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Welcome to

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TABLE OF CONTENTS

Hold the Date

37th Annual TEI SJSU High Tech Tax Institute

November 8 and 9, 2021

Virtual for 2021

https://www.sjsu.edu/taxinstitute/

Letter from the Editor

In our tenth anniversary of publishing, we are excited to present to you the Summer 2021 issue of *The Contemporary Tax Journal*, a publication of San Jose State University's MS in Taxation (MST) Program.

The issue begins with a section dedicated to Tax Enlightenment which consists of two articles written by SJSU MST students. Dimple Mukhi discovers what qualifies as a charitable contribution while Tam Nguyen determines what the IRS considers taxable income when it comes to credit card reward points.

Next, we are delighted to provide a book review on the book *Rebellion, Rascals, and Revenue: Tax Follies and Wisdom through the Ages*. We appreciate SJSU MST alum Rachana Khandelwal taking time out of her busy schedule to write us an excellent review on a book every tax practitioner should get their hands on.

Following the book review, we have two fascinating republished articles. The first article is Proliferation of NFT Transactions Raise Numerous U.S. Tax Questions. The second article is Suggestions for Pandemic State Tax Policy Endurance. A big thank you to Skadden Arps and Tax Analysts for allowing us to reprint these articles in the SJSU Tax Journal.

Next, we are grateful to Roger CPA for providing us with practice CPA Exam Questions that we hope everyone finds stimulating.

Our *Tax Maven* for this issue of our journal is Mr. Andy Mattson, Tax Partner at Moss Adams LLP and long-time member of the SJSU Tax Advisory Board. Mr. Mattson has extensive experience in providing tax solutions for starts ups and technology companies in the Silicon Valley area. I was honored to have a Zoom interview with him and learn about his incredible career. I hope you will find his accomplishments and career as interesting as I did.

Finally, *A Focus on Tax Policy* presents the analysis of two Federal tax proposals: H.R. 5377, Restoring Tax Fairness for States and Localities Act, by the Spring 223A class of MST students; and S.844, Personal Health Investment Today (PHIT) Act of 2021, by MST students Neha Nanda CPA and Karla Rees CFP. 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 Tam

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

Nguyen 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 Summer 2021 issue of *The Contemporary Tax Journal*.

Regards,
Hana Ka Yin Kwong
Student Editor

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Charitable Donation of Deconstructed House Denied

By: Dimple Mukhi, MST Student

Mann v. U.S., 127 AFTR 2d 2021-447 (4th Cir.), affirmed the judgment of the U.S. District Court for the District of Maryland (123 AFTR2d 2019-599 (DC MD)). The ruling was against the taxpayers and upheld the IRS disallowance of charitable deductions of $675,000 and $24,206 on the couple's 2011 joint income tax return for donation of house components to Second Chance, Inc., a non-profit property deconstruction organization.

Background of the case

Linda and Lawrence Mann challenged the district court's judgment affirming the IRS's disallowance of a charitable deduction claimed on their 2011 joint income tax return. The Manns had purchased a residence in Bethesda, Maryland referred to as 5300 Moorland Lane. They decided to demolish the existing house and build a new one on the property due to water issues in the basement and to make desired changes to the house's layout. The Manns were advised by their builders to consider working with Second Chance[1] not only to advance the organization's charitable cause but also to obtain a charitable tax deduction.

About Second Chance, Inc., a charitable organization

Second Chance offers deconstruction services to foster its mission of providing "workforce development and job training opportunities to disadvantaged members of the community," and also preventing "salvageable building materials and fixtures from ending up in landfills." The employees are paid an hourly wage and learn construction skills. Second Chance can perform a "systematic dismantling of a structure" to remove some building components for resale or recycle. Some building components, like drywall, tile, and roofing materials, are certainly destroyed as part of the deconstruction process, and some are destroyed as part of employee training. However, Second Chance does not provide demolition services and advises potential donors to do that at their own expense. Second Chance also asks deconstruction donors to make a cash contribution to help defray the costs of its training program for disadvantaged individuals. They usually don't accept a deconstruction project that lacks such funding unless the salvaged materials have historical significance.

[1] Second Chance, Inc., is a charitable organization under section 501(c)(3) of the Internal Revenue Code.

Facts of the case

House donation

After learning about Second Chance, Linda Mann signed an agreement with Second Chance which stated that the Manns donated the existing house in its totality2 to Second Chance but specifically excluded the underlying land or the foundation on which the residential dwelling was built. The Sales Manager of Second Chance assured the Manns of the possibility of a charitable tax deduction and agreed to assist with the paperwork to provide evidence and support for the deduction. The Sales Manager also explained that if they followed the tax law and determined the value for the deduction based on a qualified appraisal performed by a qualified appraiser, they should be entitled to the deduction. For the purposes of determining the amount of charitable deduction on the federal tax return, the Manns engaged NoVaStar Appraisals, Inc., to provide an appraisal. The appraiser calculated $675,000 as the value of the house without the land based on the "highest and best use" of the house. The appraiser established the fair market value of the entire property as $1,875,000, which included $1,200,000 as the market value of the land. The appraiser subtracted the market value of the land from the fair market value of the entire property and concluded that the value of the intact house without land was $675,000. The appraiser assessed the value of the house "without disassembly" and concluded that the "highest and best use" of the house was "not disassembly, but rather physically moving the structure intact to another lot." The Manns took a charitable deduction of $675,000 on their income tax return for 2011.

Personal property donation

Deconstruction is generally divided into two phases: the first phase is removal of non-structural interior elements, and the second phase is removal of structural exterior elements. Second Chance completed the deconstruction on July 6, 2012 and stated that it was unable to extract as much material as expected. Also, Second Chance did not maintain a list of items removed from the second phase of deconstruction of 5300 Moorland Lane. The first phase of deconstruction included items such as appliances, granite counter tops, solid wood interior doors, and 2400 square feet of wood flooring. The Manns prepared a list of 40 items of furniture and home decorations that they donated to Second Chance that was valued at $24,206 by NoVaStar Appraisals, Inc. The Manns claimed a charitable deduction of $24,206 on their 2011 income tax return for the personal property donated.

Cash donation

To finance the costs of its training program, Second Chance asked the Manns to make a cash donation of $20,000. The Manns donated $10,000 in 2011 and took a deduction of this amount on their 2011 income tax return. In 2012, they donated $1,500 and took a deduction on their 2012 income tax return.

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[2] Ms. Mann transferred to Second Chance "all of her right, title and interest in the improvements, building and fixtures located at 5300 Moorland Lane."

The IRS selected the Manns' 2011 and 2012 tax returns for audit and disallowed all the donations made to Second Chance. The IRS calculated $191,638 tax liability in federal income taxes for 2011 and $2,464 tax liability for 2012, plus statutory interest. The Manns paid the additional tax liabilities and filed a refund claim and an abatement request. They also filed an amended return for 2011 and claimed a deduction of $313,353 for the house instead of $675,000. The value of $313,353 was based on a second appraisal by NoVaStar Appraisals. The value was determined by using the R.S. Means Building Material Cost Estimating Software, wherein the cost of all materials was estimated as new due to nonexistence of well-established second-hand market price for all. The cost of all materials as new accounted for $377,534 and for depreciation based on an estimated "60 years of economic life with an effective age of 10," bringing the value of the house to $313,353. The IRS again disallowed the claimed deduction on the amended return. The Manns sought determinations that their original claimed deduction of $675,000 for the house was valid and sought a refund of $212,534.22. After learning this, the parties filed cross-motions for summary judgment.[3]

Court's analysis

House donation

With respect to disallowance of the house deduction, the court affirmed the IRS summary judgment request for two reasons. First, the court concluded that the Manns "failed to make a valid transfer of an entire interest in a real property" per Maryland law and per IRC §170(f)(3). Under Maryland law, "real property" includes both land and improvements to land.[4]

Thus, the owner of the land and the owner of the improvements to land is the same in Maryland unless there is a separate recorded deed or other instrument of record showing the transfer of the title to the improvements to another owner.[5] The separation of the land from improvements to the land would be valid only if the transaction was recorded in the land records of Maryland. Thus, record ownership is more important than contractual ownership under Maryland law.[6] The "record landowner" remains liable for paying property taxes on the real property.

The Manns entered a contract with Second Chance for the transfer of improvements at 5300 Moorland Lane but never recorded that transaction in the land records of Maryland. Therefore, Linda Mann was the "record landowner" and retained the ownership of the house. She was liable for property taxes on both the land and improvements even after execution of the contract with Second Chance. Due to this, the Manns "neither transferred their entire interest to Second Chance per 26 U.S.C. §170(f)(3)(A) nor transferred an undivided portion of their entire interest in the

[3] Cross-motions for summary judgment are filed when the dispute is not as to any material fact but it's a matter of law.
[4] Under Maryland law, improvements to land include buildings, any permanent structure or other development.
[5] *GBMC*, 32 A.3d 174 (Md. Ct. Spec. App. 2011).
[6] *Townsend*, 79 A.3d 960, 967 (Md. Ct. Spec. App. 2013).

property per 26 U.S.C. §170(f)(3)(B)(ii)." The court compared the Manns' donation to granting a license to Second Chance for use of the house for salvage and training purposes.

Also, the appraised value was determined as if the house was moved intact to another lot. However, this claim is incorrect because the Manns donated only a few components; some of the others were destroyed for training purpose and some were demolished. The court determined that the amended deduction value of $313,353 was also improper as it reflected the value of all the materials in the house being donated for reuse whereas only some materials were donated. The appraisal was overstated by NoVaStar Appraisals, and Second Chance failed to maintain the records of salvaged items. Thus, the Manns "failed to support their donation with a qualified appraisal per IRC § 170(f)(11)(C)."

Second, the court determined that even if the Manns had recorded the transaction in the land records of Maryland, they still would not be entitled to a charitable donation deduction as both the appraisals were not qualified. The appraisals were determined based on the value of all building materials without regard to the few materials that were destroyed, not salvaged and resold. Thus, the appraisals did not value what was actually donated and were overstated. The court provided a correct alternative way to claim the deduction as the resale value of specific building materials actually removed from the house and donated to Second Chance.

Personal property donation

For the personal property deduction of $24,206, the court ruled that the "appraisal supporting the donation was deficient in several respects." The appraisal did not provide the specific basis and documentation for the valuation of all 40 items. The valuation was inconsistent as it depreciated the items arbitrarily and failed to include explanation of the basis of the valuation per Reg. § 1.170A-13(c)(3)(ii)(K). The court affirmed the district court ruling and disallowed the deduction for the furniture, home, and components.

Cash donation

The cash donation of $11,500 was not addressed by the Fourth Circuit Court because it was allowed by the District Court and not challenged on appeal. The lower court allowed this cash donation due to its timing and the view that the Manns did not get a direct benefit from the donation. A donation, to qualify as charitable contribution under §170, must be an unrequired payment without expectation of any specific return. The court held that even though the Manns were required to make cash donations to Second Chance under an arrangement, it was not a *quid pro quo*[7] because the Manns did not receive any specific benefit in return.

The court held that obtaining a tax deduction is not a specific benefit, and if the motivation of tax benefit eliminates the charitable nature of a gift, then no charitable gift would be deductible.[8] Also,

[7] *Quid pro quo* is a Latin phrase which means "something given or received for something else."

[8] *Scheidelman*, 682 F.3d 189 (2nd Cir. 2012).

the deconstruction services benefitted Second Chance and did not provide any benefits to the Manns, apart from a possible tax deduction. The Manns had no need for the deconstruction services before undertaking the demolition of the house. Also, the deconstruction services did not reduce their cost of demolition.[9] Thus, the Manns were not benefitted from the deconstruction apart from facilitating a charitable donation and its tax deduction. Thus, the Manns were entitled to claim a charitable deduction of $11,500. When donating cash for removal of house components, it is important to check the details of any similar cash donations as it could be denied based on its nature and collateral benefit.

Conclusion

A charitable contribution is a donation made to a qualified organization without any expectations of something in return. This case helps us to understand the importance of being proactive and not overlooking the details of the complex charitable contribution rules in the tax law as well as sometimes state property laws that may be relevant. When it comes to charity, substantiation of the items actually donated and proper valuation play a vital role, including proper compliance when a qualified appraisal and/or Form 8283, Noncash Charitable Contributions, are needed.

[9] *Rolfs*, 668 F.3d 888 (7th Cir. 2012).

Some Credit Card Points are Taxable

By: Tam Nguyen, MST Student

***Konstantin Anikeev, et ux.,* TC Memo 2021-23**

The everyday use of certain credit cards can result in the accumulation of reward points to be credited towards another purchase or a redemption against the credit card bill itself. This accumulation of reward points can result in $5 towards a purchase of groceries to $500 against your credit card statement. The reward points are a nice perk to gain by just using your credit card for purchases you would have made anyways. While you are definitely receiving what might feel like income, the IRS has historically not taxed credit card reward points programs. The IRS views credit card reward programs as a discount on purchases of goods and services. When viewed this way, it becomes more of a reduction in price for the goods and services instead of gaining new wealth from these reward points. One taxpayer's aggressive accumulation of points from specific items purchased led him to create taxable ordinary income. This taxpayer acquired $35,665 in 2013 and $276,381 in 2014 through credit card rewards that the IRS deemed was taxable income. In this Tax Court memorandum decision, it will become obvious how complex a credit card reward program was treated when deciding if it is income or a rebate on a purchase.

Who is this mysterious taxpayer?

Mr. and Mrs. Konstantin Anikeev were the masterminds behind their grand accumulation of credit card reward points. I will mostly refer to Konstantin as his wife was not mentioned often in this case. Konstantin was a well-educated person. He earned a Bachelor of Science in Physics from the Moscow Institute of Physics & Technology (MIPT) in 1995 while graduating summa cum laude. A couple of years later in 1997, he went on to earn a Master of Science in Physics degree also from MIPT. His education would not stop there as he earned a Doctorate in Physics in 2004 from the prestigious Massachusetts Institute of Technology. For the years in which his credit card points came under scrutiny, Konstantin was working as a consultant for IBM. As it is easy to see, Konstantin was intelligent and it is no surprise he was able to see the opportunities in his credit card reward program to gain a sizeable amount of income.

What credit card did Konstantin use?

The American Express credit card with its Blue Cash Rewards Program is what Konstantin used to amass his points. The Blue Cash Rewards Program paid 1% for eligible everyday purchases and 0.5% of all other eligible purchases for the first $6,500 spent. After meeting the $6,500 threshold, the reward points multiplied significantly to 5% of everyday purchases and 1% on all other eligible purchases. For the higher percentage points, the Blue Cash Rewards Program defined eligible everyday purchases as (1) supermarkets, (2) gas stations for purchases of $400 or less of gasoline, and (3) select major drugstores. The Blue Cash Rewards Program cash rewards could be used as statement credits that could be refunded if they exceeded the balance owed. There was also no limit to the amount of cash rewards that could be earned each year. The wide range of places where you could earn cash rewards from eligible everyday purchases and the unlimited amount of earning potential made this the card of choice for Konstantin.

How did Konstantin use the American Express credit card to gain income?

To accumulate the amount of cash rewards that Konstantin did required a lot of work. The credit card itself did not have a large limit as it only capped at $35,000, which meant he would have to pay off his credit card before making more purchases and redeem more points. The tactic that he used was to use the credit card to purchase prepaid Visa gift cards and reloadable debit cards. Konstantin would purchase these gift cards from places that were considered eligible everyday purchases to get the larger percentage points for each purchase. However, there were fees when purchasing gift cards that ranged from 0.8% to 1.2%. After acquiring the Visa gift cards, he would use them to purchase money orders. These money orders would then be deposited back into his bank accounts to pay off his balance on the credit cards. There were service fees to use the gift cards to purchase money orders that ranged from 0.07% to 0.33%. After a year of doing this, it took $1,208,376 of these purchases in 2013 and $5,184,033 of these purchases in 2014 to acquire the amount of cash rewards that he did. From constantly purchasing the gift cards, reloadable debit cards, and money orders, this must have been a time-consuming endeavor to reach the significant levels of rewards points that Konstantin did.

Tax returns filed in 2013 and 2014

The Blue Cash reward dollars were a significant source of income in the years Konstantin aggressively accumulated cash rewards. On his joint tax return in 2013, he reported $149,773 in wages, $2,338 in interest, and $299 in ordinary dividends. In 2014, he reported $161,480 in wages, $1,566 in interest, $78 in ordinary dividends, and $1,821 in capital gains. Neither of these years did Konstantin report any amount from the cash rewards even though he made over a fifth of his taxable wage amount in 2013 and close to double his wage amount in 2014 from these points. After a few years, the IRS eventually came after Konstantin for this unreported income. On March 23, 2017, the IRS issued a notice of deficiency to Konstantin determining he had additional other income of $29,775 for 2013 and $277,2275 for 2014. While that amount changed a couple of times before the court, the final tax he was liable for associated with the cash rewards was $9,928 for 2013 and $93,845 for 2014.

