Welcome to
The Contemporary Tax
Journal

SJSU MST Journal
# TABLE OF CONTENTS

**LETTER FROM THE EDITOR** .................................................................................................................. 4

**TAX ARTICLE**

Countering Identity Theft and Strengthening Data Security Practices Across The Tax Preparer Community................................................................. 6

**TAX MAVEN** ........................................................................................................................................... 18

**TAX ENLIGHTENMENT**

An Introduction to the Tax Intricacies of Executive Compensation.................. 22

**FOCUS ON TAX POLICY**

H.R. 1362, Broadening Online Opportunities through Simple Technologies Act........................................................................................................... 33

AB 1121, Sales Tax Exemption Emergency Preparation Items......................... 39

S. 2511, Revitalizing Downtowns Act................................................................. 47

**TAX FEATURES – SUMMARIES FROM THE 2021 37TH ANNUAL TEI-SJSU HIGH TECH TAX INSTITUTE AND THE 27TH ANNUAL TAX PRACTITIONER/IRS FALL SEMINAR**

Global Mobility Taxation....................................................................................... 53

IRC Section 1202................................................................................................. 61

Digital Services Taxes........................................................................................ 63

Evolution During a Pandemic............................................................................. 65

**GLEIM CPA REVIEW QUESTIONS** ......................................................................................... 68

**ADVERTISING** .................................................................................................................. 80
Letter from the Editor

I and our editorial board are excited to present to you the Winter 2022 issue of *The Contemporary Tax Journal*, a publication of San Jose State University’s MS in Taxation (MST) Program. Over the past few months, we worked with SJSU MST students, professors and practitioners to present you this edition. The topics covered in this issue are current and thought-provoking.

Our 11th volume begins with an article written by five professors on countering identity theft and strengthening data security practices across the tax preparer community.

Next, we have our *Tax Maven* interview with Ray Beeman who is co-leader of Ernst & Young’s Washington Council. He offers students and new tax practitioners’ knowledge from his experiences and valuable advice as a successful tax lawyer. I was honored to have a Zoom interview with him and learn about his remarkable career in the tax field. I hope his insights and experience will inspire your professional goals. Mr. Beeman has been a frequent speaker at past TEI-SJSU High Tech Tax Institutes.

Following the interview, we have our section dedicated to *Tax Enlightenment*. This section includes an article written by SJSU MST student, Jane Lei, CPA where she covers the intricacies of executive compensation.

Our ensuing feature, *A Focus on Tax Policy*, presents the analysis of three tax proposals by SJSU MST students: H.R. 1362, Broadening Online Opportunities through Simple Technologies Act, by Tracy Than and Yulin Ke; California AB 1121, Sales Tax Exemption Emergency Preparation Items, by Pooja Karelia, CPA and Sheetal Partani, EA; and S. 2511, Revitalizing Downtowns Act, by the Fall 223A Tax Research class of MST students and myself. These tax bills were analyzed using the Guiding Principles of Good Tax Policy outlined in the AICPA Tax Policy Concept Statement No. 1.¹

We then present summaries written by MST students on presentations made at the 37th Annual TEI-SJSU High-Tech Tax Institute and the 27th Annual Tax Practitioner/IRS Fall Seminar held in November 2021. The topics covered at the High-Tech Tax Institute include issues with digital services taxes, opportunities and challenges associated with the IRC Section 1202 gain exclusion, and the current state of global mobility taxation.

Lastly, we are grateful to Gleim CPA Review for providing us with practice CPA exam questions that we hope everyone finds stimulating.

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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 our MST coordinator and journal webmaster Catherine Dougherty. Their insights and hard work made this issue of the journal possible.

I invite you to enjoy reading our journal and hope you will consider contributing to our upcoming issues. I now present to you the Winter 2022 issue of *The Contemporary Tax Journal*.

Regards,
Tam Nguyen
Student Editor
Countering Identity Theft and Strengthening Data Security Practices Across the Tax Preparer Community

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Countering Identity Theft and Strengthening Data Security Practices Across the Tax Preparer Community

Abstract

The IRS has renewed its commitment to tackle the ongoing problem of taxpayer identity theft, announcing the 2021 “Boost Security Immunity” initiative to raise awareness among tax practitioners and strengthen data security industry wide. Considering these developments, we reexamine the 2019 Taxpayer First Act against the backdrop of a growing trend of taxpayer fraud, tax preparer duties with respect to client data, and emerging IRS and Congressional efforts to confront tax return security challenges. Holding client data remains a solemn responsibility for accountants and tax preparers. Strong security practices critical to client safety, and essential to the integrity of the federal, state, and local tax systems. The COVID-19 pandemic, and the wholesale switch to remote work conditions, further illustrates the need for a renewed commitment to vigorous data protection practices. Finally, we address the need for financial institutions to reassess and strengthen data management and security practices.

Keywords: Taxpayer First Act; Data Privacy; Data Security; Cyber Security
Introduction

Holding client data has never been a more serious or consequential matter for accountants and tax preparers (Ryle et. al, 2020). The COVID-19 pandemic, which forced many employees to work remotely and electronically, saw significant increases in the number of identity theft originating from tax-preparers (IRS, 2021b). These events have highlighted the pressing need for a renewed commitment to ensure that tax professionals properly store and protect data. Not only must accountants protect data from exfiltration but must also comply with increasingly complex and restrictive data privacy laws (Ryle, et. al, 2021). Tax preparers have long faced the relentless attack of cybercriminals seeking to appropriate and profit from taxpayer data, and for many years, taxpayer data theft and tax return fraud cases were on the rise. Fortunately, the Internal Revenue Service (IRS) has taken firm action to address these challenges by forming the Security Summit, devoted to addressing the problem. Congress has also stepped forward to help strengthen taxpayer security by passing the 2019 Taxpayer First Act (the TFA). This paper examines the history of taxpayer fraud, emerging accountant and tax preparer data protection obligations, and the status of IRS and Congressional efforts to confront security challenges.

Taxpayer data security is essential to the integrity of the federal, state, and local tax systems. Taxpayer data has become increasingly valuable to cybercriminals bent on committing tax return and other financial fraud. While criminals have largely targeted taxpayers in the past, they have increasingly begun to focus on the preparer community, due largely to the massive amounts of personal data held by such professionals (Schlesinger and Day, 2018; Morgan, 2016; Smith, 2015). The development of the tax fraud threat into a full-scale crisis has amplified the seriousness of holding and protecting client information (Burt, 2019). To address the crisis, the IRS has now operated an industry-wide working group known as the “Security Summit” to collectively confront these challenges. Between 2015 and 2016, the IRS convened a group of state tax agencies and officials from the private-sector tax industry to create the Security Summit. The Security Summit has a total membership that includes over 40 state agencies and over 20 individuals from the private sector and organizes its work into six distinct work groups – authentication, financial services, information sharing, strategic threat assessment, communication and taxpayer awareness, and tax professional (IRS, 2019d).

Methods

We used a process of legal research and analysis to wholistically address the legal and practical issues surrounding identity theft in the tax preparation business environment. Legal research was conducted regarding data security and other legal considerations. Relevant case law, statutes, and regulations were examined as well as tax and reporting requirements to capture a wholistic view of the issues.

Once all relevant authority was researched and examined, the IRAC method of legal analysis was applied to the issues surrounding tax data security. The IRAC process includes the issue, rule, application and conclusion approach to legal research and analysis. It has been referred to
as the “most used method to express legal analysis” (Mitra, 2019). In this analysis, the issues regarding tax data security were segregated into tax issues, privacy issues, data security issues and practical concerns. Secondly, applicable laws, rules, statutes, and financial reporting requirements were applied to present a complete understanding of the implications and applications of those rules, based on data security issues and their relevance to tax preparation. Lastly, practical guidance and advice was given based on our conclusions from our analysis.

**Tax Preparer Data Security and Privacy Challenges**

In 2015, the IRS received 677,000 victim reports of identity theft of tax return information (IRS 2019a). As a result, traditional challenges to data security have remained a serious and growing concern to taxpayers and accountants. CPAs and tax preparers have long held a legal obligation to maintain standards for privacy and data management to safeguard information provided by a taxpayer while preparing a return. The Financial Services Modernization Act of 1999 – known more commonly as the Gramm-Leach-Bliley Act (P.L. 106-102) – established requirements for financial institutions, including CPAs and tax preparers, concerning the collection, disclosure, and protection of consumers' nonpublic and/or personally identifiable information. Financial institutions are required to comply with the GLBA, having an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers’ nonpublic personal information and must establish and maintain a privacy policy to protect users against foreseeable security and data threats.\(^1\)

There are three major provisions of the GLBA that govern the collection, disclosure, and protection of consumers' nonpublic personal information, or personally identifiable information: (1) the Financial Privacy Rule, (2) the Safeguards Rule, and (3) the Pretexting Protection. First, the Financial Privacy Rule\(^2\) requires financial institutions to provide each consumer with a privacy notice explaining information collection practices. This rule further governs disclosure about why information is stored and used, how and with whom collected information is shared, and steps taken to protect and safeguard the information. Secondly, the Safeguards Rule requires that all financial institutions “develop, implement, and maintain a comprehensive information security program.”\(^3\) The third major privacy contribution of the GLBA, the Pretexting Protection, prohibits the practice of obtaining information by false pretenses, such as using phishing schemes.\(^4\)

Accordingly, the GLBA’s three major rules, financial privacy, institutional safeguards, and pretexting protection, have provided the background for privacy practices and compliance obligations for many years in the United States. In general, tax, accounting, and CPA firms,

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\(^1\) U.S.C. §6801(a).
\(^2\) Codified at Section 15 U.S.C. §6801 et.seq.
\(^3\) Codified at Section 15 U.S.C. §6801(b) and §6805.
regardless of size, must comply with The Gramm-Leach-Bliley Act subject to certain disclosure exemptions.\(^5\)

**IRS Takes Action to Address the Problem**

The world has changed considerably since the passage of the Gramm-Leach-Bliley Act in 1999. Increased use of technology has resulted in expanded numbers of data security breaches and taxpayer identification fraud. In 2015, the IRS decided to act by devising a tax industry-wide crackdown on identity theft (McCoy, 2017). Concluding that the IRS could not solve this problem alone, then IRS Commissioner John Koskinen convened a group of tax industry stakeholders which has come to be known as the “Security Summit,” to collectively tackle problems and explore solutions (IRS, 2021a). As of 2021, total membership of the Security Summit included 42 state agencies and 20 industry offices, in addition to the Internal Revenue Service. Stakeholders include tax preparers, software developers, payroll and tax financial product processors, tax professional organizations and financial institutions.

One of the Summit’s major initiatives was to set up and establish the Identity Theft Tax Refund Fraud Information Sharing and Analysis Center (ISAC) (IRS, 2018b) for the purpose of enhancing fraud detection and prevent the processing of false refunds (Cohn, 2019). This tax practice industry group continues to work together to address challenging cyber-security problems. The Security Summit is divided into six working groups, each with a dedicated focus. These work groups are: (1) the Authentication Work Group, (2) the Financial Services Work Group, (3) the Information Sharing Work Group, (4) the Strategic Threat Assessment and Response (STAR) Work Group, (5) the Communication and Taxpayer Awareness Work Group, and (6) the Tax Professional Work Group. Each working group is tasked with addressing one of the many complex aspects of the cyber privacy issue. The working groups are co-led by representatives from the IRS, states, and industry (IRS, 2019d).

**IRS Efforts Lead to Improved Security**

Since the start of the 2015 Security Summit Initiative, the IRS has been making headway and the security landscape has steadily been improving. In its first two years, the IRS reported significant results: a “57% decline in confirmed identity theft returns and a 65% decline in the number of taxpayers reporting themselves as victims” (IRS, 2018a). Financial industry partners also contribute to the success of these initiatives, recovering more than $1.4 billion in fraudulent refunds between 2016-2018 (IRS, 2019a).

The Security Summit Initiative has issued an ongoing call for perpetual vigilance in combatting fraud and identity theft. In partnering with the tax community to get the message out to the public, the Security Summit Initiative has produced a checklist to guide tax professionals into practicing more securely and safely. This checklist is provided in Figure 1. On July 24, 2019, the IRS issued a news release reminding professional tax preparers of the Gramm-Leach-Bliley requirement to have a data

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\(^5\) Exemptions provided by 15 U.S.C. §6803(d).
protection security plan (IRS 2019b). Many of the elements of the checklist correspond to recommended actions as provided by IRS Publication 4557, which also asserts that the information security plan must be appropriate for the company’s size and complexity, the nature of its business, and the type of customer information that is maintained (IRS, 2021c).

**Figure 1. The Taxes-Security-Together Checklist**

- **Deploy the “Security Six” measures:**
  - Activate anti-virus software.
  - Use a firewall.
  - Implement an effective multi-factor authentication (MFA) system (All tax return software will offer MFA beginning in 2022) (IRS, 2020).
  - Use backup software/services.
  - Use drive encryption.
  - Create and secure Virtual Private Networks.
- **Create a data security plan:**
  - Federal law requires all “professional tax preparers” to create and maintain information security plan for client data.
  - The security plan requirement is flexible enough to fit any size of tax preparation firm, from small to large.
  - Tax professionals are asked to focus on key risk areas such as employee management and training; information systems; and detecting and managing system failures.
- **Educate yourself and be alert to key email scams, a frequent risk area involving:**
  - Learn about spear phishing emails.
  - Beware ransomware.
- **Recognize the signs of client data theft:**
  - Clients receive IRS letters about suspicious tax returns in their name.
  - More tax returns filed with a practitioner’s Electronic Filing Identification Number than submitted.
  - Clients receive tax transcripts they did not request.
- **Create a data theft recovery plan including:**
  - Contact the local IRS Stakeholder Liaison immediately.
  - Assist the IRS in protecting clients’ accounts.
  - Contract with a cybersecurity expert to help prevent and stop thefts.

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The 2019 The Taxpayer First Act (TFA)

On July 1, 2019, Congress joined the efforts to strengthen taxpayer data security and IRS privacy practices when the President signed into law the bi-partisan Taxpayer First Act (TFA). The TFA is designed to strengthen cybersecurity by imposing stricter security and data protection standards on tax practitioners (Kess and Hurok, 2019). Section 2001 of the TFA provides that the Treasury Department must:

1. Work collaboratively with the public and private sectors to protect taxpayers from identity theft refund fraud,
2. Ensure that the Electronic Tax Administration Advisory Committee studies and makes recommendations on methods to prevent identity theft and refund fraud,
3. Establish a program to issue an identity protection identification number to taxpayers,
4. Establish a single point of contact in the IRS for taxpayers whose returns have been adversely affected due to a tax-related identity theft,
5. Notify taxpayers of suspected identity theft, and
6. Develop and implement publicly available guidelines
   a. for management of cases involving identity theft
   b. refund fraud

(Taxpayer First Act, 2019, §2001).

TFA Identity Protection Personal Identification Number

Taxpayer identification challenges remain a major problem. Largely due to data breaches, the reliability of traditional identification methods such as the Social Security number have now been compromised beyond repair. To this point, a 2019 Government Accountability Office (GAO) report posited that “large-scale data breaches like the 2017 Equifax hack have made Social Security numbers and other signifiers so prevalent on the black market that they are essentially useless for authentication” (Johnson, 2019). Over the long run, the IRS and Congress have determined that the reduction in the reliability of social security numbers as a means and method of identifying taxpayers, requires the development of a new identification method.

