The Contemporary Tax Journal

Volume 12
Issue 1 The Contemporary Tax Journal Volume 12, No. 1 – Spring 2023

5-9-2023

The Contemporary Tax Journal Volume 12, No. 1 – Spring 2023

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Welcome to
The Contemporary Tax
Journal

SJSU MST Journal
The Contemporary Tax Journal Spring 2023

Student Editors
Enas J. Al-Mais
Dale Loepp, CPA

Faculty Advisor
Annette Nellen

Webmaster and Compiler
Catherine Dougherty

Editorial Board
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San José State University

Joel Busch, CPA, Esq.
San José State University

Caroline Chen, Esq.
San José State University

William Skinner
Partner, Fenwick & West
Adjunct Faculty, SJSU MST Program

MST Student Contributors
Enas J. Al-Mais
Inessa Zlobina, EA
Aizhan Toibazarova
Tiago Iorio
Michelle Buchner

Jakub Hench
Ronald Le
Sheetal Partani, EA
Aiko Kawae
Eric Shao, CPA
Yan Rapisura
Nina Kramarenko
Gelena Shvetsova
MST Students in the Spring 2023 Tax Research Class

Special Thanks to
Mindy Harada Mayo, CPP
Rachana Khandelwal, MST
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Letter from the Editor

I and our editorial board are excited to present to you the Spring 2023 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 this edition. The topics covered in this issue are current and thought-provoking.

Our 12th volume begins with our *Tax Maven* interview with Mindy Harada Mayo, who is a tax Managing Director in the San Jose office of KPMG. Ms. Mayo specializes in independent contractor determinations as well as payroll tax audit assistance. She has extensive experience in advising clients on the US employment tax issues encountered by inpatriate and expatriate employees. I had the pleasure of conducting this interview with her and I hope her insights and experience will inspire you.

Following the interview, we have the Fun Tax Facts section written by Rachana Khandelwal, SJSU MST alum and the person who started this column. The next section is dedicated to *Tax Enlightenment*. This section includes an article written by SJSU MST student, Aiko Kawae, where she discusses the details and conclusions of a court case - Rost v. U.S., 130 AFTR2d 2022-5462 (5th Cir., 2022). I invite you to read this article on the reporting requirements for a Liechtenstein Foundation. As IRS defines it, a Liechtenstein Stiftung, or foundation, is a legal entity that does not have any members.¹


We then present summaries written by MST students on presentations made at the 38th Annual TEI-SJSU High-Tech Tax Institute and the 28th Annual Tax Practitioner/IRS Fall Seminar held in November 2022. The topics covered at these conferences include Like-Kind Exchanges, Crypto Opportunities, Pillars One and Two, Form 1099 Reporting Requirements and ASC 740.

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

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this journal, and for being a leader in the tax profession. 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 Spring 2023 issue of The Contemporary Tax Journal.

Regards,

Enas Al-Mais
Student Editor
Tax Maven

The Contemporary Tax Journal’s Interview with Ms. Mindy Harada Mayo

By: Enas J. Al-Mais, MST Student

For this issue of The Contemporary Tax Journal’s – tax maven feature, I had the pleasure of interviewing Mindy Harada Mayo, CPP. Ms. Mayo is a Tax Managing Director in the San Jose office of KPMG, assisting companies of all sizes with payroll issues encountered during a company’s life cycle. She is also the sole proprietor of OS Payroll, an independent consulting firm.

Ms. Mayo has over 30 years of employment tax experience advising clients through a myriad of tax issues. She specializes in independent contractor determinations as well as payroll tax audit assistance, leveraging her experience as an auditor to assist clients who are undergoing either a federal or state payroll tax review. Mindy also has expertise with the US employment tax issues encountered by inpatriate and expatriate employees.

Ms. Mayo has also assisted clients with mergers and acquisitions, downsizing, rectifying reporting issues, and penalty abatements to name a few.

Recognized nationally as an expert in the field of payroll and worker classification issues, Mindy is a frequent presenter for the American Payroll Association at both local and national events and is a member of the APA’s National Speaker’s Bureau. Mindy has presented to tax professionals on the topic of stock option taxation, the payment of inpatriate and expatriate employees, the issues encountered with a mobile workforce, and the due diligence process for payroll when undergoing a merger or acquisition to name a few. Following are questions I asked Ms. Mayo during our interview on November 7, 2022, in San Jose.

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

I started out as a philosophy major at SJSU and quickly learned nobody is going to pay me for my deep thoughts. I switched to accounting and graduated, eager to jump into an accounting job. I participated in the on-campus interviews and talked with the State of CA. I tested with them and ended up ranked as eligible for a job. They contacted me from their employment tax division. I took the job, not realizing how specialized I was going to become. Definitely! It was not my plan in college, but it has served me well.

2. What stands out as one or two of your most significant accomplishments in your career?
I have managed to become a recognized expert in the field of employment tax, and I am asked frequently to be a speaker throughout the country. It is a small circle, but it is nice to be recognized for my professional accomplishments.

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

The joy of working in CPA firms, especially the Big 4, is being surrounded by amazingly intelligent people. This is both within the firm and the clients that we deal with as well as the state and federal agencies. We have many resources at our fingertips, but my area of tax is very specialized. I look to the American Payroll Association as well as NASPP and SHRM for updates that are payroll, stock and HR related. Staying involved at the local and national level is very important. These groups are organized and generally run by volunteers who are recognized experts in their fields. Having them available to bounce ideas off and to discuss issues as they arise is how I stay on top of changes and upcoming issues.

4. What type of business activity are you involved with today that did not exist when you graduated from school and how did you get involved in the area?

All the remote speaking opportunities and teaching to diverse audiences across all areas of tax did not exist when I graduated from school. We now have instant access to content and expect answers to be at our fingertips. The online webinars and tutorials that can be accessed instantly did not exist when I graduated. The thought leadership that is available quickly and from reliable sources is phenomenal.

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

The poor IRS has struggled tremendously with automation on the payroll side and the pandemic has only made it worse. Their backlog of what they would like to do is long; and by the time they have funding and the ability to work through it, technology has evolved. Technology is not waiting for the IRS to be able to move forward. There are many parts of my job that could be simplified if the federal and state agencies had the ability to automate their return acceptance and processing.

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

Start broad and specialize later – after you have a core base of knowledge behind you. I became specialized right out of school, and it has worked out wonderfully. But if for
some reason I either disliked the work or the tax was eliminated, I have no skill or knowledge base to fall back on.

**Fun Questions:**

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

Mother Theresa. To find a human so completely dedicated to serving others is awe inspiring.

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

I have a large glass bowl on my desk that contains dozens and dozens of electronic hotel keys from all my travels. I look at it often and am thrilled that, post-pandemic, we no longer must travel like we used to. Companies have realized we can work remote and can connect via a video conference versus traveling to the countryside on a regular basis.

Fun Tax Facts

By: Rachana Khandelwal, MST

Long Faces Behind the Nobel Prize

Alfred Nobel, the notable Swedish scientist, left behind a handwritten will which stated his desire to leave behind a legacy. Nobel was Swedish by birth, died in Italy, but having spent most of his time in France left most of his movable assets in a French bank, with the notable exception of his horses that he moved to Sweden shortly before his death.

It was important for the French courts to decide Nobel’s tax residency to determine his tax liability and the legality of his will. As a man who detested lawyers and without immediate heirs, the validity of the self-written will was challenged by his extended family. The courts decided that Sweden was the legal domicile based on his stabled horses. This, in turn, meant that Swedish law applied to the execution of the will, leading to the creation of the Nobel Foundation.

Had there been no horses, the prestigious Nobel Prize wouldn't have materialized, so thank the horses!¹

Disappearing Ink Addressed by the U.S. Tax Court

Taxpayer Lou Ann Bassan of San Francisco filed a small case petition in U.S. Tax Court to dispute an IRS penalty. She mailed a $60 check to the court for the petition filing fee. A few weeks later, the court returned the check because it turned out to be blank. The court notice stated the mail was “irradiated” which erased the ink on the check.

So how was the check irradiated? In 2001, following an anthrax (bio-terrorism) scare in mail sent to U.S. senators and news agencies, the U.S. Postal Service began irradiating all mail sent to government agencies in Washington D.C. which caused certain inks to vanish. Acknowledging the issue, the Tax Court waived Ms. Bassan’s petition filing fee.²

A Buggy Tax

Amish communities in parts of Indiana pay a “buggy tax” as compensation for road damage caused by horse-drawn buggies which they primarily use for transportation. An $80 tax per buggy (as of November 2022) is collected from each Amish family, per buggy. For a buggy sold in the middle of the year, the new owner pays the tax irrespective of any tax paid previously.

This is similar to a “wheel tax” paid at vehicle registration in many cities and counties across the U.S.  

**The Emperor’s New Tax**

On September 17, 1859, Joshua Abraham Norton declared himself to be “Norton I., Emperor of the United States”. Shortly thereafter, he also declared himself to be the “Protector of Mexico”. He was a bankrupt businessman from San Francisco whose eccentricities and antics as the self-proclaimed “Emperor” endeared him to the local populace. His fame rose, and merchants used it to sell souvenirs and keepsakes in his name. In turn, to meet his living expenses, Norton collected an “Imperial tax” which the people of San Francisco happily paid.  

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Reporting Requirements for a Liechtenstein Foundation

By: Aiko Kawae, MST Student

Rost v. U.S., 130 AFTR2d 2022-5462 (5th Cir., 2022)

Introduction

This case involved whether a “Stiftung” under the laws of Liechtenstein should be treated as a foreign trust under IRC §6677 for the federal tax purposes. This paper discusses the details of how the court reached its conclusion.

Background

John H. Rebold, a United States citizen, worked as an oil and gas company executive engineer outside the U.S. In 2005, he traveled to Switzerland and formed the Enelre Foundation (the “Foundation”) as a Stiftung under the laws of Liechtenstein. Rebold was the settler and primary beneficiary of the Foundation, and his children were secondary beneficiaries. He opened bank accounts for the Foundation at Credit Suisse, UBS, and Bank Wegelin. He transferred $2,000,000 and $1,000,000 to the Foundation in 2005 and 2007, respectively.

In 2010, UBS informed Rebold that they planned to report the account records to the IRS. Rebold did not disclose any information regarding the Foundation, including the money transfer to the Foundation on his federal income tax returns for the years 2005 through 2007. Immediately after the bank contacted him, he consulted an attorney. The attorney told him that the Foundation was a foreign trust, so he needed to file Forms 3520 and 3520-A to the IRS, and the attorney recommended Rebold to participate in a voluntary disclosure program to reduce the penalties.

In 2013, Daphne Janette Rost, Rebold’s daughter and power of attorney, filed Forms 3520 and 3520-A for the Foundation from 2005 to 2007 on Rebold’s behalf. In 2014, Rebold was notified by the IRS and assessed penalties of $1,380,252.35 under §6677(a) and (b). Rebold disputed his liability and requested a collection due process hearing against the IRS. The IRS Appeals Office maintained the notice of levy but reduced the penalties by half. In 2017, Rebold paid the penalties of $596,830.00. In 2018, Rebold filed an administrative refund claim with the IRS, but he did not receive any decision from the IRS. Then, Rebold filed a refund suit against the IRS in 2019. He passed away in December 2019, and his executor, Rost, substituted as plaintiff.

The District Court

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1 Stiftung is a German vocabulary and it means “foundation”, “donation” or “endowment” in English. Rost v. U.S., 130 AFTR 2d 2022-5455 (5th Cir. 2022) cited German-English translation from https://en.langenscheidt.com/german-english/stiftung. The court also cited Stiftung v. Plains Mktg., L.P., 603 F.3d 295, 299 n.1 (5th Cir. 2010) and stated the plural form of Stiftung as “Stiftungen”.

Rebold filed a lawsuit against the IRS for the recovery in penalties and interest pursuant to §6677, and both parties moved for summary judgment. In the end, the district court granted summary judgment for the government.

The main issue in this case was whether the Foundation should be treated as a foreign trust. Section 6048 imposes reporting requirements for a United States person when a foreign trust is established, and penalties are imposed for failure to file Forms 3520 and 3520-A. However, Rost argued that the Foundation was a Liechtenstein Stiftung, and there were no U.S. regulations stating that a Liechtenstein Stiftung was a foreign trust for federal tax purposes. Therefore, Rebold did not know he and the Foundation were required to file Forms and report income tax returns. Hence, Rost believed that the penalties violated the Due Process Clause of the Fifth Amendment to the United States Constitution, and it should be refunded.

First, the court noted that Rost was wrong to believe there was no reporting obligation because neither the IRC nor the U.S. tax regulations provided for special treatment for a Liechtenstein Stiftung. The district court cited §301.7701-1 and stated that “whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend on whether the organization is recognized as an entity under local law.” Because of this reason, although the Foundation was established in Liechtenstein, this case should focus on U.S. regulations.

To answer whether the Foundation was a foreign trust, the court applied the facts-and-circumstances test to determine if the Foundation was a trust. Reg. §301.7701-4(a) defines ordinary trusts and explains the fact-and-circumstances tests. According to the test, when a trust arrangement did not include the existence of associate and business purpose, the entity should be treated as a trust. The court pointed out that the Foundation’s statement of purpose was to provide education and general support for Rebold and beneficiaries. In addition, their statement of purpose clearly stated that the Foundation should not engage in any commercial trades. Following Reg. §301.7701-4(a) and prior case law, the court concluded the Foundation should be treated as a trust.