Why did the IRS believe it was taxable income for Konstantin?

As mentioned earlier, the IRS is aware that most purchases with credit cards are primarily used for everyday goods and services. Since credit card rewards points essentially just reduce the price paid, this is not an accession to wealth so it is not taxable income. Since Konstantin's intent was to convert the gift cards and reloadable debit cards into money orders, these purchases were seen by the IRS as cash equivalents. When cash equivalents are purchased, there is no reduction in the purchase price for a good or service because their basis is equal to their face value. For example, $500 spent to buy a $500 gift card would essentially end up being $475 spent after getting the 5%

cash reward back. Without factoring in the service fees for the gift cards or money orders, this $25 difference is taxable as there is no reduction in the purchase of this cash equivalent. IRC section 61 is extremely broad and defines gross income as income from whatever source derived. This economic benefit from buying cash equivalents was deemed by the IRS to fit this IRC definition.

What was Konstantin's position?

Konstantin argued that his purchases of Visa gift cards were in fact a product. He pointed out that each Visa gift card has a Universal Product Code (UPC). Since the Visa gift cards have a (UPC), it must be considered a product and therefore is considered a purchase that can have a purchase price adjustment without creating taxable income. Anything that Konstantin chooses to purchase with the Visa gift cards should not matter to determine if he has income.

How did the Tax Court rule in this case?

The Tax Court viewed Konstantin's aggressive accumulation of cash rewards as an extreme test of the vagueness of the IRS policy to not tax credit card reward programs. It recognized that Konstantin clearly gained economic benefit from manipulating the American Express Blue Cash Rewards Program. The Visa gift cards, the direct purchases of money orders, and the cash infusions to reloadable debit cards were held to be treated differently as will be explained next.

The Tax Court decided that the IRS must abide by its longstanding policy to not tax credit card reward points that are generated from purchasing products or services. It also viewed the IRS argument to apply the cash equivalence doctrine as not a good fit for Konstantin's purchase of Visa gift cards as the gift cards have product characteristics as they can be used as a substitute to credit cards. This holding made all reward points redeemed from purchases of Visa gift cards not subject to tax.

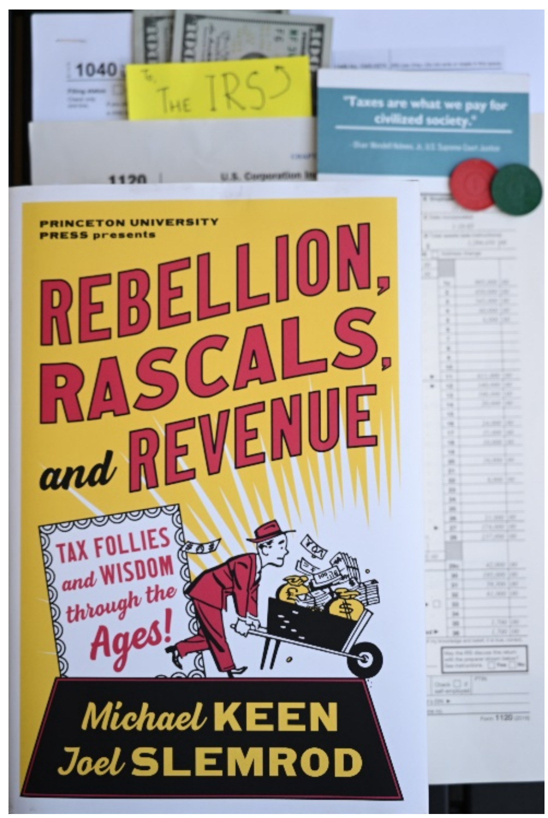
The purchase of money orders and cash infusions to reloadable debit cards are not considered a product like the Visa gift cards. The Tax Court ruled that no product or service was provided when purchasing a money order or the cash infusions to reloadable debit cards. The money orders were eligible to be deposited into Konstantin's bank account from the moment he purchased them. The cash infusions were simply not a product purchased. Since neither of these transactions are seen as a product or service, they do not align with the IRS policy of excluding credit card reward points from taxable income. In conclusion, the Tax Court held that only the cash rewards associated with purchase of money orders and cash infusions into reloadable debit cards were not properly included in income.

Book Review: *Rebellion, Rascals, and Revenue: Tax Follies and Wisdom Through the Ages*

Rachana Khandelwal, MST

Rebellion, Rascals, and Revenue: Tax Follies and Wisdom through the Ages (2021)[1] is a grand epic of hard work, strife, drama, and the triumph of the indomitable human spirit in a story as old as civilization itself - the history of taxation, of economic governance and good intentions. The authors, Joel Slemrod, Deputy Director, Fiscal Affairs at the International Monetary Fund; and Michael Keen, Professor of Economics at the University of Michigan, keep us riveted throughout this remarkable book with the global history of tax spread across centuries interspersed with delightful anecdotes, ground-breaking events, and thought-provoking observations. In my opinion, the authors successfully weave together focal points of taxation: the economics, the constitution of an effective tax policy and its effect on social behavior, and the evolution of tax systems.

The book is unique in explaining the subject with fascinating facts, sparkling humor and exciting references which makes it thoroughly enjoyable to readers. Snippets about games such as *Monopoly* and *Stick the IRS: The Tax Shelter*, the fictional tax war in *Star Wars I: The Phantom Menace,* the idea of an imaginary tax-free moon in Robert Heinlein's *The Moon is a Harsh Mistress* (2008), the galactic tax in Douglas Adam's *The Hitchhiker's Guide*, and a mention of rock bands such as The Beatles, The Who and The Kinks, makes for an exhilarating reading experience.



Tax is often misunderstood and regarded as a penalty for working hard. Reading this book, one can better understand taxation and why taxes are imposed. Governments need money to maintain law and order, protect their citizens, improve social wellbeing, and secure resources for scientific and technological developments among many other things. Joel Slemrod and Michael Keen take us through events in history to explain how some taxes proved to be wise and how others were mistakes to learn from. They connect events to project a bigger picture, that with a well-balanced tax policy, an efficient and ethical tax system, the general

[1] Book photo taken by Rachana Khandelwal.

perception about tax can be changed from “punishment” to a well-meaning “contribution” towards building a better society.
Generally, people are bitter about taxes, and the book talks about this bitterness through numerous stories of rebellions in history. The lack of “consent” often resulted in civil unrest leading to losses of life and property. In one instance, a tax imposed on huts by the British was strongly opposed by the colonials leading to a rebellion eventually destroying the tax base (huts). Some weird taxes which find mention in the book include taxes on windows, hearths, hats, beards, hair, salt, cooking oil and bachelors, which were eventually repealed due to behavioral changes in the tax base. A toll was levied in Curaçao on whoever crossed the Queen’s Bridge wearing shoes. In the early 19th century, a “breast tax” was levied in the Kingdom of Travancore (southern India) on women of lower castes for covering their breasts. Intriguing and interesting, indeed!

Among other fascinating facts in the book, the most colorful and astonishing are about stamps of Elvis Presley, the geography of Bolivia, and the Boston Tea Party. I was surprised to learn that a tax protest contributed to defining the geographical boundaries of Bolivia, and that the Boston Tea Party revolt was actually on account of a tax cut and not a tax increase.
Who actually pays taxes? The question seems fairly simple from a layman’s perspective but it is actually complex. The authors have done a wonderful job in explaining tax incidences and their impact on an economy. The economic burden of a tax falls far from its label. The tax on maids and female servants introduced by William Pitt in 1785 caused undue hardship as it, in substance, impacted the servants in the form of reduced wages.

How is all of this relevant to tax professionals today? Consider for example, the Robinhood tax, which is a tax on financial transactions. The tax seems to be levied on rich bankers, however, in a real sense, the tax is indirectly passed on to those who put their money in investment vehicles such as pension funds. In the case of excise taxes, the real tax incidence on a consumer or producer depends on price elasticity. When the demand for a product is elastic and taxes go up, the product demand likely shifts or reduces. In case of demand inelasticity, buyers bear the tax burden if there are few good alternatives to the product in demand (e.g., cigarettes and perfumes). In corporate taxes, if there is an increase in tax rates, the burden likely falls on stakeholders and labor. The authors remind us that when framing a tax policy, policymakers should consider the strata of people likely to be impacted by the tax.

It is important for students to understand the crucial economic concept of “excess burden.” Taxes such as the Greek tax on finished buildings, or the British tax on ships, led to people taking advantage of clever loopholes such as leaving buildings unfinished or reducing the size of ships to avoid being taxed. Any tax which is oppressive or brings discomfort often leads to a change in the taxpayer’s behavior, creates inefficient choices, and economic distortions resulting in an economic loss to the government and welfare loss to taxpayers. The authors emphasize that accounting for excess burden in taxation is critical to tax policymaking.

What I find invaluable is the book’s growing theme of fairness, equity, efficiency and the theory of optimal taxation. Through the account of ravaging taxes in history such as the English poll tax

(1380) and the community charge (1990), the authors demonstrate the pitfalls of bad tax design and implementation. A good tax policy is a tightrope act of fairness and equity without creating an excess burden on the taxpayer while raising the desired revenue for the government. Throughout the book, the authors elucidate the principles of good tax policy with insightful examples including ones on horizontal and vertical equity.

By calling out specific events in history, the book focuses on age-old issues which we still haven't managed to solve completely. The story of William Vestey and his coteries' countless ingenious tax avoidance schemes in the early 19th century depicts how the rich managed to escape taxes through aggressive tax planning, formation of trusts, offshore entities, political interference, lobbying and corruption. Through stories of tax evasion and avoidance, the book showcases the need for creating a fair and equitable tax policy. To achieve this, the authors emphasize the importance of the public's faith in the political-tax system and clearly defined enforcement measures against evaders.

The authors did not forget the oft-misunderstood, hardworking tax-administrators who perform their duties honestly and diligently. The book covers challenges posed to traditional means of taxation with the changing landscape of global business operations and societal behavior. By adopting technological innovations such as blockchain, enforcing comprehensive reporting requirements, and with cooperation between countries, escape routes for evaders are blocked. Advances in data sciences have facilitated the quick and accurate processing of information, streamlined tax compliance, and sped up the identification of defaulters. The authors briefly discuss the digital economy, aggressive corporate tax structures and measures taken to reform international tax policies by the Organization for Economic Co-operation and Development (OECD).

The authors share their insights on the problems the world would face against the background of Covid-19: rising public debt, increased spending on health and infrastructure, education, and tax breaks to rebuild the economy. The fiscal deficit may be addressed by a future increase in taxes. The challenge for governments is to maintain equity, fairness, and efficiency as they recover from the pandemic.

In the last part of the book, the authors provide eleven lessons[2] to learn from past events and the current state of the tax system, and how we can shape the future of taxation. They recognize that wars and revolts in the past weren't fought solely against the tax system, but also for freedom against political misgovernance and a general lack of fairness. Some taxes are imposed to correct behavior rather than raise revenue such as taxes on gasoline, tobacco, and carbon emissions. A tax, like a rose, by any other name works just as well. They point out that governments also collect revenue from people in the form of taxes by skirting around the tax moniker (e.g., levy, fee, charge, price regulation). This highlights the importance of words and linguistic precision that plays a vital role in framing laws. In summary, the nigh-unattainable gold standard is a fair and

[2] A reader might want to ask why eleven, and not ten or twelve? Hint: Think sports.

equitable tax system, which every government should grow toward; fertilized by successful tax endeavors and lessons learned from follies.

I feel that the authors present some acute observations in taxation with empirical references, which help readers think about taxes in a meaningful way. They deserve admiration for the parallels they offer on the breadth and depth of taxation: studying events in history, covering international tax aspects, underscoring the power of evolving technologies, exploring the value of (digital) information, and the deconstruction of tax policies to understand their pros and cons. The recent riots against taxes in Columbia,[3] the U.S. Treasury report on $2.4 billion in taxes underpaid by rich taxpayers,[4] a proposal by a Canadian political party to introduce excess profits tax on corporations to cover Covid-19 pandemic costs,[5] and the tremendous backlog of returns due to out-of-ink printers[6] sounds like history repeating itself, except for the absurdity of printers. To echo the authors' sentiment: "What will they think of us (in the future)?"
The book is as much a treasure trove of taxation for students, tax nerds, tax authorities, and policymakers, as it is for anyone with a curious mind. The encyclopaedic book is painstakingly well-researched, illustrated and organized with detailed notes, references, and credits. Michael Keen and Joel Slemrod take us through an uncharted path through places and time, making the book a scenic route to the well-travelled destination of taxes.

I thank Professor Annette Nellen for introducing me to *Rebellion, Rascals and Revenue* and for the opportunity to review it for *The Contemporary Tax Journal*.

[3] BBC, Colombia tax protests: At least 17 dead, ombudsman says, May 3, 2021, available at https://www.bbc.com/news/world-latin-america-56970028.
[4] Laura Davison, Bloomberg Wealth, IRS Failed to Collect $2.4 Billion in Taxes from Millionaires, March 15, 2021; available at https://www.bloomberg.com/news/articles/2021-03-15/irs-failed-to-collect-2-4-billion-in-taxes-from-millionaires.
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Proliferation of NFT Transactions Raises Numerous U.S. Tax Questions

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Background on NFTs

With the market for nonfungible tokens (NFTs) exploding, NFTs attached to art, music, video clips, tweets and other digital collectibles have sold for significant sums: An NFT of an animated flying Pop-Tart cat sold for $600,000, and an NFT from the artist Beeple was auctioned for $69 million. Demand for such tokens does not appear to be slowing, and the Internal Revenue Service (IRS) and state tax authorities undoubtedly have (or will) take notice.

An NFT is a digital certificate of certain rights associated with an asset. NFTs are usually associated with digital assets, but NFTs representing rights to physical assets or experiences have also been minted. For example, the band Kings of Leon minted an NFT giving the holder the right to front-row concert tickets, and tennis professional Oleksandra Oliynykova auctioned an NFT for the right to determine what tattoo to put on her arm.

As other authors have described, for example, in a March 30, 2021, *Bloomberg Law* article, "NFTs Raise Novel and Traditional IP and Contract Issues," NFTs raise a multitude of intellectual property (IP) and contract law issues. As for tax considerations, while each NFT transaction may differ, two points are generally applicable. First, given the novel nature of the transactions, NFT minters, purchasers and platforms that allow users to buy and sell NFTs must consider a host of U.S. tax issues. Second, no direct guidance is currently available to resolve those issues, so open questions about the tax treatment of NFTs abound. The discussion below outlines a few of the more salient tax questions relevant to NFTs and considers how existing guidance could be applied to analyze them.

Background on Taxation of Digital Assets

Little guidance addresses the taxation of digital assets. The U.S. Internal Revenue Code has generally been written to apply to transactions involving physical assets and more traditional IP (*e.g.*, patents), and the IRS has struggled to issue timely guidance clarifying how the tax law applies to rapidly evolving technologies. For example, taxpayers are still awaiting final regulations addressing the taxation of cloud-based transactions.

The IRS has advised taxpayers that virtual currency (*e.g.*, bitcoin, Ether or other cryptocurrency) "is treated as property" for U.S. income tax purposes,[1] but has yet to issue guidance specifically addressing other digital assets that leverage blockchain technology, such as NFTs. However, the

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

IRS virtual currency guidance is clearly relevant to many NFT transactions because NFTs are generally acquired in exchange for virtual currency. For example, taxpayers acquiring NFTs with virtual currency should be aware that such acquisition results in the recognition of gain or loss on the taxpayer's virtual currency.[2]

Therefore, unless and until guidance directly addressing NFTs is issued, taxpayers will have to analyze NFT transactions by applying general tax law principles, possibly through the prism of the existing (if sparse) IRS guidance on virtual currency.

How To Characterize NFTs and NFT Transactions

As noted above, an NFT is essentially a digital certificate that entitles the holder to certain rights associated with an asset. Similar to the protocol with any other such certificate (*e.g.*, a deed of ownership or a stock certificate), the underlying rights and asset should dictate how to tax transfers and ownership of the certificate.