To address the demise of the reliability of Social Security numbers, the TFA creates a new Identity Protection Personal Identification Number (IP PIN) which may eventually replace Social Security numbers as a mechanism of taxpayer identification. By 2024, the IRS must be prepared to issue IP PINs to any US resident who requests one (TFA, 2019, §2005).

The TFA Raises the Stakes: Increasing Civil and Criminal Penalties

The impact of data theft to taxpayers is frightening. While taxpayer victims of identity theft face significant financial and legal consequences, which can last a lifetime, the risks to tax preparers are
also severe. Failure to take measures to properly protect client data has traditionally exposed accountants to potential civil liability as well as possible disciplinary actions by licensing authorities and the IRS. Moreover, accountants could traditionally even face criminal liability under I.R.C. §7216 for failing to take necessary data security measures (Roane, 2016). I.R.C. § 7216 and §6713 impose serious criminal and monetary penalties on tax preparers who knowingly or recklessly disclose tax return-related client data or information. Pre-existing criminal penalties under IRC §7216 and §6713 provide serious criminal and civil penalties for return preparers who wrongfully disclose information provided in assistance with a taxpayer return. Prior to the TFA, the civil penalty is $250 for each unauthorized disclosure or use, up to $10,000 per calendar year. The corresponding criminal penalty is a misdemeanor, with a fine of up to $1,000, one year of imprisonment, or both (Petronchak, 2019).

The TFA has increased the severity of civil and criminal penalties for failure to protect taxpayer data. Under new provisions of the TFA, tax preparer penalties will increase. Congress is serious about strengthening cyber security standards and has notably increased the criminal financial penalties. Specifically, under the TFA, the penalty is increased for improper use or disclosure in connection with a crime relating to the theft of a taxpayer’s identity (whether or not it involves any tax filing). In these instances, the civil penalty is increased from $250 to $1,000. The calendar-year limitation is also increased, from $10,000 to $50,000. The maximum fine under a criminal penalty for a violation involving identity theft is now increased to $100,000 (Petronchak, 2019).

**Recommendations for Practice**

Data protection is of heightened concern as many employees were forced to work from home during the coronavirus pandemic. As many companies reimagine and reorient workspaces, work-from-home or hybrid arrangements are likely to be an ongoing part of the employment landscape. Practitioners must take data protection and privacy obligations seriously and deliberately. The stakes have never been higher, and accountants must make a commitment in time and resources to managing and protecting data. A good place to start the process would be by conducting a thorough independent third-party organizational risk assessment, as well as by appointing an organizational Chief Information Security Officer (CISO).

It is incumbent upon all financial institutions to perform an assessment of their current status with regard to data management. At a minimum, this assessment should include a mapping process of the firm’s security organizational control system, and an examination of the following questions:

1. What controls are in place to protect this information and the firm/organization’s data infrastructure?
2. What defenses exist and how can they be strengthened?
3. What are your firm’s weaknesses and how can you reduce them?
4. Does your firm have a response and notification process in place in the event of breach?
5. Does your firm have adequate insurance coverage?

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Recommendations for Further Research

The enormity of cyber-privacy issue is one that will require ongoing vigilance in the field, co-operation among many agencies at the international, national, state, and local levels, and presents many opportunities for further research. Some of the areas that we recommend for further research are: assessing compliance by financial institutions with recently enacted legislation, determining the efficacy of such compliance, and examining challenges in implementing strong cyber security protection practices. Additional research should also include analyses of data protection in the work-from-home and hybrid environments.

Conclusion

Currently, every state has some regulation defining how companies must respond to a data breach. Moreover, recently passed legislation at the state and international level, such as the California Consumer Privacy Act (CCPA), and the European General Data Protection Regulation (GDPR), currently extend liability to holders of personal information/data who are subject to a breach.

However, these measures address breaches that have already occurred. CPAs and their clients must (1) question the extent to which they need to obtain and hold consumer data, (2) assess the current processes in place, (3) implement a rigorous internal system to protect this data, and ultimately the consumers whose data the firms hold, and (4) continue to monitor current trends in data management in the ever-changing technology landscape. Possession of data carries with it serious responsibilities and major risks. Consumer privacy rights and a corresponding business responsibility to protect consumer data have become one of the leading business issues of our time. Failure to proactively manage this challenge can expose financial institutions, which include CPA and accounting firms, to substantial exposure and associated costs.
References


California Consumer Privacy Act of 2018, California Civil Code § 1798.100-199.


Tax Maven

The Contemporary Tax Journal’s Interview with Mr. Ray Beeman

By: Tam Nguyen, MST Student

Ray Beeman is the co-leader of EY’s Washington Council Ernst & Young practice where he provides clients with strategic advice and representation on issues and developments involving tax and budget policy. Prior to joining EY, Mr. Beeman was Tax Counsel and Special Advisor for Tax Reform with the U.S. House Committee on Ways and Means. He also served Congress as Legislation Counsel for the Joint Committee on Taxation where he was involved in several tax legislative proposals that were passed by Congress and signed into law by the President, including the American Jobs Creation Act of 2004.

Mr. Beeman is a graduate of the University of California at Berkeley and received a J.D. from Pepperdine University School of Law, as well as an LL.M. in taxation from Boston University School of Law. Ray is a member of the State Bar of California and the DC Bar.

I had the pleasure to interview Mr. Beeman on January 7, 2022 via Zoom. He was extremely personable and very enthusiastic about tax policy. Mr. Beeman and I delightfully conversed about being an attorney at a Big 4 accounting firm and how tax policy gets enacted. Below are the thoughts and experiences he was kind enough to share with The Contemporary Tax Journal.

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

Through two and a half years of law school and certainly during college, I had no conceivable notion that I’d ever be interested in tax law (I thought I wanted to be an antitrust lawyer, at least until I took an antitrust class). I always hated math; I was all about words rather than numbers. Fortunately, I went to a law school that required a basic tax course, which was not typical then, but I delayed taking the course until the last semester of my last year. Turns out the whole topic clicked for me. I received the highest score of any course I took in law school, and I had a great professor. My only regret is that I didn’t take the course earlier in law school so that I could have taken more tax classes, but I couldn’t wait to enroll in an LLM program.

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

My most significant career accomplishment to this point has to be my involvement in working for the House Ways and Means Committee and helping draft Chairman Dave Camp’s Tax Reform Act of 2014 (H.R. 1), important parts of which later became the GILTI and FDII provisions of the Tax Cuts and Jobs Act. Second would be my time working for
the Joint Committee on Taxation and helping draft the American Jobs Creation Act of 2004, which at that time included the most significant corporate and international tax reforms since the Tax Reform Act of 1986. Being able to work for the American people in Congress has been the greatest honor of my career, an opportunity that I had never thought would come my way.

3. **How did you get involved with the legislative and policy aspects of tax work?**

In 1996, I was offered the opportunity to move to Washington DC and join EY’s National Tax Department, where I had the opportunity to work with an entire building filled with brilliant colleagues who previously worked at the IRS and Treasury Department, and my interest in tax policy grew from there. Fortunately, EY totally supported my desire to pursue tax policy more fully by leaving the firm for a position in government, which initially turned out to be the Joint Committee on Taxation.

4. **How do you and your firm get comments to lawmakers about needed law changes or comments on active legislation?**

Hill tax staff tend to be very accessible and there is no special process for giving them comments on active tax legislation or proposals for tax legislation. If anything, even though your constituency as a Hill staffer reaches far beyond that of a particular client like in private practice, it can often feel like you are doing important but complicated technical work in a vacuum, so I encouraged or even urged people to comment on my work or what I should be working on. Of course, I tended to open emails first from people I knew versus people I didn’t know, but I tried to eventually open and respond to all of them. Comments that are more technical in nature (versus comments on policy choices) should start with the Joint Committee on Taxation.

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

Without question the federal tax legislative process would benefit from less reliance on revenue as a proxy for policy. In other words, too often the policy merits of a legislative proposal are equated with how much revenue the proposal raises or loses, and the increasing use of the budget reconciliation procedures to pass tax legislation has made this problem worse. This is not a new issue. I can’t say exactly when it became a problem, but it dates back to at least the 1990s. I would highly recommend that everyone read Professor Michael Graetz’s 1995 article entitled, “Paint-By-Numbers Tax Lawmaking,” to better understand this dynamic, which I don’t see changing anytime soon, unfortunately.

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

As with any field of law or even beyond, make sure it really is your passion, because
you’re going to be doing it for a long time. For a career in tax specifically, endeavor to gain exposure to as many areas of tax as possible early in your career, and don’t be surprised if you end up gravitating towards a particular area that you might not have anticipated. The same holds true about different career paths in the private sector, public sector, and academia. And just because a particular area might be trendy or seem to offer better job prospects doesn’t necessarily mean it’s the right one for everybody. The great thing about a career in tax is that it offers so many different paths to excellence.

Second, don’t get overly focused on choosing a particular area at the outset of your career. Inevitably, your path will change as opportunities arise or you learn more. I’ve often told younger people that wherever they start their career in tax won’t be where they end it. Far more often than not, that ends up being the case.

Finally, devour as much information and knowledge as you can early in your career because that gets much harder to do later on as you acquire more responsibilities both professionally and personally. Conversely, find opportunities and topics to write and publish your own articles. Admittedly, it has become more challenging for younger tax lawyers to find time to write and publish articles, but it’s a great opportunity to differentiate yourself from the pack and build your brand.

Fun Questions:

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

I would like to have dinner with Isaac Steele Sr., who served in the South Carolina 2nd Regiment during the American Revolution. I am a descendant of his. Needless to say, I would be fascinated to hear him describe what it was like to witness and fight for the birth of our nation, but I also think he would be amazed at what this nation has become and hopefully gratified to hear that the spirit of service to our country – whether it be military or civilian – lives on to this day in his family tree.

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

I keep a Masai talking stick in my office. The Masai are an ancient people who live in the Rift Valley of Africa, and they use the talking stick as a tool of communication. In a group setting, only the holder of the talking stick is permitted to speak. In order for someone else to speak, the stick must first be yielded to them (not too different from a speaker on the House or Senate floor yielding to another member to speak).
Ray Beeman and Tam Nguyen, January 7, 2022 (Zoom Interview)
An Introduction to the Tax Intricacies of Executive Compensation

By: Jane Lei, CPA, MST Student

Executive compensation is a multi-faceted and complex topic, engulfed in acronyms and legalese and frequently involving confounding numbers that boggle the minds of those on the outside. Just think of Elon Musk’s headline-grabbing series of sales of Tesla (TSLA) shares which he started in November 2021. In a tweet¹, Musk famously solicited input from his 60+ million Twitter followers on whether he should sell some of his TSLA stock, adding that he will abide by the results of the poll. He has since sold over $10 billion worth of shares (as of the date of writing this article) with more sales expected to come, as he reportedly faces a $15 billion tax bill on TSLA stock options that are set to expire in the coming months.

Interestingly, the way Musk has sold TSLA stock led some Twitter users to dissect his sale transactions, specifically his rationale for selling existing common stock as opposed to exercising stock options and selling a portion of those shares instead. One Twitter user openly wondered whether Musk was trying to increase his tax liability, noting “… Possible he’s selling existing common shares to increase the taxes he’s giving to the government, Would be kind of crazy but something Elon might do.”² In typical Musk fashion, the Tesla executive responded to confirm the observation in a tweet: “A careful observer would note that my (low basis) share sale rate significantly exceeds my 10b (high basis) option exercise rate, thus closer to tax maximization than minimization.”

Exercising stock options triggers ordinary income tax. Often, such exercises will be transacted on a “cashless basis,” with a portion of the exercised shares sold immediately to cover the recipient’s income tax liability. Selling existing common stock shares to cover the tax liability of an options exercise seems counter intuitive as additional capital gains tax will apply on those sales.

It certainly isn’t an everyday occurrence to see someone seemingly intentionally trying to pay more taxes. Per the company’s 2021 proxy statement³, Musk, as the company’s chief executive officer, historically earned a minimum wage base salary. He never accepted the cash salary, and

¹ Elon Musk (@elonmusk), “Much is made lately of unrealized gains being a means of tax avoidance, so I propose selling 10% of my Tesla stock. Do you support this?”, November 6, 2021, 12:17 p.m., https://twitter.com/elonmusk/status/1457064697782489088.
² Dave Lee (@heydave7), “Never heard that cost basis determines which shares need to be sold. I think he can choose which shares to sell. Possible he’s selling existing common shares to increase the taxes he’s giving to the government. Would be kind of crazy but something Elon might do.” November 13, 2021, 2:38 p.m., https://twitter.com/heydave7/status/1459654348804403200.
it was eventually eliminated by the company at his request. All of Musk’s compensation from Tesla has been equity-based and tied to the company’s performance. The shares in question that are set to expire in 2022 were granted in 2012 as performance-based stock option awards. According to the company’s disclosures in its proxy statement, Musk beneficially owned 244,018,640 shares, or 23.1 percent, of the company’s common stock as of June 30, 2021. This included common stock outstanding and common stock subject to options and other convertible securities.

While Musk is not your typical executive and the magnitude of his compensation arrangement is certainly extraordinary, by any standard, executive compensation has been soaring and has reached unheard of heights in recent years. How many of us can even dream of compensation in the millions, let alone billions, of dollars?

**Executive Compensation – Why is it important?**

A well thought out executive compensation plan helps companies attract, reward, and retain its key employees and motivate them by aligning their compensation with the company's goals to ultimately create shareholder value. It is arguably one of the most important factors in an organization’s success. Beyond the need to be competitive and to drive performance, an executive compensation program must operate within the confines of tax rules and regulations and compliance requirements. And, especially with large, public corporations, executive compensation is often subject to intense public scrutiny. Compensation that is perceived to be excessive may incur the wrath of negative public opinion, although there are no bright-line rules that define what would constitute “reasonable” compensation.

Understanding the laws will help companies and executives navigate the complexities to plan for and maximize their tax efficiency. Because of the variety and intricacies of executive compensation arrangements, both the business and the executive should research available options thoroughly to optimize their respective situations.

An executive compensation package generally includes at least some, if not all, of the following components:

- a base salary,
- annual or short-term incentives (bonus),
- deferred or long-term compensation including retirement savings benefits,
- benefits and perquisites (or “perks” such as subsidized health insurance, business travel and meals).

Unlike for most other employees, a large portion of an executive’s compensation, generally the portion that’s deferred, is at-risk. This means that it is subject to specific conditions, such as the completion of requisite service periods or the achievement of performance objectives. Hence, if the executive’s performance and/or that of the company fail to meet expectations or plans don’t materialize, the executive may only receive a fraction of their potential pay.
deferring compensation does not eliminate the payment of taxes, it does defer the obligation to pay income taxes to a future period. As far as tax planning goes, the deferred components of an executive compensation package will undoubtedly have the most compelling opportunities for the executive. The impact of deferrals can be significant, if one can adjust the timing of income to minimize her or his ultimate tax liability. The most common rationale for deferral is when the recipient expects to be in a lower tax bracket in a future year, in which case, tax deferral would be a great tax planning tool.

Generally, cash compensation is taxable to the employee or service provider in the year it is received. Transfers of stock or other property is taxed in the same manner based on its fair market value (“FMV”). Employers may take a tax deduction for compensation in the year it is paid to, received, and recognized as income by the recipient. However, what about compensation to which an executive has a legally binding right but has not technically been received by the executive? This article seeks to highlight some of the key tax implications and planning considerations pertaining to executive compensation, both from the corporate employer’s as well as the executive’s perspective.