Then, the court questioned whether the Foundation was a “foreign” trust for federal income tax purposes. Section 7701(a)(31)(B) defined a foreign trust as any trust other than a trust described in §7701(a)(30)(E). According to §7701(a)(30)(E), a domestic trust needs to meet both the court test and the control test. The court test is satisfied if a court within the United States could exercise primary supervision over the administration of the trust. For this case, the Foundation did not satisfy the court test because any conflicts must proceed to arbitration under Liechtenstein law since it was founded in Liechtenstein. The Foundation also failed the

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3 Section 6048(b), as amended by Congress in 2010, provides that the owner of a foreign trust must file a return annually.
4 Reg. §301.7701-1.
5 The district court cited cases to explain fact and circumstances test; see Elm Street Realty Trust v. Commissioner, 76 T.C. 803, 818 (1981); Estate of Bedell Trust v. Commissioner, 86 T.C. 1207, 1218 (1986); Morrissey v. Commissioner, 296 U.S. 344 (1935).
6 §7701(a)(30)(E)(i).
control test. The control test is satisfied when one or more United States persons have power to control all decisions of the trust. Reg. §301.7701-7(d)(1)(3) says “the term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions.” According to the trust arrangement, Rebold waived all the rights to the Foundation and the board of the Foundation had decision making authority. Since the Foundation failed both tests, the district court concluded that the Foundation was a foreign trust for federal tax purposes.

Rost also complained that imposition of penalties pursuant to §6677 violated the Administrative Procedure Act (“APA”). Her claim was that Rebold could not have known that he had a reporting obligation because the IRS had not posted any comments or notices that the Liechtenstein Stiftungen could be treated as a foreign trust. She argued that it was improper to impose penalties unless the law was known or provided before Rebold established the Foundation. She also asserted that the penalties violated the Due Process Clause because Rebold was subject to the penalties without clearly explaining the prohibited circumstances.

The district court reminded Rost that not all Liechtenstein Stiftungen were treated as foreign trust, and each Liechtenstein Stiftung must be analyzed on its own fact-and-circumstances tests to determine whether they should be treated as a foreign trust. For the reasons stated above, in the case of Rebold, their Liechtenstein Stiftung should be treated as a foreign trust. The district court believed that §§7701(a)(30)(E) and 7701(a)(31)(B), Reg. §301.7701-4(a), and Notice 97-34 provided enough information regarding the filing requirements for foreign trusts. Hence the court concluded that penalties were not violated by both the APA and Fifth Amendment.

Lastly, Rost asserted that Rebold failed to file forms in issues because he was unwell and lacked mental capacity. She claimed that §6677(d) stated that no penalty should be imposed if it was proven that the negligence was due to reasonable cause and not willful neglect. According to Rost, Rebold was diagnosed with clinical depression after his wife passed away in 2002, resulting in various cognitive issues. To determine whether §6677(d) applied to this case, the court stated that all facts and circumstances must be considered. The court cited Montgomery v. Commissioner that “the pertinent fact and circumstances’ include ‘the taxpayer’s efforts to assess his or her proper tax liability, the knowledge and experience of the taxpayer, and the reliance on advice of a professional.” In the case of Rebold, the court believed that Rost had the burden of proof that Rebold had attempted to fulfill his obligations as a taxpayer. However, the court believed that Rost had not sufficiently established reasonable cause. The court concluded that, although Rebold might have suffered from depression, he was mentally capable of making his own decisions. For example, Rebold reported Foreign Bank and Financial Accounts (“FBAR”) and filed forms with his signatures in 2007. Rebold was also able to file his 2005 and 2006 federal taxes with his signature by due dates. Although his wife’s death affected Rebold’s state of mind, the court concluded that Rost did not present sufficient evidence for §6677(d) to apply.

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7 §7701(a)(30)(E)(ii).
Hence, the court confirmed that failure to report required forms and ownership of the Foundation to be properly subject to civil penalties incurred, pursuant to §§6048 and 6677. The court granted the United States’ motion for summary judgment on September 22, 2021.

The Fifth Circuit

Rost appealed the district court’s ruling, but the Fifth Circuit Court of Appeals affirmed the lower court’s decision for the government.

Rost claimed that the tax rules did not explicitly classify the Liechtensteinian Stiftungen as foreign trusts. Therefore, the Foundation could be a corporation, partnership, or other entity. She cited *Oak Commercial Corp. v. Commissioner*, 9 T.C. 947 (1947), noting that the Tax Court and the Second Circuit viewed Stiftungen as a foreign corporation. She further challenged the facts-and-circumstances test adopted by the district court. The Fifth Circuit accepted her argument but determined that the Foundation was treated as a foreign trust because the Foundation was a trust under §301.7701-4(a). For federal tax purposes, the court and control test under §7701(a)(30)(E) determined it was a foreign trust as well. Most importantly, Rost had not presented any evidence or proof that it should be classified as anything other than a foreign trust.

Again, Rost asserted that the penalties were not appropriate because Rebold had failed in his obligation for mental reasons; however, the Fifth Circuit affirmed the district court’s ruling.

On August 11, 2022, the Fifth Court of Appeals concluded that the district court’s judgment was correct, and on October 11, 2022, the Fifth Court of Appeals denied Rost’s petition for rehearing.
Tax Policy Analysis

H.R. 2863 (117th Congress) – First-Time Homebuyer Act of 2021

By: Nina Kramarenko and Gelena Shvetsova, MST Students

The First –Time Homebuyer Act of 2021 was introduced by Representative Earl Blumenauer (D-OR), co-sponsored by Representative Jimmy Panetta (D-CA), on April 28, 2021 in the House of Representatives and was referred to the House Committee on Ways and Means. The proposed law offers taxpayers a refundable credit of 10% of the purchase price of the residence, limited to $15,000 ($7,500 for Married Filing Separately). Thus, the maximum credit would be for a home costing $150,000 or more.

This credit is a one-time benefit for homebuyers purchasing their first principal residence. The law does not provide a benefit for people who buy a second home, vacation home or a rental property.

The law includes specific requirements that take into account the Area Median Income and the Area Median Purchase Price of housing in different areas of the country. According to the proposed law, the data of the Area Median Income and Area Median Purchase Price should be determined and provided by the Secretary of Housing and Urban Development. To be eligible for the credit, a homebuyer may not have owned a home or co-signed on a mortgage for three years before the purchase, must be at least 18 years old at the date of the purchase, and have income of no more than 160% of the Area Median Income based on the location of their purchased home and household size. For example, if the median income in Chicago, Illinois, is $62,000, a home buyer, who is a single taxpayer, 18 years or older and purchasing their first home, may have up to $99,200 of income to be eligible to claim the credit. The home may not be purchased from a relative, as defined in IRC section 267. Also the law puts a limitation of 110% of the Area Median Purchase Price of the home for the buyer to get the maximum credit amount.

The key purpose of the First-Time Homebuyer Act of 2021 per a press release from Congressman Blumenauer is to “incentivize housing stability and generational wealth-building opportunities for low- and middle-income Americans, particularly amongst historically marginalized communities.”

The table below provides an analysis of the proposed First-Time Homebuyer Act using the AICPA 12 guiding principles of good tax policy.2

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<thead>
<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria?</th>
<th>Result</th>
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<tbody>
<tr>
<td>Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer’s income for different income levels of taxpayers.</td>
<td>There are two types of equity to consider.</td>
<td>+</td>
</tr>
<tr>
<td>1. Horizontal equity</td>
<td>Horizontal equity requires that similarly situated taxpayers should be taxed similarly. This principle is met in the proposed law. The First-Time Homebuyer Act moves away from fixed income and house purchase prices limitations. Instead, this act allows similarly situated taxpayers to get the same tax relief for the similar first home purchase, notwithstanding inequality in home purchase prices in different parts of the country. For example, according to Zillow in June 2022, the median price tag for a home in the U.S. was $355,000, while the lowest price was $139,000 in West Virginia, and the highest price was $909,000 in Hawaii.(^3) Relying on median purchase prices of different regions and taking into account household size, the proposed law prevents buyers of expensive houses in low-cost areas from getting a much larger tax benefit and provides tax relief for a moderate house purchase for residents of expensive areas, since the maximum credit is tied to and limited by $150,000 home purchase price. The $15,000 cap prevents individuals with eligible income from getting a larger credit for more expensive homes in the areas with lower home prices. Thus, the First-Time Homebuyer Act provides the same amount of credit for the similarly situated taxpayers residing in areas with different prices on the housing market. Therefore, the bill meets the principle of horizontal equity.</td>
<td>+</td>
</tr>
<tr>
<td>2. Vertical equity</td>
<td>Vertical equality means that taxpayers with higher income should pay more taxes than taxpayers with a lower income. Vertical equity is met in this act, because the credit is available and brings tax breaks to low- and middle-class taxpayers, which allows people with lower income</td>
<td></td>
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</tbody>
</table>

| **Certainty** – Does the rule clearly specify when the tax is owed and how the amount is determined? Are taxpayers likely to have confidence that they have applied the rule correctly. | The bill allows a credit against the tax imposed on an individual, so it is clear for a taxpayer to claim the credit while filing a tax return. However, there are a few specific rules, requirements, and limitations in the proposed bill, like the limitations based on area median income and area median purchase price, purchase from a relative, credit reduction and credit recapture, which can make it unclear for some taxpayers. The proposed bill considers that the IRS will provide guidance and tables with area median income and purchase price limitations. However, it is still complicated for an ordinary taxpayer to check if they meet all the requirements of the law and consider the most current tables. As a result, taxpayers may not feel confident if they calculated and claimed the correct amount of the tax credit. Finally, the proposed bill does not satisfy the principle of certainty. | – |
| **Convenience of payment** – Does the rule result in tax being paid at a time that is convenient for the payor? | The proposed First-Time Homebuyer Act does not affect a taxpayer’s return due date and methods to pay their taxes. Moreover, the bill offers to a taxpayer an election option to treat the purchase as if it was made on December 31 of the preceding year, meaning that an individual may claim the credit in a prior year tax return (or amended return) and immediately receive a cash payout. Thus, the convenience of payment principle is met. | + |
### Effective Tax Administration – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?

From the government perspective, the IRS will need to issue an additional tax form for an individual to claim the tax credit in a tax return. Moreover, the IRS together with the U.S. Department of Housing & Urban Development must promulgate annual guidance to set the area median purchase price, the area median income, and the annual credit amount, increased by the cost-of-living adjustment. Furthermore, the IRS will spend resources to develop and issue regulations and to audit taxpayers who claim the first-time homebuyer credit.

A taxpayer most likely will pay for a tax preparer’s assistance due to complexities of the rules and requirements in the First-Time Homebuyer Act.

The costs of tax reporting to individuals and of tax collection for the government would not be at a minimum level, thus, the effective tax administration principle is not met.

### Information Security – Will taxpayer information be protected from both unintended and improper disclosure?

Since, the bill requires attaching to the tax return a properly executed copy of the settlement statement used to complete such purchase, additional personal data may be exposed. However, as the IRS reported, 90% of the individual tax returns were filed electronically in 2021. This means that the additional information is protected. Therefore, the risk of its disclosure unlikely would arise. The bill meets the principle of information security.

### Simplicity - Can taxpayers understand the rule and comply with it correctly and in

The First-Time Homebuyer Act clearly offers a credit of 10% of the purchase price for the first home, but with the maximum amount available of $15,000. However, the bill includes rules and limitations based on area median income and area median purchase price, which must be updated annually. It may be difficult for a

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4 IRS. Returns Filed, Taxes Collected & Refunds Issued. Highlights of the Data. [https://www.irs.gov/statistics/returns-filed-taxes-collected-and-refunds-issued#:~:text=The%20IRS%20processed%20more%20than,other%20forms%20were%20filed%20electronically.](https://www.irs.gov/statistics/returns-filed-taxes-collected-and-refunds-issued#:~:text=The%20IRS%20processed%20more%20than,other%20forms%20were%20filed%20electronically.)
| Neutrality – Is the rule unlikely to change taxpayer behavior? | The neutrality principle states that the primary purpose of a tax is to raise revenue for governmental activities, rather than to influence business and personal decisions. The First-Time Homebuyer Act was designed to incentivize and support first-time homebuyers by providing a refundable tax credit for the purchase of the home (assuming certain conditions are met). A possibility of getting this tax credit may affect some taxpayers’ decisions whether to buy a home or not. However, it is unlikely that it would be a primary motivation for them, given other costs of purchasing a home and because many buyers live in areas where homes cost more than $150,000. Therefore, the proposed bill meets the principle of neutrality. |
| Economic growth and efficiency – Will the rule not unduly impede or reduce the productive capacity of the economy? | The overall purpose of the proposed bill is to incentivize housing stability and generational wealth-building opportunities for low- and middle-income Americans. Low- and middle-income families building their equity via home ownership should help economic growth, not impede it. | + |

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<th>Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</th>
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<td>The proposed bill clearly states the amount of credit - 10% of the home’s purchase price up to $15,000, however, taxpayers will also need to determine their eligibility by comparing their income to area median income and home’s purchase price to area median purchase price. These conditions may be too complex for taxpayers to understand and determine if the law applies to them.</td>
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<tr>
<td>The First-Time Homebuyer Act will not impose any tax, so there is no additional tax burden for taxpayers to be aware of and compliant with. However, the first-time homebuyer credit may be subject to recapture should the taxpayer sell a house during the recapture period (four years). In this case, the tax is increased by a recoverable amount that is calculated as 25% of claimed credit multiplied by a number of tax years remaining in the recapture period. The taxpayers may not be aware of when this tax should be paid and may not understand why so many restrictions exist in the proposal.</td>
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<tr>
<td>Taxpayers are likely to be aware of this credit if enacted as real estate salespersons will likely promote its existence.</td>
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<tr>
<th>Minimum tax gap – Is the likelihood of intentional and unintentional non-compliance likely to be low?</th>
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<td>The tax gap is the difference between taxes that are owed and taxes that are voluntarily paid. Complex laws can lead to noncompliance and, hence, a tax gap due to errors caused by confusion and uncertainty. The proposed bill states that the IRS with the Secretary of Housing and Urban Development will promulgate regulations and guidance that are necessary to apply the tax credit.</td>
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<tr>
<td>The likelihood of intentional and unintentional non-compliance may be reduced with clear regulations and procedural rules developed by the IRS. Also, it is important to make area median income and area median purchase price information easily available for taxpayers, so they can make informative decisions. Since the taxpayers will have to attach a copy of the settlement statement to their tax returns to claim the credit, the non-compliance is likely to be low. A tax form</td>
</tr>
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to calculate the tax should also help in proper computation of the credit. Although, there may be some cases of intentional and unintentional non-compliance when taxpayers might lie about not having owned a home in the past three years or will not follow the recapture rule after selling a home during the recapture period.