NFTs are generally associated with digital assets, which are treated as IP or intangible property, for tax purposes. Under U.S. law, any article of IP includes a "bundle of rights," and the holder of such rights can transfer some or all of them. For example, the copyright holder of a work generally has the exclusive right to reproduce, prepare derivative works of, publicly perform and publicly display that work for a certain period of time. The holder could choose to transfer all of these rights to a single transferee or to transfer certain limited rights (*e.g.*, the right to publicly display the work on certain platforms) to one or more transferees. Such rights can be transferred for the entire term or for a limited period, and can be transferred on either a nonexclusive or an exclusive basis. The scope of IP rights conveyed with an NFT can similarly vary widely.

For U.S. tax purposes, an important threshold question for a transfer of IP rights is whether the transfer constitutes a sale or a license. If the transfer is a sale, then the transferor can offset its amount realized on the sale by its basis in the IP rights. In other words, the taxable income on the transaction is limited to the transferor's gain in the property. If the IP rights were a capital asset to the transferor, then that gain on the sale is presumably eligible for long-term capital gains rates (in the case of individuals) if the rights were held for more than a year. If, instead, the transfer is treated as a license, then the transferor: (i) will generally recognize ordinary income (*i.e.*, royalties on the license); and (ii) will not be able to directly offset its income from the license with its basis in the IP rights, though such basis will continue to be amortized over future years.

Whether a transfer of IP rights is treated as a sale or license for tax purposes generally depends on whether the transferor transfers all "substantial rights" it holds in the IP. Whether all substantial rights are transferred depends on the overall facts and circumstances; whether the transfer is formally labeled a "sale" or "license" is not controlling. The more rights that are transferred, the more likely that the transfer is properly treated as a sale. For example, where a transferor holds all rights to a copyright, an exclusive license of all those rights for the term of the copyright would

[2] *Id.* at A-6.

generally be a sale for tax purposes. By contrast, a nonexclusive license of certain rights to that copyright (*e.g.*, the right to publicly display the work) by that same transferor would generally be a license for tax purposes. However, if the transferor only holds certain rights to the copyright in the first instance (*e.g.*, the transferor only owns the right to publicly display the work), a subsequent transfer of all of those limited rights would likely be a sale for tax purposes, regardless of whether the transferred rights constitute a license for IP law purposes.[3]

As outlined in the March 30, 2021, *Bloomberg Law* article referenced above, the IP rights associated with an NFT can vary from one NFT to another. In general, however, purchasing an NFT does not provide the purchaser with exclusive ownership of all IP rights in the associated work, and instead conveys a very limited license, often limited to display of the associated work for personal purposes. This can result in differing tax treatment for the "primary" and "secondary" transferors of the NFT.

- In the primary transfer of an NFT — where the creator of/copyright holder for the work associated with the NFT transfers the NFT to an initial transferee — the transferor will need to determine whether it has sold the work associated with the NFT or merely granted a license. Because, as noted above, an NFT usually does not provide exclusive ownership of all IP rights in the associated work, most primary NFT transfers are likely to be treated as licenses for tax purposes.

- The secondary transfer of an NFT — where the NFT trades in the secondary market after that primary transfer — is likely to be treated as a sale. This is because in a secondary transfer, the transferor presumably transfers all of its limited rights in the associated work.

Put another way, because the secondary holder's rights associated with the NFT are likely to be limited in the first instance, that secondary holder is more likely to be transferring "substantially all" of its rights associated with the NFT. This is true regardless of whether the primary transfer is properly treated as a sale or license.

As described above, if the transfer of an NFT is treated as a sale, the transferor can generally offset its amount realized with its basis in the NFT. For such a sale, the tax consequences of any gain or loss will depend on several factors, including, in addition to the quantum and character considerations described above: (i) whether the transferor amortized any basis in the NFT and the underlying work (which would generally be subject to recapture at ordinary income rates); (ii) whether the transferor trades in NFTs as a mere hobby (which would limit the transferor's ability to deduct losses incurred in connection with NFT transfers); and (iii) whether the NFT is properly treated as a collectible (for which gains are generally subject to higher rates than they are in normal capital asset transactions).

If the transfer of an NFT is treated as a license, the transferor generally recognizes ordinary income, as noted above, but must consider a number of other tax consequences. In particular, any

[3] *Mylan Inc. v. Commissioner*, 111 T.C.M. (CCH) 1199 (2016); *MacDonald v. Commissioner*, 55 T.C. 840 (1971).

payment for the NFT would generally be treated as a royalty for tax purposes, which may raise sourcing questions and may require a U.S. transferee to withhold on the payment if the transferor does not certify itself as a U.S. taxpayer.

Holders of NFTs will have to carefully consider the terms of their NFT transactions to properly determine and report the resulting tax consequences.

How To Treat Costs Incurred in Creating an NFT

Creators of NFTs will need to determine how to treat costs incurred in developing and marketing their NFTs. If a creator makes NFTs as part of a trade or business, it can generally deduct or capitalize costs for tax purposes. A taxpayer usually prefers to deduct rather than capitalize costs, as a deduction reduces the taxpayer's tax liability for the current year while a capitalized cost is recouped over time. Subject to certain exceptions, the tax law generally requires that costs incurred in creating or enhancing a separate and distinct asset with a useful life beyond the current taxable year must be capitalized. Capitalized costs are part of an asset's basis, and can be recovered upon a sale of the asset or, in circumstances where the asset has an identifiable useful life, by amortizing the costs over the asset's useful life.

When considering the tax consequences of creating NFTs, creators will thus need to consider whether they are in a trade or business of creating NFTs (a factually intensive question), and if so, whether to deduct or capitalize costs incurred in creating NFTs.

Large-scale enterprises that seek to monetize existing IP via NFTs (*e.g.*, professional sports leagues or entertainment enterprises) will need to assess how to best structure their NFT arrangements for tax purposes. For example, such enterprises must consider how to contractually integrate their existing IP into their NFT business and how to draft the terms of their NFT agreements to ensure an efficient tax result. Additionally, such enterprises must determine how to account for an array of costs that were incurred in acquiring, developing and marketing the relevant IP long before the enterprise contemplated monetizing such IP via NFTs. In many cases, potentially all of the underlying costs will have previously been claimed as deductions, while, going forward, a portion of such costs might more properly be capitalized or deferred to offset potential NFT income streams. Smaller-scale creators of NFTs will have to quickly familiarize themselves with the tax rules applicable to creators and marketers of IP.

How To Report NFT Transactions

The IRS has demonstrated that it is highly focused on tax compliance and reporting for digital asset transactions. The agency's efforts have included a wide-reaching campaign in which the IRS issued letters to thousands of taxpayers for potential failures to report virtual currency transactions, as well as broad demands for virtual currency exchanges to provide user information.

Most recently, the IRS added the following question to the first page of the Form 1040 (U.S. Individual Income Tax Return) for 2020: "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?" As noted above, most NFT transactions to date have been effected in virtual currency. Individual taxpayers that exchange NFTs for virtual currency should be prepared to check "yes" to this question and report the tax consequences of such transfers on their 1040s.[4] Individual taxpayers that exchange NFTs for fiat currency will have to consider whether an NFT could itself be considered "virtual currency" for purposes of the 1040 question. Also, the IRS may expand the scope of this question in future filings to specifically encompass other digital asset transactions, such as NFTs.

In April 2021 testimony to the Senate Finance Committee, IRS Commissioner Charles Rettig stated that the IRS is prioritizing new rules for information reporting on virtual currency transactions. To date, marketplaces that effect transfers of virtual currency have operated without clear guidance. Any marketplace that effects transfers of NFTs must consider whether it is obligated to report NFT transactions to the IRS and what documentation it will need from users to satisfy such reporting obligations (*e.g.*, an IRS Form W-8 or W-9).

State and Local Tax Considerations

State and local tax authorities have issued even less guidance than the IRS has regarding the taxation of digital assets. Additionally, tax laws differ across states and localities. NFT stakeholders will therefore have to navigate a maze of questions in determining how to characterize and report NFT transactions for state and local tax purposes.

Most states impose an income tax. Generally, these states follow federal tax principles for purposes of computing taxable income.[5] A state then usually taxes resident individuals on all taxable income, and nonresident individuals and corporations on taxable income "sourced" to the state. For corporations, and in some states other types of entities, doing business in multiple jurisdictions, such sourcing is generally determined based on an apportionment formula.[6]

Whether the transfer of an NFT is treated as a sale or license for federal tax purposes will thus generally determine how the transfer is treated for state income tax purposes. However, certain transferors still must determine the source of any income resulting from such transfer. For an individual that transfers an NFT, as a hobby, where the associated asset is digital, the sourcing

[4] Under current IRS guidance, the original acquisition of that virtual currency may not have been reportable if that virtual currency was acquired for fiat currency. See *Frequently Asked Questions on Virtual Currency Transactions*, A-5, IRS.gov (visited April 11, 2021).

[5] For example, in California, corporations and individuals generally calculate their income tax liability by starting with their federal taxable or adjusted gross income respectively and then make state-specific adjustments. *See* 2020 California Form 100 (California Corporation Franchise or Income Tax Return); 2020 California Form 540 (California Resident Income Tax Return).

[6] California, for example, requires most corporations to pay state income tax based on a "single sales factor apportionment" method (Cal. Rev. & Tax. Cd. § 25128.7). This generally requires that a corporation pay California income tax based on the portion of its total sales that are made in or to California.

question is probably not imperative, as income from the transfer would likely only be taxed by the individual's resident state. However, individuals that transfer NFTs as a trade or business, corporations and other business entities will likely need to determine the source of any income from their NFT transfers in order to properly apportion such income among different states. For personal income tax purposes, states usually source income from the transfer of a tangible asset based on where the asset is located, but income from transfers of intangible assets is generally sourced only to the state of the transferor's domicile unless the transferor is transferring that intangible asset as part of a trade or business. Corporations or other entities conducting a trade or business would generally source such income by reference to the state of domicile or principal place of business of the transferee. Because NFTs associated with digital assets can easily be transferred without any information regarding the transferee's location, transferors may have difficulty sourcing income from NFT transfers.

In addition to income tax, states and localities often impose sales and use taxes. Most states impose such tax on sales of tangible personal property and certain services. Some jurisdictions also impose such tax on transfers of certain types of digital property. For example, Texas imposes sales tax on the transfer of a digital product if the product would be taxable if delivered in physical form.[7]

Sales tax, if applicable, is generally imposed by the jurisdiction where the transfer of possession occurs. Use tax is generally imposed by the jurisdiction where the good or service is used or consumed. Where a physical asset is sold, where the good is transferred or used, and thus which jurisdiction could impose tax, is usually easy to determine. For the sale of a digital asset, however, this determination can be significantly more difficult. The location of the sale is likely to be determined based on the state of residence of the transferee, or the state where the digital asset is stored, used or viewed. Taxpayers will need to collect this information even though NFT transfers often occur without noting any information regarding the location of the transferee. In addition, since NFTs are stored on blockchains, which are computer networks distributed over multiple geographic locations, determining where an NFT is "stored" is not readily apparent. The same might also be true of the underlying digital asset, which may be stored on a form of distributed network. Further complicating matters is that states have different standards regarding whether remote sellers (*i.e.*, sellers based outside the state or making only casual or isolated sales) are obligated to collect and remit any applicable sales and use tax.

Given the above, NFT transferors and marketplaces will have to carefully consider what information they need from transferees in order to comply with state and local tax obligations. States may issue direct guidance regarding the taxation of digital asset transfers, but until then, NFT stakeholders will have to answer their state and local tax questions by reference to law enacted long before anyone contemplated paying $600,000 for certain rights to a flying Pop-Tart cat image.

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[7] *See* Texas Policy Letter Ruling No. 200101966L (Jan. 3, 2001).

Suggestions for Pandemic State Tax Policy Endurance

Annette Nellen

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In this installment of Moving Forward?, Nellen offers suggestions for states to reduce borrowing needs, reduce taxpayer frustration, lessen upcoming tax compliance issues, modernize tax systems for the 21st century, and ensure the opportunity for lessons learned occurs, considering the significant and uncommon challenges presented by the COVID-19 pandemic.

No doubt, the COVID-19 pandemic invaded our lives, creating substantial challenges to our well-being in terms of health, finances, and societal interactions. The pandemic also delivered ongoing tax system challenges, including how to get through a filing season severely interrupted by it. In addition, tax and nontax law changes to provide financial assistance and filing relief created new difficulties even when labeled as "relief." Taxpayers and their advisers were conscripted into quickly figuring out how new provisions operate while at the same time dealing with their own challenges of sheltering in place and helping colleagues and clients. Lawmakers and tax agencies had to gauge what assistance was most suitable for immediate relief while also considering the likely adverse impact to state and local budgets and tax agency operations.

The word "endurance" is used in the title of this article as it reminds us that while tax and fiscal systems were shocked in many ways by this pandemic, we must ensure that these systems have "the ability or strength to continue or last, especially despite fatigue, stress, or other adverse conditions."[1] The pandemic causes us to reevaluate many activities of everyday living, including access to necessities of life, how technology can improve many everyday transactions, and how quickly we can react to drastic change. Pandemic-related tax changes highlight opportunities that we should pursue to explore how to have more equitable, simpler, and technologically advanced tax systems. Also, we should be sure we, as a society, consider what is needed to be best prepared for the uncertain and unexpected because sadly, disaster — from tornado, hurricane, fire, or widespread health dangers — can happen at any time. This article offers suggestions in the following nine areas to help state tax policy endure and be stronger going forward:

- protection needed for revenues;

[1] *Endurance*, *Dictionary.com*.

- certainty needed for tax law changes;
- creativity needed for effective assistance;
- openness needed for new nexus and sourcing issues because of sheltering in place and remote work;
- compassion needed for reasonable tax mistakes;
- transparency needed for fiscal challenges;
- funds and plans needed for implementation of modern technology;
- strategy needed to address tax and related inequities exposed during the pandemic; and
- identify lessons learned and act on them.

I. Funding Sources Exist — Get the Money

By early March, about two months into the filing season for 2019 returns, it was becoming clearer to everyone that life was about to change, bringing much bigger concerns than filing season tax compliance. On March 13 President Donald Trump declared that the pandemic was "of sufficient severity and magnitude to warrant an emergency declaration" throughout the country.[2] On March 19 California became the first state to issue a shelter-in-place order for everyone other than those in critical or essential infrastructure sectors defined by federal law with modifications.[3]

California was one of the first states to address concerns about how tax returns and 2019 and 2020 income tax payments would be made with government offices closed, free tax preparation sites closed, and tax advisers scrambling to provide services within the realm of social distancing and new uses of technology. And with many people out of work or facing reduced business revenue and new costs such as child care because of school closures, tax payments would be problematic for those who owed for 2019 and those who make quarterly estimated tax payments with the first one normally due April 15.

On March 13, the California Franchise Tax Board "announced special tax relief for California taxpayers affected by the COVID-19 pandemic." Returns and payments due March 15 through June 15 were extended to June 15, including the first quarter payment of 2020 income taxes. The FTB also noted that these dates could be extended if the IRS granted a longer relief period.[4] Most states issued similar extensions either by legislation or by authority of the tax agency. Like the IRS declarations extending filing and payment dates, the emphasis was on *all* individuals and most businesses being granted the payment and filing extensions. For example, an executive order by Michigan Gov. Gretchen Whitmer (D) states[5]:

> Strict compliance with rules and procedures under sections 315, 681, and 685 of the Income Tax Act of 1967 ("Income Tax Act"), 1967 PA 281, as amended, MCL 206.315, 206.681, and

[2]Federal Emergency Management Agency, "COVID-19 Emergency Declaration," HQ-20-017-FactSheet (Mar. 13, 2020).
[3]Executive Department, State of California, Executive Order N-33-20 (Mar. 19, 2020). This followed a proclamation of a state of emergency in the state on Mar. 4, 2020.
[4]*See* State of California Franchise Tax Board, "More Time to File, Pay For California Taxpayers Affected by the COVID-19 Pandemic" (Mar. 13, 2020). This relief was later expanded to more returns and to July 15, 2020.
[5]The Office of Gov. Gretchen Whitmer, Executive Order 2020-26 (COVID-19) (Mar. 27, 2020).

206.685, is temporarily suspended so as to extend the deadline for all taxpayers required to file an annual state income tax return in April 2020, as follows:

1. An annual state income tax return otherwise due on April 15, 2020 will instead be due on July 15, 2020.

2. An annual state income tax return otherwise due on April 30, 2020 will instead be due on July 31, 2020.

These tax relief measures are significant for states because they push 2019 tax deficiencies and first, and perhaps second, quarter 2020 estimated tax payments into the next fiscal year.[6] They are also broad in that not all taxpayers need additional time to make their tax payments. That is, high-income taxpayers typically have resources available not only to address changes caused by the pandemic but also to timely pay taxes. Individuals of any income level who continue to work with little to no increased costs because of the pandemic are also likely able to pay on time. The broad extension statements covering all taxpayers likely caused cash-wealthy taxpayers and those with unchanged financial status — both individuals and businesses — to go with the July 15 date.