**Section 162(m) - $1 Million Deduction Limit**

For starters, section 162(m) of the Internal Revenue Code (IRC) imposes a $1 million per year limit on the deductibility of compensation paid to certain “covered employees” of publicly traded corporations. “Covered employees” are defined in section 162(m)(3) as the principal executive officer, the principal financial officer, and anyone who served in either role during the taxable year, as well as three other highest-paid employees of the company. Per the rules, any individual who was a covered employee for a tax year beginning after December 31, 2016, will remain a covered employee for all subsequent taxable years. This essentially means that an employee’s status as a covered employee will never cease, even if she or he no longer works for the company or is no longer among the five highest paid employees of the company, and any compensation, including post-termination compensation in excess of $1 million per year paid by the company to the individual, will not be deductible and will effectively be subject to the corporate tax of 21% (i.e., current corporate tax rate). The American Rescue Plan Act (P.L. 117-2, 3/11/21) expanded the term “covered employees” to include an additional five of the highest paid employees for tax years beginning after December 31, 2026.

Since the enactment of the Tax Cuts and Jobs Act in 2017 (“TCJA”), the remuneration subject to the $1 million deduction limit has included qualified performance-based compensation, which was previously exempt from the deduction limitation. The TCJA includes a clause, however, that allows certain written binding employment agreements, in effect as of November 2, 2017, to be grandfathered under the old rule so long as they have not been materially modified or renewed since that date. Proper recordkeeping is key to tracking and substantiating payments to employees under grandfathered agreements year over year through retirement to ensure those payments can be deducted beyond the $1 million limit.
Section 409A – Income Tax Treatment of Nonqualified Deferred Compensation

IRC section 409A governs nonqualified deferred compensation (“NQDC”) arrangements. The code stipulates that, if at any time during a taxable year, a nonqualified deferred compensation plan fails to meet the provisions under section 409A, all compensation deferred under the plan shall be included in taxable income of the employee or service provider for the year with an additional 20 percent excise tax imposed on that income. Potential late payment penalties and interest on the taxable amount, all payable by the recipient of the deferred compensation, may also apply. Section 409A is complex and far-reaching and can affect the design of benefit programs, severance pay arrangements, and employment agreements to name a few.

To comprehend section 409A, it is important to understand the principle of constructive receipt. Income is taxable upon its constructive receipt by the employee. To avoid constructive receipt, the compensation must be subject to substantial risk of forfeiture. In other words, “entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial.”

When compensation is no longer subject to substantial risk of forfeiture, it is deemed to be vested.

Deferred compensation, on the other hand, is compensation that is earned in one year but paid out in a later year, i.e., an employee or service provider has a “legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year.” Certain exemptions are provided, including one for short-term deferrals.

At a high level, the difference between qualified and nonqualified plans is that qualified plans, such as 401(k) plans, are generally intended to provide benefits to a broad scope of employees. A trust must be established for a qualified plan and is funded by contributions made by either employer or employee. In contrast, an unfunded NQDC plan does not have its own, separate trust set up and the funds for deferred compensation are intermingled with and paid out of the employer’s general assets, which have little to no protection from the employer’s general creditors and would be subject to a creditor’s claim in the event of the company’s insolvency.

NQDC plans serve as an important tool to set compensation for executives apart from compensation for regular employees. Unlike with qualified plans, a corporation has greater flexibility in the design of NQDC plans. Specifically, corporations can discriminatorily select which of its employees may participate in such plans, and deferrals from contributions to NQDC plans are unlimited. Examples of NQDC plans include employer-owned life insurance policies and supplemental executive retirement plans, or SERPs.

4 IRC Reg §409A-1(d)(1).
5 IRC Reg §1.409A-1(b)(1).
6 IRC Reg §1.409A-1(b)(4).
7 IRC §401(a).
For compensation earned under a NQDC plan that complies with the provisions of section 409A, the income tax liability may be deferred to a future date. Specifically, those provisions are:

- The plan must be in writing.
- At the time an amount is deferred, the plan document(s) must specify:
  - the amount to be paid,
  - the payment schedule, and
  - the triggering event(s) that will result in payment.\(^8\)
- The employee must make an irrevocable election to defer compensation before the year in which the compensation is earned. There are generally no provisions for early withdrawal and no acceleration of payment is possible.

While income tax is deferred until the amounts are actually paid out to the recipient (i.e., constructive receipt), employment tax (i.e., social security and Medicare) applies at the time of vesting. However, because participants of such nonqualified deferred compensation plans are often highly compensated employees, their wages are usually well above the social security wage base such that the Medicare tax may be the only employment tax that applies during the year of vesting.

By the same token as income tax is deferred for participants, employers may not take a current deduction on their contributions to NQDC plans until the benefits are paid out to participants and the participants are taxed on them. Further, any investment earnings under the plans are taxed currently to the employer rather than being compounded on a tax-deferred basis.

*Section 409A and equity-based compensation*

NQDC that’s subject to section 409A also includes stock-based compensation, specifically restricted stock units, phantom stock and the like, as these represent an unsecured, unfunded promise by the employer to grant a set number of shares of stock or pay their cash equivalent to the employee or service provider upon the satisfaction of set performance criteria. Nonqualified stock options (“NSOs”) and stock appreciation rights (SARs) are also NQDC if they are granted at an exercise price below FMV. To avoid taxation at the time of grant, they must meet the provisions of section 409A discussed earlier. It is important to note that stock rights, including stock appreciation rights, do not provide for a deferral of income as they are not subject to a substantial risk of forfeiture under Reg § 1.409A-1.

To provide some context, section 409A was codified in 2005 on the heels of years of corporate mishandling of deferred compensation plans, most notably in the case of Enron, which saw

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8 IRC §409A(a)(2)(A) prescribes five permissible payment events in addition to scheduled distributions, including the employee’s separation from service, disability, or death, a change in ownership or control of the corporation, and the occurrence of an unforeseeable emergency. Also see IRC Reg §1.409A-3.
their executives accelerate the payout of their deferred compensation on the eve of the company’s ultimate demise. In addition to preventing exploitative payment acceleration, section 409A also sought to address the then common practice for companies to give employees options to purchase stock that were already “in the money,” i.e., options with a strike price lower than the FMV of the underlying stock at the time of grant. For example, if the share of stock in a company is worth $10, but the company provides for an option to buy the stock for $8, there is $2 of value that the employee is receiving immediately and that the government will want to tax. For stock option grants to be treated as tax-free events to a company’s employees, the exercise price of an option must be set at or above FMV, and the company will be required to prove that the FMV applied is reasonable.⁹

Specifically, for privately held companies whose stock is not actively traded, the FMV of the stock may not be readily determinable. A valuation is required when private companies grant equity awards to their employees, including founders, to determine the proper exercise price for an option. In the past, a company would have decided on its own what they felt was an appropriate price. Post section 409A, a proper valuation requiring substantial supportable evidence is required. An updated valuation must be obtained every twelve months or earlier if there was change in the business that may have materially affected the value of the corporation. Determining whether there has been a material change that may have rendered a company’s current valuation obsolete can be subject to significant judgment and companies would be well advised to seek legal counsel and appropriate valuation expertise. Probably the most common event that would affect a startup company’s valuation is the injection of new capital. However, other events, such as the launch of a new product, macro-economic changes (e.g., due to COVID), or an unexpected entry into a material contract may also require a new valuation study to be conducted for a company.

Per the regulations, valuations must be performed by an independent appraiser with significant experience, which generally means “at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.”¹⁰

Equity-based compensation exempt from 409A

Section 409A does not apply to certain statutory stock options including incentive stock options (“ISOs”). To qualify as ISOs, stock options must satisfy the requirements under section 422, including but not limited to:

- Option may only be granted to employees.
- Option (exercise) price may not be less than the FMV of the stock when granted (110% of FMV if granted to employees who are 10% shareholders).

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⁹ IRC Reg §1.409A-1(b)(5)(iv)(B)
• FMV of options vesting during a year may not exceed $100,000 (any other options vesting will be treated as NSOs).

ISOs offer preferential tax treatment for employees. No compensation is recognized at the time of grant or exercise of an ISO and the employer receives no tax deduction for the compensation. While no income tax applies on the grant or exercise of the option, the difference between the FMV and the exercise price is treated as income for purposes of calculating the employee’s alternative minimum tax.

Because of the $100,000 limitation, ISOs are less prevalent than NSOs when it comes to executive compensation. In a qualifying disposition where holding period requirements are met (i.e., employee holds stock for at least two years from the date of grant and one year from the date of exercise), the entire gain on sale may be taxed as long-term capital gains. In a disqualifying disposition where holding period requirements are not met, the compensation is considered wages and is deductible by the employer. As with ISOs, section 409A also does not apply to stock options granted under an employee stock purchase plan (ESPP). However, since the purpose of an ESPP is to encourage employee ownership of company stock on a broader level and less relevant for executive compensation, this article will not delve further into the mechanics of ESPPs. It is worth noting that employment taxes (i.e., FICA, FUTA and FITW) do not apply on the exercise of an ISO or ESPP option, irrespective of whether the exercise was a qualifying or disqualifying disposition.11

Section 83(b) – Special Election on Restricted Stock

Section 83(b) provides the recipient of property, which includes restricted stock, the option to elect to accelerate her or his tax liability by paying taxes on the total FMV of the restricted stock at the time of the grant rather than upon vesting. A section 83(b) election, if made, must be within 30 days after the date of grant of the restricted stock.12

In effect, with a section 83(b) election, the recipient may pay ordinary income tax on a low valuation if the value of the equity is expected to increase in future years. This also allows the recipient to start the clock for the long-term capital gains holding period earlier, so that any appreciation between grant date and vesting date is taxed at the applicable capital gain rate instead of the ordinary income tax rate. However, if the value of the share declines in future years or the shares are forfeited, the employee may end up being negatively impacted. If the restricted stock is subsequently forfeited, the forfeiture is treated as a sale of the shares in exchange for no consideration. Further, the recipient is not entitled to a deduction or credit for taxes paid as a result of the section 83(b) election paid or the subsequent forfeiture of the property.13

11 Notice 2002-47.
12 IRC §83(b)(2).
13 IRC §83(b)(1), IRC Reg §1.83-2(a).
Section 280G – Golden Parachute Payments

The last item to consider is compensation paid to executives under section 280G, aptly titled “golden parachute payments” to characterize the lucrative payouts. Parachute payments are compensation, including severance payments, (accelerated) equity compensation and any types of benefits, that are paid to disqualified individuals in connection with a change in control of the corporation (i.e., change in the ownership of effective control or of a substantial portion of the assets of the corporation). Disqualified individuals include shareholders, corporate officers and directors and highly compensated individuals who perform services for the corporation.\(^{14}\)

Section 280G is triggered if parachute payments exceed three times the annualized includible compensation for a base period, or base amount. Then, not only will the corporation lose its tax deduction on the excess amount, but the disqualified individual will also owe a nondeductible 20 percent excise tax on the “excess parachute payment.” Annualized includible compensation per section 280G is the average annual compensation (as reported on Form W-2) paid by the corporation to the employee over the most recent 5-year period. The excess parachute payment is the amount by which total parachute payments exceed the base amount. Simply put, once section 280G is triggered, any amount of an executive’s parachute payments in excess of his or her base amount is generally subject to a nondeductible 20% excise tax.

Obviously, triggering section 280G provisions can be very expensive for both the corporation and its executives. From a planning perspective, companies may include gross up provisions in their severance agreements, or they may adopt such provisions in anticipation of a transaction. However, gross up provisions can be expensive and result in additional non-deductible expenses, as it essentially requires corporations to gross up parachute payments to neutralize the tax impact to the executive. Also, there are rules that provide shareholders with an advisory vote on the matter which, of course, will invite public and shareholder scrutiny. Other planning considerations include base amount planning to effectively increase the base amount by exercising stock options or accelerating stock awards during the base period. In these scenarios, executives should be cautioned to not unwittingly trigger the 20 percent excise tax under section 409A instead.

\(^{14}\) IRC §280G(c)
**Key Takeaways**

To recap, the following tables highlight (i) the key provisions and concepts of said tax statutes and provide (ii) a summary of the common types of equity-based compensation offered in executive compensation plans and their respective tax treatment:

<table>
<thead>
<tr>
<th>IRC Section</th>
<th>Key Provisions</th>
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| 162(m)      | Applies to corporations that issues publicly traded securities (debt or equity)  
- Deductibility of compensation is limited to $1 million per “covered employee” (all current or former principal executive or principal financial officers during the year and the three highest paid executives)  
- “Once a covered employee, always a covered employee” concept for tax years beginning after December 31, 2016  
- Performance-based compensation included in $1 million limit since TCJA, unless grandfathered under old rule |
| 409A        | Applies to nonqualified deferred compensation plans. Provisions include documentation requirements (i.e., plan documents must specify amount to be paid, payment schedule, and triggering events) and irrevocable election regarding timing and form of payment made by the participant before the year in which the compensation is earned.  
- If 409A requirements met, tax deferral until payment or constructive receipt of the income  
- If 409A requirements not met, compensation includible in current year with additional 20% excise tax and potential penalties and interest payments – all imposed on the employee and not on the corporation  
- Short-term deferral exception for compensation paid within two and a half months after the end of the year  
- Equity-based compensation granted with an exercise price below FMV also subject to 409A  
- Independent appraisal of equity securities required to determine their FMV in certain situations |
| 83(b)       | Applies to property transferred to employees and service providers in connection with the performance of services  
- Special election to accelerate tax of full award in the year in which the award is made based on the FMV of the award at the time  
- Upon election, ordinary income tax and tax deduction triggered on award for executive and employer, respectively, and “start of clock” for long-term capital gain treatment |
| 280G        | Applies to parachute payments, i.e., compensation made to an executive in connection with a change in control of the corporation, in excess of three times the average annual compensation of a base period.  
- 20 percent nondeductible excise tax imposed on excess parachute payments in addition to applicable state and federal income taxes and employment taxes  
- Excess parachute payments nondeductible by employer |

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<thead>
<tr>
<th>Award Type</th>
<th>Description</th>
<th>Tax Treatment</th>
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| Incentive Stock Options (“ISO”) | Provided under IRC sections 421 and 422. Subject to certain limitations:  
- Only available to employees | Employee:  
- No income upon grant or exercise of option if holding periods are met; |
<table>
<thead>
<tr>
<th>Award Type</th>
<th>Description</th>
<th>Tax Treatment</th>
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| Nonqualified Stock Options  | • Any option that does not qualify as an ISO  
• May be granted to any service provider (employee or nonemployee)  
• Exercise price must not be less than FMV of underlying stock on date of grant (otherwise subject to section 409A penalties)  
• More flexibility regarding lifespan of option (although companies typically apply 10-year lifespan) | Employee or Service Provider:  
• Income and employment taxes apply on option exercise for amount equal to excess of FMV of stock (on date of exercise) over exercise price  
• Capital gain on sale of stock if sale price is greater than FMV of stock on date of exercise  
Corporate employer:  
• Tax deduction equal to amount of ordinary income recognized by employee or service provider |
| Restricted Stock Units      | • Right to full ownership of stock vests over time                                                                                                                                                          | Employee or Service Provider:  
• Section 83(b) election available  
• Income and employment taxes apply at the time of grant (if section 83(b) election is made) or vesting based on the then FMV of the stock  
Corporate employer:  
• Tax deduction equal to amount of ordinary income recognized by employee or service provider (depending on whether 83(b) election is made) |
| Stock Appreciation Rights   | • Right to receive the increased value of the employer’s stock (service provider can only benefit from the appreciation in the value of the stock)                                                             | • No tax until settlement  
• Amounts received treated as ordinary income to the service provider and deductible by the employer  
• Not considered property for purposes of section 83(b), so no election may be made under section 83(b) at the time of grant |
| Phantom Stock               | • Deferred amounts are determined by reference to hypothetical “phantom” shares of the employer’s stock                                                                                                      | No doubt, executive compensation is a complex topic. With compensation in the millions and even billions of dollars, as in the case of Elon Musk, the tax effects can be substantial. The |
difference between ordinary income taxed at 37 percent (highest marginal tax bracket in 2021) and capital gains taxed at 20 percent is impactful to the bottom line. Musk’s move to increase his tax liability will not appeal to most of us, although there may be other not readily apparent factors that are influencing his stock sale decisions. This summary of key concepts and tax code provisions affecting executive compensation is not intended to constitute professional or legal advice. The tax rules and regulations governing executive compensation are nuanced and ever evolving, and there are obviously many exceptions and special rules that have not been covered here. As always, in determining the right course of action, companies and their executives will be best served by consulting professional tax and legal advice.
Background