Overall, the minimum tax gap principle is met.

**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?

The purpose of this law is easy to understand - to support low- and middle-income Americans to purchase their first home.

This law modifies a first-time homebuyer credit that was in effect from 2008 to 2010, so we can assume that the alternatives were considered. However, providing a tax credit will likely be not enough for low-income taxpayers to help them to buy their first home, compared to providing a grant for a down payment and/or a low mortgage rate.

Some taxpayers may also not understand why the government would provide a tax benefit for homeowners in addition to tax benefits that already exist, such as the mortgage interest deduction. One may think that if the government wants to encourage people to help purchase their first home, other homeowners tax incentives should be reconsidered.

Therefore, the proposed bill does not meet the principle of accountability.

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

A reasonable estimate can be made of the cost of this proposed credit using data on the amount of first-time homebuyers in previous years. Therefore, the bill meets the principle of appropriate government revenues.
The above analysis shows that the First-Time Homebuyer Act of 2021 mostly meets the principles of good tax policy as it meets seven out of the twelve principles. The proposed bill fails to meet principles of certainty, effective tax administration, simplicity, transparency and visibility, and accountability.

Nevertheless, we believe that the government should consider enacting this bill, because its purpose to help buy a first home for low- and middle-income Americans is helpful for the American economy in general and particularly amongst historically marginalized communities. It may help more people to build equity in a home rather than continue to pay rent. This bill also eases the burden for the residents of expensive areas since it relies on an area median purchase price. Therefore, the proposed bill prevents the buyers of unduly expensive houses in less expensive areas from getting the tax benefit and provides the tax relief for moderate house purchase for residents of expensive areas.

Some modifications of the bill can be made to address the failure to meet the principles of simplicity, certainty and accountability, such as eliminating the phase-out provision of the credit. Additional suggestions for improvement:

- Provide the credit or a grant for down payment via the lender at the time of the purchase. With the proposed bill, taxpayers will receive the credit only after they purchase their home and pay the down payment. This can be a dealbreaker for low-income families. Often, families struggle with saving for a down payment. Providing the funds at time of the purchase will help relieve the burden for such taxpayers.

- Reconsider existing tax incentives for homeowners, such as mortgage interest deduction on a second home, mobile home or boat. The mortgage threshold should be kept at $750,000. The unused funds from these tax expenditures can help finance the First-Time Homebuyer Act credit program.

- Perhaps, consider increasing the amount of credit to help taxpayers who live in expensive areas afford the purchase of their first home.
Tax Policy Analysis

H.R. 6392 (117th Congress) – No Tax Breaks for Drug Ads Act

By: Inessa Zlobina and Yan Rapisura, MST Students

Introduction

Do you find commercials for medications are almost inevitable when watching your favorite news or TV shows? About three decades ago, the only medication advertised on TV were nonprescription drugs. In 1997, the Food and Drug Administration permitted pharmaceutical companies to publicize prescription products directly to consumers in TV commercials. Since then, advertisement for prescription drugs has significantly grown, leading to such advertising expenses skyrocketing to average $6 billion annually.

On January 13, 2022, Representative Elissa Slotkin (D-MI) introduced H.R.6392, No Tax Breaks for Drug Ads Act and referred it to the Ways and Means Committee. The purpose of this bill is to “prohibit a tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs”. The bill would add new section 280I called Disallowance of deduction for direct-to-consumer advertising of prescription drugs. In the past few years, several bills have been introduced in Congress to end “tax subsidies” for prescription drugs ads, such as H.R. 8399 (116th Congress), S. 2478 (115th Congress) and S. 2623 (114th Congress).

The current tax law allows a deduction for advertising expenses as an ordinary and necessary expense that relates to the taxpayer’s trade or business (§162). Such a deduction is not listed as a tax expenditure in the Tax Expenditures Report from the Office of Tax Analysis of the U.S. Department of the Treasury, since it is not a provision “attributable to provisions of Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability”. Advertising expenses are a normal deduction in a business income tax system.

However, Representative Slotkin and others view the advertising expense tax deduction for pharmaceutical companies as “a tax loophole that allows these giant companies to avoid paying billions of dollars in taxes while prices on prescription drugs continually increase for consumers”.

Next, we apply the AICPA Tax Policy Concept Statement 1 – Guiding principles of good tax policy: A framework for evaluating tax proposals to analyze H.R. 6392.

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<th>Criteria</th>
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<td><strong>Equity and Fairness</strong></td>
<td>Pharmaceutical companies will be taxed similarly since no tax deduction for direct-to-consumer advertising expenses would be allowed for any pharma company. However, corporations in other industries that have similar revenues would be allowed to deduct advertising expenses in calculating their taxable income. For example, Company A is a pharmaceutical company that has $50 billion of gross income and $30 billion of expenses (including $2 billion of advertising expenses), with the bill enacted, Company A’s taxable income is $22 billion, of which $4.62 billion tax liability is calculated. Company B is an automobile manufacturer that has the same gross income and expenses, and with the deductibility of advertising expenses, Company B’s taxable income is $20 billion, of which $4.2 billion tax liability is calculated. Both companies have the same amount of revenue and expenses per GAAP, but this bill makes Company A pay an additional $420 million in tax. A similar result is met in comparing pharma and non-pharma businesses of any size. Therefore, the bill does not meet the principle of horizontal equity. Vertical equity is met among pharma companies, but not in looking at all businesses that advertise.</td>
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<th><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?</th>
<th>Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs will affect certainty negatively, because defining direct-to-consumer advertising can be complicated and tricky when creativity comes into play. For example, a pharmaceutical company invites a celebrity or an industry expert to a popular talk show or a YouTube channel presenting the significance of depression and adds ten seconds to the presentation mentioning the prescription drugs. How will this ten seconds be treated? How is the expense of this advertising computed? Therefore, the bill does not meet the certainty principle on how to determine the amount that is disallowed, when some business activities might include an element of direct-to-consumer advertising. In addition, what about when they run ads directed at doctors or hospitals? Since the individual viewers might also be consumers of the drug, is that advertising disallowed too? What about the cost of apparel they give to employees that has the company name on it and that causes the viewing public to think of the company's drugs?</th>
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<td><strong>Convenience of payment</strong> – is the tax due at a time that is convenient for the payor?</td>
<td>Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs will have no effect on the business tax return and payment due date. Corporations will file their tax return and pay their taxes in the same manner no matter whether this bill is enacted.</td>
<td>N/A</td>
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<tr>
<td><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.</td>
<td>Due to the complexity of defining direct-to-consumer advertising in practice, the corporate taxpayers need to spend more time to identify advertising expenses. The IRS will likely spend more audit time to ensure the advertising cost deducted by pharmaceutical companies is not related to direct-to-consumer advertising. There is a possibility that more court cases will emerge due to noncompliance to business advertising expense deductions.</td>
<td>N/A</td>
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<tr>
<td><strong>Information Security</strong> – Will taxpayer information be protected from both</td>
<td>Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs will have no effect on the information security, as there are no specific reporting requirements in disclosing any sensitive information.</td>
<td>N/A</td>
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<tr>
<td>Factor</td>
<td>Description</td>
<td>Implications</td>
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<td><strong>Simplicity</strong></td>
<td>Can taxpayers understand the rules and comply with them correctly and in a cost-efficient manner?</td>
<td>Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs will add another layer of complexity to the tax code, because categorizing direct-to-consumer advertising will require precise definitions such as to distinguish direct-to-wholesaler advertising that serves multiple markets. Corporate taxpayers in the pharmaceutical industry will need to spend more time and money to make sure staying in compliance with this tax nondeductible expense when nontraditional advertising is involved.</td>
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<td><strong>Neutrality</strong></td>
<td>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>Removing the deductibility of drug advertising violates the principle of neutrality of the tax code. Additionally, it violates neutrality to treat advertising expenses as any different from normal business expenses. Current tax law allows advertising expense deduction in general. Adding a section to disallow expenses relating to direct-to-consumer advertising of prescription drugs can affect pharmaceutical companies’ decisions on how to promote their products. Instead of traditional advertising, these companies may reach out to more healthcare professionals including caretakers to promote their products privately (through means other than advertising which would be disallowed by the bill), which may cause biased recommendations and unhealthy competition among healthcare professionals.</td>
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<td><strong>Economic growth and efficiency</strong></td>
<td>Will the tax unduly impede or reduce the productive capacity of the economy?</td>
<td>Pharmaceutical companies spend billions of dollars in advertising every year. By disallowing the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs, these companies may reduce such advertising, which will negatively affect the profitability of many businesses, including advertising agencies, television and radio stations and publishers. For example, newspapers in print or in digital versions rely on selling advertising space to make profits. Significant decrease in advertising revenue for many businesses will also negatively impact jobs, which ultimately reduces the productive capacity of the economy.</td>
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If the bill leads pharma companies to not spend as much on advertising and use the savings to reduce drug prices, customers will have more funds for other spending or for savings, which can help the economy.

Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs does not affect transparency and visibility. All the pharmaceutical companies are giant businesses and have their own accounting and tax department, which allows these companies to know that the tax exists and when it is imposed upon them no matter whether this bill is enacted or not.

However, the classification of various advertising activities is not easy, which may cause errors in calculation and reporting. A Treasury Regulation with examples will be needed to provide more detailed information on compliance.

Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs will likely increase intentional and unintentional non-compliance due to the complexity of defining direct-to-consumer advertising in practice when more innovative ways of promoting prescription drugs are created. The interpretation of what constitutes direct-to-consumer advertising can also be different by the IRS, the courts, and the pharmaceutical companies.

This bill has a strong intention to reduce pharmaceutical companies’ advertising expenses relating to direct-to-consumer advertising, so that more funds can go to R&D, lower prices of prescription drugs and increase the government revenue. The rationale for disallowing such advertising expenses as a tax deduction seems clear for the taxpayers because it is very specific.

However, the purpose of this bill is to change the big pharmaceutical companies’ behavior and lower prices for consumers. It is not clear what data was reviewed and why is it proposed to be part of the tax law rather than provided in

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<th>Transparency and Visibility – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</th>
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<td>Prohibiting the tax deduction for expenses relating to direct-to-consumer advertising of prescription drugs will likely increase intentional and unintentional non-compliance due to the complexity of defining direct-to-consumer advertising in practice when more innovative ways of promoting prescription drugs are created. The interpretation of what constitutes direct-to-consumer advertising can also be different by the IRS, the courts, and the pharmaceutical companies.</td>
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<th>Accountability to taxpayers – Do taxpayers have access to information on tax laws and their development, modification and purpose; is the information visible?</th>
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<td>This bill has a strong intention to reduce pharmaceutical companies’ advertising expenses relating to direct-to-consumer advertising, so that more funds can go to R&amp;D, lower prices of prescription drugs and increase the government revenue. The rationale for disallowing such advertising expenses as a tax deduction seems clear for the taxpayers because it is very specific. However, the purpose of this bill is to change the big pharmaceutical companies’ behavior and lower prices for consumers. It is not clear what data was reviewed and why is it proposed to be part of the tax law rather than provided in</td>
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another manner, such as via other government agencies such as FDA establishing stricter rules or banning or reducing the amount or size of direct-to-consumer advertising of prescription drugs? 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?

The government has access to the data on how much advertising expenses were deducted by pharmaceutical companies in past years and can use the data to estimate the amount of tax revenue to be generated if the bill is enacted. However, it is difficult to predict how significant that pharmaceutical companies will shift from direct-to-consumer advertising to other types of marketing. Therefore, it will be difficult to produce a reasonable estimation on the potential revenue. +/-

**Tax Analysis Summary**

Based on the tax policy analysis, H.R. 6392 does not meet the principles of good tax policy with only mixed rating on the principle of accountability to taxpayers. Most of the key principles of good tax policy are not satisfied. Overall, this bill has more weaknesses than strengths.

