<th>Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor?</th>
<th>The payroll tax credit is comparatively easy to claim since it is applied to employment taxes with Form 941 on a quarterly basis. The credit will be collected when reporting the quarterly employment taxes, which is more beneficial than an annual basis currently because it provides struggling businesses with almost-immediate relief. The employers that are adversely impacted by the COVID-19 national lockdowns will quickly receive the payment closer to when they need it, instead of waiting till 2021 when their 2020 tax return is filed. With the current allowance in place to defer payment on payroll taxes, this bill offers additional timing convenience for the employers to get additional tax relief, as long as the qualified pandemic-related expenses are determined. Therefore, this bill meets the principle of convenience of payment.</th>
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<td>Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?</td>
<td>Some companies would have minimum cost influence if they have already implemented efficient payroll tracking systems. For example, they have good record-keeping procedures on employees’ reimbursement, which saves time and cost to track and calculate the amount of credit. While, for other companies, the bill increases the burden of tracking and reporting the payment of qualified employee benefit expenses. Accountants and tax administrators may have to go back and review thousands of transactions incurred and reimbursed to employees in months already passed (i.e. March to July), which is a significant time and cost consuming.</td>
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The guidance for §139 does not explicitly require an employer to institute a written Section 139 program. Still, while the employer is likely to have to establish systems for the purposes of receiving the payroll tax credit, it is also important to note that Rev. Rul. 2003-12 described a fact pattern in which the employer established a written program and the IRS favorably held that the payment met the criteria of §139 and was allowed to be excluded from income tax.\textsuperscript{11} Accordingly, employers may need to devise a system that identifies expenses that will be reimbursed, the method of reimbursement and the start/end dates of the program, as well as appoint an administrator. Employers interested in adopting such a program will need to consider aspects of implementation including, but not limited to the administrative burden at a time when staffing may be decreased or remote as well as the costs.

Also, it is important to note that by itself, §139 does not require employers to instruct employees to document their actual expenses, provided that the relief payments are reasonably expected to be commensurate with the expenses incurred. Yet, most tax professionals recommend that employers secure signed statements from employees, affirming that their claims arise from an area covered by the disaster declaration, have incurred these expenses and that such expenses have not been covered through an insurance policy. If the employer requires documentation or a signed statement with proof from the employee, this would also place a compliance burden on the individual taxpayer.

The bill also increases the cost of the government to examine the records. The IRS needs to update or issue multiple tax returns as well as regulations to comply with the credit. It is even more challenging for the IRS auditors to testify the expense paid to the qualified employees. They need to have more staff to verify the accurate amount of expenditures paid to the frontline workers by the employers in essential industries. Referring to the Bureau of Labor Statistic data, there are 50 million people who qualify as frontline workers while a majority of 90 million people

\textsuperscript{11}Rev. Rul. 2003-12, 2003-1 CB 283
are employed in essential industries.\(^{12}\) The burden of examining and tracking expense reimbursement is heavy. Therefore, this bill does not meet the principle of effective tax administration.

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<th>Information Security – Will taxpayer information be protected from both unintended and improper disclosure?</th>
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<td>The bill is unlikely to impact information security. The credit is received based on the payroll taxes of current employees. Employees’ personal information, such as name, address, and social security number, is likely to already be recorded in a company’s payroll system. Therefore, there is no additional risk to disclose employees’ important information.</td>
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<td>However, this principle becomes a cause of concern if employers require documentation from employees to verify expenses. As of date, §139 does not require documentation for qualified disaster-relief payments; however, several tax professionals are recommending employers to do so due to the ambiguity of the pandemic. If this is the case, privacy concerns as well as information security considerations are now prevalent. Employees may be forced to disclose certain medical concerns or even sensitive information that they may have not had to or been protected from having to do so under the U.S. labor and employer-employee relationship laws.</td>
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<td>Furthermore, taxpayers’ information is further disclosed to the federal government as it is likely that IRS auditors may need to look at receipts of reimbursement in order to assure that the correct amount of qualified expenses paid to the eligible workers. While it is unlikely that that information is will be subjected to improper or intentional disclosure, the lack of clarify regarding the necessity and extent of documentation from the employee raises concerns of privacy and information security. If documentation is required, the principle of information security may be violated.</td>
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Lastly, the IRS may need issue new tax forms that will be attached to the employment taxes for employers to claim the credit. However, the risk of information leakage would not be greatly increased than the case without new forms. As a result, the bill would comply with the principle of information security, disregarding the issue of employee documentation.