On December 7, 2020, the Federal Communications Commission (FCC) announced that millions of rural Americans in 49 states and the Commonwealth of the Northern Mariana Islands will have access to high-speed Internet service through Phase I of the Rural Digital Opportunity Fund (RDOF) auction. The published auction results show that bidders received funding to deploy high-speed broadband to more than 5.2 million unserved households and businesses, representing nearly 99% of the locations available for the auction. In addition, the FCC will allocate $9.2 billion through its RDOF to communities across the country for distribution over the next 10 years.¹

According to the FCC “2018 Broadband Deployment Report”, the internet speed standard is the speed benchmark of 25 Mbps download/3 Mbps upload (25 Mbps/3 Mbps) for fixed services. By the end of 2016, 92.3% of all Americans had access to fixed terrestrial broadband at speeds of 25 Mbps/3 Mbps, compared to 89.4% in 2014 and 81.2% in 2012. Nevertheless, more than 24 million Americans continue to lack fixed terrestrial broadband at speeds of 25 Mbps/3 Mbps.² Meanwhile, the U.S. Census Bureau in late 2019 estimated that 15 million American households were below the federal minimum standard for broadband speeds, more than one-third of which lacked broadband connectivity.³

The RDOF gives internet providers up to 10 years to reach all assigned locations. U.S. Rep. John Moolenaar (R-MI) sponsored the Broadening Online Opportunities through Simple Technologies (BOOST) Act, H.R. 1362, which will provide a short-term solution.⁴ The bipartisan BOOST Act would allow eligible rural homeowners and primary lessees to claim a consumer tax credit up to $400 after purchasing a signal booster or hotspot to improve a slow internet connection. The tax credit would expire when the broadband speed in the household’s area meets the federal minimum standard or after the credit sunsets in five years (2025). The Act is

also technology neutral. Families could use the credit to purchase the solution that suits them best, whether it is equipment to receive Internet from a satellite or a signal booster.

**Principles of Good Tax Policy**


### Principles of Good Tax Policy Worksheet

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
</tr>
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<tbody>
<tr>
<td><strong>Equity and Fairness</strong> – Are similarly situated taxpayers taxed similarly? Also consider any different effects based on an individual’s income level and where they live.</td>
<td>Horizontal equity: Horizontal equity exists when taxpayers in similar situations are taxed in the same manner. This proposal respects horizontal equity. Most urban homeowners do not have the trouble of internet connection, but rural homeowners need to purchase a signal booster or hotspot to improve a slow internet connection to achieve the same level as urban homeowners. Providing a tax credit to eligible homeowners is a way to achieve conditions similar to those of urban homeowners, consistent with horizontal equity. Specifically, a credit is worth the same to all taxpayers, whereas a deduction is worth more to high-income individuals. All eligible taxpayers would be able to benefit from the credit, irrespective of their income, and achieve horizontal equity. Vertical equity: The proposal may satisfy that principle in part. On one hand, the proposal allows eligible rural homeowners to claim a refundable tax credit after purchasing a signal booster or hotspot to improve a slow internet connection. As a result, this proposal is consistent with vertical equity in that it provides eligible rural homeowners with the opportunity to increase their internet use. On the other hand, this proposal only benefits taxpayers who can purchase this enhanced equipment, because taxpayers must purchase the equipment before they can claim the credit. For taxpayers with such low incomes that they cannot purchase equipment, it is impossible to take advantage of this proposal.</td>
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<p>| <strong>Certainty</strong> – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined? | This proposal clearly states that an individual taxpayer is allowed to elect a tax credit for 75% of qualified signal booster expenditures up to $400 in a single tax year through 2025. Also, the proposal defines qualified signal booster expenditures as amounts paid for the purchase of any communications signal booster for use by the taxpayer in a principal residence located in an underserved area. This proposal therefore meets the principle of certainty. | + |
| <strong>Convenience of payment</strong> – is the tax due at a time that is convenient for the payor? | This proposal does not add an extra burden on taxpayers to pay their taxes because it only involves additional credits on their tax returns which does not affect the date they pay their taxes and the methods they use for paying taxes. However, if the money is necessary to make the purchase, taxpayers will not get it until they file their tax returns. Money is not available when needed, which harms lower income individuals. This proposal partially meets this principle. | +/- |
| <strong>Effective Tax Administration</strong> – 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. | There are some concerns regarding this proposal which can hinder the effectiveness of tax administration. First, such expenditure must be &quot;qualified signal booster expenditures&quot;. This means that the taxpayer's principal residence must be situated in an &quot;unserved area&quot; and the expenses incurred for the purchase of any communication signal booster. Confirmation of these conditions will impact the effectiveness of enforcement. Second, &quot;unserved area&quot; means an area eligible for funding under phase 1 or phase 2 of the RDOF established by the FCC in the Report and Order in the matter of the RDOF and Connect America Fund that was adopted by the Commission on January 30, 2020 (FCC 20–5). Taxpayers and the IRS must confirm the &quot;unserved area&quot; in order to qualify for the credit. However, this can be challenging to determine. For example, the origin unserved area becomes a service area in the middle of a particular year. Whether or not the taxpayer can still benefit from the credit and how to allocate it will become an issue. Third, the credit may only be used by eligible taxpayers once before the proposal expires in 2025. If the taxpayer moves during this period, this may make implementation more difficult. | - |</p>
<table>
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<tr>
<th><strong>Information Security</strong> – Will taxpayer information be protected from both unintended and improper disclosure?</th>
<th>With respect to information security, the credit would be available to taxpayers based on their current information; there are no additional tax forms with their annual tax return.</th>
<th>N/A</th>
</tr>
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<tr>
<td><strong>Simplicity</strong> - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</td>
<td>A special calculation is not required under this proposal. Eligible taxpayers can claim up to $400 in tax credits after purchasing a signal booster or hotspot to improve a slow internet connection. The important thing to remember is that taxpayers are required to keep receipts or any other documents to support the purchase. Some of the definitions in this proposal make taxpayers not completely understand that they are qualified for the credit, so they can miss it. In this way, the proposal complies partially with the principle of simplicity.</td>
<td>+/-</td>
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<tr>
<td><strong>Neutrality</strong> - The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</td>
<td>The bill was introduced to support families to get more reliable internet service in their homes in unserved areas. However, it may encourage households to purchase a simple signal booster or mobile hot-spot equipment to get the tax credit even though they do not need one. Taxpayers who want to make a purchase may try to install expensive equipment that maximizes up to a $400 tax credit. As the bill affects taxpayers’ behavior, the neutrality principle is not met. However, the sponsors are trying to influence taxpayer behavior with the tax credit.</td>
<td>-</td>
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<tr>
<td><strong>Economic growth and efficiency</strong> – will the tax unduly impede or reduce the productive capacity of the economy?</td>
<td>Since the BOOST Act enables people to connect to the internet by creating their own internet hotspots or by boosting the speed of a connection they already have, it will support the rural community to conduct business from home, do homework, and work from home effectively during the pandemic and will be useful for many years to come. A study shows that the work-from-home boom lifts productivity in the U.S. economy by 5%, mostly because of savings in commuting time. This bill will make people have the rapid adoption of new technology during the pandemic, which will offer lasting economic gains and boost the economy after the pandemic. The principle of economic growth and efficiency would be satisfied. At the same time, because this proposal promotes the growth of e-commerce, it could also harm in-person businesses in rural areas. They have to go work and in office and pay their expenses.</td>
<td>+/-</td>
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on their own and do not get any tax credit to reduce their tax liability.

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

Taxpayers will easily know of the existence of the new rule because the mobile industry and technology companies will promote the policy to attract more purchasers. In addition, the IRS will also update the credit when an individual files a tax return with instructions on qualified signal booster expenditures. Taxpayers will easily follow the instructions to get the tax credit. The bill meets 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?

There is no risk of intentional or unintentional noncompliance as it is straightforward that taxpayers need to prove the purchase of communications signal boosters in areas with inadequate broadband internet access service. It requires taxpayers to document and record purchases to be qualified if the IRS audits. Thus, it gives an additional incentive for the taxpayer to file the tax return on time to receive their refundable tax credit.

**Accountability to taxpayers** – Do taxpayers have access to information on tax laws and their development, modification and purpose; is the information visible?

Taxpayers should readily have access to information for understanding and utilizing the tax law. The purpose of this bill is to encourage Americans in rural areas to have the ability to access the internet in the form of a refundable tax credit. This is an interim alternative before the standard network speed is completely reached. However, it would be challenged for them due to limited access to high-speed broadband in limited access to real-time information. Taxpayers may not know the amount of the credit applicable to the particular tax year until they file their tax return, and there are no references where taxpayers can find this information in the bill. In addition, the taxpayer will not understand why this approach is used rather than issuing the equipment to low-income individuals. They have to buy equipment to claim credit instead. Therefore, the principle of accountability to taxpayers is partially met.

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

To make broadband more accessible to people, giving a tax credit will decrease the revenue available to the government, without regard to other available credits supporting taxpayers currently. In addition, it will be difficult for the government to estimate the tax cost for this bill. There will be an increase in the tax credit as high demand for internet for people in rural areas continues after the pandemic. Since the credit is refundable, it may be harder to estimate which and how many taxpayers will engage in tax
planning to take advantage of this particular aspect. At this point, the government should be able to figure out how many are likely to be purchased. The principle of appropriate government revenues is not met.

Summary

According to the above analysis, H.R.1362 satisfies three principles of good tax policy, including certainty, transparency and visibility, and minimum tax gap. There are mixed results, which are equity and fairness, convenience of payment, simplicity, economic growth and efficiency, and accountability to taxpayers. Effective tax administration, neutrality, appropriate government revenues are the principles that are not met. Although this bill enables rural families to access the Internet by boosting the speed of connection they already have, it will only benefit a few such as those who can afford the high cost of mobile hotspot service or those who already have a signal to boost. Purchasing a hotspot is a small part since broadband has an expensive monthly fee for low-income taxpayers. Therefore, this bill is not favorable to low-income taxpayers.

There are some improvements that could be made:

1. Consider reducing the threshold of the purchase price of communications signal boosters that is suitable for each bracket low-income taxpayers fall into. This should help satisfy vertical equity.
2. As the taxpayers in rural areas cannot access the Internet, it is necessary to deliver information about the credit for purchasing signal boosters through the tax return forms so they can know before filing and do not miss the opportunity to get that credit. Additional avenues of communication should be considered such as magazines, television ads, and posters in government offices.
3. The RDOF gives the internet providers up to 10 years to reach all assigned locations, but the bill may expire after 5 years. The bill can consider extending the applicable period and cooperating with the local government or a telecommunications company to promote: Whether the local area has already met the federal connection speed standard, so this credit can no longer be applied, or the local has not yet reached the standard, so residents can use this credit.
4. The proposal is based on the condition that the taxpayer’s principal residence is in the unserved area, if several taxpayers live in the same residence at the same time, they may be able to buy several enhanced equipment (even if so much equipment is actually not required). To avoid this situation, the proposal can increase restrictions such that each address can be applied to the credit only once.
California AB 1121, Sales Tax Exemption Emergency Preparation Items

By: Pooja Karelia, CPA and Sheetal Partani, EA

Introduction

On February 18, 2021, California Assembly Member Rodriguez (D-52) introduced AB-1121, Sales and Use taxes: exemptions: emergency preparation items.¹ The proposal was referred to the Committee on Revenue and Taxation on March 4, 2021 but was not acted upon in 2021. This bill aims to provide an exemption from sales taxes for the sale of, and the storage, use, or other consumption of emergency preparation items, as defined, sold or purchased during the 3-day period beginning at 12:01 a.m. on the Saturday before the last Monday in June and ending at midnight on the last Monday in June. Thus, this bill would create a “sales tax holiday” which would be the first one in California.² This bill is proposed as a temporary provision for the period January 1, 2022, to January 1, 2024.

There is no limit on the number of items that can be purchased, however there is a limit on the dollar amount of the items. The proposal specifies 12 items which would be exempt, divided into two parts namely a portable generator up to $1,500 and 11 other types of products which have a sale price under $75.

California cities and counties generally conform to the state sales and use tax law. Amendments such as the proposed bill, are automatically incorporated into the local tax law. Currently the California State law requires the state to reimburse counties and cities for loss of revenue caused by enactment of exemptions however this proposal explicitly provides that no appropriation would be made, and the state would not be required to reimburse any local agencies for sales and use tax revenues lost by this new sales tax holiday.

AB-1120 Sales and Use tax: exemption: disaster preparedness products which was introduced by Assembly Member Tran on February 23, 2007, which was similar in purpose to the current bill. In the comment section of the bill, the sponsors stated that "Sales tax holidays are popular with consumers and retailers in other states. By targeting goods that are useful in the event of a disaster AB 1120 would encourage preparedness and self-reliance of Californians while giving retailers that supply these goods the ability to offer these products at a lower cost to consumers."³


² Many states have various types of sales tax holidays; see https://taxfoundation.org/2021-sales-tax-holiday.

This section analyzes California AB 1121, Sales Tax Exemption Emergency Preparation Items using the twelve principles set out in the AICPA’s Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals.4

### Principles of Good Tax Policy Worksheet

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
<th>+/-</th>
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| **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:* Horizontal equity requires similarly situated taxpayers to be taxed similarly. This proposal exempts certain items from sales tax during a three-day window in June for years 2022 and 2023. This practice is quite common and many states like Florida,5 Texas, Louisiana have almost similar provisions for emergency/disaster preparedness items. However, this proposal favors selected products relative to other products. One can argue that various items like axes, pocketknives, handwarmers, ladders, blankets, tents, bug repellants, etc., are also useful in emergencies6. There is no exemption for these items (states like Texas7 exempt axes as well as emergency ladders). The sales tax exemption is available only during the three-day period and not during other days, encouraging people to stock up during such time.  
*Vertical equity:* The vertical equity principle is satisfied when taxpayers with higher income pay more tax than taxpayers with lower income. There is no phase out/limitations for higher earning taxpayers. The taxpayers with higher income would get the same amount of exemption as taxpayers with a lower income. There is some debate whether higher income individuals really need a sales tax exemption and whether it is fair to distribute the burden of that tax expenditure on all the taxpayers. Generally, because high-income taxpayers have more resources available to purchase emergency preparedness | -   |

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items, they will get a greater benefit of the sales tax exemption assuming they spend more money on such items. Since the exemption treats all consumers equally regardless of their income levels, it violates the principle of vertical equity.