Limiting tax deductions is an arbitrary way of approaching a legitimate concern. Consumer drug ads play an important role in debates about the costs of prescription drugs, the risks of misuse and overuse of some medications, the balance of authority between doctors and patients, the limits of commercial speech, and a host of other issues.

H.R. 6392 is not well crafted to address these issues. Allowing drug companies to deduct advertising costs is not a subsidy. Many other deductions are such as certain tax credits and the mortgage interest deduction. The corporate income tax is a tax on corporate income. To calculate income properly, businesses total up their revenues and deduct their expenses of producing that income. Those expenses include wages for workers, rent for office space, and the costs of advertising. Under an income tax, companies deduct those expenses because they incur them in pursuit of the profits. It is debatable how fast companies in any industry should write-off their advertising costs as some of these ads may produce long-term benefits for the company. But in an income tax, it is an allowable business expense.

The purpose of this bill is to reduce the expenses related to direct-to-consumer advertising of prescription drugs, so that more funds can go to R&D, lower prices of prescription drugs and increase the government tax revenue. However, can the goals of this bill truly be achieved by simply cutting the deduction?
First, pharmaceutical companies can always find other types of marketing to promote their products, so the deductible advertising expense may not be reduced by this bill. Second, even if funds are saved from expenses, they may not be used to invest in R&D, but to repurchase their company stocks or to pay out more dividends to shareholders. Third, the high prices of prescription drugs are not only due to heavy advertising. There are two primary factors that push prescription drugs prices high. The first one is the monopoly situation in the pharmaceutical industry, which is caused by the strict drug manufacturing rights that are protected by the U.S. government. The other reason is that pharmaceutical companies are allowed to set prices for drugs with little negotiation with buyers or consideration of affordability by the target consumer base. Without changing our healthcare system, it will be difficult to change the high price situation of prescription drugs [Note: The Inflation Reduction Act of 2022, allows the Secretary of Health and Human Services to negotiate prices on certain drugs in Medicare Parts B and D. This provision aims to lower the cost of drugs that are at least nine years past FDA approval. The Act imposes a significant penalty on drug companies unwilling to negotiate.]

We do not believe that limiting deductibility is the right way to discourage direct-to-consumer drug advertising. Disallowing the tax deduction may not reach the purpose of reducing prescription drugs prices. Instead, it creates a financial penalty based on the corporate tax rate. Eliminating the tax deduction would have increased the effective cost of drugs by more than a third. Without deductibility, a $100,000 ad would have cost as much as a deductible $127,000 one.

To conclude, our suggestion is that not all goals can be achieved through our tax system. Instead of proposing a tax bill that is not considered a good tax policy, other government agencies, such as FDA and Congress, might step in and put stricter regulations and rules on the direct-to-consumer advertising of prescription drugs. The Food and Drug Administration should weigh the pros and cons of consumer ads and how they vary across different conditions, therapies, and advertising media.

9 The net after-tax cost of a $127,000 expenditure under the current system is actually only $100,000 [Deduction = $127,000 X .21 = $26,667; $127,000 - $26,667 = $100,333, or about $100,000].
Tax Policy Analysis

S. 3191 (117th Congress) – Everyday Philanthropist Act

By: Jakub Hench, Tiago Iorio, and Ronald Le, MST Students

On November 4, 2021, U.S. Senators Ben Sasse (R-NE) and Tammy Baldwin (D-WI) introduced the Everyday Philanthropist Act (S. 3191, 117th Congress) and referred it to the Senate Finance Committee as a proposed amendment to IRC Section 132. The bill was introduced as a fringe benefit change and a new tax expenditure to incentivize U.S. taxpayers to engage in pre-tax charitable giving of up to $2,700 using new Flexible Giving Accounts (FGA). These FGAs would be created using an employer’s separate written plan for the benefit of all “eligible employees.” Taxpayers would be allowed to deduct the amount they donate through the FGAs as a pre-tax exclusion on their tax return with no charitable donation deduction allowed.

To qualify for a Flexible Giving Account, taxpayers must be an “eligible employee” defined as excluding “highly compensated employee” per IRC Sec. 414(q) and “key employees” per IRC Sec. 416(i). S. 3191 allows employers to exclude otherwise eligible employees who are under 21 years of age, have less than one year of work experience with their current employer as of the current plan year, and nonresident aliens who work outside of the United States.

Employees who qualify for a Flexible Giving Account “may elect—(I) to receive a reduction in compensation and have the employer deposit the amount of the reduction in a flexible giving account of the electing employee, and (II) before the reduction under subclause (I), to designate 1 or more eligible entities to which distributions are to be made from the account.” Employers would have to play their part by only allowing a deduction if the qualified employee has named at least one eligible entity to whom the donation in the FGA would go to, engages in providing reductions to the employee after the initial donation deposit to the FGA, is transparent to the employees about the arrangement availability, manages FGAs for qualified employees, and provides qualified employees with financial information regarding the initial deposits and donations made by their FGA during the prior tax year before February 1 of the current tax year.

For example, Louis, a U.S. citizen, is a 23-year-old college student at San Jose State University and works part time for 30 hours a week as a lower-level employee at a technology company for a salary of $75,000 per year over a period of four years. He is not a highly paid employee, nor does he make significant contributions to the firm. Assume the Everyday Philanthropist Act is passed, and the technology company makes a separate written agreement with Louis to allow him to obtain a Flexible Giving Account. This agreement would allow Louis to provide charitable donations of up to $2,700 to one or more entities that Louis lists that he would like the donations to go to. This would allow him to take an itemized pre-tax deduction of up to $2,700.
**Application of the Principles of Good Tax Policy**

The following section applies the 12 Principles of Good Tax Policy as outlined in the *AICPA Guiding principles of good tax policy: A framework for evaluating tax proposals* to S. 3191, the Everyday Philanthropist Act.

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<th>Criteria</th>
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<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 requires similarly situated taxpayers to be taxed similarly. This principle is not met in this proposal because for two eligible individuals with the same level of income, the benefit of this credit may or may not be the same because let’s say earning $80,000 for company A may allow you to be eligible for this deduction, while earning the same $80,000 for company B may not allow you to be eligible for this deduction if that is considered “highly compensated employee” for company B. Factors such as the type of industry who work in, size of the company, and other factors, can easily change eligibility.</td>
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It is also important to consider whether the employer allows employees to set up Flexible Giving Accounts. Let’s say that Company A allows their employees to obtain FGAs while Company B decides not to allow employees to obtain FGAs. Employees at Company A making $80,000 a year would be allowed to take the pre-tax deduction for donations made to FGAs while employees making $80,000 at Company B would not qualify for the pre-tax deduction owing to their inability to obtain an FGA. Thus, the principle of horizontal equity is not satisfied.

The vertical equity principle is satisfied when taxpayers with higher income pay more tax than taxpayers with less income. This logic also applies to deductions in the sense that taxpayers with higher income should receive less deductions than taxpayers with lower income.

S. 3191 includes a cap of the amount of pre-tax FGA deductions that taxpayers may take of $2,700. A high-income person with a salary of $300,000 per year would take the same amount of deductions as a low-income person.

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<th><strong>taxpayer making $30,000 a year (assuming both are “eligible employees”). Hence, vertical equity is met for the Everyday Philanthropist Act.</strong></th>
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<tr>
<td><strong>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?</strong></td>
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| The proposal provides a good description of how and when the amount of the deduction is determined. It is determined based on the “written plan of an employer for the exclusive benefit of all eligible employees” and the timing of this credit is determined “on or before January 31 of each year” based on “a written accounting of the employee’s flexible giving account showing deposits and disbursements during the previous calendar year.” This credit is only available for individuals who are “eligible employee[s]” per Section 2, (o)(2)(A)(i).

The amount to be deducted (i.e. not paid) is determined per “amount of the reduction in a flexible giving account of the electing employee” up to $2,700.

This proposal also clarifies if there will be any changes to the individual income tax return form due to this deduction. So, the taxpayer will be able to get the deduction while filing a tax return.

However, while employees should be able to comprehend that they can qualify for a pre-tax deduction based on the amount of charitable donations that they provide for an FG, some may have a difficult time determining whether they qualify as an eligible employee. S. 3191 identifies an eligible employee as “any employee who—(I) is not a highly compensated or key employee, and (II) has not been excluded from the arrangement.” S. 3191 does not define what a highly compensated employee or a key employee is, instead redirecting the definitions to IRC Sec. 414(q) and IRC Sec 416(i). This adds some uncertainty on part of the taxpayer as to whether they would qualify as an eligible employee, highly compensated employee, or key employee.

The level of confidence in this proposal is neutral because on one hand, the calculation for this credit described in the bill is easy to understand, and it will use information from reliable sources. However, it does not provide the taxpayer with any information about what constitutes a highly compensated employee or a key employee.

**Convenience of payment – is the tax**

The bill’s introduction of the flexible giving account and its distributions do not affect the due date to pay taxes or

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<th><strong>Effective Tax Administration – Are</strong> the costs to collect the tax at a minimum level for both the government and taxpayers? Also consider the time needed to implement this tax or change.</th>
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<td>S. 3191, the Everyday Philanthropy Act, provides a simple calculation for the taxpayers since they only deduct a pre-tax amount based on the total amount of deposits that qualified taxpayers put into their flexible giving accounts as long as they are at or below $2,700. Given that the bill provides guidance on how to be eligible for FGAs, who may qualify, and how to attain the pre-tax deduction, the government would incur low costs enforcing compliance with the law. But they need to provide guidance to employers and employees. Taxpayers would also incur low costs in following the Everyday Philanthropy Act due to being attracted by its promise of a pre-tax deduction along with its simplicity in understanding the rules. However, the amount of compliance costs can further be lowered if the IRS could explain to taxpayers what a pre-tax deduction is. That is, when can they deduct the charitable donated amounts that they gave to their FGAs. This would allow taxpayers to understand whether they are given a benefit. Hence, S. 3191, the Everyday Philanthropy Act, meets the effective tax administration requirement.</td>
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<th><strong>Information Security – Will taxpayer information be protected from both unintended and improper disclosure?</strong></th>
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<td>The new information introduced by the bill is the flexible giving account and the eligible entity of where the distribution from said account is given. The distribution will not be excluded from gross income unless taxpayers specify the name and address of the eligible entity on their tax returns. The bill also does not state whether the charities named by the employee in their flexible giving accounts require the employees to provide them with employees’ taxpayer identification number (TIN). Hence, it is possible that the information may not be for an eligible entity and, as such, misused due to unintended and improper disclosure of taxpayer information.</td>
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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>
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The percentage of taxpayers taking itemized deductions is 11%. Before the passage of TCJA, the percentage of taxpayers taking itemized deductions was 30%. In this regard, the Everyday Philanthropist Act would encourage more employees to take itemized deductions instead of standard deductions as the pre-tax deduction is an itemized deduction.

For other taxpayers, particularly the ones who itemize deductions or/and who are “highly compensated employee” or “key employee”, this bill most likely will have no effect since they can donate to charity and itemize those amounts (subject to AGI limitations) regardless of this flexible giving account.

Low-income taxpayers are also less likely to get impacted because they earn less money, so may not be able to afford to make charitable contributions. This accounts for 40% of all taxpayers in the U.S., with the remaining 60% being those who likely can afford to make charitable donations. This displays favoritism to the top 60% of U.S. taxpayers compared to the bottom 40%.

Overall, the influence to carry out a particular transaction will be neutral with this bill.

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

S. 3191, the Everyday Philanthropist Act, provides taxpayers “a tax-advantaged flexible giving account as a fringe benefit. Flexible giving accounts allow employees to set aside up to $2,700 of their annual pretax earnings to make tax-deductible charitable contributions without having to itemize tax deductions.” This bill will not impede or reduce the productive capacity, as “the philanthropy industry . . . thrive[s] as the economy prospers”. Hence, as the economy is also dependent on charitable and philanthropic giving, the Everyday Philanthropist Act would help the economy prosper even more, especially given that as “…of 2021, the civilian labor force of the United States numbered about 161.2 million people.” Hence, S. 3191 passes the economic growth and efficiency test.

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| **Transparency and Visibility** – Will taxpayers know that the tax exists and how and when it is imposed upon them and others? | It is likely that employees and employers can get the information about the bill from tax professionals, charitable organizations, and their employer. However, it is also unlikely that taxpayers as employees may not know that the entity that they named and addressed the distributions to may be eligible or not. Employees may not consider themselves to be highly compensated or a key employee for them to not have a flexible giving account. As such, the transparency principle is partially met. |
|---|
| **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? | The likelihood of intentional and unintentional noncompliance is likely to be low because it provides taxpayers with a simple understanding in how to qualify for a flexible giving account, the amount of money that can be donated via an FGA (up to $2,700), and the fact that they can achieve a pre-tax deduction from an FGA. This bill would attract most middle-income taxpayers who use the standard deduction so they can take advantage of charitable giving and helping the economy while being able to take a pre-tax deduction. The bill would also encourage employers to comply with this proposal should it pass as the bill directs them to write a separate written plan with the employees to help the employees obtain a FGA. Thus, this bill would result in a wider taxpayer base and meets the requirement of minimum tax gap. |
| **Accountability to taxpayers** – Do taxpayers have access to information on tax laws and their development, modification and purpose; is the information visible? | The bill has a strong intention to encourage eligible employees to make a reduction of their paid wages to invest in the flexible giving account for each employee to make charitable contributions all the while their employer manages each account. The rationale for making distributions from the flexible giving accounts can be clear to both employees and employers. However, employees who are not designated as highly compensated or a key employee are unlikely to elect a cut of their earnings and need information of who exactly is eligible to invest in the flexible giving accounts. Lawmakers, however, are likely to support such a rationale to increase charitable contributions. |
| **Appropriate government revenues** – will the government be able to determine how much tax | The cost of providing this deduction could be estimated by knowing how many taxpayers have W-2 income, minus the ones that are considered to be a “highly compensated employee” defined per 414(q) or “key employee” defined per 416(i). According to IRS statistics from 2018 (latest data |
revenue will likely be collected and when? available), there were 144,631,072 taxpayers with wage income.