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<th><strong>Simplicity</strong> - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner?</th>
<th>Although there is no complicated process to increase the difficulty of calculation, employers would easily have confusion amongst the terminology of essential work and frontline workers. Without clear legal definitions, employers would be easily misunderstood and spend more time and cost to claim the credit that they may not be qualified for. As a result, taxpayers are unlikely to comply with the rule correctly due to ambiguous definitions. In addition, with no income threshold, employers have to trace after code sections 139, 125, and 414(q) to look at the meanings of “qualified pandemic-related employee benefit expense” or “highly compensated individuals”, in order to help understand some of the specified terms. The bill sets barriers for companies to comply with, especially for small businesses with no tax professionals. Therefore, this bill does not meet the principle of simplicity.</th>
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| **Neutrality** – Is the rule unlikely to change taxpayer behavior? | The proposed law may influence a taxpayer’s decision to reimburse expenses for their employees during the started time period provided in the bill. Large employers that can afford to incur and support qualified pandemic-related employee benefit expenses may extend this benefit out to their employees, but most likely will extend it only up to the cap of the credit. In addition, taxpayers may engage in tax planning to take advantage of the refundable perspective of this credit. The bill is also not neutral because it favors particular industries and types of workers over others. The amount of the credit is 50% of pandemic-related expenses of essential employees and 30% for all other employees. Employers, with a limited budget, may be more motivated to reimburse or compensate for the qualified expenses of their “essential employees” first before considering the expenses of a non- |
essential employee in order to receive a greater benefit for themselves.

This bill seeks to establish a payroll tax credit for employers who reimburse qualified pandemic-related expenses for their employees. Inherently, the credit is not neutral. It purposefully incentivizes businesses that have the ability to support employees adversely impacted by the pandemic and provide them a benefit for doing so.

### Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy?

**Short Term:**
In the short run, the credit may allow or provide relief to some employers that are adversely impacted by the pandemic. For those businesses that may see reduced business due to the shelter-in-place and lockdown orders, but still need to maintain a physical presence through their employees and pay payroll taxes as a result, this credit may provide some relief in that manner. It may also incentivize employers to retain more employees, rather than downsize, which would neither impede nor reduce current production capacity in the economy.

Yet, the credit provides relief to certain industries, but not others. More particularly, industries that are essential and can continue to operate during this time are likely to receive the relief, while businesses, such as gyms and salons, that cannot operate are not likely to receive this relief. Instead, this credit redirects resources away from these non-operational businesses, which may impede economic growth. With this tax rule favoring particular industries, thereby causing capital to flow to such areas for reasons not supported by economic factors, this can harm other industries as well as the economy as a whole.

At the individual level, the bill may help more employees and families to be able to work if §139 expenditures included things like computers or school supplies for children whose schools are closed or online. Families would not have the burden of additional expenses during this time where most are seeing reductions or a complete loss of income. It would also reduce the spending burden of the federal government and allow it to direct resources to other issues. However, based on the intentions noted by...
Congresswoman Sánchez in her press release, such expenses do not seem to be the purpose of this bill, though, due to the vagueness of §139 would qualify.

**Long Term:**
In the long-run, failing to support non-essential and non-operational can lead to massive collapses in certain industries, as indicated above.

Moreover, a tax credit of such design may impede the incentive for individual taxpayers to work. If a large number of companies take advantage of this credit, this could impact Social Security and Medicare. “The Social Security Trustees’ annual report, released in April of 2020, noted that the trust funds will be depleted by 2035, at which point the system may be able to pay only 79% of promised benefits. Medicare’s funding for Part A (hospital coverage) is expected to run dry by 2026 and be able to cover 90% of benefits. However, with the current economic crisis and the added payroll credit, economists believe that these shortfalls could arrive sooner.”

Furthermore, in a model designed by Penn Budget Wharton Model, the organization estimated that eliminating payroll taxes altogether would have little effect on the economy in the short-run, but could reduce the size of the economy by 0.1% in 2030 and 0.2% in 2050 due to additional debt. While this credit does not eliminate the entire payroll taxes, it still reduces them significantly, which in turn could have similar, but slightly smaller impacts on the economy in the long-run.

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**Transparency and Visibility** – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?

It is likely that taxpayers can get information about the bill from the IRS website itself. The IRS has been updating the instructions page for Form 941 with significant changes to the form that allows for the reporting of new COVID-19 related tax credits or tax relief. All such changes are condensed into one section at the top of the IRS page, and it is likely that if this bill were to pass, the information would be made available in that section of the webpage. Yet, owners of small businesses that may not frequently check the instructions webpage may miss out on receiving such information, without an official campaign to create awareness of this particular credit.

Moreover, the title, “Providing Essentials to Frontline Workers”, is misleading and businesses may pass over the credit believing that it does not apply to their business. Furthermore, in general, the payroll tax structure violates the principle of transparency because roughly half of the payroll taxes (the employer’s portion) are hidden in the form of lower wages, thus causing the individual (employee) to bear a larger burden of the tax. With this bill, revenues to fund Social Security and Medicare are expected to decrease and funds from the general fund are expected to be appropriated to cover the cost of this credit. This, in turn, may reduce available funds for other programs that individual taxpayers may benefit from. As a result, in the long-run, individual taxpayers may see higher taxes to compensate for the lower revenues, but may not be entirely apparent to taxpayers currently, due to how the taxes are levied.\(^\text{16}\)

### Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?

The likelihood of non-compliance is high currently due to the lack of well-defined definitions of eligible frontline workers and essential industries. It is not particularly clear how many employees working in essential industries are still reporting to the job site and how many of them are qualified for the credit. Thus, if no further regulations are issued, employers may easily make unintentional errors caused by confusion and uncertainty.