**Certainty** – Does the rule clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined?

The proposed bill includes a detailed description of when the sales tax would be exempt, which products would be exempt and for how many years will this provision exist (unless extended). The proposal is uncomplicated with basic requirements and no complex exemptions. The items listed in the provision are general and widely used items. There is little scope of interpretation. For example, portable, self-powered light sources include lanterns, candles, flashlights etc.

Also, it does not require special forms or additional reporting. The overall confidence for compliance is high because of its simplicity and easy to follow requirements. This proposal meets the principle of certainty. However, the bill is unclear about the benefit, if any, when eligible items are purchased online and the vendor charges sales tax.

**Convenience of payment** – is the tax due at a time that is convenient for the payor?

This proposal does not add any burden of payment on the consumer or sellers. On the contrary this bill is about the exemption of certain items. The taxpayers do not need to make a payment and vendors are not required to collect any tax. This proposal does not affect the principle of convenience of payment.

**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.

As a whole, the cost to comply with this proposal would be reasonable for both the government and the taxpayers. At present, Section 2230 of Revenue and Taxation Code requires that California state reimburse counties and cities for the revenue losses caused by the enactment of sales and use tax exemption. The reimbursement shall be made when funds have been appropriated. However, it is provided in the bill that no appropriation is made, and the California state government would not reimburse any local agencies for sales and use tax revenues lost by them pursuant to this bill, notwithstanding Section 2230 of Revenue and Taxation Code.

The vendors of the specified emergency preparedness items need to be aware of the temporary provision of exemption for three-day period and will need to take
necessary steps to ensure compliance. Since the list is quite specific and has dollar amount limitations, it should not be too burdensome to identify and track the exempt items. Yet, there will be costs of this additional recordkeeping and high risk of error. Today, sophisticated sales software can help identify and track the exempt items for a specified time in a cost-efficient manner. For smaller business owners this might include additional efforts but overall, it could be a manageable burden. So, this proposal mostly meets the principle of Effective Tax Administration.

| Information Security  – Will taxpayer information be protected from both unintended and improper disclosure? | The bill does not require any additional reporting or disclosures. The exemption of sales tax on the emergency preparation items does not require any taxpayer to have an exemption certificate or additional information reporting by the seller in the tax forms. So, there is no additional risk of unintended or improper disclosure of taxpayer information. The bill is neutral to the principle of information security. | N/A |

| Simplicity - can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner? | The proposal is short and concise. It does not require any special calculations to be made. There is a list with 12 types of items which are exempt from sales tax during the three-day period. The list states the dollar amount and any other specifications for the 12 types of items. (e.g., $1,500 limit for the portable generator and $75 limit for the remaining 11 items). The only thing that would be required is for the sellers to not collect tax during this period. There are no additional forms, receipts or supportive documents required. Given the sophistication of widely used billing and sales software, this can be easily managed by medium and large businesses. For small businesses with limited/no software and hardly any tax professional consultation, there will be an additional effort to understand the change and earmark the products which will be exempt from sales tax during the proposed three-day period. However, all in all this proposal is straightforward and taxpayers would be able to comply with this proposal in a cost-efficient manner. Thus, this proposal mostly meets the principle of simplicity. There might be some issues of properly identifying the eligible items. Vendors will have special reporting to separate out the exempt items sold during the three days and keep good records to ensure they did this correctly. | + |
**Neutrality** - The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.

The proposal may result in government influencing consumers to change when they purchase goods. It might not be wise idea for the consumers to wait until the 3-day period mentioned in the bill. It might not be true in all the situations. For example, it might not be a good idea to wait until the weekend before school begins to buy school supplies. For others it might be wiser to wait until the weekend to take the benefit of the bill (sales tax exemption on certain items.). This kind of proposal might affect consumer timing decisions. In addition, consumers may engage in tax planning and take advantage of the sales and use tax exemption during the mentioned period in the bill. This bill does not support principle of neutrality because it favors consumers in picking products and industries to favors with sales and use tax exemptions. This bill discriminates among the products and across the time and alter consumer decisions.

**Economic growth and efficiency** – will the tax unduly impede or reduce the productive capacity of the economy?

This bill would be beneficial to the consumers and provide relief to those who are adversely impacted and who are in need of these emergency supplies. This exemption provides some relief to low-income individuals, whereas this kind of sales tax exemption gives unexpected benefit to high income earners. This bill does not promote economic growth or significantly increase consumer purchases. The 2017 study by the Federal Reserve found that this kind of exemption simply shifts the timing of purchases without necessarily increasing spending. It is possible that some retailers will increase prices of the products during the 3-day holiday period, thereby reducing consumer savings. This bill provides an exemption for certain items, but not for others which might also be required for emergency situations. This proposal favors particular products, thereby causing capital to flow to particular products mentioned in the bill. This can harm other industries. This bill does not provide a significant boost to the economy.

Similar bill in different states have faced difficulties and some states and localities had to cancel or opt out their

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sales tax holidays. “The District of Columbia Office of Taxation and Revenue estimated that it would save $640,000 in tax revenue by canceling its sales tax holiday in 2009.⁹ North Carolina officials found that repealing their sales tax holiday in 2013 would save the state $16.3 million the next year, and put those dollars toward individual and corporate income tax cuts.¹⁰ Experts from the sales tax industry and economists agree that there is little evidence of increased economic activity as a result of temporary sales tax exemptions (popularly called sales tax holidays).

<table>
<thead>
<tr>
<th>Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</th>
<th>It is more likely that consumers can get information about the bill from the California CDTFA website itself. The other states with a similar bill have been updating the website with instructions and a detailed list of products that are eligible for the exemption. There is high possibility that consumers might miss out on the details of the eligible product list without an official campaign to create awareness of exemption. Moreover, providing sales and use tax exemption only for particular products listed in the bill might be misleading and businesses may be demotivated if they are selling the products which are also essentials, and this exemption does not apply to their business. It is also likely the vendors will provide the advertising needed to be sure consumers are aware of the holiday.</th>
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<tr>
<th>Minimum tax gap – is the likelihood of intentional and unintentional non-compliance likely to be low? Is there any way people may intentionally or</th>
<th>The likelihood of this bill causing non-compliant is low as vendors will be motivated to properly comply to avoid any liability to themselves and to help sell products. It is not clear why only a few items are listed in the essentials list whereas other items like handwarmers, ladders, blankets, tents, bug repellants etc. are also useful in emergencies. But this bill includes the detailed list of items that fall under the sales tax exemption. The items listed are widely used</th>
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<tr>
<th>Question</th>
<th>Answer</th>
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<td>unintentionally avoid or evade this tax or rule?</td>
<td>during emergencies. There are no further regulations required and there is very little scope of consumers making errors caused by confusion and uncertainty. This bill meets this principle</td>
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<tr>
<td><strong>Accountability to taxpayers</strong> – Do taxpayers have access to information on tax laws and their development, modification, and purpose; is the information visible?</td>
<td>The local and state government should release guidance and inform consumers regarding developments in the tax code. Taxpayers will understand the purpose of the bill as well as the qualifications for the sales tax exemption as this exemption is for the essentials required during emergency situations. The government must publish the data which can be readily made available to the taxpayers. There have been many bills and alternatives of the similar bill in various states that have been proposed in the past and are publicized through national news and there have been lots of articles and posts on Twitter. Not all the bills catch the public’s attention tough. It is not likely that most consumers know that the exemption exists unless they regularly follow the news channel and social media like Twitter. It is likely that consumers might not know that only a few listed items are exempt from the sales tax. It is not likely that the average person knows about this bill. Some consumers may assume that it is a bill for all the essentials required during emergencies. Consumers likely will not understand why some items are exempt and others are not and why the exemption only applies for a three-day period.</td>
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<tr>
<td><strong>Appropriate government revenues</strong> – will the government be able to determine how much tax revenue will likely be collected and when?</td>
<td>There are similar bills passed in different states and the data is available that would help the California government to approximately determine how much tax revenue will not be collected during the holiday. Most of the states have prompted and have opted out of such sales tax exemption bill. For example, the District of Columbia has estimated the savings of $640,000 in tax revenue by cancelling its sales tax holiday in 2009. There was a similar bill in California (AB 1120)(^{12}) - Sales tax: exemptions: disaster preparedness products in the year 2008. BOE staff estimated that retailers would incur approximately $9.3 million cost to implement the change in price again. Hence from the past bills from the State of California and using the data from the other state’s government, determining tax revenues can easily be determined.</td>
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**Conclusion:**

AB 1121 should be reevaluated. Rather than providing tax cut or boost to the economy, this bill is likely to impose costs on consumers and businesses without providing sufficient benefits. To achieve the goal of this bill the sales tax exemption should be neutral towards the products and timing decisions; all the products required during emergency should consistently be subject to the same sales tax rate. The sales tax exemption will benefit buyers of the proper products during the three-day period but also provide benefit to people who would have purchased these products anyway. Also, if these products are so important to all individuals, why are they only lower cost (assuming vendors don’t increase prices during the holiday) only for three days of the year?

This bill likely does not contribute to economic growth or increase purchases. The funds lost during the holiday could instead be spent on publicity and buying supplies for low-income households. This bill in general does not provide expected tax relief to the low-income individuals, but provides larger tax savings to the high-income individuals.

**Suggested Improvements:**

1. If a purchase is made during the holiday period and is exchanged for another item after the holiday period, the exemption would not apply to the new item, thereby causing potential confusion and reporting errors. The bill should include a provision regarding return/exchange of items.

2. Also such exemptions set precedents for future exemptions, there should be a proper study conducted to understand whether such tax holidays change the consumer behavior or simply subsidize existing behavior.

3. Non-tax solutions should be pursued to meet the intended goal of ensuring more people have emergency supplies such as providing them to low-income households.
Revitalizing Downtowns Act

S. 2511 (117th Congress)

By: Tam Nguyen, MST Student and MST Students in BUS 223A Tax Research, Fall 2021

On July 28, 2021, U.S. Senator Debbie Stabenow (D-MI) introduced the Revitalizing Downtowns Act (S. 2511, 117th Congress), to create the Qualified Office Conversion Tax Credit. This 20 percent credit applies to qualified expenditures related to converting an office building into a residential, retail, or other commercial use property. The COVID-19 pandemic forced businesses to adapt to employees working from home and this shift away from offices is likely to stay. Per sponsor Senator Stabenow: “As our workplaces change because of the COVID-19 crisis, we will see more unused buildings in our downtowns. Converting these buildings to residential and mixed-use properties will benefit families and our cities. Our bill will help with this transition, support the economic growth of our cities, help small businesses and provide people affordable places to live.”

The Revitalizing Downtowns Act’s name might appear to only apply to buildings within a specific area, but it actually applies to any building that meets specified requirements. These building requirements are as follows:

- Prior to conversion, the building was nonresidential real property that was leased, or available to lease, to office tenants;
- The building was substantially converted from office use to residential, retail, or other commercial use;
- If converted to residential use, the building must meet requirements detailed later in the bill;
- The building was initially placed in service at least 25 years before the beginning of the conversion; and
- Depreciation (or amortization in lieu of depreciation) is allowable with respect to the building.


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### Application of the Principles of Good Tax Policy

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<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
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<tr>
<td><strong>Equity and Fairness</strong> – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer’s income for different income levels of taxpayers.</td>
<td>Horizontal equity: Taxpayers with similar abilities to pay should pay the same amount of tax. The Revitalizing Downtowns Act proposes a 20 percent tax credit on expenditures for taxpayers that satisfy the requirements of converting an office building to a residential or other commercial use property. The amount of credit provided would be higher or lower depending on how much is spent to convert the office building. For two eligible taxpayers with the same level of income, the benefit of the credit will be the same if spending the same amount on renovations. Therefore, this bill meets the principle of horizontal equity. However, if similar taxpayers engage in building renovations where one building doesn’t qualify under the specifics of S. 2511, only the qualified property generates a tax credit. For example, the 25-year use requirement will cause some buildings not to qualify even though the use of the building has changed. Vertical Equity: Vertical equity is satisfied when taxpayers with higher income pay more tax than taxpayers with lower income. There is no cap on the 20 percent tax credit on expenditures allowed by the tax credit. This would allow more affluent taxpayers to likely receive a larger tax credit as they would have more resources to convert their properties. Therefore, this bill does not meet the principle of vertical equity.</td>
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<td><strong>Certainty</strong> – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that they have applied the rule correctly.</td>
<td>The proposal clearly states that taxpayers can claim a credit on their tax returns in the tax year expenditures related to converting a qualified office building occur. The tax credit is equal to 20 percent of expenses accumulated toward the office conversion. The bill also includes that more than half of the expenditures must be paid by the taxpayer. If the taxpayer follows the necessary requirements for the credit, they will receive the tax credit when filing their tax return. Therefore, this bill meets the principle of certainty.</td>
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| **Convenience of payment** – Does the rule result in tax being paid at a time that is convenient for the payor? | A tax payment should be convenient for the taxpayer to pay at a time or in a manner. The more difficult a tax is to pay, the more likely that payment will not happen. The Qualified Office Conversion Tax Credit is a general business credit which may be claimed on a tax return. Taxpayers can estimate the amount of this credit before filing their tax return, so the bill satisfies the convenience principle. If the bill is approved, the IRS would create a new form to input necessary information required of the credit. This bill does not add any extra burden on taxpayers to pay their taxes because it only involves the additional credit which does not affect the due date or methods to pay taxes. The benefit of the credit will not be received until the taxpayers file their tax return but they can estimate its benefit in their estimated tax payments. | + |
| **Effective Tax Administration** – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers? | This tax credit proposal would have new administration costs such as the IRS writing rules on how this credit is computed, creating new tax forms, and conducting audits to ensure that taxpayers are calculating the credit correctly. These initial costs are incurred with any new proposal and would be minimal after implemented. With a well-drawn up tax form to be submitted with annual tax returns, identifying taxpayers not in compliance would become a routine part of verification of returns. This bill would meet the effective tax administration principle. | + |
| **Information Security** – Will taxpayer information be protected from both unintended and improper disclosure? | There are no specific reporting requirements to disclose additional personal information for taxpayers to receive this credit. Any personal information would already be provided in the tax return submitted to receive the credit. It is unlikely that this information will be misused due to unintended and improper disclosure. Therefore, this bill meets the principal of information security. | N/A |
| **Simplicity** – Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner? | S. 2511 includes many special rules to determine if expenditures or projects qualify for the credit and numerous special definitions. The most complex inclusion in the bill is the requirements for the tax credit when converting the office building to a residential property. The requirements if the building is converted to a residential property is that 20 percent of the units must be rent-restricted and occupied by individuals whose income is 80 percent or less of the area median income. Another requirement is that the building must have been placed in |
service at least 25 years prior before the conversion begins. Details like this in the proposal makes it complex for taxpayers to ensure they are qualified to receive the tax credit. This complexity reduces confidence that a building owner is eligible and if they meet all the requirements. Therefore, this bill fails to meet the principle of simplicity.