The $2,700 limit on the total contribution still helps the government a little bit in having a basic idea of the maximum amount of government tax expenditure per taxpayer with this bill.

However, it is challenging to estimate how many are considered to be a “highly compensated employee per 414(q), which is defined as being in the top 20 percent of the employees when ranked based on the compensation during that year. This calculation is different for every company, so it is very difficult to have an estimate. For instance, for company “A”, a highly compensated employee could earn $80,000 while in company “B” this number could be $200,000.

Additionally, the amount contributed to this flexible giving account could fluctuate based on variables such as the condition of the economy, the salary (which if you get promoted and get a raise, you might now be considered “highly compensated employee”), and other factors.

Summary:

Overall, S. 3191, the Everyday Philanthropist Act, passes the majority of the requirements in the principles laid out by the AICPA’s Principles of Good Tax Policy. Through this analysis, we have determined that the Everyday Philanthropist Act provides U.S. taxpayers with more benefits than weaknesses. Given that the bill has a good intention of encouraging charitable giving through the use of flexible giving accounts (FGAs), one strength that it possesses is that it provides taxpayers with the simplicity and certainty on how the requirements of obtaining an FGA and how the proceeds in the FGA get distributed. Another strength that the bill has is that it encourages economic growth and efficiency as charitable giving to non-profit entities plays a major factor in the growth and prosperity of the economy. Another strength that this bill has is that it encourages compliance with taxpayers given the bill’s simplicity, certainty, and attractiveness of a possible pre-tax deduction. This bill also does not widen the tax gap or provide any excess burden to neither the US government nor US taxpayers.

One weakness that S. 3191, the Everyday Philanthropist Act, provides is in regard to equity and fairness. Even if “eligible employees”, employees may only participate if their employer establishes an FGA plan.

Another weakness presented by the Everyday Philanthropist Act is that it does not provide a definition on what constitutes a highly compensated employee or a key employee without referring to Code sections and company information. Every employer or company has a different
limitation of what constitutes a highly compensated employee, and employees may consider themselves to be highly compensated in different situations.

One simplification for the proposal is to remove the limitation for “highly compensated employees” to participate. These individuals may not opt to participate anyway as they likely itemize deductions so can claim charitable contributions and the FGA amount may not be large enough to entice them to participate.

This bill is directed towards middle income taxpayers who use the standard deduction and end up not receiving the temporary tax deduction over $300 (single) or $600 (MFJ) for contributing to charity that existed in 2021. For example, with this bill, a middle-income taxpayer who is in the 22 percent tax bracket, single, and uses the standard deduction, could donate $2,700 through their employer’s flexible giving account. The $2,700 deduction for this taxpayer would lower the tax liability by $594 dollars (0.22 x 2,700), whereas without this bill, this taxpayer would only get a tax reduction of $66 (0.22 x $300, if the small above-the-line charitable deduction were renewed).

In conclusion, S. 3191, the Everyday Philanthropist Act, is a helpful idea to encourage individuals to give to charity while lowering their tax liabilities with a pre-tax deduction and encourages donations even without itemizing deductions. However, this bill should be passed in a way that provides more horizontal equity among U.S. taxpayers, discourages noncompliance and tax evasion, and identifies which taxpayers are allowed a flexible giving account and subsequently a pre-tax deduction.
Tax Policy Analysis

S. 4691 (117th Congress) – Volunteer Driver Tax Parity Act of 2022

By: Students of the Spring 2023 Tax Research Class

Introduction

S. 4691 (117th Congress) proposes to increase the standard mileage rate for charitable driving to be equal to the rate for business miles for 2022 and 2023. Thereafter, the charitable rate would be 24 cents per mile, adjusted annually for inflation (rather than the current 14 cents per mile specified at IRC section 170(i)).

This section analyzes S. 4691 using the twelve principles of good tax policy set out in the AICPA’s Guiding Principles of Good Tax Policy: A Framework for Evaluating Proposals.¹

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<tr>
<th>Criteria</th>
<th>Does the proposal satisfy the criteria? (explain)</th>
<th>Result</th>
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<tr>
<td>Equity and Fairness – Are similarly situated taxpayers taxed similarly? Consider the tax effect as a percentage of the taxpayer’s income for different income levels of taxpayers.</td>
<td>Horizontal equity: Among all individuals who drive for charitable work and who have similar income, the benefit is the same. While those who drive more miles get a larger deduction, they are also incurring greater costs of driving. The proposal improves equity for volunteers who get to deduct the actual costs of items used for charity to allow drivers to come closer to being able to deduct the actual costs of driving by increasing the deduction from 14 cents per mile to 24 cents per mile (adjusted for inflation after 2023). If similarly situated taxpayers are individuals with similar income, this bill provides a potentially greater benefit to individuals who drive for charity relative to other individuals. However, because only about 11% of individuals itemize deductions today,² most individuals will receive no tax benefit from this proposal. Vertical equity: Higher income individuals who itemize their deductions will get a greater benefit from this change.</td>
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because they already itemize, and they are in a high tax bracket, so the tax savings are greater.

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<tr>
<th><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?</th>
<th>Mere changing of a number does not change the related calculations. The law is clear on the 24 cents per mile figure for charitable driving.</th>
<th>+</th>
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<tr>
<td><strong>Convenience of payment</strong> – Does the rule result in tax being paid at a time that is convenient for the payor?</td>
<td>No change to when tax is due.</td>
<td>n/a</td>
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<td><strong>Effective Tax Administration</strong> – Are the costs to administer and comply with this rule at minimum level for both the government and taxpayers?</td>
<td>This will not require any new regulations. Just a change in the Form 1040 instructions to change from 14 cents per mile to 24 cents per mile. The inflation adjustment will not be a burden to the IRS as there are other figures they also adjust annually for inflation. However, other mileage rates are not adjusted annually for inflation, but for changes in the cost of driving (see Rev. Proc. 2019-46). It likely would be simpler for the IRS to adjust all mileage rates in the same manner rather than have one tied to the CPI index.</td>
<td>+/-</td>
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<tr>
<td><strong>Information Security</strong> – Will taxpayer information be protected from both unintended and improper disclosure?</td>
<td>The proposal does not require reporting or use of any confidential information.</td>
<td>n/a</td>
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<tr>
<td><strong>Simplicity</strong> - Can taxpayers understand the rule and comply with it correctly and in a cost-efficient manner?</td>
<td>Mere change from 14 cents to 24 cents is simple to understand. There are no changes in definitions, or any special rules added.</td>
<td>n/a</td>
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<tr>
<td><strong>Neutrality</strong> – Is the rule unlikely to change taxpayer behavior?</td>
<td>The proposed change is minimal and unlikely to change behavior. Also, individuals who claim the standard deduction may realize that this increased deduction is unlikely to cause their itemized deductions to exceed their standard deduction. For taxpayers who already itemize deductions, this might encourage them to drive more miles for charity.</td>
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<td><strong>Economic growth and efficiency</strong> – Will the rule not unduly impede or reduce the productive capacity of the economy?</td>
<td>This change is unlikely to cause more people to volunteer to drive for charitable work, so it is unlikely to result in any increase in gasoline or car sales and unlikely to lead anyone to reduce their paid work hours to do more charitable driving.</td>
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<tr>
<td><strong>Transparency and Visibility</strong> – Will taxpayers know that the tax exists and how and when it is imposed upon them and others?</td>
<td>This bill is unlikely to cause more taxpayers to know that there is a mileage deduction for certain charitable driving. However, charities that require volunteers to do a lot of driving are likely to inform volunteers of this change. However, many individuals will not realize that they do not get any benefit of this change unless they itemized their deductions.</td>
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<td><strong>Minimum tax gap</strong> – Is the likelihood of intentional and unintentional non-compliance likely to be low?</td>
<td>Because 90% of individuals claim the standard deduction, most taxpayers won’t know of this deduction and also would not have an awareness or opportunity to improperly claim it.</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Accountability to taxpayers</strong> – Will taxpayers know the purpose of the rule, why needed and whether alternatives were considered? Can lawmakers support a rationale for the rule?</td>
<td>The text of the bill states: “To amend the Internal Revenue Code of 1986 to equalize the charitable mileage rate with the business travel rate.” However, when this bill was introduced in August 2022, the standard mileage rate was 62.5 cents per mile which includes 26 cents per mile for depreciation, which suggests the non-business mileage rate would be 46.2 cents per mile should be the rate rather than 24 cents per mile. It is not clear why the bill allows a high mileage rate for 2022 and 2023 but then drops it to 24 cents per mile, adjusted for inflation, after 2023. Taxpayers are likely to understand the reason to increase the mileage reimbursement rate due to the increased costs of driving and the 14 cents per mile rate has been set at</td>
<td>+/-</td>
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that amount since 1998 (by the Taxpayer Relief Act of 1997, P.L. 105-34).

| Appropriate government revenues – Will the government be able to determine how much tax revenue will likely be collected and when? | The government has information to easily calculate the cost of increasing the mileage rate under §170(i) from 14 cents per mile to 24 cents per mile using data about charitable work. Also, for most individuals, this increase will not be large enough to move them from claiming the standard deduction to itemizing deductions so for many drivers, there will be no tax change. | + |

Conclusion

This proposal does not meet most of the principles of good tax policy. The stated intent at the start of the bill - to equalize the charitable mileage and business mileage rates, seems to have been missed because most individuals do not itemize which is necessary to claim a mileage deduction for charitable work. To provide a benefit or cost reimbursement to individuals driving for charitable organizations, a direct approach, such as a voucher or gasoline gift card, seems simpler and more direct than offering a higher tax deduction if the person itemizes their deductions (rather than claim the standard deduction).

The proposal is a reminder that the mileage rate for charitable work is set by statute (IRC section 170(i) at 14 cents per mile) so cannot be annually adjusted for changes in the cost of driving as is done for the mileage rates for business, medical and moving. Consideration should be given to modifying IRC section 170(i) to give the authority to set and periodically adjust the mileage rate similar as to what the IRS is allowed to do for the mileage rates for business, moving and medical travel.
MST Program Webinar on November 18, 2022

Section 1031 Like Kind Exchange Update

By: Eric Shao, CPA, MST Student

The section 1031 of the Internal Revenue Code commonly known as the like kind exchange has been in effect since 1921. Normally gains and losses are recognized when a property is disposed of but this section requires deferral of the gain or loss when the taxpayer exchanges the property with like-kind property. Section 1031 applies to real property held for business or investment use. The tax on the deferred gain will be paid eventually when the property is disposed (unless held by an individual at date of death); Section 1031 provides a powerful cashflow benefit to the taxpayer during the investment cycle.

A refresher webinar on this topic was hosted on November 18 by the SJSU MST program. The presenters were Mr. Zachary Nolan, adjunct faculty in San Jose State’s MST program and two partners Mr. Nolan works with at Greenberg Glusker LLP, a law firm based in Los Angeles. Mr. Skip Kessler and Mr. Michael Wiener shared their knowledge and experiences working with the section 1031 like kind exchanges. The presenters noted that they have many years of experience working with Section 1031 exchange transactions including forward exchanges, reverse exchanges, and build-to-suit exchanges. Many interested MST students at San Jose State University and working professionals joined this webinar to gain some insights on this popular topic.

Mr. Nolan started off the webinar with a brief review of section 1031. A like kind exchange is a useful tool for taxpayers who want to reshuffle their real estate investment portfolios without immediate tax consequences. The investors may want to exchange properties for reasons such as consolidation, diversification, change in location, or changing management complexities. Section 1031 helps investors achieve these goals without immediate tax consequences which would also reduce the funds available for reinvestment. When available, section 1031 will give investors better cash flow to continue to invest in the real estate. Like kind exchanges are not a tax loophole as the tax is eventually paid by the investors when the properties are disposed of at the end of the investment cycle (unless held until an individual owner’s death). Also, the deferral is mandated by section 1031. According to a 2021 report by Ernst & Young, section 1031 generates about $55 billion to the U.S. economy. ¹

The presenters also discussed section 1031 from practical perspectives. They recalled at one time this section was widely used by investors when downtown Los Angeles properties were revitalized. After the Tax Cut and Jobs Act, only real property qualifies under section 1031.

Transactions can be structured three ways under the section 1031: simultaneous exchange, deferred exchange and reverse exchange. Taxpayers may structure their transactions in any

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one of these three ways, but some rules must be followed in order to qualify. A replacement property must be identified within 45 days of the disposition and acquired within 180 days. The proceeds cannot be received by the taxpayer. The services of a qualified intermediary are utilized to help meet these requirements.