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The likelihood of intentional errors is also increased due to the nature of credit. Per the bill, if employers reimburse employees for qualified pandemic-related expenses, then the employers can get a quarterly-based credit. What would normally be a business deduction is currently a more frequent credit against payroll taxes. The deviation from the norm of the tax system would easily lead to mistakes and fraud (i.e. overstating the number of essential workers and the amount of employee benefit expenses).

As a result, employers are likely to make intentional and unintentional errors to get more tax relief. Therefore, this bill does not satisfy the principle 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?

Although the IRS tries to release guidance and inform taxpayers regarding developments in the tax law, taxpayers are unlikely to understand the purpose as well as their qualification for the credit due to the title of the Act. Should the bill be passed, the title “Providing Essentials to Frontline Workers” eludes that this credit may be particularly aimed at employees and employers in the medical and healthcare industry.

In current news and common terminology, “frontline workers” are often regarded as those workers employed within the medical and healthcare industry. Yet, the bill allows for credits for all “essential workers”, a broader group. Those employers (typically of a large size either in financial capital or human capital) with resources and abilities to track and review recent developments will likely understand their qualifications for taking advantage of this credit. Smaller businesses that are not up-to-date with the slew of tax legislation coming out of Congress are likely to not know of or understand the purpose of this rule. Furthermore, the title of the bill alludes to the idea that the benefits of this bill are being provided to the workers, themselves. Yet, the context of the bill outlines that the benefit is for the employers, not the employees.

Multiple alternative payroll tax credits have been proposed and made available through congress.gov, and are frequently being publicized through the national news coverage due to the on-going pandemic. Yet, due to the
amount of proposals, not all bills catch public attention, which could therefore hinder the understanding and informed debate in the evaluation of multiple alternatives. Still, lawmakers can support the rationale for this credit. Due to the on-going pandemic and forced business closures, consumption across the U.S. economy has fallen, reducing a business’ ability to fulfill their tax obligations. Yet, the burden of payroll taxes is borne by the workers themselves.

Employers hire workers based on the total compensation cost of that employee. With higher taxes, employers are not as willing to pay higher wages. Even with the credit, it is unlikely for employers to increase wages during this time as the pandemic continues to have an adverse economic impact.

<table>
<thead>
<tr>
<th>Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?</th>
</tr>
</thead>
</table>
| While the credit is not a direct expenditure, it is an indirect expenditure because it reduces the amount of tax revenues available to the federal government by reducing the amount of taxes collected from payroll. As of June, 2020, the U.S. Bureau of Labor Statistics reported an unemployment rate of 11.1%. This in turn translates to a further reduction in payroll taxes being collected by the federal government that may have provided available revenues to fund the current influx in tax expenditure legislation being enacted to support taxpayers impacted by the pandemic as well as resuscitate the economy. 
While the federal government has data available from agencies such as the Social Security Administration and the Internal Revenue Service that can produce an estimate as to the number of taxpayers as well as the amount of tax credit claimed per this bill, due to the constant evolving changes in state and local jurisdictions’ shelter-in-place and lockdown orders, it is unlikely that the federal government can produce a reasonable estimate. The lack of predictability, stability and reliability in the current pandemic situation disables the federal government from being able to determine the extent of this tax expenditure. |

Furthermore, since the credit is refundable, it may be harder to estimate which and how many businesses will engage in tax planning to take advantage of this particular aspect.

However, the timing of this tax expenditure is more predictable as the credit is applied on a quarterly basis.\footnote{18} While the credit’s impact on revenues incurred between March 2020 to July 2020 may be more easily understood, it will be difficult to foresee and estimate the impact of this credit on future revenues.

### Conclusion

The foundation of H.R. 6787 rests on positive morals with the intention to provide opportunities for employers to obtain an immediate source of liquidity and incentives to maintain more employees.

However, our analysis above shows more shortcomings than successes, as the bill fails to meet eleven of the twelve guiding principles for good tax policy. Many key principles are violated, including equity, certainty, simplicity, neutrality, minimum tax gap, and economic growth and efficiency, due to several long-term repercussions and costs associated with the bill. Yet, one particular facet of the credit, the delivery method, satisfies the principle of convenience of payment and provides some positive points to the principle of information security. Therefore, before the government can consider enacting this bill, the design needs to be modified such that its positive externalities outweigh the negative ones.

### Suggested Improvements

1. To address the equity issue, the bill should set forth limitations on the size of business that is eligible for the credit, either in terms of quarterly income and gross receipts or number of employees. If Congress deems to credit necessary and appropriate for large companies with more employees and more revenue, it may be more efficient to issue the credit through the income tax system, or grant a business deduction instead of the payroll credit, for these sizes of businesses, which would bring greater equity to small businesses with fewer employees and mitigate some of the long-term repercussions.

2. To address the certainty and simplicity issues, the bill should set forth legal definitions of specific terms, such as “essential worker” and define an income threshold and phase-out

\footnote{18 Treasury Reg. §31.6302-1; Form 941 - Quarterly Wage and Tax Return is generally filed each quarter. If the taxpayer reported $50,000 or less of taxes for the lookback period, it is a monthly schedule depositor. If it reported more than $50,000, the taxpayer is a semi-weekly schedule depositor.}
structure for highly compensated individuals. Regulations should also be issued out under §139 to address certain situations and areas of ambiguity in relation to the COVID-19 pandemic.