Federal pandemic relief also included $292 billion of recovery rebates (also known as economic impact payments) for most individuals,[7] even if the recipient did not need the funds. Also, federal tax changes allow for net operating losses for 2018, 2019, and 2020 to be carried back five years, a measure that — if also followed at the state level — exacerbates state budget issues.

Despite filing and payment extensions and new tax breaks to help taxpayers with new financial problems, there are funding sources that states should consider. Following are suggestions for getting funds to help the state and to find alternative sources for some state spending or tax reductions.

A. Encourage Taxpayers With the Means to Pay to Do So at the Usual Time

The pandemic has not created economic hardship for everyone. Wealthy individuals and cash-rich businesses and those perhaps even experiencing greater business activity during the pandemic[8] can still pay taxes on time. And it is these taxpayers that generally provide a considerable amount of tax revenues. Federal and state messages that said everyone had until July 15 (in most states)

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[6]Not all states extended April 15 tax payments for 2019 and 2020. For example, in Arizona General Tax Notice GTN 20-1, the Department of Revenue extended the filing and payment for 2019 returns from April 15 to July 15 but kept the usual first and second quarter estimated tax payment dates for 2020 taxes. Arizona Department of Revenue, GTN 20-1 (Apr. 1, 2020). For a complete list of state tax actions regarding due dates, see AICPA, State Tax Filing Guidance for Coronavirus Pandemic.

[7]The Joint Committee on Taxation, JCX-11R-20 (Apr. 23, 2020).

[8]For example, Microsoft reported that for the quarter that ended Mar. 31, 2020, revenue increased 15 percent and net income increased 22 percent. The company also reported that for this quarter, "COVID-19 had minimal impact on the total company revenue." "Microsoft Cloud Strength Drives Third Quarter Results" (Apr. 29. 2020).

but to file earlier if getting a refund should have instead been worded to encourage those with the means to pay before June 30 to do so to reduce borrowing needs and costs for states.

Statements about additional time to make tax payments for any disaster relief should always include language that individuals and businesses who are able to pay timely are encouraged to do so. Given the significant amount of revenue that comes from high-income individuals, that phrasing sends a better message and reminder that governments also need funds during a disaster.

The first notice issued by the IRS to grant additional time to pay and file had dollar thresholds. Notice 2020-17, 2020-15 IRB 590, postponed payments up to $1 million for individuals. This is not an ideal approach though, because it related to pre-pandemic tax liabilities and required some taxpayers to perform extra work to see how the extension applied (or did not apply) to them.

To help taxpayers understand the message to pay on time if possible, despite a broad grant of authority to pay at a specified later date, governments should inform the public of their costs of borrowing related to these extensions. This might better entice taxpayers with the means to pay to do so earlier.

B. Ask Cash- and Property-Rich Taxpayers to Help Now and to Pay It Forward

To obtain needed funds today, encouraging taxpayers to prepay property and income taxes can help. The downside is that the prepaid taxes will not be available in future years. Thus, states might only permit a portion of future taxes to be paid early. While a discount could be offered, with interest rates low and many people interested in helping, it should not be. These taxpayers should be given assurance that the advance tax payments will be properly recorded; taxpayers should keep good records as well.

Some people with the means to do so continued to pay their home cleaners, hairstylist, and others during the pandemic even though they were not providing services. Why not also ask and encourage people able to do so to pay their state and local governments the sales tax and gasoline excise taxes that they would normally be paying — and more, if possible. To be sure that people know of this opportunity, government agencies should promote it on websites and in press releases.

C. Make it Easy for Taxpayers to Help Others Financially

Despite the severe blow to the economy and the finances of many households, many individuals and businesses can help others. States should be ready to aid in the collection and effective distribution of these donated funds. These funds include the federal economic impact payments that were part of the Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136), which some recipients would like to transfer to those with greater needs.
An example of this type of transfer was a proposal in Pennsylvania for the Common Wealth Fund managed by the Department of Revenue to enable individuals to contribute their economic

impact payment to help those with a need greater than that of the recipient.[9] Those funds should be created in a way that makes the contributions qualify as charitable deductions for federal and state purposes. Another example is Silicon Valley Strong, a fund coordinated by Santa Clara County and others to get money, food, and other supplies to individuals and nonprofit organizations in need. This entity's website (www.siliconvalleystrong.org) explains how to both get help and offer help.

D. Be Sure the Relief Available in Federal COVID-19 Legislation and FEMA is Fully Used

Federal COVID-19 legislation such as the CARES Act[10] includes several forms of financial assistance for individuals, businesses, and others. Many eligible recipients might not be aware of the assistance available to them, such as unemployment compensation for self-employed individuals, economic impact payments even for nonfilers, disaster loans, paid leave from their employer, and assistance for some farmers.[11]

Some COVID-19 federal legislative changes were too complex, potentially causing the benefit to go unused by the individual or business targeted by the relief. For example, the Families First Coronavirus Response Act (FFCRA) (P.L. 116-127) required small employers with under 500 employees to pay up to two weeks of sick leave and up to 10 weeks of family leave if conditions were met and documented by the employer and employees. The amounts paid translated into fully refundable payroll tax credits. This law includes numerous requirements to meet and terms to understand. Guidance from the relevant federal agency was also complex. For example, the Department of Labor (DOL) issued over 100 FAQ on the paid leave credits, while the IRS issued over 60 FAQ. The DOL also issued a temporary rule on the leave, which it later updated after losing a challenge brought by the attorney general of New York about key aspects of its rule.[12]

Many small businesses do not have ready access or cannot afford to hire legal counsel to assist them in complying with new and existing laws. State and local officials should work together to propose techniques to avoid that complexity for small businesses in the future.

Governments should also create resources to help constituents. For example, depending on the expertise needed, employees (such as labor law attorneys working for the state employment or labor department) could be designated to help individuals and small businesses during a disaster. One or more state or local government agencies should be required to collect and regularly update names and expertise of a volunteer corps able to assist for a myriad of possible needs

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[9]Memorandum of State Senator Anthony H. Williams, "Creating the 'Pennsylvania Commonwealth Fund'" (Mar. 30, 2020).

[10]Federal COVID-19 legislation with tax provisions: Families First Coronavirus Response Act (FFCRA) (P.L. 116-127); and Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136).

[11]*See*, *e.g*., the U.S. Department of Agriculture website on several types of assistance for farmers.

[12]*State of New York v. Department of Labor*, No. 20-CV-3020 (JPO) (S.D. N.Y. Aug. 3, 2020). Just over a month afterwards, the DOL issued an updated temporary rule and FAQ 101 to 103 to address the issue it lost in this case. *See* , "U.S. Department of Labor Revises Regulations to Clarify Paid Leave Requirements under the Families First Coronavirus Response Act" (Sept. 11, 2020); and Families First Coronavirus Response Act: Questions and Answers.

during a disaster or crisis. This is especially important when state and local laws may create special considerations in how they interact with similar federal laws. For example, some cities and states created new required sick leave laws that may have broadened the paid leave requirements of the FFCRA.[13]

State and local governments should also help small and medium-size businesses with any documentation required to obtain and support federal benefits. For example, the FFCRA requires employers subject to the act's paid leave provisions to obtain written documentation from employees to show they were qualified for the sick or family leave that produced the employer's fully refundable payroll tax credits. This documentation can include proof that a child's school was closed, the relevant dates, and government isolation orders. Some employers might not realize they need this proof or do not have all that is required until a future audit by the U.S. Department of Labor or IRS. To help these employers and employees, state and local governments should either require public schools to keep information about their closure on their website for at least four years or consolidate all information on a state-level website.

Some federal funds might be available, such as from the Federal Emergency Management Agency, because of the pandemic being declared a federal disaster on March 13, 2020.[14] And states might be able to obtain additional FEMA assistance depending on need and the length of the pandemic.[15] The federal disaster declaration also made IRC section 139, disaster relief payments, available, which employers might want to use, if possible, to provide tax-free assistance, such as technology resources for children of employees.

Providing lists of these federal and state resources on websites and to elected officials who individuals and businesses often call for assistance should prove helpful for the duration of the pandemic and beyond. Many taxpayers might not realize until months or years later that they were eligible for financial or tax relief measures and will seek information on it, likely from government agencies and elected officials.

E. Consider Tax System Oddities and Outdated Items That Can Generate Revenue

While not easy during difficult times, lawmakers should always be looking for tax loopholes to close, outdated provisions to repeal, and inequities to fix or remove. The weakened budgets following the pandemic can be helped by addressing these areas. Working to identify helpful tax law changes annually is necessary.

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[13] For example, Los Angeles required all employers to provide employees with supplemental paid sick leave for COVID-19 reasons (Ordinance No. 186590). Some of the provisions of this ordinance, such as the maximum pay level, tie to the FFCRA. Providing assistance to small businesses on how to comply with local, state, and federal sick pay laws during the pandemic helps ensure that the rules are followed and any possible federal benefits are fully obtained.

[14] FEMA, *supra* note 2. All states, the District of Columbia, and four territories were approved for major disaster declarations. FEMA, COVID-19 Disaster Declarations.

[15] For details on the federal disaster declaration process and state benefits for the pandemic, see Congressional Research Service, "Stafford Act Declarations for COVID-19 FAQ" (Apr. 22, 2020).

Examples of problem areas to address include:

- tax breaks based on age rather than need (such as senior exemptions);
- outdated economic stimulus provisions;
- tax incentives that are no longer needed;
- a rate structure that can be more progressive;
- tax breaks that favor high-income taxpayers or those who do not need breaks (such as credits for purchasing expensive electric cars and necessity-of-life sales tax exemptions that benefit high-income consumers more than others[16]);
- conformity to federal tax breaks when state relief is not warranted; and
- negative externalities when significant costs are not compensated sufficiently or at all by those creating the externality.

F. Push for More Federal Tax Relief

In addition to pushing Congress for more state and local government aid, lawmakers should help the individuals and businesses in their state obtain needed federal support and relief. Legislators and state agencies can find out from constituents and industry associations what additional relief would help. For example, businesses could have used additional Paycheck Protection Program funds and flexibility to obtain cancellation of the loans. Many taxpayers sought (and continue to seek) guidance on how some provisions of the federal COVID-19 legislation work so they could effectively and correctly use the provisions.

An example of requesting federal relief is a March 26 letter from the attorneys general of 24 states and the District of Columbia requesting that the U.S. Department of Education "immediately implement emergency measures to protect federal student loan borrowers in the wake of the COVID-19 crisis."[17]

II. Describing Relief Provisions — Focus on Certainty

While a lot of relief measures were undertaken quickly by all levels of government, a good deal of them were drafted in terms difficult to understand. Given the immediate need for relief, these provisions were typically effective within one or two weeks with little time to obtain clarification. Certainty needs to be a goal of all laws,[18] but especially when there is a need to understand and apply the rules quickly.

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[16]Annette Nellen, "Now Is a Good Time to Start Fixing the Sales Tax Base," *Tax Notes State*, Sept. 7, 2020, p. 987.

[17]Letter from Letitia James, Attorney General of New York, to U.S. Department of Education Secretary Elisabeth DeVos, "Re: Emergency Measures to Protect Student Loan Borrowers" (Mar. 26, 2020).

[18]The tax principle of certainty is described by the AICPA as follows: "tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made." AICPA, "Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals," at 3 (2017).

For example, a California executive order issued April 23 on some federal aid under the CARES Act[19] includes the following language:[20]

> It shall be unlawful to collect any money in a manner inconsistent with Paragraph 1 or Paragraph 2, or to retain any money so collected, including (but not limited to) any money so collected prior to the date of this Order. Any money so collected shall be promptly refunded without any further action (including, but not limited to, the filing of any claim of any kind, or the payment of any fee or penalty of any kind) by the individual entitled to that money under Paragraphs 1 and 2.

A press release accompanying the order mentions 90 days forbearance as a possible relief option for some student loans. There is no explanation if the possible forbearance is a deferral of payment or forgiveness and if the later, what tax treatment applies.[21]

In contrast, within three weeks of enactment of the federal CARES Act, Wisconsin enacted A.B. 1038 (Chapter 185), which includes conformity to several of its code and non-code provisions. While the legislative language, with reference to numerous section numbers of the CARES Act and numerous other provisions, was confusing, the DOR provided in Guidance Document Number 100265 a summary of less than 300 words clearly listing what CARES Act provisions the state conforms to. That guidance included a phone number and email address to use for questions and comments.[22] It is a good example of the issuer considering what information users needed and how to explain it simply. Following is an excerpt from that guidance:

> These provisions apply for Wisconsin tax purposes at the same time as for federal income tax purposes.
>
> - Section 1106 – relating to the exclusion from income for the cancellation of small business loans
> - Section 2202 – relating to the waiver of penalties for early withdrawals from qualified retirement plans
> - Section 2204 – relating to an above-the-line deduction for up to $300 of charitable cash contributions
> - Section 2205 – relating to increased limitations on charitable contribution deductions
> - Section 2206 – relating to an exclusion from income for payments an employer makes for an employee's student loans
> - Section 2307 – relating to the classification of qualified improvement property for depreciation purposes.

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[19]P.L. 116-136.

[20]California Executive Order N-57-20 (Apr., 23, 2020).

[21]Office of Gov. Gavin Newsom, "Governor Newsom Announces Additional Relief for Californians Impacted by COVID-19" (Apr. 23, 2020).

[22]Wisconsin Department of Revenue, Guidance Document No. 100265, Wisconsin Adopts Tax Relief in the Federal CARES Act.

Another good example of providing information that is simple and direct is the Nebraska DOR's release on its FAQ on income tax changes because of the pandemic. In under 130 words and in a box highlighted with a dark blue background, the DOR explains that FAQ are only advisory but are binding on the DOR, that they can change frequently, and that users can sign up to get updated information emailed to them on topics of interest, with a link to sign up.[23]

Following are suggestions to help ensure that both legislative and administrative tax guidance that people need to understand quickly meet the tax principle of certainty.

- In drafting, focus on the needs of users who are stressed and pressed for time and need assurance that they understand how to obtain the provided relief without risk of error and possible loss of the relief. Test the language out with colleagues before passing the legislation or posting administrative guidance. If possible and appropriate, be sure the purpose and goal are provided to help in understanding. Consider the example set by General Motors CEO Mary Barra, who reduced the company's 10-page dress code to two words: "dress appropriately."[24]
- For changes to existing statutes, provide a "track changes" version of the new legislation so tax professionals already familiar with existing law can readily see the changes.
- Many of the federal COVID-19 tax changes were not made to the IRC (non-code provisions), but instead are in the public law only. This leaves confusion in states with rolling conformity as to whether any of these non-code provisions were automatically conformed to. Provide the answer as soon after enactment of the federal legislation as possible. Also, some tax preferences, such as the paid leave credits of the FFCRA, require that the credit be added back to gross income to avoid a double benefit. States need to let taxpayers know as soon as possible whether that adjustment also affects state taxable income so that estimated tax payments can be computed correctly. Again, thinking about the changes from the perspective of taxpayers and their advisers should help in achieving certainty.
- Tax agency websites need to be updated, ideally with a single site rather than spread across multiple websites. Users need to know how to reach the agency, the status of audits and collection activities already underway before shutdown orders, and what deadlines are extended. All the information needs to be as clear as possible with no detail overlooked that will cause confusion and perhaps costly mistakes and missed opportunities for tax benefits. Include a link asking the reader to share additional questions they have.
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III. Think Broadly in Providing Assistance, but Consider Hidden Messages

[23]Nebraska Department of Revenue, Frequently Asked Questions About the Income Tax Changes Due to the COVID-19 National Emergency.

[24]Sam McEachern, "How General Motors CEO Mary Barra Changed the Company's Dress Code for the Better," GM Authority, June 17, 2020.

How can governments provide financial relief to distressed individuals and businesses at minimal costs to current and future budgets? What creative techniques can be used to help taxpayers satisfy tax liabilities when their financial needs may have drastically changed, such as no longer needing all the physical space they once used? The following are suggestions for out-of-the-box thinking for financial assistance. For many of these, it is important to consider any hidden message, such as encouraging actions that may be risky to employee health.

A. Use Existing Tax Dollars Rather Than Create New Tax Breaks if Possible

Identifying how existing tax breaks can be accelerated is a good start in providing financial assistance. For example, let taxpayers with credit carryforwards treat all or part of them as refundable in the current year. Allow for some carryback of current year NOLs. While these efforts will harm current year budgets, they are better for the long term relative to creating new tax breaks. If the state does not allow for the sale of tax credits to other taxpayers, it should be considered to help use existing tax breaks and provide immediate cash, rather than creating new tax breaks.