Another detail taxpayers need to be cautious of when claiming the tax credit is not to double dip with other similar tax credits. A couple of credits the bill specifically mentions are section 42 (low-income housing credit) and section 47 (rehabilitation credit). Taxpayers will have to be cognizant to not calculate any tax credit for expenditures that are also being allowed under other existing legislation. With all of these factors to consider, this bill does not meet the principle of simplicity.

| Neutrality – Is the rule unlikely to change taxpayer behavior? | The Revitalizing Downtowns Act will affect a taxpayer’s decision about how to utilize their property. The proposal encourages taxpayers to convert their existing office building to a residential, retail, or other commercial use property. This affects decisions on what the property will be converted to. This will deter taxpayers from converting their office building to a school or government office space even if that would be a better use for the property. Therefore, this bill does not meet the principle of neutrality. |
| Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy? | This bill would have a positive impact on growing the economy. As office work transitions to working from home, nearby businesses are missing out on the workers that usually commute past there stores. Whether it be restaurants, gyms, or day cares, businesses are not benefitting from an empty office with no foot traffic towards the stores. Converting these empty office buildings to bring new businesses to the area would bring more customers and stimulate economic activity. Therefore, this bill meets the principle of economic growth and efficiency. |
| Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others? | City officials in areas that believe this bill will benefit their town will likely promote this to eligible taxpayers. As this tax credit mostly benefits big city’s downtown areas this is likely not going to be publicized nationwide. Only taxpayers with buildings 25 years or older and inside big metro areas would be able to benefit their local community with this tax credit. With little benefit to other locations there is no guarantee |
this would be a well-known tax credit. Therefore, this bill would not meet the principle of transparency and visibility.

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<th>Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?</th>
<th>The complexity of calculating the correct amount of tax credit could cause unintentional non-compliance. The multiple requirements for existing office buildings to be eligible for conversion could result in taxpayers claiming the credit for office buildings that comply to some but not all of the requirements for the tax credit. The various uses office buildings can convert to have differing requirements to qualify for the credit, such as the residential property and the requirement for a certain amount of low-income occupants. Ensuring that the tax credit is not double dipped with other tax credits can create claiming too much in tax credits. These details that must be carefully complied with makes this bill not meet the principle of minimum tax gap.</th>
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<th>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?</th>
<th>This bill aims to ensure efficient use of buildings and enable new businesses to enter high traffic areas. However, taxpayers may be confused why it is limited to old buildings as that can limit several buildings that would be beneficial to also convert. A downtown area might only have a small number of old buildings, leaving many office buildings still empty after the migration to work from home. Also, this tax credit is complex and eligible building owners might not pursue the conversion and leave the office buildings as currently constructed. This bill does not meet the principle of accountability to taxpayers as people are unlikely to understand the age and some other qualifications for the credit given the purpose stated by the sponsors.</th>
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<th>Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when?</th>
<th>The government would have access to data on taxpayers that have owned and rented out office buildings at certain addresses and for how long. It would be difficult to forecast how many of these taxpayers would convert their office buildings due to this tax credit and how much they would spend to convert these buildings. As there is no cap on how much expenditures can be spent to convert these office buildings, the tax credit could be extremely large for some taxpayers and likely difficult for the government to estimate. Therefore, this bill does not meet the principle of appropriate government revenues.</th>
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Based on this analysis, the Revitalizing Downtowns Act has a positive rating for the principle of certainty, convenience of payment, effective tax administration, and economic growth and efficiency. Several key principles including equity and fairness, simplicity, neutrality, transparency and visibility, minimum tax gap, accountability to taxpayers, and appropriate government revenues are not met.

Suggestions for improvement (although overall principles of good tax policy are not well met for the proposal):

1. Consider including converting taxpayers’ office buildings to government office spaces or schools. This will improve how the proposal meets the principle of neutrality.
2. Adjusted gross income (AGI) limitations can help better meet the principle of vertical equity. For example, if the taxpayer’s AGI exceeds a certain threshold, the credit must be reduced. This limitation will allow taxpayers with a lower AGI to receive a higher tax credit and pay less taxes than taxpayers with a higher AGI.
Global Mobility Taxation

By: Inessa Zlobina, EA, MST Student

The 37th Annual TEI-SJSU High Tech Tax Institute Conference took place on November 8 and 9, 2021. This was the second time since its establishment that the conference was held virtually due to the continuing gathering restrictions of the COVID-19 pandemic. The conference featured panels with government representatives, tax practitioners, academic professionals, and industry professionals. The panel that spoke on global mobility taxation addressed the issues and industry trends that have arisen in the post pandemic world. Panel representatives were Eric M. Anderson, Managing Director at Andersen; Kristen Nygren, Senior Attorney, IRS; Richard Tonge, Principal, Grant Thornton; and Cosimo Zavaglia, Partner, Morgan Lewis.

Current state of “global mobility”

Mr. Tonge kicked things off by looking at the current state of “global mobility” and trying to forecast future trends going into 2022. The world has changed dramatically, according to Mr. Tonge, and the global mobility activity has slowed since March 2020 because of the unprecedented global pandemic. However, there are hopes that the mobility business will rebound. In particular, there is expected to be an influx of business travel into the U.S. after the travel ban was lifted on November 8, 2021.

Mr. Tonge further discussed the context for global mobility, which is marked by significant fluidity as the Delta variant stalled return-to-work strategies and consolidated remote and hybrid working. At the same time, global mobility functions are already undergoing rapid and permanent change. Over the last few years, global mobility professionals have been asked to help lead the digital transformation that is reshaping organizations worldwide. Feeling connected to home has proved vital for assignees, and so flexible work is here to stay post-pandemic.

Companies have changed their hiring strategies in response the “Great Resignation,” a new harsh reality for businesses already struggling to attract workers back to the office. To stay competitive, more and more companies allow for remote work arrangements. Internationally, there is competition to attract immigrant professionals into their countries. For example, Costa Rica now allow digital nomads, who can work remotely without a visa sponsorship that used to be required.

This brings new challenges for corporations and employees because of tax considerations. For companies looking to embrace remote work, it is important to make sure there is clarity and understanding of all components of hybrid remote work arrangements.

According to Mr. Tonge, there are no new tools to address global mobility in the post-pandemic world. Internationally, looking at U.S. tax rules and agreements addressing individual taxation and employer considerations, the starting point are the protections that double tax treaties offer. There are approximately 70 double tax treaties which mitigate double taxation, including
employment income related to period of time (typically up to 183 days in a specified 12-month period) working in a foreign country.

Similarly, the U.S. has concluded bilateral “totalization” agreements covering social security contributions with 30 countries. These agreements allow for social security contributions to be made only in the home country for a period typically up to five years.

Mr. Tonge illustrated as an example – U.S. Model Tax Treaty Article 14 (2), according to which remuneration derived by a resident of a Contracting State in respect of employment exercised in the other Contracting State shall be taxable only in the first-mentioned Contracting State if:

a) the recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days for all twelve-month periods commencing or ending in the tax year concerned;

b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other Contracting State; and

c) the remuneration is not borne by a permanent establishment that the employer has in the other Contracting State

Mr. Tonge explained, that when looking at the application of a double tax treaty, its definition of residency must be considered. Companies should be aware of what puts them on the radar of tax authorities. China is a prime example of using big data to identify taxable individual sources of income and then offensively following through to identify whether there are compliance failures. Mr. Tonge, reasoned that it is going to be important for the tax department to be cognizant of the potential risks that exist, which at this stage are unknown – e.g., parameters, hybrid work policy, and the limit on the number of days that an individual is allowed to spend at a location.

**IRS – limited relief and not much guidance**

From the federal perspective, Ms. Nygren, IRS Chief Counsel Office (Small Business-Self-Employed), acknowledged that not only are businesses trying to navigate constantly changing work conditions by addressing hybrid work arrangements, but also that some foreign employees are stuck in the U.S. or were prematurely brought home from their international assignments. She noted, however, that as of now the IRS has not released any advice in relation to working from home or hybrid working arrangements. Instead, Ms. Nygren suggested looking at the history of what the IRS has done in the past and also informed that unless the IRS sees more cases coming from large taxpayers, they will not be offering any advice.

Ms. Nygren further elaborated on the IRS response to travel limitations caused by COVID-19. In particular, Revenue Procedure 2020-20 defines COVID-19 Emergency Period as a single period of up to 60 consecutive calendar days selected by an individual starting on or after February 1, 2020 and on or before April 1, 2020, when the individual is physically present in the U.S. COVID-
Emergency Travel Restrictions are travel disruptions or restrictions that prevent an individual from leaving the United States during the COVID-19 health emergency.

Ms. Nygren explained that an eligible individual is a person who: (1) was not a U.S. resident at the close of the 2019 tax year; (2) was not a lawful permanent resident at any point in 2020; (3) was present in the U.S. on each day of the individual's COVID-19 Emergency Period; and (4) did not become a U.S. resident in 2020 due to days of presence in the U.S. outside of the individual's COVID-19 Emergency Period.

Under Rev. Proc. 2020-20, an eligible individual who planned to leave the U.S. during the individual's COVID-19 Emergency Period but was prevented from doing so due to COVID-19 Emergency Travel Disruptions may exclude up to 60 days during the individual's COVID-19 Emergency Period for purposes of applying the substantial-presence test. Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition, should be filed by the due date for filing Form 1040-NR.

Ms. Nygren further expanded on IRC section 911(a) which allows a "qualified individual" to elect to exclude from gross income the individual's foreign earned income and a housing cost amount, where:

1) An individual is a qualified individual under IRC section 911(d)(4) for the period in which the person was a bona fide resident of or was present in a foreign country if the individual left the country during a period for which the Treasury Secretary determines that individuals were required to leave because of war, civil unrest, or “adverse conditions”.

2) For 2019 and 2020, the COVID-19 emergency constitutes an adverse condition that precluded the normal conduct of business for purposes of IRC section 911(d)(4).

Ms. Nygren pointed out that, generally, the Treasury Secretary must declare what meets the waiver of time requirements under Section 911 for individuals electing to exclude their foreign earned income and who must leave a foreign country because of war, civil unrest or similar “adverse conditions” in that country.

Ms. Nygren emphasized that the global health emergency caused by the COVID-19 pandemic is “an adverse condition” according to the Treasury Secretary. Further guidance might be provided. She advised to stay tuned to an annual revenue procedure which publishes the details of which countries meet this requirement. As per current Rev. Proc. 2021-21, no countries are listed due to COVID-19 implications.

State tax implications of remote work

Mr. Zavaglia addressed state tax implications of remote work. He began with identifying four aspects of state tax considerations: Secretary of State registrations, corporate income tax, sales and use tax, and payroll tax.
Mr. Zavaglia pointed out that, in order to qualify as doing business in a state, which also requires registration with Secretary of State, it is often enough to have just one employee working for a business in a state for a short duration of time.

Based on the *Wayfair* decision, more states adopted thresholds to establish economic nexus for sales and use tax as well as for corporate income tax, which do not require physical presence in a state. These thresholds vary and may depend on a sales amount and/or a certain number of transactions as set by the state. For example, online retailers should be mindful that in situations where they are not hitting the sales or transactions thresholds, they can create nexus by having an employee working in the state. This will result in tax filing obligations.

Mr. Zavaglia reminded that the “employer nexus” to trigger withholding for most states is an employer office in the state, or some other nexus to trigger state income tax and payments of any wages subject to income tax in the state (or subject to contribution under the state’s unemployment compensation laws). Often it is enough to have one employee in a state in order to qualify as having presence in a state. Whereas some states provide thresholds before withholding is triggered (e.g., New York and Connecticut), based on days worked, dollars earned, or some combination of the two. Other states require withholding on the first day of work (although for lower-paid workers, minimal allocated income may be less than the standard deduction and a personal exemption).

Next, Mr. Zavaglia commented that due to the pandemic, most of the states provided leniency during 2020 and issued temporary relief. For example, if business activity in a state was limited to having an employee in the state working from home because of the pandemic, the state may not have required this business to register and begin withholding. For the most part, these temporary relief measures have expired and there is no certainty as to what will happen next.

COVID-19 presents many fiscal challenges to already cash-strapped states. Mr. Zavaglia warned that states are looking for ways to bridge their budget deficits. Because payroll taxes have been an area with a high audit potential, employers who allow remote work arrangements may consider updating to a payroll system capturing an employee tracking component in order to best prepare for potential audits. Employers should stay alert for up-to-date guidance on future audits in a state where a business has employees, and should regularly consult with advisors and maintain documentation on conversations with officials.

Mr. Zavaglia summarized the general rules for employee state income tax withholding applicable to resident and nonresident employees. Specifically, if an employer is doing business in a state, then income tax withholding is generally required on all wages paid to resident employees regardless of the state where wages are earned. States have various rules about whether, and how much credit is allowed against resident income tax withholding for income taxes withheld in other states.

For nonresident employees, state income tax withholding applies to wages that nonresident employees earn for work they perform (or, in some states, are “deemed to perform”) in the
nonresident state. Wages earned outside of the nonresident state are generally not subject to state income tax withholding – subject to exceptions for “convenience of the employer” states. Generally, an employer who pays wages to an employee in a state, must register with the state and begin withholding. There are exemptions, such as reciprocal agreements, for example between New Jersey and Pennsylvania.

Furthermore, Mr. Zavaglia advised to be mindful of the “convenience of the employer” rule. Some states use this for sourcing income earned by nonresidents who work for in-state employers at a location outside the state (e.g., from a home office). Under the convenience rule, the sourcing of this income depends on whether the nonresident taxpayer was working remotely for the employee’s convenience or for the employer’s necessity. Five states (Arkansas, Delaware, Nebraska, New York, and Pennsylvania) apply the convenience rule. Connecticut applies it only if the taxpayer’s resident state applies a similar rule for work performed for a Connecticut employer. The convenience rule also has implications for the income tax credit states that allow resident taxpayers to claim for taxes paid to other jurisdictions (i.e., resident credit). Although the resident credit is generally intended to avoid double taxation, differences in the income sourcing rules between states can result in the same income being taxed by two states. Tax experts have raised the question of whether the days employees work remotely during the pandemic should qualify as convenience days or necessity days in states that apply a convenience rule. New York, for example, has issued guidance indicating that taxpayers should treat these remote days as convenience days, and thus source the income earned for these work-at-home days to New York. There have been legal challenges to this rule.

With hybrid work arrangements getting more popular, Mr. Zavaglia addressed remote work policy considerations such as approval from a payroll department before an employee begins remote work in a certain state. He highlighted the importance of setting expectations and to establishing remote work parameters, i.e., where remote and in-office rules differ; teleworking as an accommodation or as a job requirement; productivity and performance; work-hour expectations; break period expectations; and recordkeeping expectations. Additionally, according to Mr. Zavaglia, such policies should address protection of proprietary information, absences (sick leave and vacation), home as the workplace, expense reimbursement, and choice of law.

Mr. Zavaglia concluded by reminding attendees that an employer has an obligation to withhold taxes to the state. He suggested best practices such as telecommuter training and telecommuter manager training; requiring an employment contract that addresses work-from-home expectations for employees who voluntarily opt to primarily work remotely; and assuming that employees who work remotely, are working from their home/residence address of record, unless an employee says otherwise. Mr. Zavaglia further emphasized that employers need to make employees aware that working remotely has its own tax consequences. Employers should warn employees that proof of remote work location may be required, but should also refrain from giving tax advice to employees. Instead, they should encourage employees to consult their own tax advisors.
Global mobility and local taxes

Next on the agenda was a presentation by Mr. Eric M. Andersen on how global mobility affects local taxes. Local taxes have added another layer of complexity. Mr. Andersen provided details on possible implications of remote work arrangements from a local tax perspective. As such, Mr. Andersen explained that the pandemic has had a monstrous impact on state taxes, especially in major metropolitan areas, starting with residency issues such as migration to certain states. As many local tax measures are based on where services are performed, flight from a city may create an opportunity to reduce taxes. Mr. Andersen urged businesses to look at their numbers and to pursue tax refund opportunities, if any, to lessen tax burdens. He confirmed what the other speakers said: hybrid and remote working arrangements are here to stay. Mr. Andersen illustrated how three big cities tackle the global mobility issue as summarized in the following chart prepared based on his presentation.