3. To address the issue of appropriate government revenues, the bill should scratch the provision that allows the credit to be refundable. A non-refundable credit would discourage tax planning and help the IRS forecast tax revenues with some certainty and reasonability.

4. Congresswoman Sánchez noted in her press release for this bill, “This legislation is...about giving [essential workers] peace of mind by covering their cost of staying at a hotel. It’s about easing the burden of child care costs for a food processing worker.” To address and lift the burden of this credit off of the intended targeted individuals, a viable alternative would be to issue a similar credit or deduction directly to these individuals (“essential workers” and “frontline workers”).

Supporting America’s Restaurant Workers Act

S. 4319 (116th Congress)

By: Xiaoyue Tan, MST Student and Students in BUS 223A Tax Research, Fall 2020

On July 27, 2020, U.S. Senator Tim Scott (R-SC) introduced the Supporting America’s Restaurant Workers Act (S.4319, 116th Congress), to allow businesses to deduct 100% of the cost of business meals in 2020, rather than the 50% deduction limitation of §274(n).

It is one of eight bills in the Health, Economic Assistance, Liability Protection and Schools (HEALS) Act which would increase funding for schools, higher learning institutions, hospitals, and provide a payroll tax credit to businesses equal to 50% of COVID expenses. The National Restaurant Association’s 2021 State of the Restaurant Industry report addresses the devastating impact of COVID-19 on the restaurant industry. The report highlights include the following:

- Among full-service restaurants, 87% had an average 36% drop in sales.
- More than 110,000 eating and drinking places were closed for business temporarily as of December 1, 2020.¹

To support restaurant businesses and increase the employment level, Senator Scott introduced this bill:

The Supporting America’s Restaurant Workers Act will lead to more customers, more opportunities for hardworking waitstaff and kitchen staff, and much needed revenue for small businesses across the country.

Generally, entertainment expenses are disallowed for deduction purpose. Meal expenses can be deducted up to 50% during the tax year with several exceptions. S. 4319 will add an exception under Sec. 274(n)(2) that expenses for food or beverages provided by a restaurant and paid or incurred before January 1, 2021 are fully deductible. This change was enacted into law for such restaurant expenses paid or incurred in 2021 and 2022.²

The following section applies the twelve principles of good tax policy to Supporting America’s Restaurant Workers Act of 2020 by MST students. These principles were laid out in the AICPA’s

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**Principles of Good Tax Policy Worksheet**

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity and Fairness</strong> – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer’s income for different income levels of taxpayers.</td>
<td><em>Horizontal equity:</em> Horizontal equity requires similarly situated taxpayers to be taxed similarly. The proposal favors restaurants relative to other businesses by encouraging more people to buy meals from restaurants. The 100% meal expense deduction is only available for food or beverage purchased from a restaurant, but it is not available for other businesses, such as for those providing entertainment. In addition, no equivalent tax rule is proposed to help increase activity at other businesses adversely impacted by the pandemic. <em>Vertical equity:</em> The vertical equity principle is satisfied when taxpayers with higher income pay more tax than taxpayers with lower income. Generally, high-income taxpayers may purchase more expensive food than low-income taxpayers. This bill will provide a greater tax savings to higher income taxpayers, violating vertical equity.</td>
<td></td>
</tr>
<tr>
<td><strong>Certainty</strong> – 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.</td>
<td>The proposal is short and easy to understand, however, it does not give any clear definition of a restaurant. Generally, a restaurant is where people pay to sit and eat meals. Taxpayers can be confused when they apply this tax rule. For example, if taxpayers purchase food from food truck or cafeteria or deli counter at a grocery store, is it treated as qualified meal expenses for the 100% deduction? The proposal stated that the deduction will apply to amounts paid or incurred after the date of the enactment of this Act, and before January 1, 2021. It is also not clear for prepaid meal expenses. If businesses prepaid lunch meal from a restaurant on January 1, 2020 for the whole year, is it fully deductible on 2020 tax return? The proposal is not clear</td>
<td>+/-</td>
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</tbody>
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and easy to comply for taxpayers. Thus, S.4319 does not fully meet the certainty principle.

| Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor? | Taxpayers report the amount of meal expenses on their Schedule C or other business return and keep the supporting documents. Taxpayers do not need to make any payment. The deduction will offset the taxable income, and taxpayers will pay the tax due or receive refund from the IRS. The proposal does not affect the convenience of payment principle. | N/A |
| Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers? | The deduction for meal expenses is not a new idea. Government and taxpayers do not need new instructions or trainings for this proposal. The only issue may be what is considered a restaurant. Therefore, S.4319 will not increase costs for both the government and taxpayers. The IRS may add a line on business returns for 100% deductible meal expenses and there is no need for any special tax form. Based on that, S.4319 does meet the effective tax administration principle. | + |
| Information Security – Will taxpayer information be protected from both unintended and improper disclosure? | No new information needs to be obtained by businesses as this is a change in the amount of a deduction currently 50% disallowed. | N/A |
| Simplicity - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner? | No special calculations are required by this proposal. If taxpayers paid $1,000 for meals provided by a restaurant in 2020, they would report the $1,000 on their tax return. The only thing to keep in mind is that taxpayers must keep the receipts or any other supportive documents for the meal expenses. Thus, the bill does meet the principle of simplicity. | + |
| Neutrality – Is the rule unlikely to change taxpayer behavior? | S.4319 was introduced to provide more opportunity to restaurant businesses which have suffered under the pandemic since March 2020. It may encourage businesses to purchase food and beverages from restaurants. Taxpayers who used to purchase food from a food shop or food truck may change their behavior. Businesses will also make decisions between amusement which is nondeductible expense and meal which could be 100% deductible. Thus, the bill influences taxpayers’ decisions, and the neutrality principle is not met. | - |
| Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy? | The bill could have a positive impact on the economy. There is an economic downturn since February 2020. Government have prohibited people eating inside restaurants to protect people from COVID-19. Thus, people have been staying at home instead of eating outdoors. Lots of restaurants have been closing. Real gross domestic product (GDP) – the value of goods and services produced in the United States dropped 5.0% in the second quarter of 2020, according to data from the Bureau of Economic Analysis. The national economy lost more than 22 million jobs in March and April 2020, according to data from the Bureau of Labor Statistics (BLS). S.4319 may help restaurants reopen and bring back more job opportunities. In another aspect, the proposal may have a negative impact for businesses other than restaurants. If cafeteria, food shop or food truck is not included in the definition of a restaurant, people will tend to purchase food from a restaurant rather than a food truck. These businesses may be left worse than before. Overall, the proposal does meet the economic growth and efficiency principle. | + |
| Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others? | Businesses may get the information from their tax advisor. The proposal was introduced to support the restaurant businesses and increase employment. To achieve the goals, the government must spread awareness of this expanded deduction. Restaurants can also inform businesses of this expanded deduction. Thus, the transparency principle is partially met. | + |
**Minimum tax gap** – Is the likelihood of intentional and unintentional noncompliance likely to be low?

S.4319 is relatively straightforward for taxpayers to comply. The likelihood of intentional and unintentional noncompliance may be low. The bill does meet the principle 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?

S.4319 has a strong intention to encourage businesses to purchase food from restaurants. The lawmakers may support the proposal because restaurant businesses suffer during the pandemic. The rationale for fully deductible meal expenses can be clear for the taxpayers and lawmakers. However, they may also consider if there are alternatives. The proposal is unfair for businesses other than restaurants. Taxpayers may ask for fully deduction for entertainment expenses or other nondeductible business expenses, or a tax credit to encourage purchases from other businesses that are suffering during the pandemic. Thus, the proposal mostly meets the accountability to taxpayers principle.

**Appropriate government revenues** – Will the government be able to determine how much tax revenue will likely be collected and when?

It might be difficult for the government to estimate the costs of this proposal. Existing data on the meals deduction cannot just be doubled because the pandemic has reduced the inclination of businesses to have meals with clients. However, there is some data including from the restaurant industry to estimate the drop in sales and what they think the bill might lead to regarding an increase in sales to business customers. The bill mostly does not meet the principle of appropriate government revenues.

### Summary

Based on our analysis, S.4319 satisfies six of the twelve principles of good tax policy. We have a mixed positive/negative rating for equity and fairness principle. Several key principles, including convenience of payment, effective tax administration, simplicity, economic growth and efficiency, minimum tax gap, transparency and visibility, and accountability to taxpayers’ principles are mostly satisfied. Certainty, neutrality, and appropriate government revenues principles are not met.

Another consideration is whether this proposal is the best one to help the restaurant industry as it doesn’t do anything to help increase non-business purchases or provide assistance to remain open and retain employees. Other COVID-19 changes such as Paycheck Protection
Program (PPP) loans and various payroll credits might help more and should be extended and broadened.

Suggestions for improvement:

1. Giving the clear definition of a restaurant. Listing out the examples of qualified restaurants and disqualified ones. The certainty principle could be satisfied.

2. To better meet the neutrality principle, lawmakers could consider making other expenses deductible, such as entertainment and transportation expenses. However, the cost of increased numbers of individuals contracting the coronavirus must also be considered.

3. Consider changes that would help more types of struggling businesses rather than just one industry.
S.2697 (116th Congress) - Tariff Tax Credit Act of 2019

By: Liubov Shilkova and Hanna Shatanionak, CPA, MST Students

On October 24, 2019, Senator Rick Scott (R-FL) introduced the Tariff Tax Credit Act (S.2697, 116th Congress) in the Senate and referred it to the Committee on Finance. Per Senator Scott, the purpose of this proposal is to “establish a refundable tax credit to return revenue raised from tariffs against Chinese imports to American families.”\(^1\) According to S.2697 only “eligible individuals” would qualify for this refundable tax credit, which would be calculated based on the amount of collected duties and tariffs levied on imports of goods from China. The U.S. government has significantly increased tariffs against China for not abiding by the World Trade Organization (WTO) rules and intellectual property laws.