B. Accountability

While it is hoped that all taxpayers will use tax relief wisely, clawbacks should be considered such as when a company uses relief funds for a stock buyback.[25] Clawbacks and similar accountability measures are needed for any direct aid or tax credits intended to reward desired pandemic behavior such as employee retention, performing extra cleaning, and providing personal protective equipment (PPE) to employees.[26]

C. Allow for Tax Payments in Ways Other Than Cash

Some businesses may suffer significant losses because of curtailing operations and struggling to meet fixed costs. Some businesses may find they have unneeded assets, such as office, production, and retail space and vehicles, because of moving to more virtual and work-from-home (WFH) operations during the pandemic and perhaps afterward.

Consider ways that taxpayers with unneeded assets might pay their income and other tax liabilities with this property. State and local governments may find immediate needs for some of the real property, such as for COVID-19 testing or treatment and for housing homeless individuals. Some of the properties might be in better condition than existing government office space and possibly reduce the need for future building upgrades. This transfer of property might be helpful to some businesses unable to sell excess property because of the pandemic and uncertainty

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[25]For example, H.R. 6339 (116th Cong.) prohibits a corporate stock repurchase during the specified emergency period and the following 120 days.

[26]For example, H.R. 6827 (116th Cong.) requires corporations receiving federal COVID-19 financial aid to provide 14 days of paid leave to all workers, pay employees a minimum wage of $15 per hour and limit CEO and top executive pay.

potential buyers face. Taxpayers should be reminded of the tax consequences of using noncash property to satisfy tax liabilities.

D. Design Any New Tax Breaks to Help Liquidity and COVID-19 Relief

Tax systems should be regularly reviewed to ensure they reflect how we live and do business and meet principles of good tax policy. Some of the pandemic changes to how we work and do business are temporary. One significant temporary change is the widespread need for PPE. Given the importance of PPE and financial difficulties faced by so many individuals and businesses, as well as governments, a temporary sales tax exclusion is an appropriate tax break. That exemption also removes the cost and compliance complexity when taxpayers donate PPE. Indiana Executive Order 10-05 (March 19, 2020) requires the DOR to not impose use tax on manufacturers who donate medicine, medical supplies, and other goods to help fight COVID-19.

Any new tax breaks should be temporary and aim to reduce new costs of preventing and fighting the pandemic. For example, A.B. 2496 introduced in California (but not enacted) would provide an income tax credit for the purchase of cleaning and sanitizing supplies for use at business locations to help prevent transmission of COVID-19.

Additional targeted relief can be provided to extend due dates of debts owed to the state (beyond tax debts) and possibly also waive interest for a few months. Qualification for this relief should be automatic or only require a simple, online form. For example, Indiana Executive Order 10-05 provided a 60-day waiver of penalties for property taxes due on May 11, 2020.

E. Watch for Dangers in New Tax Breaks

The $600-per-week federal unemployment benefit provided by the CARES Act helped many individuals who lost their job when their employer had to shut down or reduce operations or when telework was not a feasible option. This benefit though also served as a disincentive to return to work. Idaho Gov. Brad Little (R) offered one-time return-to-work bonuses of $1,500 to full-time workers and $750 to part-time employees. The funds were distributed first come, first served once the employee returned to work.[27] At the federal level, S. 4031, American Tax Rebate and Incentive Program Act, proposed to compensate for some travel expenses of individuals traveling more than 50 miles from their home via a refundable credit of up to $4,000 per taxpayer plus $500 per child under age 17.

While these types of proposals are well intentioned and aim to help both workers and the economy, they pose risks that might be more costly than the grant or tax credit. These proposals can encourage behavior that is risky to the main party and those they encounter.

[27] Idaho Office of the Governor, "Gov. Little to Offer Back-to-Work Cash Bonuses" (June 5, 2020).

In contrast, Sacramento, California, considered paying some infected workers $1,000 to stay home.[28] This can help both the worker and those who will not get exposed to the virus when the worker shelters in place rather than goes to work. As noted in Section VIII of this article, the need to provide a cash incentive for a sick person not to go to work highlights sick leave inequities that exist in today's workforce.

Certainly, caution and data are needed to help with predictions on what all might happen in encouraging behavior that could further spread the virus. Needed resources include education on COVID-19 symptoms and risk factors, where to get tested, and resources to help individuals who cannot go to work because they are sick or exposed or at high risk of complications if they get sick. Obviously, governments need to be clear on messaging, including direct messages and those indirectly being made by some law changes, including tax laws.

F. Promote Use of Not-So-Obvious Resources

Governments should search broadly to find existing rules that can help individuals and businesses but that might be overlooked. For example, reminding individuals about the CARES Act recovery credit (referred to as economic impact payments by the IRS) and the earned income tax credit can help. Also, encourage individuals and businesses to review unclaimed property lists for possible assets to claim.

Promoting government aid programs and what local charities can provide will help because many individuals and businesses are unaware of the resources available to them. For example, the San Jose Community Development Block Grants Microenterprise Grant Program offers awards up to $15,000 to microenterprises to help with COVID-19 expenses.[29] Also, some companies, such as Facebook, offer grants to help small businesses.

There are also numerous websites such as Craigslist and FreeCycle that help people with excess resources such as boxes, office supplies, and furniture sell them or give them to others. These sites can be promoted by governments to help those in need, particularly when someone might have face masks or other PPE. Governments should also consider creating or co-sponsoring these types of websites as an efficient way to help those with extra resources get them to community members who need them.

[28]Tony Bizjak, "Sacramento May Pay People $1,000 to Stay Home When Infected by Coronavirus," *The Sacramento Bee*, Aug. 25, 2020.

[29]Many cities may have these funds through government or charitable organizations. For example, *see* information on the San Jose Community Development Block Grants.

New systems are needed to better distribute assets so what one person or business doesn't need can easily be given to others who need them rather than going to waste, particularly in times of crisis.

IV. Sheltering in Place Restricts Activity — But Tax Implications Should be Simple and Clear

The pandemic forced a growing trend of the past several years of remote work. According to one pre-pandemic survey, remote work in the United States increased almost 8 percent from 2016 to 2017, while it increased 91 percent in the last 10 years.[30] Another study found that about 16 percent of employees will continue to WFH even after the pandemic ends.[31]

Some companies, including Microsoft, Twitter, and Facebook, announced that WFH would be a permanent change for much of their workforce. Facebook CEO Mark Zuckerberg expects that by 2030, half of the company's employees (about 22,000) will WFH, with new technologies used to help build employee connections.[32] WFH might be for part of the work week for some employees and permanent for others. WFH strategies have created new terms such as "remote first" to allow most employees the option to work off-site or have a mix of office work and WFH.[33]

A result many companies and employees faced with the shelter-in-place and WFH conditions is that some employees were working in states other than where their normal workplace is located. This raised tax issues both for employers and employees. Employers may have created nexus in

[30]Beth Braccio Hering, "Remote Work Statistics: Shifting Norms and Expectations," Flexjobs (Feb. 13, 2020).

[31]Kristen Senz, "How Much Will Remote Work Continue After the Pandemic?" Harvard Business School (Aug. 24, 2020).

[32]Jeff Horwitz, "Facebook to Shift Permanently Toward More Remote Work After Coronavirus," *The Wall Street Journal*, May 21, 2020. *Also see* Ben Gilbert, "Microsoft Will Let Employees Work From Home Permanently," World Economic Forum (Oct. 13, 2020).

[33]*See, e.g.,* Coinbase Inc. blog post by CEO Brian Armstrong, "Post COVID-19, Coinbase Will Be a Remote-First Company" May 20, 2020.

36

states where they had not been subject to tax before. Employers also needed to register for employment tax purposes if not already done.

Employees might have learned that their tax consequences changed so that they could be subject to tax both in their WFH state and the state of their normal office location. Some of these employees might not be aware of new tax consequences until they receive a notice of tax due. For example, New Hampshire residents who normally work in Massachusetts discovered via publication of a DOR final rule in October that if they worked for a Massachusetts employer while working from home in New Hampshire, they still owed Massachusetts income tax under the state's sourcing rule.[34] That led Gov. Chris Sununu (R) of New Hampshire, a state without an income tax, to suggest filing a lawsuit with the U.S. Supreme Court opposing the action.[35]

An October 2020 AICPA/Harris poll of remote workers found that 55 percent did not know about the possible tax consequences of working from a new state. Also, almost half of those surveyed did not know that the tax rules on remote work were not the same among all states.[36] Variances among states increased during the pandemic as some states provided temporary relief in which, for example, for a specified number of days, the remote worker would be treated as not having changed their work location.[37]

The details of state actions and varying treatment both before and during the pandemic are not further discussed here. *Tax Notes State* has published several articles on how remote work affects employers and employees among the states.[38]

Suggestions for dealing with the sourcing and nexus issues for employers and employees and the states include the following.

1. States need to issue clear guidance on what are usually complex rules for both businesses and individuals. An explanation of the relevant rules, and any special rule adopted for the pandemic, should be readily available on the DOR's website. For employers, the information needs to address the nexus threshold for each type of tax imposed by the state. Possible tax credits and other preferences potentially available to filers should be noted. Information for individuals must clearly explain the filing obligation such as which return to use, filing thresholds, and if the state has reciprocity agreements with other states.
2. States should work together to develop more consistent rules on when a remote worker (employee or sole proprietor) has tax obligations in the state. Technology

[34] 830 Mass. Code Regs section 62.5A.3: Massachusetts Source Income of Non-Residents Telecommuting Due to the COVID-19 Pandemic (Oct. 16, 2020).
[35], "NH To Challenge MA Taxation of NH Remote Workers in U.S. Supreme Court" (Oct. 16, 2020).
[36], "AICPA/Harris Poll Reveals Many Taxpayers Unaware of State Tax Liabilities Related to Working Remotely" (Nov. 5, 2020).
[37] Various regularly updated lists of state actions are available, such as AICPA's State Tax Filing Guidance for Coronavirus Pandemic.
[38] *See*, *e.g.*, Kathleen K. Wright, "Tax Ramifications of Staying Home," *Tax Notes State*, Apr. 27. 2020, p. 505.

solutions should be considered to make determinations and e-filing as simple as online banking or shopping. Congress has long-standing proposals for state-level mobile workforce rules, as well as to address rules for the pandemic, such as the Remote and Mobile Worker Relief Act of 2020.[39] States should be ready to provide input to their elected officials on this type of legislation.

V. Tax Relief Needed This Year and Later — Be Forgiving

During the pandemic, all taxpayers have faced and will continue to face for some time, challenges in tax compliance and controversy. New laws and guidance from all levels of government have mostly been complex with guidance lacking and changing. Financial challenges mean that many businesses do not have as many human resources to help understand new tax and nontax rules. Also, financial challenges will result in outstanding tax debts for many taxpayers.

Tax agencies need to have a disaster mindset today and for years to come. That is, they cannot forget the challenges taxpayers faced for most of 2020 despite the tendency that time often helps us forget the panic, seriousness, and confusion that existed during the crisis. In a crisis, errors are easily made, and financial decisions may have been driven more by emotion (such as helping a relative or employee) than law (making sure legal obligations were satisfied by stated due dates). Many businesses were dealing with myriad confusing rules during the pandemic, including state laws on layoff, family, and sick leave, testing employees for COVID-19, and obtaining PPE that was often difficult or impossible to obtain when needed.

In an April 2020 letter to the *Tax Notes State* editor, Kip Dellinger, CPA, described the challenges and solution well by highlighting that the IRS should not try to return to "business as usual" for years.[40] This is also true for state tax agencies. Examination of 2020 tax returns are bound to include errors because of the number of changes, confusion over federal-state conformity, and lack of complete guidance. Reasonable cause for penalty relief should be a given in most cases. Collection issues will also be around for years because of the financial crisis many individuals and businesses faced with some businesses not surviving the pandemic.

To best help taxpayers, state lawmakers and tax agencies should say now that reasonable cause will be the starting point for penalty waivers or for not assessing them in the first place. Substantial compliance should be viewed liberally with state tax auditors regularly reminded for years about the panic and confusion that accompanied most tax and other changes of 2020. Collection actions should be extended, and as noted earlier, noncash assets no longer needed by businesses should be accepted easily as allowable payment options.

VI. Tough Financial Times Ahead – Don't Hide It, Be Transparent

[39]Sen. John Thune, R-S.D., sponsor of S. 3995, stated reasons for the bill in an op. ed.: "State Taxes Shouldn't Be Another Pandemic Worry," *The Wall Street Journal*, June 17, 2020.
[40]Kip Dellinger, "Dear IRS: It Shouldn't Be Business as Usual!" *Tax Notes State*, Apr. 20, 2020, p. 409.

All levels of government were hit hard by the pandemic with reduced revenues for fiscal year 2020 and beyond, along with increased spending to address new and increased expenditures. Governments faced increased costs for their employees to enable WFH, extra cleaning of facilities, and greater use of sick and family leave. Rainy day funds were tapped in many states.[41] Increased spending needs at the federal level with new expenditures and increased interest expense from significant new borrowing means state and local governments might not get much more assistance from the federal government.[42]

As states seek to meet budget demands but are reluctant to increase taxes in difficult financial times, budgets and rainy day funds will be severely challenged. Tax increases of some degree are inevitable and, as noted in Section I, could come from closing loopholes and removing special rules that are not required elements of some taxes (such as various sales tax exemptions for personal consumption).

State and local governments should be transparent about their fiscal challenges to avoid surprises and disappointment to resident individuals and businesses. People are keenly focused on their own problems, so they are unlikely to have time to devote to figuring out on their own whether their governments are experiencing problems and the degree of budget issues. Clearly laying out the issues is prudent.

An example of that transparency is an April 4, 2020, press release by the California State Association of Counties. It explains why counties could not delay the due date for property taxes. While noting they would exercise their authority to waive penalties for those unable to pay, they noted that the tax revenue is crucial to local governments including schools. Per the statement: "Delaying the April 10 property tax payment would take tens of billions of dollars away from local government, create cash flow problems, and cause some to default on their loans, which would have significant long-term effects on all local agencies in California."[43]

Another transparency example — also from California — is a fiscal update from the Department of Finance. In bullet points, it lays out that almost 478,000 unemployment claims were filed in the first week of May and personal income tax collections are expected to be 9 percent lower than originally projected. The document included a link to a 10-page presentation with pie charts reviewing a normal budget and highlighting expected budget deficits because of the pandemic.[44]

Will many people find the agency websites with documents that aim to make budget problems more transparent? Likely not. Governments need to continue efforts to push information out via social media, posting information on frequently visited sites such as for driver and vehicle license renewals, and encouraging elected officials and schools to help in distributing information on their

[41] *See* National Conference of State Legislatures, State Fiscal Responses to Coronavirus (COVID-19) (June 30, 2020).
[42] Deficit spending increased from $984 billion in fiscal 2019 to $3.1 trillion in fiscal 2020. Congressional Budget Office, "Monthly Budget Review: Summary for Fiscal Year 2020" (Nov. 9, 2020).
[43], "Joint CSAC / CACTTC Statement on COVID-19 and the April 10 Property Tax Deadline" (Apr. 4, 2020).
[44] California Department of Finance, "Fiscal Update" (May 7, 2020).

websites. The information provided needs to be simple and direct with links to more details for those who want them. The goal is to help people understand the fiscal issues and what is being done, setting expectations for current and future budgets and being transparent about fiscal challenges.

VII. Embrace 21st Century Technologies

The pandemic forced tax agencies to embrace modern technologies that many taxpayers were already accustomed to as some of these tools, such as digital signatures, originated in the last century.[45] A good deal of tax administration and compliance is paper based even with e-filing, which has been around since the late 1990s. Yes, paper based! Consider how e-commerce does not involve completing an electronic version of an order form, yet tax filing still requires completion of what continues to be a paper-based form usually requiring input from other paper-based forms such as Form W-2 and Forms 1099. Also, many federal and state tax forms cannot be e-filed.[46]

While many states have moved toward online taxpayer accounts, they tend to not be as robust or easily navigable as online banking and e-commerce websites and apps. The IRS and likely all states still use some forms that require a wet signature.

Online filing, document transfers, payments, and digital signatures allowed by the IRS and many state tax agencies were quickly implemented during the pandemic but mostly on a temporary basis.[47] Given the number of taxpayers engaged in online shopping, banking, and education, there are many people eager for permanent online options for tax compliance.