<table>
<thead>
<tr>
<th>Name of the tax</th>
<th>New York</th>
<th>San Francisco</th>
<th>Los Angeles</th>
</tr>
</thead>
<tbody>
<tr>
<td>What’s included</td>
<td>trades, professions, and certain occupations of an individual, partnership, limited liability company, fiduciary, association, estate or trust where Professional and other service organizations are large taxpayers: hedge funds, private equity, law firms, accounting firms, consulting firms, advertising agencies, SaaS, and licensing companies</td>
<td>all persons doing business in the city - most businesses regardless of form</td>
<td>all persons doing business in the city - most businesses regardless of form</td>
</tr>
<tr>
<td>Rate / Components</td>
<td>4%</td>
<td>Gross receipts tax depends upon NAICS category up to 0.65%. Homelessness gross receipts tax up to 0.69%. Payroll expense tax 0.38%</td>
<td>0.45%</td>
</tr>
<tr>
<td>Allocation formula</td>
<td>Services performed in NYC / Services performed everywhere = NYC allocation %.</td>
<td>Payroll allocation based upon percentage of working hours in San Francisco, percentage of business transacted in San Francisco, based upon a reasonable method given facts and circumstances.</td>
<td>Tax depends upon business activity up to .45% of gross receipts for “professions and occupations” businesses. Taxable gross receipts measured by “work performed in the city.”</td>
</tr>
</tbody>
</table>

Mr. Andersen demonstrated the substantial savings on local taxes might be achieved, based on the data of one of his firm’s clients with offices in San Francisco and New York City, if they track the locality of where work is performed by their employees. Mr. Anderson went on to consider how working hours are apportioned in other localities where the work was performed. There are different regimes across the country. For example, Philadelphia came up with their version
of the convenience test. If a worker based in Philadelphia is working in New Jersey or outside of the city limits, the city considers that this employee is still working in Philadelphia and will impose their tax based on payroll expense upon this employee telecommuting. Substantiation may be the key to determining and realizing tax benefits, because the burden is on the taxpayer. Expenses and parking receipts can be used as evidence to show that the work was performed outside the city limits. Companies may employ technology solutions, such as an app on an employee’s phone to track where employees perform work. Privacy concerns should be addressed.

Conclusion

The session concluded with Mr. Tonge, who emphasized the role of technology in addressing real time mobility. Over 90% of companies surveyed by Grant Thornton confirmed that their return-to-work strategy incorporated technology solutions, such as identifying the geo-location of the employees and to automating tax and risk analysis, which supports audit defense. This is critical in the post-pandemic world where hybrid work arrangements are here to stay. The role of a tax and finance department is to deal with complexity of domestic and international rules, to identify options to support the business, to mitigate attrition, and to realize a form of hybrid working with tax parameters central to format. The participants briefly discussed current challenges that their clients encounter in this post pandemic world. As the clients are located all over the map, this becomes an important area for risk management. Because the workforce is so mobile, taxes are triggered in multiple jurisdictions and liabilities arise which must be accounted for. The participants highlighted the important role of tax and finance departments in navigating these different layers of the tax complexities along with leveraging technology solutions.

Hold the Date

38th Annual TEI-SJSU High Tech Tax Institute

November 7 and 8, 2022

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

Also check the webinars tab for presentations by SJSU MST faculty.
IRC Section 1202 – Don’t Overlook This Old Rule

By: Priti Trivedi, MST Student

The 37th Annual TEI-SJSU, High Tech Tax Institute, took place on November 8 and 9, 2021. One of the programs addressed “IRC Section 1202 – Don’t Overlook This Old Rule” and featured panelists Thomas Bondi, Partner, Armanino; Jeff Kirkendall, Partner, Moss Adams; Erika Reigle, Senior Attorney, IRS; and Nancy Young, Partner, Seiler LLP. These panelists addressed the opportunities and challenges associated with the section 1202 gain exclusion and how investors and corporations can maximize the benefits of this exclusion.

Section 1202 overview and planning opportunities

Section 1202 was enacted in 1993 to encourage investment in small businesses operating as C corporations. Section 1202 defines qualified small business stock (QSBS) as shares of a qualified small corporation. It generally permits a non-corporate shareholder to exclude up to 100% of the gain from the sale or exchange of QSBS issued after September 27, 2010 and held for more than five years. A gain exclusion of 50% and 75% is available for QSBS issued between August 1993 and September 27, 2010. The overall exclusion per issuer is limited to $10 million or 10 times the aggregate adjusted basis of the disposed shares. This section became more attractive when the exclusion was raised to 100% for shares issued after September 2010 and when the capital gain tax rate increased from 15% to 20% in 2013.

Mr. Bondi and Mr. Kirkendall discussed qualifications for a QSBS treatment. A small corporation must meet the gross assets test of $50 million or less, and 80% of these assets must be used in an active trade and business. No service businesses such as accounting, law, engineering, farming, restaurants, hotels, and others, qualify for this treatment.

Mr. Bondi and Mr. Kirkendall emphasized taking advantage of section 1202 in the reorganization and incorporation of an entity. They gave an example of a taxpayer who holds QSBS with a current fair market value of $5 million and zero-cost basis with a holding period of four years who exchanged shares in a domestic corporation in a triangular merger transaction for $1 million cash and $4 million shares of non-QSBS buyer. The $1 million boot is taxable immediately. If the taxpayer holds the shares for another two years and sells for $12 million, then $4 million of gain will still qualify for the QSBS exclusion, and the rest is taxable.

Mr. Kirkendall emphasized that recapitalization, as defined under section 368, can also qualify for exclusion, as defined under section 1202(h)(4)(a), if QSBS can be exchanged for other QSBS, and if a transaction qualifies as a reorganization, as defined under section 368. When the holder ultimately sells the replacement QSBS, the holder will claim the section 1202 gain exclusion if the holder meets the five-year holding period requirement. However, anti-churning rules prohibit shareholders from converting non-qualified shares into QSBS shares.

Ms. Young discussed aggregating Section 1202 gain exclusion substantially by spreading it over more than one “taxpayer,” each with a separate $10 million cap and 10 times aggregated adjusted basis cap. Founders can structure the ownership of QSBS to include a spouse, adult children, and other family members. In addition, exercising stock options early to cover the
holding period, making 83(b) elections, and section 1045 rollovers may qualify under the section 1202 exclusion. For example, if the taxpayer successfully rolls over the sales proceeds under section 1045, gain on the original QSBS will be deferred if it is held for more than six months and by rolling the sales proceeds over into replacement QSBS until the replacement QSBS is sold. Lastly, shareholders can also take advantage of gift and estate tax exemption or structure the trust as a non-grantor trust for income tax purposes but not as a completed gift for gift and estate tax purposes. Section 1202 planning should also consider state tax consequences.

Proposed tax law considerations

Mr. Bondi emphasized that very little guidance in this area is provided by the IRS. All the panelists agreed that legislative history and some private letter rulings are the only guidance available to help make decisions for tax practitioners. Another challenge is that the QSBS-issuer does not advise the shareholders on whether they qualify for a section 1202 exclusion. The burden falls on shareholders to take a position on how the gain should be treated on their tax return. Ms. Reigle said, “we are aware that additional guidance is needed.” She noted proposed changes to section 1202, including retaining the exclusion benefits for taxpayers with an AGI of $400,000 and below, retaining the 50% exclusion for all taxpayers, and eliminating the 75% and 100% exclusion for taxpayers with an AGI above $400,000. These changes as included in the Build Back Better Act would be effective for QSBS sales after September 13, 2021.

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Digital Services Taxes

By: Tam Nguyen, MST Student

The 37th Annual TEI-SJSU High Tech Tax Institute was honored to have a prestigious panel presenting on the highly complex topic of digital services taxes (DSTs). This panel consisted of Ken Harvey, Partner at Armanino; Jenny Austin, Partner at Mayer Brown; John Clausen, Managing Director at Moss Adams; and Mike Shaikh, Partner at Baker McKenzie LLP. This panel discussed the implementation of DSTs to address problems in international commerce, and the OECD’s Pillar One framework being created for the international community. With the world becoming more digitized by the minute, these taxes will likely become implemented by many governments.

International commerce problem

Mr. Harvey began by discussing a problem over 50 years old about how international commerce is taxed. In the past, if the taxpayer didn’t have a permanent establishment (PE) in the country, then it wasn’t subject to taxes there. With the rise of digital commerce, countries now want more tax revenue from these sales as most taxpayers do not have a permanent establishment in most countries that they are selling to.

This is challenging for countries as they must identify suppliers, sellers, and service providers who are selling domestically. Then the country must identify the customers those businesses are selling to. Ms. Austin brought up an example of a United Kingdom resident taking a vacation in Spain. While in Spain, the United Kingdom resident books a tour to see the Eiffel Tower in Paris. In this scenario, which country has the right to tax this digital transaction? To solve this problem, countries must decide who is taxed and where they are going to be taxed.

Implementation of digital services taxes

With digital commerce becoming more and more prevalent, countries want to enforce a tax on online transactions to broaden their tax base. One solution would be to create DSTs targeted towards online advertising, video streaming or downloading, e-commerce sales or services, and crypto transactions. The focus is on business-to-consumer transactions rather than business-to-business transactions. The governments that are currently enforcing DSTs are all implementing them differently, so it is difficult for a taxpayer to ensure they are in compliance.

In Europe, for example, a 3% tax has been proposed on gross revenues from the following digital services: selling online space, digital intermediary activities, and selling user data. The DSTs would apply to domestic and foreign companies with worldwide income of 750 million euros (approximately 846 million U.S. dollars) and European revenues of 50 million euros (approximately 56 million U.S. dollars). France was the first country to enact DSTs—followed by Italy, Austria, and Spain. In total there are just over 30 countries around the world that have enacted DSTs.

Nevertheless, the United States is generally opposed to DSTs as they mainly target U.S. companies. State governments, however, have not been hesitant to pursue DSTs. They believe
that because of the transition to a digital economy, there is a tax base erosion with fewer in-person transactions. As more transactions happen online, digital goods and services transactions are seen as an untapped source of revenue to make up for losses incurred due to less taxes collected from in-person transactions. Maryland was the first state to enact a DST: HB 732, which created a gross receipts tax on digital advertising services provided by companies with a minimum of $100 million in gross annual revenues. Other states have already proposed new taxes on the sale of digital advertising services, consumer or user data, and social media providers. Some states have placed this new tax as high as 15% on gross receipts, which is concerningly high for taxpayers who already must abide by income tax and sales tax.

**Pillar One**

Pillar One is an international proposal to provide a tax framework to address the issues arising from the transition to a digital economy. As currently drafted, Pillar One would affect the largest companies whose revenue exceed 20 billion euros (approximately 22.5 billion U.S. dollars). It allows countries to reallocate taxing rights for these companies to the market countries. Nexus is determined when a company derives at least 1 million euros of revenue (approximately 1.1 million U.S. dollars) from a country. For smaller countries with gross domestic product lower than 40 billion euros (approximately 45 million U.S. dollars), nexus is set at 250,000 euros (approximately 282,000 U.S. dollars) of revenue. After nexus is determined, 25% of residual profit above the 10% profitability threshold is subject to tax and allocated to market countries by a revenue allocation key.

This new tax framework would eliminate the need for countries to rely on the permanent establishment principle to determine tax liabilities. Certain rules still need to be developed such as safe harbor amounts and relief from double taxation. Even though many details are still to be developed, Pillar One is expected to come into effect globally in 2023. Once Pillar One is in effect, countries would remove any active DSTs, and all countries would tax companies under this new framework.

**Conclusion**

The problem of taxing companies internationally has been a problem for several decades. With digital commerce becoming the dominant way to conduct transactions, imposing proper taxes due to each country became more difficult. The implementation of DSTs can help countries overcome the difficulty of abiding by the longstanding permanent establishment principle. DSTs helps governments increase their tax base and provide revenue from sales that are being conducted in their jurisdiction. Several DSTs are enacted throughout the world at national and state levels with many more governments actively considering them. This new tax is seen as necessary as the world continues to move towards digital transactions. DSTs have propelled the international community to create Pillar One that will become a global framework for every country to follow.
Evolution During a Pandemic: The 27th Annual Tax Practitioner/IRS Fall Seminar

By: Dale Loepp, CPA, MST Student

Being able to thrive in the midst of change has always been a mark of distinction for the tax professional. However, developments over the past two years have launched a significant evolution in tax practice that no one could have predicted. These developments, which include new laws, new roles, and new risks for tax preparers, were highlighted at the 27th Annual Tax Practitioner/IRS Fall Seminar, co-sponsored by San José State University’s Lucas College and Graduate School of Business, and a number of local chapters of the California Society of Enrolled Agents. This seminar, held on November 9 and 10, 2021, provided a lively forum in which participants could update their knowledge on “hot topics” in federal and California taxation, and gain a broad overview regarding the direction of the profession in light of the upheaval brought on by the COVID pandemic. Attended by more than 300 virtual participants, the event showcased nearly twenty different speakers: tax practitioners, academics, and personnel from the Internal Revenue Service and Franchise Tax Board. Presentations not only included law-specific topics such as the Employee Retention Credit, Estate and Gift Tax developments, but also included presentations focusing on economic trends, the current state of IRS operations and services, and new perspectives on tax preparers’ ethical responsibilities, especially in light of current realities.

While it would be impossible to summarize here all of the information presented during this seminar, several broad themes did emerge over time. First, Congress’s response to the pandemic has clearly stretched the resources and roles of both the tax professional and government agencies, especially and including the Internal Revenue Service. Second, communicating as tax professionals, a process already undergoing development prior to the pandemic, has been catapulted squarely into the internet age. Third, changes in office environments and remote work arrangements have presented new ethical and security challenges for tax preparers. And fourth, some of the fundamental ways in which we undertake and understand commercial transactions are likely to change with the increased presence and use of virtual currency. Taken together, these basic shifts not only challenge tax preparers to think through and revise many of their long-standing business practices, but also encourage practitioners to explore exciting new horizons in the way tax professionals can better serve their clients.

While understanding new developments in tax law has always been part of being a responsible tax practitioner, the pandemic turned the attention, at least temporarily, of both preparers and governmental agencies toward a patchwork of programs intended to bring economic relief: for example, various Federal and state stimulus payments, the Paycheck Protection Program, the Employee Retention Credit, and advance payments of the Child Tax Credit. Clients have understandably relied upon their tax professionals for assistance with these programs and to help them understand the programs’ ever-shifting regulations and accompanying tax strategies.
Sharon Fisk and Tim McCormally of the IRS’s Office of Professional Responsibility reminded seminar participants that accepting new and unfamiliar projects on behalf of pleading clients may force the tax preparer beyond their level of expertise and could also potentially threaten independence. McCormally observed that tax professionals might even be tempted to simply “wing it” in order to meet the urgent needs of their clients, when the situation actually calls for either additional professional education or even the referral of business to someone who is more qualified. Especially in the current environment, tax preparers may not be able to be all things to all their clients.