To receive a refundable credit as a qualified individual, a taxpayer must file a federal income tax return for any tax year ending with or within a calendar year before October 15 of the succeeding calendar year. Some taxpayers are not qualified for this credit, such as estate or trust, nonresident alien individuals or any alien who is not authorized for employment in the U.S. Also, an individual who is claimed as a dependent by someone else is not eligible for this credit.

The amount of the credit is determined by dividing the total amount of collected duties imposed on imported goods from China during the preceding calendar year by the estimated number of eligible individuals. This applicable amount shall be determined every year no later than March 1. For any taxable year beginning after December 31, 2018 and ending before January 1, 2020, the amount of collected duties and tariffs shall be equal to the sum for 2018 and 2019 calendar years. Based on the figures from the IRS, the estimated amount of a tax rebate for the 2019 tax year is $180 or more for every eligible individual.\(^2\)

The following section is analyzing the proposed S.2697, Tariff Tax Credit Act of 2019, by using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.\(^3\)


\(^2\) Id.

### Application of the Principles of Good Tax Policy

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
<th>+/-</th>
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<tbody>
<tr>
<td><strong>Equity and Fairness –</strong> Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</td>
<td>There are two types of equity that should be analyzed.</td>
<td>+/-</td>
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<tr>
<td></td>
<td><strong>Horizontal equity:</strong> Horizontal equity requires similarly situated taxpayers to be taxed similarly. This principle is met in the proposal. For two eligible individuals with the same level of income, the benefit of the credit will be the same. The amount of collected tariffs is divided equally among every eligible individual. Therefore, this tax policy meets the principle of horizontal equity.</td>
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<td><strong>Vertical equity:</strong> The vertical equity principle is satisfied when taxpayers with higher income pay more tax than taxpayers with lower income. There is no phase out for higher earning taxpayers. The taxpayers with higher income could claim the same amount of credit as taxpayers with a lower income. However, assuming that high-income taxpayers spend more on tariffs, there are no greater benefits for this type of taxpayers that reduce the progressivity of the income tax. The fixed credit amount reflects the purpose of the bill to allocate the tariff amounts collected from Chinese goods equally among all eligible individuals regardless of their income level. Therefore, vertical equity is not met.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>This bill meets the principle of horizontal equity but fails to meet the principle of vertical equity.</td>
<td></td>
</tr>
<tr>
<td><strong>Certainty –</strong> 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?</td>
<td>Overall, the fact patterns covered in the proposal are clear. The proposed bill includes a detailed description of how and when the amount of the credit is determined. The credit is allowable only for individuals. However, the proposal does not specify when and how the rebate will be paid and claimed by the taxpayers. For example, the proposal does not specify whether there will be changes in an individual income tax return form due to this credit. It is not clear if taxpayers will be required to claim the credit while filing a tax return or the IRS will distribute the amount of the credit once the return is filed. Also, the bill has “October 15” as the due date to file a return to qualify for the credit. This due date covers a broader group of taxpayers and makes the rule easier to administer. The overall level of confidence is high for this proposal as the calculation of the credit described in the bill is easy to follow, and it will use data from reliable sources.</td>
<td>+/-</td>
</tr>
<tr>
<td><strong>Convenience of payment –</strong> is the tax due at a time that is</td>
<td>This bill does not add any extra burden on taxpayers to pay their taxes because it only involves the additional credit which does not affect the due date or methods to pay taxes. The benefit of the credit will not be received</td>
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</table>
The language of the bill does not specify information about how eligible individuals can apply for the credit if they decide to file their federal income tax return before March 1, the due date for calculating and announcing the credit amount by the Secretary. In this case, they need to file an additional form, such as an amended tax return, to get the credit, which could decrease the level of convenience for this group of taxpayers. In general, the credit can make it easier for taxpayers to pay their taxes as it decreases the amount owed. Overall, the bill satisfies the convenience of payment principle.

**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.

Overall, the cost to comply with this proposal will be reasonable for both the government and taxpayers. The calculation is straightforward as it utilizes only two factors that are available through the government records. To calculate the rebate amount, the U.S. Treasury will have to estimate in advance the number of eligible individuals and also to determine the total amount of money collected by the United States from tariffs on Chinese goods. The tax on imports collection data comes from the U.S. Customs and Border Protection (CBP). The duties usually must be paid within 10 days of the shipments clearing customs. “Every item imported into the United States legally has a customs code. Importers are expected to check the tariffs and other taxes and duties due on the goods they bring in, calculate what they owe, and pay it. U.S. Customs reviews payments and sends importers a fresh bill if it detects underpayment”. The effectiveness of tax administration would depend on how soon the data related to tariffs collection can be available. The second factor for the rebate calculation is an estimate of the number of eligible individuals that will file federal income tax returns. The bill does not provide the details of how this number should be estimated, but the IRS has collected a significant amount of data over the years that can be used to come up with a reasonable estimation. It might be more time consuming for the government to calculate and issue the rebate to the taxpayers, but no additional action is required of taxpayers in order to claim the credit. They only need to file their federal individual income tax returns on time. Also, the effective tax administration of the IRS depends on how taxpayers receive this credit. For example, if the credit will be available for claiming through the income tax return, the cost to administer will be not significant. However, if the IRS is supposed to distribute the credit amount to every eligible individual, it would be costly and more time consuming. Overall, the Effective Tax Administration principle is met.