New online and digital activities started or temporarily expanded during the pandemic by state tax agencies need to move to a permanent basis post-pandemic. Lessons learned from these new efforts must be considered in aiming to move to completely online systems.[48] In addition, to benefit from economies of scale and compatible systems, states and the IRS must work together to create the 21st century technology-based tools for modern tax compliance.

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[45]For example, the Electronic Signatures in Global and National Commerce Act (P.L. 106-229) was enacted June 30, 2020. Amazon.com launched in 1994 and eBay in 1995.

[46]The IRS national taxpayer advocate's midyear report also notes the paper-based system: "Not all operations will function seamlessly in a remote environment, but the IRS will be better positioned if it is not such a paper-based organization. Accordingly, the National Taxpayer Advocate recommends that the IRS prioritize the modernization of its technology as well as increase the use of digital communications and the electronic production of documents in a secure environment." National taxpayer advocate, "Fiscal Year 2021 Objectives Report to Congress," Systemic Advocacy Objectives report, at 44 (2020).

[47]For example, *see* Maryland Tax Alert 04-20, Temporary Acceptance of Digital Signatures. *Also see* Treasury memorandum of June 12, 2020, on "implementing a temporary deviation" for approval to accept images of signatures and digital signatures.

[48]While compliance systems should be completely online, there will continue to be a need for other approaches because not all taxpayers use 21st century technologies yet.

Online tax filing should consider other online systems that have replaced paper, such as those used in banking. The focus should be on data and where it originates and how to get it in a digital form that allows it to be efficiently and safely used to compute tax liabilities. For example, rather than focus on the Form W-2, the data on the W-2 and its location should be the focal point. With many workers being paid via automatic bank deposit, a digital file already exists. Many employees also do not receive paper pay stubs from their employer but must instead access them electronically. This digital data should be made available in a manner for taxpayers to easily access it to feed into the tax preparation software they use. Similarly, business taxpayers should set up their digital accounting records to be easily converted to a digital format that feeds into the tax preparation software, with appropriate book-tax adjustments made by the software. These systems would allow taxpayers to calculate income tax liabilities daily, and regularly ensure tax liabilities are covered, such as with a direct link to their bank account or credit card. Due dates would eventually not be necessary in this tech-driven system. Online taxpayer accounts should also end the need to file amended returns. Instead, taxpayers access their secure account to make necessary changes, which are then reviewed online by the tax agency to be accepted or declined.

Beyond eliminating the need for due dates for many filings, use of 21st century technology should also end the issue of unclaimed tax refunds (such as from individuals not claiming overpaid taxes from wage withholding) and missing mailed notices that either don't get delivered or are sent to an incorrect address.[49]

A starting point beyond lessons learned from use of new technologies during the pandemic is to also obtain information from taxpayers. A recent example of such an effort from the U.S. Department of the Treasury is a request from the Office of the Comptroller of the Currency. It seeks public input on specific questions to help ensure that regulatory frameworks enable "banks to adapt to rapidly changing trends and technology developments in the financial marketplace to meet customers' evolving needs while continuing to operate in a safe and sound manner." Questions include ones on how new technologies such as the blockchain, artificial intelligence, and payment systems can be used to improve banking operations.[50]

VIII. The Pandemic Highlights Inequities — Plan to Remove These from Tax Systems

While millions of individuals sought unemployment compensation during the pandemic, others continued to collect their regular pay, including in safe WFH environments. And some ultra-wealthy became even wealthier. For example, about 40 million workers in the United States sought unemployment compensation assistance, while billionaires experienced about a $500 billion increase in net worth.[51]

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[49] *Also see* Nellen, "Change in Mindset Needed to Move Tax Compliance Into the Modern Era," *State Tax Notes,* May 22, 2017, p. 785.

[50] Treasury, Docket ID OCC–2019–0028 (July 7, 2020), F.R. 40827.

[51] Hiatt Woods, "How Billionaires Saw Their Net Worth Increase by Half a Trillion Dollars During the Pandemic," *Business Insider*, Oct. 30, 2020.

A crisis such as the pandemic can highlight long-standing problems, such as inequities regarding insurance coverage, access to paid sick and family leave, wide and growing income and wealth gaps, and access to affordable health care. Several of these inequities exist in our tax systems or are exacerbated by existing tax rules. Now is a time to start discussing and addressing these issues and not create greater inequalities by new tax law changes.

States should find tax system inequities and identify how to eliminate them. Existing data on tax incidence by income quintiles, which most states likely gather for the U.S. Department of Commerce[52] and their own needs, is a good starting point. Hearings on the topic should help to identify more inequities as well as solutions for eliminating them.

Tax inequities include income exclusions, such as for employer-provided health insurance, that provide greater tax savings to higher-bracket individuals who also likely receive greater benefits from their employers. The cost of this tax expenditure, likely one of the largest for each state, could be reduced with the savings used to distribute health care subsidies more equitably to all individuals, not just employees with employer-provided health insurance.[53]

Homeowners with mortgages receive tax savings greater than what renters receive. This subsidy, delivered via a deduction, is also upside down in providing greater savings to higher-bracket taxpayers who are also likely to have a larger mortgage than lower-income individuals. Individuals with the largest mortgages that can produce deductible interest are also least in need of this subsidy. For example, those individuals can likely afford a $1 million dollar home even without the mortgage interest deduction or if not, they can buy a slightly less expensive home and still live in a manner not possible for the vast majority of individuals.

Similar inequities exist in the tax system with other tax preferences (tax expenditures) that primarily benefit higher-income taxpayers and further increase their wealth. These special rules include pension contributions and income deferral, not taxing capital gains at death, lower capital gain rates used in some states, and exclusion for municipal bonds, gifts, life insurance, and various fringe benefits beyond health insurance.

States should also look at special tax rules for all their taxes. For example, are charitable organizations provided sales and property tax breaks even if they do not mostly aid local communities? Do sales and use tax rules allow residents to avoid sales tax on expensive airplanes and other vehicles through special provisions on how the vehicle is purchased or delivered?

Efforts should also be directed at addressing new inequities created by the pandemic that might be further exacerbated by tax rules or that might hurt future tax collections. For example, many high school and college graduates entering the workforce during the pandemic saw reduced

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[52]The U.S. Department of Commerce's Census Bureau provides a great deal of federal, state, and local tax data, *see* U.S. Census Bureau, Government Taxes.

[53]Also suggested in Nellen, "Looking Ahead: Supporting the Modern Workforce," *Tax Notes State*, Dec. 16, 2019, p. 913.

opportunities that might have long-term consequences to them and state revenues. Will new aid programs help these individuals catch up?

State and local governments should also identify agencies beyond the DOR to help identify and reduce tax system inequities. If Chicago's 2019 creation of an Office of Equity and Racial Justice led by a chief equity officer[54] becomes a trend in other state and local governments, tax inequities should also be an agenda item for that office.

Beyond economic inequities in the tax system, recent attention has also been directed at racial and gender inequities[55] tied to tax rules and government spending programs. That is, both direct and indirect spending (such as through tax expenditures) should be evaluated as part of a state's efforts to improve tax systems by making them fairer and more equitable.

IX. Engage in Identifying and Actualizing Lessons Learned From Tough Times

The IRS national taxpayer advocate's midyear 2020 report summarized this topic well — ensuring we identify and act upon lessons learned from the pandemic.

> Once the IRS resumes normal operations, it is crucial to evaluate the challenges the agency faced in providing taxpayer services and conducting mission-critical functions including compliance initiatives during the COVID-19 crisis. The IRS must prepare for the next national emergency, based on the lessons it learned from this crisis. While the circumstances of the next incident will differ, the IRS can take actions now to ensure that the agency's core operations will continue in the face of similar challenges. This will require each function taking a hard look at what worked and what did not in the face of this unexpected and unprecedented event.[56]

In preparation for post-pandemic analysis though, lots of notes must be taken now on what worked and did not work, what could not be accomplished because of lack of resources, and what was learned by other government agencies and businesses.

The evaluation and work on lessons learned and planning to put those lessons into action does not have to wait until after the pandemic. For example, the Chicago Recovery Task Force issued a 104-page report in July. Per the report's introduction, the mayor convened this thought leadership group:

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[54]Nate Berg, "'It's Stressful, Lonely Work': The Newest Job at City Hall is Also the Most Important," *Fast Company*, Aug. 3, 2020.

[55]*See*, *e.g.*, Tax Policy Center, "Racial Disparities and the Income Tax System" (Jan. 30, 2020); and Michelle Harding, Grace Perez-Navarro, and Hannah Simon, "In Tax, Gender Blind is Not Gender Neutral: Why Tax Policy Responses to COVID-19 Must Consider Women," OECD Centre for Tax Policy and Administration (June 1, 2020).

[56]*See* "Fiscal Year 2021 Objectives Report to Congress," *supra* note 46.

> to keep our city moving forward despite the far-ranging impacts of this disease. Our objective was as bold as it was simple: Nothing less than the most breathtaking recovery effort Chicago has ever seen. To succeed, we knew there could be no half measures and no cutting corners. It would require bold, visionary action that would build on the efforts already taken to expand equity and opportunity over the previous nine months.[57]

A "lessons learned" endeavor must also consider how business and individual activities have changed. For example, increased WFH efforts can easily result in empty office space and declined property values and property tax collections. Fewer commuters means added pressure on mass transit funding, reduced parking revenues on city-owned lots, and even reduced revenue from traffic violations. With more employees working from home and fewer in business-owned buildings, business license fees, particularly those tied to payroll or number of employees in the city, may need to be reevaluated. College towns need to consider if populations will decrease with more students permanently participating remotely and consequently adversely affecting local tax revenues.

The pandemic likely changed a variety of daily activities permanently. This includes how people pay for goods and services such as with electronic funds and certainly with less tangible currency. Those practices will be expected when people pay for government services. Similarly, many people will expect to continue to interact with government employees virtually rather than in person at a government office. Consideration should be given to how this affects tax agencies and the work of their employees.

In looking ahead to be ready for the next disaster, governments should evaluate how rainy day funds are replenished and if changes are needed. Since future emergencies are likely to involve distribution of funds to residents such as for unemployment compensation or recovery rebates, how can it be done efficiently via technology. What can be done now to provide access to funds for individuals who are unbanked? How do new financial technologies help solve these challenges?

How can all levels of government share the lessons learned and be informed of actions of one agency that will help another? Ideas for sharing information is crucial as innovations in one agency can easily affect and help other agencies. In addition, governments will need to find and use information gathered by businesses and others and obtain input from all stakeholder groups.

X. Conclusion

The pandemic challenged and continues to challenge us all in many ways. All government systems from public health to education to transportation to taxes are affected. The severity and wide reach of the pandemic will change our day-to-day activities and perspectives permanently in many ways. Those changes, along with financial recovery post-pandemic, will affect tax systems and tax

[57] City of Chicago, "Recovery Task Force Advisory Report: Forward Together Building a Stronger Chicago" (July 9, 2020).

policy. Endurance is a good focal point for tax considerations. Attention is needed now to deal with numerous tax law changes that will linger on in audits and litigation for the next few years. Many lessons are learned from the current crisis, and efforts are needed now and over the next few years to be sure tax systems endure to reflect our changed economy, business practices, and lifestyles. Hopefully, ideas laid out in this article will help policymakers and taxpayers in this learning and endurance endeavor.

REG

Regulation CPA Exam Questions

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Sample CPA Exam Question & Answer Explanation 1

An employed, married taxpayer owns three rental properties in which the taxpayer does not actively participate. In the current year, Property 1 had a net loss of $10,000, Property 2 had a net gain of $25,000, and Property 3 had a net loss of $5,000. The taxpayer's W-2 wages were $110,000. Considering only these facts, what is the taxpayer's adjusted gross income?

A) $110,000

B) $120,000

C) $125,000

D) $135,000

Correct: B

Passive income includes trade or business activities in which the taxpayer does not materially participate (eg, partnerships, S corporations) and all rental activities. Passive activity losses are deductible to the extent of passive activity income. Unused losses are suspended and carried forward to offset future passive income.

There are two exceptions regarding losses from rental real estate activities. The exceptions require that the taxpayer either actively participate in the rental activity or is considered a real estate professional. If neither exception applies, the passive loss deduction is limited to passive income.

Because this taxpayer does not actively participate in the rental real estate activities and is not considered a real estate professional, neither exception applies. Therefore, the losses from the rental activities may offset only passive income. The taxpayer's AGI is $120,000.

(Choice A) AGI of $110,000 implies that only the W-2 wages are considered as income. The net income from the passive rental activities is also taxable.

(Choice C) AGI of $125,000 ($110,000 + $25,000 − $10,000) suggests that only Property 1's loss of $10,000 is deductible; however, the entire $15,000 is deductible against the $25,000 passive income.

(Choice D) AGI of $135,000 ($110,000 + $25,000) incorrectly assumes that none of the passive losses are deductible. Passive losses are deductible to the extent of passive income.

Things to remember:
Passive income includes trade or business activities in which the taxpayer does not materially participate (eg, partnerships, S corporations) and all rental activities (except for those of a real estate professional). Passive activity losses are deductible to the extent of passive activity income (unless the active participation exception applies).

Sample CPA Exam Question & Answer Explanation 2

A 2018 divorce decree provides that Alex pay alimony of $10,000 per year to Blair, to be reduced by 20% on their child's 18th birthday. The divorce decree has not been modified. During the tax year, Alex paid $7,000 directly to Blair and $3,000 for Blair's tuition to an accredited university. What amount, if any, of these payments should be reported as income in Blair's income tax return for the year?

A) $0

B) $7,000

C) $8,000

D) $10,000

Correct: C

Prior to the Tax Cuts and Jobs Act (TCJA), alimony payments were income to the payee and deductible to the payer. TCJA flipped the rules for divorce decrees issued or modified after 2018 so that alimony is no longer included in taxable income, nor is it deductible. Note that modified divorce decrees must specifically elect the TCJA rules in the modification.

Among the many specific rules regarding alimony, one important rule is that alimony must not contain any type of disguised child support. The $10,000 annual payment decreases 20% ($2,000) when the child reaches 18 years; therefore, it is considered disguised child support. This portion is not taxable to Blair (nor deductible by Alex). Only 80% ($8,000) is true alimony and included in Blair's income tax return.

(Choice A) Since the divorce settlement was issued prior to 2019, Blair must still include the alimony payment in income. However, if the TCJA rules applied because the divorce decree was issued or modified after 2018, $0 would be correct.

(Choices B and D) When the pre-TCJA rules applied, amounts paid on behalf of the spouse were considered taxable alimony. Alex's $3,000 payment for Blair's tuition is also alimony, not just the $7,000 direct payment. However, the full amount of $10,000 ignores the 20% portion that is considered child support.

Things to remember:

Alimony paid pursuant to a divorce decree issued on or before December 31, 2018, is taxable income to the payee (and deductible by the payer). When those pre-TCJA rules apply, alimony must not contain any disguised child support. For divorce decrees issued or modified after 2018, alimony is no longer taxable or deductible.

Sample CPA Exam Question & Answer Explanation 3

Cobb, Danver, and Evans each owned a one-third interest in the capital and profits of their calendar-year partnership. On September 18 of Year 1, Cobb and Danver sold their partnership interests to Frank and immediately withdrew from all participation in the partnership. On March 15 of Year 2, Cobb and Danver received full payment from Frank for the sale of their partnership interests. For tax purposes, the partnership

A) Terminated on September 18 of Year 1.

B) Terminated on December 31 of Year 1.

C) Terminated on March 15 of Year 2.

D) Did not terminate.

Correct: D

A partnership generally terminates for tax purposes when no part of the business, financial operations, or venture of the partnership is carried on by any of its partners. Here, the partnership did not terminate because there was no agreement to dissolve, wind up the business, and distribute property to the partners. The partnership business continued with original partner Evans (33.33%) and new partner Frank (66.67%).

The TCJA of 2017 repealed the rule that a partnership be terminated for tax purposes when 50% or more of the partnership interests changed hands within a 12-month period. The current IRS rule now aligns with how partnership terminations are generally treated under state law.

Things to remember:
For tax purposes a partnership terminates when no part of the business, financial operations, or venture of the partnership is carried on by any of its partners.

Sample CPA Exam Question & Answer Explanation 4

Which of the following items is not normally taken into account in determining distributable net income of a simple trust?

A) Tax-exempt interest.

B) Fiduciary fee.

C) Taxable interest income.

D) Personal exemption.