Along with brand new programs and enhanced tax credits, the pandemic has also forced the rapid adoption of new means of human interaction and information exchange, just as the virtual nature of this seminar itself demonstrated. The system of communication between taxing authorities and the tax practitioner, as well as between taxing authorities and individual taxpayers is currently in a state of flux. However, based on some of the tools that that IRS has already adopted, one can get a good sense of where the IRS is headed on this front. The burden of Congressionally-mandated economic relief and new remote-working environments have exposed serious fault lines in the IRS’s traditional phone-call and paper-correspondence systems. In response, the IRS has been rolling out a series of innovations that incorporate taxpayer and tax professional internet portals—adapting certain features which were first modeled by California’s Franchise Tax Board. Face-to-face audits and conferences have largely shifted to virtual settings, a trend which seminar presenter Albert Ju, IRS Exam Territory Manager, predicted would continue for the foreseeable future. Tax Pro Accounts will soon gain added functionality beyond simply being able to file Powers of Attorney and Tax Information Authorizations. With enhanced mobile-friendly identity verification, taxpayers will increasingly be communicating directly with the IRS using IRS online portals and services. All of these enhancements have required a significant commitment by the IRS to an expanded workforce and increased employee development, processes which have also employed virtual methods. Over time, both taxpayers and tax professionals will see significant changes in the way they interact with the IRS.

Of course, new means of communication and exchanges of information haven’t been limited to the IRS. Remote working and lack of face-to-face interaction between tax professionals and clients have also revolutionized both the means of communication and the way tax work is documented. New and unusual physical work environments have created scenarios that are much more difficult to monitor or supervise than those of the traditional office, and these new forms of communication and information exchange automatically bring on new risks. Fisk and McCormally observed that tax practitioners will need to closely examine and probably redesign many of their systems and procedures. Encrypting document exchanges and drop boxes, developing means to oversee remote working environments, and examining firewalls, password policies, servers, and disaster recovery plans all require additional scrutiny in these new and evolving work environments. Professional practices and work settings, even if remote, must still comply with Circular 230 and practitioners were urged to take advantage of IRS Publication 4557 to help create a strong and viable written security plan to protect their clients.
Several seminar speakers reported ways in which criminals have also taken advantage of new vulnerabilities brought on by the pandemic. Older and more familiar techniques such as email phishing and hacking, malware, ransomware, and identity theft have all continued apace—but new and innovative techniques have also been tried, exploiting pandemic work settings such as mostly-empty business suites and home offices. Seminar presenter Special Agent Mark Pearson of the IRS’s Division of Criminal Investigation highlighted some of the innovative ways in which criminals have taken advantage of new vulnerabilities. Cybercriminals posing as janitorial crews have broken into tax systems—rich sources for data and identity theft—now made especially attractive by new flows of government payments. Home smart speakers and internet connections have proven particularly susceptible to security breaches. Agent Pearson reiterated many of the concerns expressed by Fisk and McCormally, stressing the need for an updated, written data security plan that covers all of an individual firm’s potential work environments.

Another dimension of change for the tax professional is the increased use and popularity of virtual currency, which, as Special Agent Pearson observed, is often employed in cybercriminal schemes because of the difficulty in tracing transfers. Professor Annette Nellen, Director of the Masters of Science in Taxation Program at San José State, presented many of the unresolved tax issues posed by virtual currency as part of the seminar’s “hot issues” panel discussion. As this medium of exchange both evolves and increases in number and type, basic questions about the nature and definition of virtual currency and its sale or exchange remain unaddressed by Congress—although the IRS is beginning to recognize the difficulty of detecting and regulating this economic activity which occurs outside the traditional banking system. Professor Nellen helpfully provided participants with a link to a website that she maintains compiling tax information on this topic: http://www.21stcenturytaxation.com/virtual-currency-and-tax.html. Obviously, this is an area which will require increased scrutiny and attention by preparers for a long time to come.

Employing many different perspectives, this seminar demonstrated that the way tax professionals serve their clients will be significantly redefined over the coming years; almost everything we do is now undergoing some element of transformation. Of course, tax law will continue to develop and change and tax practitioners will need to find systems to keep abreast of these changes, but adapting to new ways of communicating, a multiplicity of new work environments, and even fundamentally different ways of doing business may all eventually prove to be an even greater challenge for the tax practitioner in near term.

The SJSU MST Program will continue its co-sponsorship of this excellent annual program. Expected dates for the 28th Annual forum are October 26 & 27, 2022. For more information, visit https://www.sjsu.edu/taxinstitute/ or https://missioneas.org/.
1. Study Unit 6.1 [Source: CPA 21 REG-29]

Required: The expenses deducted to calculate net profit.

A real estate broker reported the following business income and expenses for the current year:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>Commission income</td>
<td>$100,000</td>
</tr>
<tr>
<td>Expenses:</td>
<td></td>
</tr>
<tr>
<td>Auto rentals</td>
<td>2,000</td>
</tr>
<tr>
<td>Referral fees to other brokers (legal under state law)</td>
<td>20,000</td>
</tr>
<tr>
<td>Referral fees to nonbrokers (illegal under state law)</td>
<td>8,000</td>
</tr>
<tr>
<td>Parking fines</td>
<td>200</td>
</tr>
</tbody>
</table>

What amount should be reported as net profit on Schedule C, Profit or Loss from Business?

A. $69,800  
B. $70,000  
C. $77,800  
D. $78,000

**Explanation**

1. **Choice “D” is correct.** A deduction from gross income is allowed for all ordinary and necessary expenses paid or incurred during a tax year in carrying on a trade or business. An expenditure may be nondeductible if allowing the deduction would frustrate public policy. No amount can be deducted from gross income unless allowed by the Internal Revenue Code. Fines and penalties paid to a governmental entity and fees incurred that are deemed illegal by state laws are not deductible. Thus, net profit is $78,000 ($100,000 commission income – $2,000 auto rentals – $20,000 referral fees to other brokers).

2. Choice “A” is incorrect. Allowing a deduction for fines and penalties paid to a governmental entity and illegal bribes and kickbacks (i.e., fees incurred that are deemed illegal by state laws) would frustrate public policy. Therefore, such items are not deductible.
3. Choice “B” is incorrect. Allowing a deduction for fees incurred that are deemed illegal by state laws would frustrate public policy. Therefore, such fees are not deductible.

4. Choice “C” is incorrect. Allowing a deduction for fines and penalties paid to a governmental entity would frustrate public policy. Therefore, such fines and penalties are not deductible.
2. Study Unit 6.2 [Source: CPA 21 REG-13]

**Required:** The entity subject to the net investment income tax.

Which of the following can be subject to the net investment income tax?

A. An individual who is a resident of the U.S.
B. A domestic C corporation.
C. A nonresident alien.
D. A trust whose unexpired interests are devoted to a charitable purpose.

**Explanation**

1. **Choice “A” is correct.** The tax is imposed on the lesser of an individual’s net investment income or any excess of modified adjusted gross income for the tax year over a specified threshold. This tax essentially applies FICA taxes to income that previously was not subject to the taxes. Net investment income tax applies to a resident of the U.S.

2. Choice “B” is incorrect. A domestic C corporation is not subject to the net investment income tax, just as FICA tax does not apply to a corporation’s income.

3. Choice “C” is incorrect. Net investment income tax does not apply to nonresident aliens.

4. Choice “D” is incorrect. Net investment income tax does not apply to trusts, just as FICA tax does not apply to a corporation’s income.
3. Study Unit 8.2 [Source: CPA 21 REG-10]

**Required:** The amount of passive activity income.

A taxpayer employed full-time as an engineer has the following income items:

<table>
<thead>
<tr>
<th>Income Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Self-employment income</td>
<td>$50,000</td>
</tr>
<tr>
<td>Rental income</td>
<td>15,000</td>
</tr>
<tr>
<td>Dividend income</td>
<td>2,000</td>
</tr>
<tr>
<td>Long-term capital gain</td>
<td>1,500</td>
</tr>
<tr>
<td>Short-term capital loss</td>
<td>1,000</td>
</tr>
</tbody>
</table>

What amount is the taxpayer’s passive income?

A. $2,500
B. $15,000
C. $17,500
D. $18,500

**Explanation**

1. **Choice “B” is correct.** A passive activity is either a trade or business in which the person does not materially participate or a rental activity. Passive activity rules do not apply to:
   1. Active income/loss/credit
   2. Portfolio income/loss/credit
   3. Casualty and theft losses, vacation home rental, qualified home mortgage interest, business use of home, or a working interest in an oil or gas well held through an entity that does not limit the person’s liability

   Therefore, the $15,000 rental income is the only income item listed that is considered passive income.

2. Choice “A” is incorrect. Dividend income and capital gain/loss items are considered portfolio income and are not passive income items.

3. Choice “C” is incorrect. Only rental income is considered passive income.

4. Choice “D” is incorrect. Dividend income and long-term capital gain are not considered passive income.
4. Study Unit 9.3 [Source: CPA 21 REG-26]

**Required:** The taxpayer’s maximum deduction for the current year.

During the current year, an individual taxpayer completed the following stock transactions related to Alpha Corp. stock:

<table>
<thead>
<tr>
<th>Date</th>
<th>Shares traded</th>
<th>Price/share</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 15</td>
<td>1,000</td>
<td>$18</td>
</tr>
<tr>
<td></td>
<td>purchased</td>
<td></td>
</tr>
<tr>
<td>June 1</td>
<td>1,000</td>
<td>$12</td>
</tr>
<tr>
<td></td>
<td>purchased</td>
<td></td>
</tr>
<tr>
<td>June 10</td>
<td>1,000 sold</td>
<td>$10</td>
</tr>
</tbody>
</table>

The 1,000 shares sold on June 10 had been purchased on May 15. What is the maximum amount, if any, that the taxpayer can deduct in the current year?

A. $0
B. $2,000
C. $3,000
D. $8,000

**Explanation**

1. **Choice “A” is correct.** To prevent abusive transactions in which a taxpayer sells property at a loss but quickly repurchases the property, leaving the taxpayer in the position of still having the property but with the benefit of recognizing a loss, a current loss realized on a wash sale of securities is not recognized. A wash sale occurs when substantially the same securities are purchased within 30 days before or after being sold at a loss.

   1. The disallowed loss is added to the basis of the stock purchased in the wash sale.
   2. The holding period includes that of the originally purchased stock.
   3. Spouses are treated as one person.

   The stock sold on June 10 was purchased less than 30 days prior on May 15; therefore, the disallowed loss is added to the basis of the stock purchased in the wash sale.

2. **Choice “B” is incorrect.** The amount of $2,000 is representative of the $2 decrease in price from June 1 of $12 to June 10 of $10, which is not deductible.
3. Choice “C” is incorrect. An individual may deduct a net capital loss in the current year up to the lesser of $3,000 ($1,500 if MFS) or ordinary income. The amount of $3,000 is not deductible in this instance.

4. Choice “D” is incorrect. The amount of $8,000 is considered a realized loss and is added to the basis of the stock purchased on June 1.
5. Study Unit 10.5 [Source: CPA 21 REG-28]

Required: The item not allowed in determining gift tax liability.

In determining the amount of taxable gifts, the Internal Revenue Code allows each of the following except the

A. Charitable contribution deduction.
B. Standard deduction.
C. Gift tax annual exclusion.
D. Marital deduction.

Explanation

1. Choice “B” is correct. The standard deduction is not allowed in determining the amount of taxable gifts. See below for the formula to calculate gift tax liability.

   GIFT AMOUNT
   FMV on date of gift, for
   All gifts in the calendar year
   - Exclusions
     Annual exclusion
     $15,000 per done
     Paid (directly) on behalf of
     Medical care
     Education tuition
   - Deductions
     Marital
     Charitable
   = TAXABLE GIFTS FOR CURRENT
   + Taxable gifts for prior years
   = TAXABLE GIFTS TO DATE
   × Tax Rate
   = TENTATIVE GIFT TAX
   - (Prior year’s gifts × Current tax
   - Applicable credit amount
   = GIFT TAX LIABILITY

2. Choice “A” is incorrect. The charitable contribution deduction is allowed in determining the amount of taxable gifts.
3. Choice “C” is incorrect. The gift tax annual exclusion is allowed in determining the amount of taxable gifts.
4. Choice “D” is incorrect. The marital deduction is allowed in determining the amount of taxable gifts.
6. Study Unit 13.6 [Source: CPA 21 REG-16]

Required: The state apportionment ratio for State B.

A C corporation conducted all of its business activities in States A and B and generated $1 million of pretax income in Year 1. The tax rate is 10% in State A and 5% in State B. Both states apportion the taxable income of multistate corporations by employing an equally-weighted three-factor apportionment formula. Neither state allows a tax deduction for state corporate income taxes. At the end of Year 1, the corporation reported the following percentages for its activities in each state for the purpose of calculating the state apportionment factors:

<table>
<thead>
<tr>
<th>Activity</th>
<th>State A</th>
<th>State B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payroll expense</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Sales</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Net property value</td>
<td>25%</td>
<td>75%</td>
</tr>
</tbody>
</table>

What is the corporation’s Year 1 state apportionment ratio for State B?

A. 25%
B. 50%
C. 75%
D. 150%

Explanation

1. Choice “B” is correct. Once nexus is established, net income must be accurately allocated or apportioned among the various jurisdictions. The Uniform Division of Income for Tax Purposes Act provides a uniform method for allocating and apportioning a business’s income. The rules for the business’s nonbusiness income are different than those for the business’s business income. Allocation is used to identify nonbusiness income to a specific state or local taxing authority for income derived solely from assets held for investment purposes. Apportionment uses the formula below to calculate the average amount of business income a company brings in by conducting operations within the taxing state.

\[
\frac{\text{Property factor} + \text{Payroll factor} + \text{Sales factor}}{3}
\]

Therefore, the state apportionment ratio for State B is 50% \([(75\% + 50\% + 25\%) \div 3]\).
2. Choice “A” is incorrect. The corporation’s Year 1 state apportionment ratio for State B is calculated by averaging the sum of the three percentages of the payroll, sales, and property activities in State B; it is not based on the single factor of sales.

3. Choice “C” is incorrect. The average amount of business income a company brings in by conducting operations within the taxing state is calculated by dividing the three factors by the number of factors (i.e., 3), not by the number of states (i.e., 2), nor is it based on the single factor of net property value.

4. Choice “D” is incorrect. The ratio 150% is the numerator of the state apportionment formula and is required to be divided by 3 to calculate the actual apportionment ratio.
7. Study Unit 14.2 [Source: CPA 21 REG-36]

**Required:** The calculation of an S corporation shareholder’s stock basis.

An S corporation is owned equally by A and B, whose respective stock bases at the beginning of the year are $12,000 and $13,000. During the year, the corporation had $100,000 in ordinary business income and $5,000 in tax-exempt income. The corporation distributed $50,000 to each shareholder for the year. What is owner B’s stock basis at year end?

A. $15,500  
B. $15,000  
C. $13,000  
D. $10,500

**Explanation**

1. **Choice “A” is correct.** The adjusted basis of the shareholder’s stock is calculated at year end with increases for the shareholder’s pro rata share of all income items of the S corporation, including tax-exempt income, that are separately stated and any nonseparately stated income of the S corporation. The adjusted basis of the shareholder’s stock must also be decreased by the shareholder’s pro rata share of distributions by the S corporation. Owner B’s basis is $15,500 [$13,000 + ($100,000 × 50%) + ($5,000 × 50%) – $50,000].

2. Choice “B” is incorrect. Owner B has a 50% pro rata share of the ordinary business income and tax-exempt income of the S corporation.

3. Choice “C” is incorrect. The adjusted basis of the shareholder’s stock is calculated at year end with increases for the shareholder’s pro rata share of all income items of the S corporation, including tax-exempt income.

4. Choice “D” is incorrect. The shareholder’s basis is increased (not decreased) by the shareholder’s $2,500 ($5,000 × 50%) portion of the tax-exempt income.
Acknowledgement

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