**Information Security** – Will taxpayer information be protected?

There are no specific reporting requirements to disclose additional personal information for taxpayers to receive this credit. All personal information, such as a taxpayers’ residency and whether someone can claim a taxpayer as 

| Convenient for the payor? | until the taxpayers file their tax return. The language of the bill does not specify information about how eligible individuals can apply for the credit if they decide to file their federal income tax return before March 1, the due date for calculating and announcing the credit amount by the Secretary. In this case, they need to file an additional form, such as an amended tax return, to get the credit, which could decrease the level of convenience for this group of taxpayers. In general, the credit can make it easier for taxpayers to pay their taxes as it decreases the amount owed. Overall, the bill satisfies the convenience of payment principle. |
| 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. | Overall, the cost to comply with this proposal will be reasonable for both the government and taxpayers. The calculation is straightforward as it utilizes only two factors that are available through the government records. To calculate the rebate amount, the U.S. Treasury will have to estimate in advance the number of eligible individuals and also to determine the total amount of money collected by the United States from tariffs on Chinese goods. The tax on imports collection data comes from the U.S. Customs and Border Protection (CBP). The duties usually must be paid within 10 days of the shipments clearing customs. “Every item imported into the United States legally has a customs code. Importers are expected to check the tariffs and other taxes and duties due on the goods they bring in, calculate what they owe, and pay it. U.S. Customs reviews payments and sends importers a fresh bill if it detects underpayment”. The effectiveness of tax administration would depend on how soon the data related to tariffs collection can be available. The second factor for the rebate calculation is an estimate of the number of eligible individuals that will file federal income tax returns. The bill does not provide the details of how this number should be estimated, but the IRS has collected a significant amount of data over the years that can be used to come up with a reasonable estimation. It might be more time consuming for the government to calculate and issue the rebate to the taxpayers, but no additional action is required of taxpayers in order to claim the credit. They only need to file their federal individual income tax returns on time. Also, the effective tax administration of the IRS depends on how taxpayers receive this credit. For example, if the credit will be available for claiming through the income tax return, the cost to administer will be not significant. However, if the IRS is supposed to distribute the credit amount to every eligible individual, it would be costly and more time consuming. Overall, the Effective Tax Administration principle is met. |
| Information Security – Will taxpayer information be protected? | There are no specific reporting requirements to disclose additional personal information for taxpayers to receive this credit. All personal information, such as a taxpayers’ residency and whether someone can claim a taxpayer as |
protected from both unintended and improper disclosure? a dependent, must be already reported and reflected on their tax returns. It is unlikely that this information will be misused due to unintended and improper disclosure. Therefore, the bill meets the principle of information security.

| Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner? | The taxpayer can understand the idea of the proposal and its purpose to return money collected in tariffs back to American families. There are no additional forms or calculations that the taxpayer has to perform. The fixed amount will be determined by the government and will be the same for all taxpayers. No additional effort is required of taxpayers to claim the credit. They just need to file their federal individual income tax returns on time. Overall, the simplicity principle is met. | + |

| 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 purpose of this principle is to minimize situations in which taxpayers’ decisions are affected by a tax rule. In general, the bill will not influence a taxpayer’s decisions in terms of whether to engage in a particular transaction and how to carry it out. This bill establishes a credit that will be allowable for all eligible individuals regardless whether they buy Chinese goods or not. There are no restrictions and limitations about how the credit amount can be spent. However, due to some positive aspects of the tax credit, some taxpayers might be influenced to buy more Chinese products as they will then be compensated. Overall, the principle of neutrality is met. | + |

| Economic growth and efficiency – will the tax unduly impede or reduce the productive capacity of the economy? | This bill aims to compensate for the economic damage caused by the significant tariffs increase. According to the Organization for Economic Cooperation and Development study, U.S.-China tariff hikes could reduce U.S. GDP by 0.9% by 2021-2022 (relative to its baseline). The proposal partially meets the economic growth and efficiency principle as it helps to improve the economic situation by compensating taxpayers in the amount of the tariffs and, therefore, reducing the cost of tariffs passed on to consumers. “A growing number of U.S. companies has warned about the negative impact of the tariffs on U.S. consumers. Nike Inc. and 172 other footwear companies have urged Trump to remove footwear from a list of imports facing a proposed extra 25% tariff, warning the move could cost consumers an additional $7 billion a year”. At the same time this principle is partially violated as the bill relates only to the goods imported from China and not |

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from other countries. As such, it favors one product category over others and can affect international competitiveness.