The one-hour webinar was too short to get into depth with this tax rule, but the speakers provided the attendees a strong overview of section 1031 and the potential benefits that clients may receive and common pitfalls to avoid.
Charles Rettig, the 49th commissioner of the IRS, was the keynote speaker at the 2022 Fall IRS Practitioner Seminar. Since he took office in 2018, the IRS has faced many challenges which included the implementation of the Tax Cuts and Jobs Act (largest tax reform since 1986) and the COVID-19 pandemic. He is most proud of how the IRS came together during the unprecedented COVID-19 economic shutdown. Despite the physical closure of the IRS offices, IRS employees found a way to support taxpayers and responded to many of the 220 million phone calls received, collected over $4.1 trillion in annual revenue for the federal government in 2021, and processed Economic Impact Payments providing $1.5 trillion in relief to taxpayers.

Prior to serving as commissioner, Rettig was a tax controversy litigation lawyer in Los Angeles. Compared to his predecessors who he notes were Ivy League graduates, he came from humble beginnings attending public school in the LA area and UCLA as a commuter student. His wife, a Vietnam refugee, has also opened his eyes to the many challenges the IRS faces with limited reach to non-English speaking communities. Rettig wanted to fix this disparity since the IRS deals with more people in the US than any other among government agencies. In 2021, Form 1040 was published in a language other than English and today is published in four languages, the EIP materials went out in 35 different languages and the non-English IRS website pages have received 90 million visits to date. Although he is proud of these achievements, he noted that there are 170 languages spoken in the U.S., so the IRS has a long way to go to serve all the people in the U.S.

As his time in office comes to an end, he sees the new Commissioner’s responsibilities to continue the upgrade of the IRS by continuing to hire and train new IRS employees and continuing to upgrade online systems to provide taxpayers more access to online services. He also indicated that compliance challenges in the areas of foreign sourced income and virtual currency need to be addressed. As for what’s next for Commissioner Rettig, he would like to continue to support underserved communities in any way he can during his retirement.

Some Facts about the IRS Shared by Commissioner Rettig

- Collects over $4.1 trillion annual revenue, which is 96% of the country’s revenue.
- 83,000 employees work at the IRS.
- COVID-19 Economic Impact Payment materials were provided in 35 different languages.
The 28th Annual Tax Practitioner/Fall IRS Seminar on October 26, 2022

Settle for Less with the IRS

by Inessa Zlobina, MST Student

The basics and tips about offers in compromise was presented at the 28th Annual Tax Practitioner and IRS Fall Seminar held in Los Gatos on October 26, 2022, by Donna Beeman, Area Manager, Stakeholder Liaison, IRS.

Miss Beeman explained that an offer in compromise or OIC, is an agreement between the taxpayer and the IRS that settles the tax debt for less than the full amount owed. The government, like other creditors, encounters situations where an account receivable can't be collected in full, or there's a legitimate dispute as to how much is actually owed.

The goals of the OIC program are to achieve a resolution that is in the best interests of both the taxpayer and the government. Generally, this means to collect what can be reasonably expected at the earliest possible time and at the least cost to the government, as well as to secure revenue that may not be collected through any other means. The program aims to provide the taxpayer a fresh start towards future voluntary compliance with all filing and payment requirements being met.

There are three types of offers. The first one involves doubt as to collectability. This is when taxpayers are unable based on a financial analysis, to pay their liability in full. This is the most common type of offer.

The second type involves doubt as to liability. Taxpayers basically doubt the accuracy of their tax liability. These offers are often routed to examination after they are received.

The third type involves the effective tax administration where the taxpayer owes the amount and they have enough in assets and income to pay the liability in full. But, due to special circumstances, requiring full payment would create an economic hardship or simply be inequitable.

Before taxpayers start investing time to do the paperwork necessary to submit an offer, they want to check out the IRS Offer in Compromise Pre-Qualifier Tool to make sure they are eligible to file one (https://irs.treasury.gov/oic_pre_qualifier/).

Onward from April 2022, a taxpayer must use the latest version of Form 656. Taxpayers are strongly encouraged to study the Form 656 Booklet Offer in Compromise booklet that addresses everything a taxpayer needs to know for a successful decision. That booklet includes the Form 656, Form 433-A (OIC) and Form 433-B (OIC).

Miss Beeman strongly recommended to use five instructional videos explaining how to prepare Forms 656, 433-A, and 433-B (https://www.irsvideos.gov/oic).
The OIC program currently does not have the ability to receive original offer applications electronically. All offer applications must be submitted by mail, and must contain the taxpayer's original signature, that's very important.

The success of the OIC program will be assured only if taxpayers make adequate compromise proposals consistent with their ability to pay, and the IRS makes prompt and reasonable decisions.
The 38th Annual TEI-SJSU High Tech Tax Institute Conference on Nov 7 – 8, 2022

Crypto Opportunities and Compliance Considerations

By Inessa Zlobina, MST Student

The 38th Annual TEI-SJSU, High Tech Tax Institute, took place on November 7 and 8, 2022 in Palo-Alto. This conference featured panels with representatives from government, industry, and academia.

One of the programs addressed “Crypto Opportunities and Compliance Considerations” and featured panelists Michael R. Fiore, Area Counsel, Office of Chief Counsel, IRS; Greg Broome, Partner, Wilson Sonsini Goodrich & Rosati; Andy Howlett, Member, Miller & Chevalier Chartered; Yu-Ting Wang, Tax Partner, Armanino. These panelists discussed the opportunities and challenges associated with virtual currency taxation.

As Professor Annette Nellen states: We are in the midst of a “Fourth Industrial Revolution” in which technology is advancing at an exponential pace, bringing us mostly digital tools and processes. In the tax world, “digital” translates to: “how do rules designed for a tangible world apply?”

Cryptocurrency is a great example to remind us that tax as well as other laws and compliance processes need to be fluid to keep our economy moving ahead. Inaction or inappropriate responses can shut down or decelerate advancements that benefit society and lead to further technological progress.

Overview of Virtual Currency Taxation

The IRS representative, Michael R. Fiore, described how existing general tax principles apply to transactions using virtual currency. He provided a broad overview of the IRS guidance issued up to date regarding digital transactions and how to report them on a tax return in order to stay compliant.

The first document to start off with is Notice 2014 - 21, which includes 16, easy to understand, questions and answers. The notice defines virtual currency as a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value. The most important takeaway from Notice 2014-21 is treating virtual currency as property, and, therefore, the general tax principles relating to property transactions apply to transactions in digital assets.

The IRS is transitioning to using the term digital assets, which are broadly defined as any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.
On October 9, 2019, the IRS released Revenue Ruling 2019-24, which provides guidance with respect to hard forks and airdrops of cryptocurrency, and new frequently asked questions (FAQs), which provide guidance on other cryptocurrency issues.

For purposes of this revenue ruling an airdrop is the distribution of a new token to the whole of the legacy token at the time of the hard fork. Although that's not always the case as an airdrop doesn't always follow a hard fork. And there were two conclusions in this revenue ruling. One is that you don't have income if you don't receive new crypto in connection with the hard fork. And the next one is that you do have income if you receive the new currency, taxed at its fair market value. This ruling defines dominion and control as the ability to transfer the virtual currency.

Three Chief Counsel Advice (CCA) that have been issued to date. First, CCA 202035011 explains that convertible virtual currency received in exchange for performing a microtask in a crowdsourcing platform is taxable as ordinary income. Next, CCA 202114020 clarifies the tax treatment of hard forks of virtual currencies as applied to the Bitcoin Cash hard fork that occurred in August 2017. The IRS position is that the receipt of the new property (due to the hard fork) represents an accession to wealth. Specifically, based on *Glenshaw Glass*, the CCA concludes that the taxpayer recognized taxable income from the receipt of virtual currency in a hard fork at the time the taxpayer obtained complete dominion over the currency received, which occurred when the new coin became available to the holder. Therefore, a taxpayer who received BCH in the hard fork event has taxable income in the amount of the fair market value of the Bitcoin Cash received at the time a person had control (the CCA does not state what that value was).

Finally, CCA 2021124008 describes the applicability of section 1031 to exchanges of Bitcoin for Ether, Bitcoin for Litecoin, and Ether for Litecoin. The IRS explains in the CCA that differences among these currencies, such as the availability of smart contracts with Ether but not for Bitcoin makes these three currencies fail to be like kind to each other.

Michael Fiore expressed hope to see some more CCAs in the future providing more guidance, at least what the IRS is thinking about some other cryptocurrency transactions. He carried on his presentation with a summary of transactions that could/ could not affect taxable income.

For example, selling virtual currency for U.S. dollars, exchanging one type of virtual currency for the other, which generally would result in a capital gain or loss. Sending or receiving virtual currency for services, mining virtual currency, getting block rewards or fees in connection with mining, that would be ordinary income.

On the other hand, transactions that don't affect taxable income include simply buying virtual currency for cash and holding onto it, it's no different than if you bought a car or stock.

Mr. Fiore explained that reporting crypto activity requires various tax forms depending on the type of transaction and the type of account. These forms include Form 1040, Schedule D, Form 8949, Schedule C, or Schedule SE to report crypto activity.
If you earn cryptocurrency by mining it, it's considered taxable income and might be reported on Form 1099-NEC at the fair market value of the cryptocurrency on the day you received it. You need to report this even if you don't receive a 1099 since it is taxable income and may also be subject to self-employment tax in addition to income tax.

Staking cryptocurrencies is a means for earning rewards for verifying cryptocurrency transactions. Earning cryptocurrency through staking might be viewed as similar to earning interest on a savings account. In exchange for staking your virtual currencies, you can be paid money that counts as taxable income. If staking is a business activity for an individual, self-employment tax might also be owed.

If you received other income such as rewards and you are not considered self-employed then you can report this income on Schedule 1, Additional Income and Adjustments to Income.

Cryptocurrency charitable contributions are treated as non-cash charitable contributions. A charitable organization may assist in documenting your crypto-charitable contribution by providing a written acknowledgement if claiming a deduction of $250 or more for the virtual currency deduction.

For crypto transactions you make in a tax-deferred or tax-free account, like a Traditional or Roth IRA, respectively, these transactions don’t get taxed like they would in a brokerage account (tax consequences are deferred).

By far, the most important thing an investor can do is maintain detailed records of their virtual currency. The records should summarize (1) when the currency was received, (2) the currency’s fair market value on the date of receipt, and (3) for what purpose the asset is held (investment, inventory, etc.). An effective way to track multiple batches of virtual currency is to store each purchase in a separate online wallet. Also, appropriate records should be maintained to show when each wallet was established. According to Mr. Fiore: “You want to keep note of all of those clicks and keep contemporary record keeping because it's gonna really save you a lot of headaches and frustrations at tax reporting time.”

More Crypto Tax Issues

Gregg Broome discussed certain crypto tax Issues such as information reporting (sections 6045 and 6050I); compensation; initial coin offerings; charitable donations; DAOs; and how we learn together in solving these issues.

In general, cryptocurrency exchanges make it easy for everyday consumers to buy and sell cryptocurrencies. Instead of having to interact directly with the blockchains that these digital assets are stored on, users can simply log into their preferred cryptocurrency exchange, click a few buttons, and purchase their very own cryptocurrency.

Being able to send cryptocurrencies to other locations and other wallet addresses is actually core to the whole premise of crypto. It’s a fairly easy mechanism of value transfer requiring no
third-party verification that makes the idea of cryptocurrency exciting. However, this core principle is also a challenge for reporting of cryptocurrency transactions.

Since the IRS treats cryptocurrencies as property for tax purposes, not as currency, just like with other forms of property—stocks, bonds, real estate—the owner incurs a tax reporting obligation when they sell or trade cryptocurrency.

A problem can arise when cryptocurrency exchanges provide customers with tax reports. Because some users are constantly transferring crypto into and out of exchanges, the exchange has no way of knowing how, when, where, or at what cost (cost basis) the customer originally acquired these cryptocurrencies. It only sees that they appear in your account.

In 2023, tax reporting will become more challenging for exchanges. With the new infrastructure act passed in late 2021, exchanges must file new Form 1099-DA with the IRS and customer but may not have access to the customer’s complete transaction history. That means the burden is on the taxpayer to accurately report taxes.

Industry participants are still not clear on who is a digital asset broker under the new digital asset reporting under section 6045. The revised broker tax reporting rules define a broker as including “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.” This is a relatively broad definition and industry participants are hoping that guidance from the Treasury Department will narrow the scope of the definition.

Another crypto issue can arise when an employer pays compensation in cryptocurrency. Tokens as compensation offer many of the same benefits as stock options. Similarly, they also carry legal and tax implications, so any business that is considering using tokens as compensation should follow related best practices with respect to each area. Some of the key tax considerations include the need to withhold the appropriate taxes (e.g., income and payroll). While paying people in virtual tokens the IRS wants taxes withheld in old-fashioned U.S. dollars. This is difficult to implement since there is no cash in the transaction.

With regard to vesting schedules, things get a bit more complex. A typical token award is taxed at the fair market value when the award occurs (i.e., the recipient is fully vested, and there are no stipulations for vesting). If the awards are restricted and vest equally over, say, four years, the recipient is taxed once the token vests, which could be significantly greater than the value at the grant date. That’s where a section 83(b) election could be beneficial. A section 83(b) election may be filed so that a token recipient pays ordinary income tax on the fair market value of the tokens at the date they were granted, instead of over the four-year period that precedes their vesting. Section 83(b) offers two potential advantages: It could save the recipient taxes over the lifetime of the vesting as it starts the clock running sooner on qualifying the tokens under capital gain status. The downside is that if the recipient forfeits the awarded restricted tokens, they cannot get that prepaid tax they paid based on the value at grant date.