Correct: D

A trust's distributable net income (DNI) represents current income, including taxable and tax-exempt interest, available to be distributed to beneficiaries after paying costs incurred by the trust (eg, fiduciary fees) **(Choices A, B, and C)**. DNI determines the maximum amount of (1) distributed income that is taxable to beneficiaries, and (2) the trust's deduction for distributed income. Capital gains and losses are generally excluded from DNI since the proceeds are considered a return of corpus (ie, property transferred to the trust).

A personal exemption is solely a statutory amount allowed to reduce taxable income. As such, a personal exemption is not an actual cost incurred that would reduce the amount available for distribution and is not used to determine DNI.

Things to remember:
Distributable net income (DNI) represents the remaining current income after paying incurred costs and is available to be distributed to beneficiaries. Because the personal exemption is a statutory amount that is not an actual incurred cost, the personal exemption does not affect DNI.

Sample CPA Exam Question & Answer Explanation 5

An LLC exchanged an office building with a fair market value of $550,000 and an adjusted basis of $220,000 for a shopping center with a fair market value of $600,000. If the LLC paid an additional $50,000 to complete the exchange, what amount of gain, if any, would the LLC realize?

A) $0

B) $50,000

C) $330,00

D) $380,00

Correct: C

A like-kind exchange is a nontaxable trade of investment/business real property (ie, qualified property) for similar qualified property of equal fair market value (FMV) ($600,000 FMV = $550,000 FMV + $50,000 cash). Although no gain or loss is recognized, any realized gain or loss is deferred until the property received is disposed (eg, sold) **(Choice A)**.

Like other dispositions, realized gain or loss is the difference between the FMV of property (including cash) received and the adjusted basis of property given (including cash) (FMV received − adjusted basis and cash given).

The LLC received a shopping center ($600,000 FMV) by giving cash ($50,000) and a building ($220,000 adjusted basis). Therefore, the LLC realized a gain of $330,000 [$600,000 − ($50,000 + $220,000)].
The office building's $550,000 FMV is not used to determine the realized gain but is considered when determining if the transaction is an even economic trade.

(Choice B) An amount of $50,000 represents boot (ie, additional consideration offsetting the difference between the two buildings' FMVs).

(Choice D) An amount of $380,000 represents the difference between the FMV received and the office building's adjusted basis but omits additional cash or boot given.

Things to remember:
A like-kind exchange (LKE) is a nontaxable trade of qualified property for similar qualified property of equal fair market value (FMV). Although no gain or loss is recognized, any realized gain or loss on an LKE is deferred until the asset is disposed. The realized gain or loss is determined by subtracting the adjusted basis of property given from the FMV of property received.

Tax Maven

The Contemporary Tax Journal's Interview with Mr. Andy Mattson
By: Hana Kwong, MST Student

Andy Mattson is a Tax Partner at Moss Adams LLP. He has been providing tax solutions to start-ups and other technology companies in Silicon Valley since 1985. His specialties include corporate, partnership, and individual tax and compensation planning; stock option taxation and planning; and international taxation.

Mr. Mattson received a Bachelor of Science Degree in Accounting from the University of Southern California and is a Certified Public Accountant (CPA) in the state of California. He has been with the San Jose State University (SJSU) Tax Advisory Board since 2013. Mr. Mattson is also an appointed member of the American Institute of Certified Public Accountants (AICPA) Tax Division committee or technical resource panel for over 20 years.
I had the pleasure to meet with Mr. Mattson on June 11 via Zoom. Our encounter was a short, yet a meaningful one. Mr. Mattson was eager to share his career experiences with *The Contemporary Tax Journal*.

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

I attended the University of Southern California (USC) because of their accounting school. At USC, I gravitated towards tax, so I started with Price Waterhouse (now PwC) in the tax department. My preferences were confirmed when I was getting my 500 hours of audit time (that used to be required) and adding up payroll registers at an onion processor in Gilroy.

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

I built my firm's South America practice, and I'm proud of that. We are now representing about 250 Latin American companies that have raised about $6 billion in venture capital financing. I also enjoy the trips down there. I go just once a year, but its summer in January in the Southern Hemisphere. When I retire, I'll have made spots for two or three partners to take my place.

I'm also proud of the work I have done for the AICPA for a couple of decades. I have cosigned quite a few letters that have gone to the legislative and executive branches. I remember when there was a bill that was going to eliminate the IRC Section 911 exclusion, just for revenue raising purposes. We sent a letter out in less than a week that went to every member of the Senate.

As Professor Nellen can tell you, it is really rewarding to give back to the profession and not just for altruistic reasons. It can be engaging and at times exciting.

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

My firm uses the Lexis® Daily Federal Tax Tracker, I do read it everyday. I would also use it to forward articles to others, for example, the AICPA, people at the firm, etc. Keeping up to date is very important as there are a lot of concerns of being what is happening now, especially in terms of the clients.

For better or for worse, due to the stalemates in DC, the tax code is changing less frequently than it used to. But it is still not easy. Just last week I was working with a tax partner with a Big 4 firm in Sao Paulo with strong knowledge of U.S. tax law. But he was unaware of the repeal of IRC Section 958(b)(4) which has significant implications for international companies. Fortunately, my client didn't listen to him.

As far as new types of businesses in the digital era, this is what makes what we do worthwhile and exciting. If you look at the Fintech industries, for example, these are companies that are meeting the needs of historically "underbanked" individuals and companies that were ignored by the existing financial infrastructure such as traditional banks. It is easy to assume that countries outside of the developed world have financial systems like ours, but that is simply not the case.

4. **How did you get involved with having tax clients in South America? What is something surprising you have learned from this experience?**

I represented a single Argentinian client for many years. Then, the CFO at their Brazilian VC Fund asked if I'd take on a Brazilian client that they had just invested in. He subsequently referred a second one. He was nice and I basically decided to fly down to Sao Paulo to meet with him. Word quickly got out in the VC-backed tech community there, that a U.S. CPA was coming down and I probably had 20 meetings in two weeks. It grew from there and continues to grow. This has been a nice change in my career. I've been practicing in Silicon Valley since 1985 and these are also tech companies but on another continent.

This work involves investor tax reporting. I was able to handle it because I had represented so many individual clients in Silicon Valley who were receiving Forms K-1 involving complex international tax reporting. The tax person at a multi-billion dollar east coast VC firm told me once that we have a unique practice in this area.

What surprised me, and opened my eyes, was how sophisticated these South American companies are. I guess I was guilty of having a mindset without all the facts or an understanding of the business environment. Do you know that in Brazil, nobody uses checks? Everything is electronic. Many of these countries have leap-frogged the U.S. in terms of going digital. Also, did you know that Sao Paulo is the largest city in the Western Hemisphere & the fourth largest in the world? Here again, I assumed that NYC, or maybe Mexico City had that title. Sao Paulo is 400 years old and has over 12 million people.

5. **Why did you get actively involved with AICPA tax committees and how did that benefit your career?**

My grandfather chaired the Antitrust Section of the American Bar Association (ABA) in the 1970s and was president of the American College of Trial Lawyers. He always talked about the importance of giving back to the profession and making it better.

I was performing a lot of international tax work and heard that the AICPA's International Tax Committee was having a meeting in Las Vegas in 1999 so I flew there to attend the meeting. After that I applied for membership and was appointed as a volunteer committee member. I was later appointed chair of this committee. I've been serving in an appointed role on committees since then and served on the AICPA Tax Executive Committee and later chaired the IRS Advocacy and Relations Committee.

In terms of benefitting my career, I'd say that participating made me a better adviser because I've been able to interact with many smart people from across the U.S. It also made me realize how important the work that we do is to our voluntary compliance system of taxation. It is genuinely enjoyable.

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

The requirements for disclosing international investments are burdensome and the penalties are highly punitive for minor foot faults. I understand that there are bad actors who moved money offshore to try to hide their assets, but the world is one big economy and many of the fundamental U.S. international tax rules date back to the Kennedy Administration.

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

Being responsive to your clients is of utmost importance. How did you feel the last time you were at a store and could not find anyone to help you find the items you needed? That's an oversimplification, but always put yourself in the shoes of your client. Your client expects to be treated like you would expect to be treated yourself.

This is important because the clients you interact with will ultimately refer their colleagues to you if you simply treat them right. I was never much of a "marketing" person. I was always more technical. But now, because I have spent my career trying to do well for my clients, I happen to be in the top five percent at Moss Adams for new business.

What we do is complex and there are high requirements to entry, such as the CPA exam. So, the point is, if you wonder how you will bring in clients, the answer is easy: treat your existing clients right, and business comes to you.

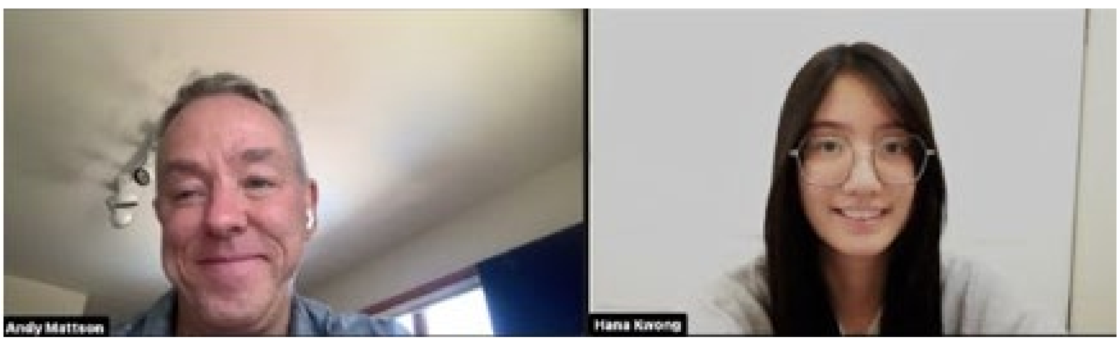
Fun Questions:

8. **If you could have dinner with anyone (living or not), who would it be?**

Sir David Attenborough. He is probably the most well-known environmental activists and he’s still going strong at 95 years old.

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

I have always loved photography. In junior high we developed film and then printed in a darkroom (yes, I’m that old). So, I’ve decorated my office with large prints that I’m proud of having taken.



Andy Mattson and Hana Kwong, June 11, 2021 (Zoom interview).

Restoring Tax Fairness for States and Localities Act, Section 4 H.R. 5377 (116th Congress)

By: Hana Kwong, Tam Nguyen, MST Students in BUS 223A Tax Research, Spring 2021

On December 10, 2019, Congressman Thomas Suozzi (D-NY) introduced the *Restoring Tax Fairness for States and Localities Act (*H.R. 5377, 116th Congress). In addition to changes to the state and local tax deduction for individuals, H.R. 5377 would allow teachers an increased above the line deduction from $250 to $1,000 for K-12 educator expenses.

Per Internal Revenue Code (IRC) Section 62, eligible educator expenses include expenses in professional development courses for the educator, professional development for the students the educator provides instructions to, or books, supplies, and equipment used by the educator in the classroom.[1]

Regarding eligible educator expenses, those expenses must incur in the taxable year for an educator in a kindergarten through grade 12 school. The educator must be a teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during the school year.[2]

The following section applies the twelve principles of good tax policy to section four of *Restoring Tax Fairness for States and Localities Act* proposing an increase in K-12 educator expenses from $250 per year to $1,000 per year. These principles were laid out in the AICPA's *Tax Policy Concept Statement No.1-Guiding Principles of Good Tax Policy: A Framework for Evaluation of Tax Proposal.* [3]

[1] Section 62(a)(2)(D).
[2] Section 62(D)(1)(A).
[3] American Institute of Certified Public Accountants (AICPA) Tax Division. (January 2017). *Tax Policy Concept Statement No.1-Guiding Principles of Good Tax Policy: A Framework for Evaluation of Tax Proposals*; available at https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/tax-policy-concept-statementno-1-global.pdf.

Principle of Good Tax Policy Worksheet

Criteria	Does the proposal satisfy the criteria? (explain)	Result
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer's income for different income levels of taxpayers.	This proposal partially meets the equity and fairness principle. Horizontal equity requires similarly situated taxpayers to be taxed similarly. In terms of horizontal equity, the $1,000 above the line deduction would be considered equitable because it is for all qualified kindergarten through grade 12 teachers. Vertical equity means the benefit is not providing a greater benefit for higher income individuals relative to lower income individuals. As a deduction, the tax benefit (savings) is greater for a higher income individual relative to a lower income individual because they are in a higher tax bracket.	+/-
Certainty – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that they have applied the rule correctly.	This proposal satisfies the certainty principle because it clearly states the effective date (for tax years after December 2018). It also clearly states that the annual amount changes from $250 to $1,000. Therefore, taxpayers should have confidence that they have applied the rule correctly.	+
Convenience of payment – Does the rule result in tax being paid at a time that is convenient for the payor?	The convenience payment principle is satisfied. First, taxpayers would need to know this rule: Section 62(a)(2)(D), then they can simply claim this deduction on Form 1040 individual income tax return, along with Schedule 1. However, taxpayers cannot get the tax savings until their returns are filed.	+
Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?	This proposal fulfils the effective tax administration principle because only the dollar amount of the deduction changes. The IRS does not need to create a new form for such changes. From the taxpayers' perspective, they do not need to hire tax professionals to explain and comply regarding to this tax rule change.	+

Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	There will be no impact to information security as this change is only to the amount of the deduction and no new information is required.	N/A
Simplicity - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner?	The simplicity principle is met because the proposal simply changes the deduction amount from $250 to $1,000 and the effective date is clearly stated. There are no complicated calculations to compute. The higher deduction amount means that more record keeping is required by taxpayers but this should not be complex.	+
Neutrality – Is the rule unlikely to change taxpayer behavior?	The neutrality principle is not satisfied because it may encourage teachers to spend more out-of-pocket to purchase materials as the tax deduction amount has increased from $250 to $1,000. For example, a teacher might tend to buy computer equipment and software rather than paper and pencils. However, it is likely that the sponsor's intent in increasing the dollar amount of the deduction is to encourage teachers to spend more money as well as to better assist teachers already spending over $250 on classroom supplies and professional equipment.	-
Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy?	This proposal likely has minimal impact on economic growth and efficiency. The increased deduction does not mean that all teachers will spend $1,000. Also, many teachers likely are already spending over $250 per year.	N/A
Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?	This proposal is transparent and visible. Since this is not a new law, but an increase to an existing deduction, taxpayers already know how to claim this deduction. Also, K-12 schools are likely to update teachers about this change since teachers spending their personal funds, with a limited tax break, benefits the school.	+

Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?	The minimum tax gap principle is not satisfied because there might be some level of improper claiming of expenses.	-
Accountability to taxpayers – Will taxpayers know the purpose of the rule, why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?	This does not fulfill the accountability to taxpayers because the public is unlikely to understand the reason for the rule, as it is not explained why there would be an increased deduction or why other approaches are not used to help teachers and schools. Taxpayers might consider, for example: How does this compare to other federal, state, and local spending on education?	-
Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?	The appropriate government revenues principle is satisfied because it is easy for the government to predict the revenue loss based on existing data. As the change is just increasing the amount from \$250 to \$1,000, the IRS can estimate the deduction amount likely to be claimed.	+

Summary

Based on our analysis, section four of the Restoring Tax Fairness for States and Localities Act is considered a good tax policy as it fulfils a slight majority of the applicable twelve principles, including equity and fairness, certainty, convenience of payment, effective tax administration, simplicity, transparency and visibility, and appropriate government revenues. On the other hand, the principal neutrality, minimum tax gap, and accountability to taxpayers are not met.

Suggestions for improvement:

1. The IRS could ask for a list of items purchased and remind taxpayers to keep their receipts so that improper allocation of the increased amount will be less likely to increase the tax gap.

2. The sponsor can provide the reason behind the increase deduction as well as why this provision exists for educators and not other employees who might also have to incur employment related costs out-of-pocket.

Tax Policy Analysis

S. 844 (117th Congress) - Personal Health Investment Today (PHIT) Act of 2021

By: Neha Nanda CPA and Karla Rees CFP® EA, MST Students

Introduction

On March 18, 2021, Senator John Thune (R-SD) introduced the Personal Health Investment Today Act of 2021 (S.844, 117th Congress). This bipartisan bill was co-sponsored by eleven Senate members, and there is a related bill, H.R. 3109, co-sponsored by 30 bipartisan members of the House of Representatives. The purpose of this proposal is to "encourage more physical activity in the United States and incentivize healthier living by allowing Americans to use a portion of the money saved in their pre-tax health savings account (HSA) and/or flexible spending fees."[1]

In general, S.844 modifies IRC Section 213 to allow a medical care tax deduction for "qualified sports and fitness expenses." S.844 defines "qualified sports and fitness expenses" as an amount paid for "participating in physical activity" and includes the following: (i) "membership at a fitness facility"; (ii) "participation or instruction in physical exercise or physical activity" or (iii) "equipment used in program of physical exercise or physical activity." The annual limitation on the fitness expense is $2,000 for joint or head of household filers and $1,000 for all other filers. This proposal defines a fitness facility as one "which provides instruction in a program of physical exercise, offers facilities for the preservation, maintenance, encouragement, or development of physical fitness, or serves as the site of such a program of a State or local government."