| **Transparency and Visibility** – Will taxpayers know that the tax exists and how and when it is imposed upon them and others? | A tax rule should be visible to taxpayers so they can figure out their tax liability in advance. Eligible taxpayers should know that this credit exists and how they can claim it. All general information, such as how the amount of the credit is determined, who can qualify, and when it must be calculated, is presented in the bill. Taxpayers will likely get the information about the bill from tax professionals or tax software. However, there is no guarantee that taxpayers will know about this new credit if they do not use the services of tax preparers or software. Therefore, it is important to communicate all the necessary information about this credit through the IRS website and the Form 1040 instructions before the filing season begins. This would allow taxpayers to evaluate their tax liability in advance. As it stands, the bill partially meets the transparency principle. | +/- |
| **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? | This proposal does not carry a risk of intentional or unintentional non-compliance as it only provides an additional incentive for the taxpayer to file the tax return on time to receive a refundable credit. There is also no way to abuse this rule by under- or overreporting as the amount of the credit will be fixed and will not correlate with the income or tax amount. The proposal meets this principle because it will help decrease the tax gap by stimulating individuals to file the return on time. | + |
| **Accountability to taxpayers** – Do taxpayers have access to information on tax laws and their development, modification and purpose; is the information visible? | Taxpayers should readily have access to information for understanding sources and uses of tax revenues. Senator Scott clearly states that the purpose of this bill is to give the tariff money back to the taxpayers in the form of a refundable tax credit. However, such administrative items as the amount of the credit applicable to the particular tax year and the references where taxpayers can find this information are not indicated in the bill. Therefore, the accountability to taxpayer’s principle is partially met. | +/- |
| **Appropriate government revenues** – will the government be able to determine how | The Tariff Tax Credit Act has a negative effect on government revenue. The main purpose of taxation is to raise government revenue. The bill would not impair the predictability of the tax system, as the data for the credit calculation will be available and reliable, but it will decrease the stability and reliability of the tax system. According to this proposal the amount of the | - |
much tax revenue will likely be collected and when?

| credit is determined by dividing the total amount of collected duties imposed on imported goods from China during the preceding calendar year by the estimated number of eligible individuals. As a result of this proposal the government will lose not only the funds raised due to the recent increase in tariffs but also the funds that were generated from those tariffs prior to the Section 301 Investigation.6 Appropriate government revenues principle is not met: the government revenues will decrease as all the taxes collected on imports from China will be refunded to the individuals. |

To summarize, according to the above analysis, the Tariff Tax Credit Act does not pass the test of all twelve principles of Good Tax Policy. Overall, this proposal has more strengths than weaknesses. The main goal of this bill is to compensate Americans for the economic damage caused by the significant increase of tariffs imposed on imported goods from China. One of the strengths of the proposal is that it meets the principle of horizontal equity and does not discriminate against taxpayers based on their income level. Another strong aspect of the bill is that it would reduce the tax gap by providing a refundable credit incentive to file the income tax returns on time. This policy does not add an extra burden for individuals who are qualified for this credit. One of the weaknesses of the proposal is that it does not take into account the income level of the taxpayer as it does not suggest a phase out for higher earning taxpayers.

Part of the reason is that the purpose of the bill is to allocate the tariff amounts equally among all eligible individuals regardless of their income level. Also, the nature of the involved transactions is closer to the consumption tax category than the earned income tax category. It is usually difficult for consumption tax to meet the vertical equity principle as it will trigger a violation of the simplicity principle. Another weakness of this bill is that it does not completely meet the economic growth and efficiency principle as the proposal favors goods imported from China over imports from other countries. This bill also violates the principle of appropriate government revenues. It would spend not only funds raised from the recently increased tariffs by the Trump administration, but also the amount that the government had generated in prior years from tariffs.

We have already suggested a few improvements in the analysis above, such as:

- provide clearer instructions on how the eligible individuals can receive this credit if they must file a federal income tax return before March 1 (or on whichever date the credit amount is finalized for that year)

- communicate all the necessary information about the credit through the IRS website and the Form 1040 instructions before the filing season begins.

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A significant improvement can also be made to the calculation of the credit to make the proposal better meet the following two principles of Good Tax Policy: appropriate government revenues, and economic growth and efficiency. The determination of the credit can be rectified by using only the difference between the original tariffs amount and the increased amount, instead of the full amount collected. Tariffs can be an important revenue source for the U.S. government as a mix of taxes reduces financial risk and provides more stability for the government. For example, it can play a significant role to support the government during economic downturns when the revenue from income tax decreases. “Through May 1, Washington has assessed $23.7 billion in tariffs since early 2018, according to data from the CBP. Total tariff revenue - including levies that pre-dated Trump - shot up by 89% in the first half of the current fiscal year starting Oct. 1, to a total of $34.7 billion, according to U.S. Treasury data”. Accordingly, if the calculation is adjusted so the government can keep about $23.7 billion in tariffs collected in prior years, the individuals will still receive a large portion of the collected amount. In this case, the policy would be more reliable and stable for the government. This improvement will also solve an international competitiveness issue by not favoring imports from China as tariffs on imports from other countries will be excluded from this credit. As a result, the credit calculated only based on the recent tariff hikes will directly target the issue caused by those large increases of the tariffs on imports of goods from China, which is a main purpose of The Tariff Tax Credit Act of 2019.

To conclude, the Tariff Tax Credit Act is a good idea to bring money back to American families, but this goal can be achieved in a more effective way if the amount collected will be allocated between the government and individuals.

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