Employees don’t have money to pay tax when holding crypto. Education of employees is required on how to vest tokens including market volatility issues and it is important to reach out to a tax pro.
In Letter Ruling 202019028, an entity formed to provide education on crypto was denied exempt status. The IRS explained that some sort of educational instruction must be present for a nonprofit’s purpose to be deemed educational within the meaning of section 501(c)(3). The IRS clarified that such instruction can be devoted to individual skills training or public education surrounding relevant issues. Acceptable forms of instruction include workshops, clinics, lessons, seminars, panel discussions, and lectures.

Case Discussion: Jarrett v. United States

Panelist Andy Howlett described the *Jarrett* case in detail and explained its importance. Some members of the cryptocurrency community had hoped to use the tax refund case of *Jarrett v. United States*, as the precedent to demonstrate that staking rewards received by a crypto validator only trigger gain upon the ultimate disposition of the reward, rather than constituting taxable income upon receipt. However, the IRS apparently decided it was not ready to fight that battle and sought to moot the taxpayer’s suit by actually refunding (without explanation) the amount of tax the taxpayer claimed to have (over)paid on his staking rewards on his amended return. A lot of useful information about this case can be found on the Proof of Stake Alliance website (https://www.proofofstakealliance.org), including the key briefs of the case.

So, what's an issue here? Joshua and Jessica Jarrett initiated the closely watched lawsuit over Tezos tokens created by Joshua through the process known as staking, seeking a tax refund of nearly $4,000. The Jarretts argued that the tokens shouldn’t be taxed as income when received because they were newly created property - similar to a farmer growing crops or a baker baking a cake. If you’re a baker, you don’t have income just because you've created a cake; you must first sell it. In staking, cryptocurrency holders are rewarded with additional tokens for lending their tokens and computing power to validate new crypto on a blockchain. The Jarrett’s argument was that this was self-created property.

While the dispute concerns the 2019 tax year, the Jarretts claimed that they were entitled to a refund for all income taxes paid on the tokens. The IRS issued a refund in early 2022, and the couple rejected it. They continued to fight the issue in court, hoping to force a judicial ruling that staking gains only be considered income when new tokens are sold, as is generally the case for other forms of new property. The US District Court for the Middle District of Tennessee sided with the IRS, dismissing the case as moot with the issuance of the refund.

With the recent upgrade of Ethereum to proof of stake (from proof of work) and the exponential growth of digital assets involving staking rewards, taxpayers engaging in staking activities were hopeful that the *Jarrett* case would provide much-needed clarity on when staking rewards should be taxed. Presently, stakers are taking a wide range of positions with respect to the tax character and tax timing of staking rewards. For example, some stakers take the position that the receipt of staking rewards results in taxable income from the performance of services, while others assert that staking rewards are not taxable until they sell, exchange or otherwise dispose of the rewards.

With Jarrett’s dismissal, taxpayers continue to operate in uncharted tax waters. While recent legislative proposals have tried to bridge the gap between taxation and digital assets, including
the Responsible Financial Innovation Act introduced in June 2022, which permitted
cryptocurrency stakers to defer taxes with respect to such activities (including the receipt of
staking rewards) until those assets were disposed of, such legislative proposals have not yet
gained any traction in the Congress.

In the meantime, the IRS continues to remain silent on the issue with the only analogous
guidance (involving mining activities) implying that staking awards should be taxed as ordinary
income upon receipt. As a result, taxpayers should continue to proceed with caution.

**Business Challenges Involving Virtual Currency**

Yu-Ting Wang, Tax Partner from Armanino, discussed how the U.S. and other selected countries
regulate digital assets. She also highlighted business and tax challenges involving virtual
currency.

She started her presentation by pointing out that we all really need a set of rules to tame the
crypto “Wild West”. As cryptocurrencies spread across the world, regulations are also being
put in place that attempt to regulate them. The landscape is constantly evolving, and it is not
easy to keep up with the rules of the different regions.

Existing guidance for cryptocurrency taxation has struggled to keep pace with the evolution of
the industry. There are a lot of uncertainties with the current regulations, but the worst thing a
taxpayer can do is not report cryptocurrency activity at all.

On March 9, 2022, the Biden Administration released an Executive Order (EO) outlining a
whole-of-government, comprehensive approach to the regulation of cryptocurrencies and
other digital assets. The EO focuses on six key priorities: (1) consumer and investor protection;
(2) financial stability; (3) illicit finance; (4) U.S. leadership in the global financial system and
economic competitiveness; (5) financial inclusion; and (6) responsible innovation. By creating a
predictable regulatory environment, the U.S. government can encourage growth in the
development of digital assets and assist American FinTech’s to compete in global markets.

In India, Union Budget of 2022 introduced specific proposals to tax virtual digital assets (VDAs),
including cryptocurrencies. For example, there will be tax on income from VDAs and
withholding.

In the UK, HMRC is working alongside leading crypto exchange platforms to gather information.
Capital gains tax usually applies on any profits realized for individuals holding crypto as personal
investment.

El Salvador adopted the cryptocurrency as official currency in 2021. Sanctioned countries, like
Russia and North Korea, might use cryptocurrencies to evade U.S. and other sanctions.

In the meantime, there are certain U.S. proposed legislation such as H.R. 6582, Virtual Currency
Tax Fairness Act of 2022. It proposes to exclude up to $200 of gain from disposition of virtual
currency in a personal transaction.
S. 4356, Lummis-Gillibrand Responsible Financial Innovation Act includes the following provisions:

- Gross income shall not include gain or loss from sale or exchange of virtual currency in a personal transaction if the gain does not exceed $200.
- Amends section 6045(c)(1)(D) broker definition and delays the effective date of broker reporting for digital assets.
- Decentralized Autonomous Organizations (DAO) shall be a business entity which is not a disregarded entity.
- Staking income is not recognized as income until disposed of.
- No qualified appraisal is needed for charitable contributions valued at more than $5,000 that are traded on established exchanges.

S. 4608, Virtual Currency Tax Fairness Act (Toomey and Sinema), proposes to exclude gain, up to $50, from sale or exchange of virtual currency in a personal transaction.

The lack of official guidance on crypto taxation makes tax practitioners unsure of what to do in many situations. A tax professional should strategically guide clients through the process of cryptocurrency use and reporting to get ahead of the challenges and changes of taxing a new currency. There is a massive demand in the market for crypto tax services.

Advisors need to know the language of crypto, what constitutes a taxable event and what doesn’t. For example, the sale of currency is taxed differently than mining. Clients need to make their tax advisors aware of various transactions they engage in to help them assemble the necessary information for every transaction.

Potential tax issues involving virtual currency are timing for recognition of loss and identifying types of loss sustained. Despite the potential and promises, many cryptocurrencies and NFTs have gone bust in recent months, with swaths of investors losing most, if not all, of the value. In some cases, the creators and promoters were simply unable to achieve the goals they promised. But others were scams in which the creators had no intention of repaying their investors and would disappear after taking the investors’ money, also known as rug pulls. What type of loss was sustained? Was it abandonment/ worthlessness, theft loss or capital loss?

The popularity and enthusiasm over digital currency continues to grow. To serve clients proficiently, a tax advisor, in addition to having an accounting degree, and having to pass CPA exams and pursuing continued professional education (CPE) every year, needs to gain actual work experience in the world of crypto and practice what they learned. The regulatory environment surrounding digital assets continues to evolve, and clients who invest in crypto need to be made aware of any updates to tax guidance. Having crypto tax knowledge and being able to serve crypto clients is no longer an option for tax practitioners, it is becoming a necessity.
**Conclusion**

Taxpayers involved in investing in, trading, or creating digital assets should use the available IRS guidance. While this guidance is helpful, more complicated technical questions are largely left unaddressed. As a result, taxpayers will have to continue to seek advice from their own counsel.

With more than $1 trillion in cryptocurrency value wiped out since the 2021 high-water mark, many investors may be tempted to enter the cryptocurrency orbit at a potentially attractive, lower price point.

Finally, taxpayers should always let their tax return preparer know when they engage in a virtual currency transaction. The IRS has been on the watch for those using virtual currencies to evade taxes. Keeping a tax preparer informed will allow taxpayers to properly report their virtual currency transactions.
The 38th Annual TEI-SJSU High Tech Tax Institute Conference on Nov 7 – 8, 2022

OECD Pillars One & Two – What Should Tech Companies Focus On?

By: Enas J. Al-Mais, MST Student

Limitations in the international tax rules created opportunities for base erosion and profit shifting (BEPS). Furthermore, digitalization of the economy enhanced those tax challenges. The OECD, G20 countries, and the Inclusive Framework members (more than 140 countries) reached a consensus-based solution, comprising two pillars: Pillar One, which focuses on nexus and profit allocation; and Pillar Two, which focuses on a global minimum tax.

The 38th Annual TEI-SJSU High Tech Tax Institute conference featured a panel of five subject matter experts tackling the contemporary topic of Pillars One and Two. The panelists: Lonnie E. Brist, Managing Director – Transfer Pricing at Anderson; Sirsha Chatterjee, Principal at Ernst & Young LLP; Wayne Monfries, Senior VP and Head of Global Tax at Visa; Zack Perryman, Managing Director at Ernst & Young LLP; Ben Shreck, Tax Counsel at the Tax Executive Institute Inc. The following is a summary of what was discussed in the presentation.

Pillar One: How to Split Up the Pot?

The OECD wanted to tax companies that have access to market jurisdictions with no physical presence. As a taxpayer, one must understand their own supply chain and where value is created – whether from a customer base, R&D contribution, or marketing expenditure. Therefore, a statement about how much tax is attributed to that market jurisdiction is based upon this rule: the splitting of the pot.

Pillar One – Amount A – is targeted at companies with 20 billion EUR of revenue in excess of 10% operating margin. Mr. Monfries noted that Pillar One would only affect about 100 companies worldwide. Ms. Chatterjee added that a significant portion of these companies are technology multinational companies, incorporated in the United States. Pillar One focuses on the allocation of revenue to market jurisdictions and is not based on transfer pricing principles. Mr. Shreck explained that Pillar One has nothing to do with “arm’s length”; it is best to think about it as a new tax and “you’re trying to get support for that market contribution”.

Amount A is based on financial statements. A number of things to consider for amount A: who are you going to tax, nexus and revenue sourcing rules, and what jurisdiction you are actually operating in.

Transfer Pricing and Pillar One

As explained above, Pillar One has nothing to do with transfer pricing. However, as Mr. Brist mentioned, when one layers in the complexity of the rules, the elimination of double taxation, the giving of safe harbor, and the computing of excesses, a new definition of profit arises. The public consultation guideline came up with a definition for what an entity level profit margin is going to be. Ms. Chatterjee elaborated that in the transfer pricing context, this profit margin
would be called segmented beginners, or the target operating margin for a legal entity. Now, a new term is introduced: “elimination profit”, which is accounting profit with many adjustments. Therefore, a multinational would have GAAP profit, taxable income, statutory tax jurisdiction, and then they can compute the elimination profits.

Challenges of Pillar One

The panelists discussed the possible challenges with Pillar One implementation. There may be controversy between jurisdictions, not just between taxpayer and tax authorities, especially when it comes to taxing rights. Also, if unanimity isn’t reached, taxpayers may still have unilateral imposition of different taxes and may not have tax treaty support to manage against double taxation. Mr. Brist added that from a political perspective, he can’t see a lawmaker “handing over taxation rights of their pot” to someone else. In addition, challenges may arise because of compliance costs, implementation burden and operational burden. Furthermore, Mr. Brist advised that the threshold of Pillar One needs to be taken into account if companies are planning a growth strategy or even an exit strategy.

Probable Future of Pillar One

Pillar One requires full consensus. The United States must completely back it to pass. Ms. Sirsha thinks that even if the U.S. doesn’t back Pillar One, “it will go through anyway in some hybrid fashion format”. Moreover, the OECD rules have already laid out the blueprint of how international taxation laws may change.

Pillar Two: What is Your Footprint?

Thresholds are a lot lower for Pillar Two than that of Pillar One (as described above). Pillar Two will include multi-national corporations (MNC) with global revenue of at least €750 million. Nevertheless, a jurisdiction can opt to impose an Income Inclusion Rule (IIR) on its headquartered multinational enterprises (MNEs) regardless of threshold. A global anti-base erosion regime (GloBE rules) applies through an IIR and an Undertaxed Payments Rule (UTPR).

The GloBE minimum rate is 15% for IIR and UTPR, applied based on effective tax rate in each jurisdiction. The application of the IIR is done “top down” so that an IIR of the Ultimate Parent Entity (UPE) of the group overrides lower-tier IIRs. If the UPE does not apply an IIR, through a waterfall effect, its subsidiary can apply it and so on. This is done through the chain of ownership stopping with the subsidiary that applies the IIR, if any. The application of the IIR will turn off the application of the UTPR to any low-taxed subsidiaries that are subject to the IIR.

Pillar Two has rules that may allow one country to reach into another country’s tax jurisdiction, only if that country is not taxing as much as it could. For example, if a UPE is in a low-taxed jurisdiction and it has two subsidiaries in two different countries – Country A is high-taxed jurisdiction and Country B is a low-taxed jurisdiction. If UPE has not adopted the IIR, Country A can apply the UTPR to Country B. In addition, Country A (the high-taxed jurisdiction) can also apply the UTPR to the UPE’s low-taxed profit, even if the UPE country has implemented the IIR!
What if GILTI is a “Qualified IIR”?