Expenses that qualify under this proposal include exercise videos, books, and similar material if "such materials constitute instruction in a program of physical exercise or physical activity." Expenses related to sports equipment other than exercise equipment will also qualify if they are used "exclusively for participation in fitness, exercise, sport or other physical activity" and the amount paid for any single item does not exceed $250. In addition, apparel and footwear expenses will qualify if they are not used for any other purpose other than the "specific physical activity." Expenses that do not qualify under this proposal include "a private club owned and operated by its members" and clubs that offer "golf, hunting, sailing, or riding facilities." The amendments made by this proposal will apply to taxable years that begin after the date this proposal is enacted.

[1] Thune, Murphy Reintroduced Bill to Encourage Healthy Living, (March 18, 2021); available at https://www.thune.senate.gov/public/index.cfm/press-releases?ID=18436FDD-2082-4D5D-8D0D-0149AA09DE8E.

According to IRC Section 213, a medical care deduction is allowed for unreimbursed expenses that “exceed 7.5 percent of adjusted gross income”.

Some individuals have a medical benefit plan through their employer, known as a Health Savings Account (HSA) or Flexible Spending Account (FSA). In each of these benefit plans an employee can set aside pre-tax funds, up to a specified annual limit, that can be used to pay for certain qualifying out of pocket medical expenses, including copays, coinsurance, deductibles, and prescriptions for either medical, vision, or dental care, based on the definitions of IRC Section 213. If S.844 was enacted, the qualifying sports and fitness expenses would also be allowed for reimbursement through an individual’s HSA or FSA benefit plans. Taxpayers would be able to receive a deduction on their paycheck through their employer and request reimbursement of the qualifying expense that is processed through these accounts, thereby avoiding federal income, Medicare tax and Social Security tax.

Application of Principles of Good Tax Policy

This section analyzes S.844 using the twelve principles set out in the AICPA’s *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*.[2]

Criteria	Does the proposal satisfy the criteria?	Rating +/-
Equity and Fairness – Are similarly situated taxpayers taxed similarly? Also, consider any different effects based on an individual’s income level and where they live.	Horizontal equity will not be met because similarly situated taxpayers will not be taxed similarly. Tax deductions for U.S. taxpayers with similar income will differentiate based on whether they have medical expenses that exceed the 7.5 percent AGI floor for medical expenses or have access to an HSA or FSA. Some taxpayers will be able to use their Flexible Spending Accounts (FSA) and Health Savings Account (HSA) to pay for medical expenses on a pre-tax basis. However, not all employers provide this benefit. Larger businesses typically provide these, but a vast majority of taxpayers do not use these accounts. For instance, in 2017, Forms W-2 showed that less than 9.7 million taxpayers reported an amount in Box W, which identifies a taxpayer’s HSA deduction through the	-

[2] American Institute of Certified Public Accountants (AICPA) Tax Division. (January2017). Tax Policy Concept Statement No. 1—Guiding Principles of Good Tax Policy: A Framework for Evaluation of Tax Proposals; available at https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf.

	employer.[3] In addition, another 1.2 million taxpayers claimed an HSA deduction outside the employer plan, possibly through individual coverage or self-employed plans that are HSA eligible.[4] The total of these two sources is over 10.9 million returns with HSAs but only represent 7.1 percent of the 153 million returns filed.[5] Similarly, taxpayers in different locations are likely not a factor under this proposal. For instance, swimmers that exercise in colder regions would have access to indoor facilities versus states like California, where some swim clubs workout year-round outside. In both scenarios, taxpayers using their FSA or HSA would qualify for reimbursement of these expenses. Vertical equity partially limits the impact of taxpayers with higher income that will pay more in taxes than taxpayers with lower income due to the qualified expense limitation and the overall 7.5 percent AGI floor. However, many higher-income taxpayers can enroll in an FSA plan or have an HSA and benefit if they do not already exceed the spending account limits. According to the Bureau of Labor Statistics, 44 percent of workers have access to flexible spending accounts, but 70 percent of the workers with access have the highest 10 percent of average wages.[6] Based on this analysis, the equity and fairness principle has not been met.	
Certainty – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?	This proposal does not meet the principle of certainty because individuals will not be able to easily calculate their medical care tax deduction related to "qualified fitness expenses" on their annual filing of tax return due to several reasons including, difficulty calculating the tax base and clarity over definitions related to proposal.	

[3] IRS SOI Tax Stats – Individual Information Return Form W-2, Table 5.A.; available at https://www.irs.gov/pub/irs-soi/17inallw2.xls; accessed 7/16/2021.
[4] IRS SOI Tax - Returns with Itemized Deductions: Sources of Income, Adjustments, Deductions, Credits, and Tax Items, Table 2.2; available at https://www.irs.gov/pub/irs-soi/17in22ms.xls; accessed 7/17/2021.
[5] IRS SOI Tax - Individual Statistical Tables by Size of Adjusted Gross Income, Table 1.6; https://www.irs.gov/pub/irs-soi/17in16ag.xls ; accessed 7/17/2021.
[6] Bureau of Labor Statistics; available at https://www.bls.gov/ncs/ebs/factsheet/flexible-benefits-in-the-workplace.htm#ref2 ; accessed 7/17/2021; https://www.bls.gov/ncs/ebs/benefits/2019/employee-benefits-in-the-united-states-dataset.xlsx ; rows 124793 and 125047.

	The proposal discusses limitations, such as a $250 limitation for an item of sports equipment, and exceptions, such as clubs that offer golf, hunting, sailing, or riding facilities are not qualified "fitness facility" for this deduction. Furthermore, the proposal has a specific definition for what is defined as "qualified sports and fitness expense" and "fitness facility"; however, it does not define terms such as "specific physical activity" concerning apparel and footwear bought for the activity. There is also not enough detail provided for programs that have multiple components. Recordkeeping information is also not listed in the proposal explaining the documents needed from taxpayers to substantiate their "qualified expense" and how they can validate the expense was related to a qualifying item for a "specific physical activity." Furthermore, taxpayers may not know until year-end if they have sufficient medical expenses to itemize.	-
Convenience of payment – is the tax due at a time that is convenient for the payor?	Taxpayers take a deduction on Schedule A of all of their medical expenses and retain the expenses with their payment receipts for proper record keeping. The deduction will reduce taxable income if taxpayer's total medical expenses exceed the AGI floor limit of 7.5 percent and they are itemizing deductions instead of taking the standard deduction. Therefore, no special tax payment is needed under this bill. Furthermore, for taxpayers that use FSA or HSA plans, their paychecks are automatically adjusted, and the proper withholding is calculated on their paychecks.	N/A
Effective Tax Administration – Are the costs to collect the tax at a minimum level for both the government and taxpayers? Also, consider the time needed to implement this tax or change.	The cost to collect the tax at the minimum level for both the government and taxpayers will increase. This bill contains limitations and special definitions on the type of qualified expenses such as "fitness facility," "qualified sports and fitness expenses," etc. The IRS may need to pay more attention to the deductions taken by taxpayers and check related documents to ensure correct deduction is taken and substantiated. For instance, it is unclear from the bill how the IRS will ensure that the "apparel and footwear" are "necessary" and taxpayers are using them for only the "specific physical activity."	-

	Moreover, there are terms in the bill that are left undefined such as programs that include "components," "specific physical activity," a facility that provides "encouragement of physical fitness", hence, the taxpayer may need to consult a tax adviser to understand the terms and what recordkeeping is needed to substantiate these expenses. Therefore, this bill does not meet this principle.	
Information Security – Will taxpayer information be protected from both unintended and improper disclosure?	No additional information changes will need to be made for this proposal because third-party administrators are already equipped with the proper security for those enrolled in an FSA or HSA. This change would require an itemizing taxpayer to keep additional documentation, but protection of these documents would be similar to other medical expense deductions. The principle of information security is met for this bill.	+
Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?	S. 844 does not meet the principle of simplicity as it contains limitations, specific definitions, as well as exceptions. These proposed new rules and definitions may lead to *"unintentional errors"* in calculating the tax deduction or HSA/FSA usage. The taxpayer also might not be aware that certain activities such as sailing, golf facilities are excluded from the tax deduction. Also, some expenditures may cover both included and excluded activities and need to be separated. Taxpayers may need a tax advisor to review their expenses to ensure correct deduction is taken on their tax returns. Furthermore, IRC Section 213 deduction is only available to individuals who itemize their deductions – which is more complex than individuals who take the standard deduction. Taxpayers not expensing items through an FSA/HSA will also need to ensure they meet the 7.5 percent AGI floor to take this deduction under IRC Section 213.	-

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.	This bill does not meet the principle of neutrality primarily because this proposal is intended to encourage individuals to spend more money on physical fitness activities and related items. Even though taxpayers could decide to participate in an additional or different qualified activity instead of exempted activities such as golf and sailing, taxpayers with flexible spending plans could choose to participate in an activity where they would otherwise not choose to do so without this bill. S. 844 would encourage taxpayers to participate in qualified activities for a potential tax benefit. However, the tax savings for those without an HSA or FSA are minimal or non-existent (since they might not itemize or have enough medical expense to claim that deduction).	-
Economic growth and efficiency – will the tax unduly impede or reduce the productive capacity of the economy?	This bill does not meet the economic growth and efficiency criteria because it impacts specific fitness facilities and companies that manufacture exercise equipment, fitness apparel, fitness videos more than any other type of organization. This bill could promote health and fitness activities, but not all health and fitness activities are included in this bill. This may adversely impact businesses or clubs that offer activities such as golf, or sailing. Furthermore, providing this deduction to taxpayers may decrease the government's revenue and compensate for the lost revenue by increasing taxes elsewhere. Other consequences of positive health benefits could reduce an individual's need for prescriptions to lower blood pressure or cholesterol levels. This could also deter individuals from eating unhealthy foods and reduce their spending at restaurants, although perhaps increasing their sending on natural foods.	-
Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is	Taxpayers may read articles or IRS publications on the addition of allowable medical expenses. However, it is likely that fitness gyms and fitness equipment companies would advertise the new law if passed to solicit additional revenue. This type of advertising could lack details of the tax law and cause misunderstanding.	

imposed upon them and others?	The overall deduction is based on an individual's AGI, their qualified fitness expense and can be easily calculated. However, the taxpayer will have to keep track of their AGI, other above-the-line deductions, qualified fitness expenses to ensure they have expenses of more than 7.5 percent to get the tax deduction on their tax return. In addition, there is likely to be confusion on the actual tax saving which are small given that a deduction is only allowed if all unreimbursed medical expenses for the year exceed 7.5 percent of AGI and the savings depends on the taxpayer's tax rate. A single person in a 20 percent bracket will save just $200. Additionally, the businesses that provide employees with HSA and FSA benefits should be informed of the included additional qualified medical expenses. Hence, this bill is neutral on the principle of transparency and visibility.	+/-
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?	S. 844 does not meet the minimum tax gap principle. There is a higher likelihood of intentional and unintentional non-compliance. For instance, individuals may purchase clothing and footwear for purposes other than the "specific physical activity". There are many terms in the bill that are left undefined; hence, increasing the chance of unintentional compliance with taxpayers.	-
Accountability to taxpayers – Do taxpayers have access to information on tax laws and their development, modification, and purpose; is the information visible?	Taxpayers may read articles or IRS publications on the addition of allowable medical expenses. Information will also be available upon enrolling in FSA or HSA plans of allowable expenses. Taxpayers will be held accountable to third-party administrators of FSA and HSA plans, as the taxpayer will need to provide documents to substantiate the reimbursement. However, the proposed bill does not clarify how spending more on paid fitness activities, and related items will help their health goals. For example, a taxpayer may get the	+

	same health benefit by participating in free fitness activities – such as hikes and eating healthy. Also, joining a gym does not necessarily mean the person will use the equipment that improves health as many gyms also sell high-calorie food or offer massages and other items not always associated with improved physical health. Thus, taxpayers may be confused about the purpose of the bill.	
Appropriate government revenues– will the government be able to determine how much tax revenue will likely be collected and when?	S. 844 does not meet the appropriate government revenues criteria. Depending on their economic situation, their AGI amount, and their medical and dental expenses, they might take this deduction or opt to take the standard deduction. Moreover, participating in qualified fitness programs is at the discretion of the taxpayer. Hence, the government will likely struggle to get a good estimate of the cost of this bill and how many taxpayers will take this deduction or increase contributions to their flexible spending plans or health savings accounts.	-

Conclusion

S.844 modifies the IRC Section 213, Medical, Dental, etc., expenses by adding “qualified sports and fitness expenses.” Although this proposal has appears to have the best intentions of promoting healthier lifestyles and providing incentives for individuals, based on the above analysis, it is not a good idea as presented due to the following reasons.

Higher-income taxpayers are more likely to afford to enroll in qualified fitness expenses and purchase fitness gear and equipment; however, they may already have good health insurance so are unlikely to claim a medical expense deduction. By including qualified fitness expenses in IRC Section 213, taxpayers can use their flexible spending plans, health savings accounts or add to their itemized deductions these new medical expenses. Again, this won’t benefit most taxpayers as they don’t have these plans.

Some terms are left undefined for taxpayers increasing the complexity of the bill. For instance, S.884 defines a fitness facility as a facility that provides physical exercise, “offers facilities for preservation, maintenance, encouragement, or development of physical fitness or serves as a site of such program of a State or local government.” However, terms such as “encouragement” “preservation” are not defined. Similarity, in sections where limitations are discussed for apparel and footwear, terms “necessary” and “specific physical activity” are not defined. The term “components” is also not clarified in the section of the bill that discusses “programs which include components other than physical exercise and physical activity.”

Even though S. 844 aims to encourage physical activity and provide incentives to taxpayers, this bill fails to explain why certain clubs and activities are excluded from generating the tax break. The bill defines qualified fitness expenses to include fitness facility membership costs, participation or instruction in physical activity, or equipment costs used in a physical exercise/activity program. However, it excludes certain physical activities and clubs. For instance, the proposal specifically excludes private clubs owned and operated by its members or clubs that offer golf, hunting, sailing, or riding facilities. It also does not discuss how it may impact free activities individuals participate in, such as walks around the neighborhood, hiking, etc., which are equally good at promoting health. The proposal should equally value all physical activities.

Under this proposal, the cost for exercise videos, books, and similar material will also qualify. However, it is unclear if taxpayers will use them long-term to keep up their health and physical activity. It is also unclear how the IRS will ask taxpayers to substantiate if they use the apparel and footwear only for the “specific physical activity.”

S.844 should be modified to include more definitions of the terms, discuss why certain activities were excluded, describe how it will work with the IRC Section 213 medical and dental expenses and other code sections, and how the taxpayers should substantiate their expenses. In addition, there are better and less expensive alternatives to promote a healthy lifestyle, such as public service campaigns on the benefits of walking and healthy eating or creation of government funded parks and fitness facilities that can benefit those unable to afford gym memberships.

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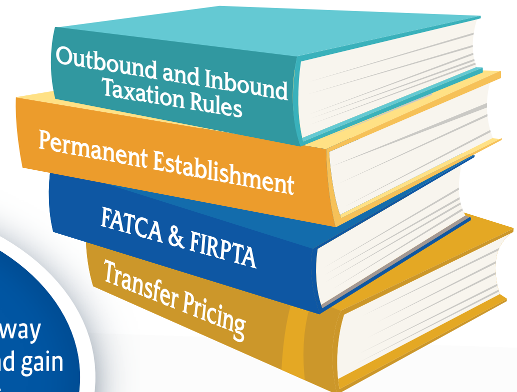

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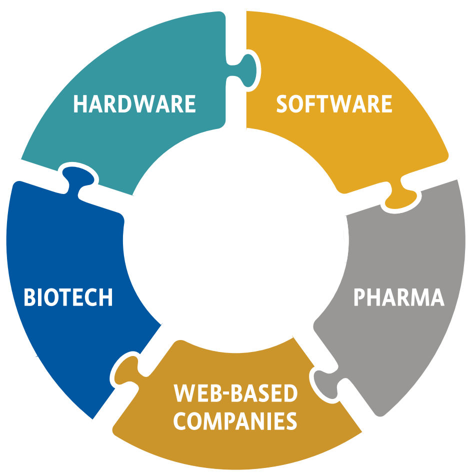

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