If GILTI is a “Qualified IIR”, it will prevent the waterfall effect of the IIR and turn off the application of the UTPR to foreign subsidiaries of US UPE. Furthermore, the qualification would prevent other countries from applying the UTPR to foreign subsidiaries of US UPE – like in Country B in the example above – but NOT to the US UPE itself. The final assessment is still outstanding on whether GILTI is a “Qualified IIR” or not. Articles 2.1 to 2.3 of the GloBE Rules may provide more background information on the possibility of qualifications of different US tax rules – for example, BEAT, GILTI or CAMT.

When will Pillar Two be enacted?

Unlike Pillar One, Pillar Two doesn’t need consensus to move forward on a global basis. Most recently, the OECD has recommended that Pillar Two rules become effective in 2024 and the UTPR in 2025. The implementation is generally optional for countries through changes to domestic laws and treaty provision for Subject to tax rule (STTR). Mr. Perryman explained that many countries around the globe, including Japan, Australia, and many EU countries, have put out some draft legislation to enact Pillar Two. He added that slowly all countries will follow suit. This is because it is in the best interest of these countries to enact rules to protect their tax base according to the Pillar Two guidance. While Mr. Brist agreed with Mr. Perryman that it may be advantageous for some countries, he argued that it may still be more advantageous for other countries to stay out of Pillar Two depending on the footprint.

Mr. Perryman continued that as part of the Pillar Two process, countries are incentivized to enact rules which consider qualified investment to protect their tax base. The “Qualified Domestic Minimum Top-up Tax” (QDMTT) can be looked at as an incentive as it would turn off other elements of Pillar Two rules, like the Global Anti-Base Erosion (GloBE) elements.
The 38th Annual TEI-SJSU High Tech Tax Institute Conference on Nov 7 – 8, 2022

IRC Section 6050W - Form 1099-K Reporting Requirements

By: Aizhan Toibazarova, MST Student

One of the topics presented at the 38th Annual TEI-SJSU High Tech Tax Institute, on November 7, and 8, 2022, was Form 1099-K reporting requirements. The speaker panel was represented in full array by IRS and CPA firms’ advisor representatives: David M. Carl, Sr. Counsel IRS Office of Chief Counsel, Small Business/ Self-Employed Division; Vivian Cheng, CPA, Industry Subject Matter Expert for Telecommunications and High Technology Industries; Aureon Herron-Hinds, Principal, RSM US LLP; and Candace B. Ewell, Principal, PwC.

Ms. Ewell started off briefly mentioning the topic of discussion regarding the possible 1099-K reporting information issues due to an increase in reporting volume for the tax year 2022. Ms. Herron-Hinds announced the agenda, the focus of which were the rule changes regarding the reporting threshold for third party settlement organizations and what issues can be expected with these reporting changes.

Who is Required to Report 1099-K

The Form 1099-K was initiated in 2011 and governed by Section 6050W. Ms. Cheng reviewed the basic filing requirements under Section 6050W, which generally requires payment settlement entities (PSEs) to file information returns to report payments made to participating payees in settlement of payment card transactions and third-party network transactions. The payment card transaction is any transaction in which a payment card is accepted as payment, including gift cards. Payment card transactions exclude ATM withdrawals, cash advances, and convenience checks. The third-party network transactions are any transaction settled through a third-party network. There are three characteristics of the third-party payment network:

1) Any agreement or arrangement between a central organization and a substantial number of providers of goods or services unrelated to such organization to settle transactions for provided goods and services in accordance with agreement or arrangement.

2) Standards and mechanisms for settling the transactions; and

3) Guaranteed payment to the provider of the goods or services.

Further Mr. Carl covered the types of transactions that are reportable: payment card transactions and third-party network transactions. These transactions are reported by the following PSEs:

1) Merchant Acquiring Entity defined as a bank or other organization that is contractually obligated to pay merchants to settle the transaction.
2) Third Party Settlement Organization defined as the central organization that has the contractual obligation to make payments to participating payees of third-party network transactions.

Mr. Carl emphasized the meaning of “make a payment.” It does not mean who has funds rather, who gives the instructions to transfer those funds to the payee account. A careful analysis must be done in determining who the PSE is in any transaction by looking at the agreement and payment obligations and is the first hurdle to approach.

Ms. Ewen explained the reporting exceptions where reportable transactions are settled through intermediaries that include aggregated payee and electronic payment facilitators. An aggregate payee is a person that contracts with a PSE to receive payments on behalf of one or more participating payees and distributes the funds to them. In this case, a PSE is required to report the payment to the aggregated payee, which in turn issues a 1099-K to each participating payee. Ms. Ewen used an example mentioned in Reg. Section 1.6050W-1 where an aggregated payee was a large franchising organization who contracted with the merchant acquiring entity for the whole organization.

Electronic Payment Facilitators (EPFs) are third parties that make payments on behalf of a PSE. This kind of arrangement shifts filing requirements to the EPF, which submits instructions to transfer funds to settle transactions. EPFs do not need to have an agreement/arrangement with the participating payee, and a payment can come from another account not belonging to the EPF.

Ms. Herron-Hinds emphasized the special rule when two or more PSEs are involved in a payment chain. The PSE who makes the payment are required to file a 1099-K despite the agreement designating another person to file.

**Possible Issues with 1099-K Reporting Change**

The American Rescue Plan Act of 2021 lowered the federal reporting threshold for third party settlement organizations from $20,000 to $600 with no minimum transaction volume. This rule change will cause a surge in filing volume of Forms 1099-K. Additionally, some states have their own reporting thresholds and require separate sets of forms to be filed that might not necessarily be accepted electronically.

Also, there is a risk with withholding. It is very important to have a compliance program in place that outlines the policies, procedures and controls regarding reporting and collecting all necessary information to prevent backup withholding liability, which is 24% of the gross amount that was paid. Emphasis must be placed on team training to collect the TINs and all necessary information for proper reporting compliance of 1099-K.

Form 1099-K reporting requires two key elements: the gross amount of reportable transactions and the participating payee. The participating payee, defined broadly, is any person, including the government and tax-exempt entities, who receive payment settlements of a payment card
or third-party network transaction. The gross amount is an aggregate payment transaction for the calendar year that the form covers determined by the date of transaction.

Mr. Carl remarked that reporting challenges can arise when there are changes in the settlement amount or a portion of the payment is a sales tax, which is not reportable. Furthermore, there is concern with the system’s ability to identify what transactions are reportable when the payments are not for goods or services and carry a personal purpose. For instance, splitting a dinner bill with someone or sending a monetary gift for their birthday. Mr. Carl acknowledged that identifying those reportable transactions would pose difficulty for taxpayers and advisors and there is a reliance on the payee to determine those payments.

Certain transactions may get reported on more than one form and will need to be reconciled. To prevent double reporting the “tiebreaker rule: in the Section 1041 regulations relieves payors from filing Form 1099-MISC or Form 1099-NEC when they make a payment through a PSE. The PSE is a payor and files Form 1099-K. However, in a case of a merchant-acquiring entity, every card transaction would be reported on 1099-K without regard to the nature or character of the payment. Payments like rent and royalties will end up reported on Form 1099-K. Therefore, it is important to utilize the available tools to reduce the amount of information required to be reported and using a PSE can be a good start to limit the reporting.

Some of the merchant-inquiring entities or PSE, facilitate payments to merchants that choose to accept a digital currency might issue 1099-K, 1099-MISC, or 1099-NEC. These transactions could be an exchange transaction and not related to the purchases of goods or services. Ms. Herron-Hinds warned that tax advisors need to be diligent while dealing with the 1099-K due to a strong likelihood of misreported amounts.

**Non-compliance Consequences**

Mr. Carl covered additional filing requirements. Form 1099-K must be filed with the IRS by February 28 if filed on paper. The due date is extended to March 31 for electronically filed forms. To receive a possible 30 day extension, Form 8809 must be filed accompanied with a letter explaining the need for additional time to file. Each participating payee must be furnished with a payee statement by January 31.

Two types of penalties can be assessed:

- IRC 6721 for failing to timely file a correct information return, which are missing TIN and discrepancy in the name or TIN.

- IRC 6722 – failure to furnish a timely or correct payee statement.

If errors are corrected within 30 days of the due date, a reduction of penalty can be granted, or the penalty can be abated based on reasonable cause.

The Form 1099-K can be furnished to a payee either by mail or electronically. However, the IRS has specific requirements on acquiring the consent of a payee to deliver their 1099 forms
electronically. Consent must be an affirmative consent listing the options of delivery such as mail, email, access to website or a dashboard. Additionally, there is a language requirement for information presented. Not having proper consent might increase the chance to be penalized for failure to deliver the information return to payees.

Conclusion

The decreased threshold of $600 will increase the volume of Form 1099-K reporting. Additionally, the lack of proper policies and procedures in place or technical inability to discern the reportable and unreportable transactions can further contribute to a greater volume of Forms 1099-K. This will lead to increased risk of penalties for mismatches and obligations to support people who received Form 1099-K for transactions that were not supposed to be reported in the first place. These can cause frustration in settling the misreported transactions with the IRS and expose clients to additional IRS inquiries and fees.

Update

On December 23, 2022 the IRS issued the Notice 2023-10 announcing a delay in implementation of new reporting requirements of Form 1099-K by third-party settlement organizations for 2022. The IRS and Treasury Department’s decision was driven by professional public concerns regarding the compliance issues. Calendar year 2022 will be a transition period to provide sufficient time to help all parties get ready for the increased filing requirement. Reporting for 2022 will use the prior threshold for third party settlement organizations of aggregate payments over $20,000 and the number of transactions over 200.
The 38th Annual TEI-SJSU High Tech Tax Institute Conference on Nov 7 – 8, 2022

U.S. Tax Legislation Affecting ASC 740: IRA and CHIPS Act

By: Tiago Iorio, MST Student

Tax Changes

In August 2022, President Biden signed into law the Inflation Reduction Act of 2022 (P.L. 117-169). This legislation includes approximately $400 billion of tax incentives to promote clean energy, and significant changes to credit requirements and utilization. The U.S. Congress also passed the CHIPS and Science Act of 2022 (P.L. 117-167), which will provide $52 billion in subsidies for U.S. chip manufacturers.

The effect of these tax changes on income tax provisions was covered at the 38th Annual TEI-SJSU High Tech Tax Institute Conference, on November 8, 2022. The presenters: Cort Yoder, partner at Deloitte; Jared Huish, partner at KPMG; and Spencer Brock, partner at Grant Thornton. This article summarizes some of the key points made by these presenters.

Corporate AMT

The IRA adds an alternative minimum tax (AMT) of 15 percent of the average annual adjusted financial statement income of domestic corporations (excluding Subchapter S corporations, real estate investment trusts, and regulated investment companies) that exceeds $1 billion over a specified 3-year period. This new tax is effective in taxable years beginning after December 31, 2022.

Although a company may expect to be subject to the corporate AMT for the foreseeable future, ASC 740-10-30-11 states that “no one can predict whether an entity will always be an alternative minimum taxpayer”. So, a company may elect to either disregard or take into consideration its AMT status (comparable to the treatment of GILTI status) when evaluating its existing deferred tax assets under the regular tax system. Some relevant questions include:

- Is the corporation within the threshold to be considered a corporate AMT taxpayer?
- Should the corporation recognize a valuation allowance on the deferred tax asset if it is subject to the corporate AMT?
- Can the corporation elect to have corporate AMT status?

Refundable Credits

Some tax jurisdictions allow for a refundable credit (such as fuel tax credits for U.S. federal income tax and R&D credits in certain state and foreign jurisdictions) that do not depend on the tax position of a company (for instance, a company may receive a refund even though having a loss for the tax year). Tax credits whose realization does not depend on the generation of taxable income (such as refundable credits) are not in the scope of ASC 740. So, a company should not
record such tax credits as a reduction of income tax expense, but instead treat them as a type of government grant.

The CHIPS Act allows a credit of 25 percent for capital expenses for manufacturing of semiconductors and related equipment. Because this credit is refundable even if the taxpayer had no taxable income, such credit is outside the scope of ASC 740.

Transferable Credits

The IRA also allows an eligible taxpayer to transfer (by selling) eligible credits to an unrelated taxpayer. In certain situations, a company may not have enough taxable income to use such tax credit, or it could take many years until it can use it, so selling the credit can be the best option. The important point is that if a credit is not refundable, and the credit can be used only to lower an income tax liability either of the company that generated such credit or the company to which such credit is transferred to, ASC 740 would apply. To the amount in which the tax credit does not lower current taxes payable, the company must recognize a deferred tax asset or DTA for the tax credit carryforward.

The company that purchased a transferable credit should record such credit as a DTA and it should also record a deferred credit for the difference between the DTA recognized and the amount paid in conformity with ASC 740.

Stock Buyback Tax

The IRA also imposes a new non-deductible 1 percent excise tax on the fair market value of stock repurchased by a publicly traded corporation after 2022, including purchases of corporate stock by certain corporate subsidiaries and foreign corporations. Taxes that are not based on income are not in the scope of ASC 740.

Next Steps

Certain provisions of these new tax laws will be subject of further guidance from the Treasury Department and IRS. As the guidance continues to evolve, a VP of tax or a CFO of a large company should understand how this new tax legislation will affect its effective tax rate and reporting of income tax on its financial statements.
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