California Tax Lawyers Propose Changes, Improvements

UNDATED

SUMMARY BY TAX ANALYSTS

Treasury has released a submission from the California Lawyers Association Taxation Section that includes proposals from various individuals on reporting for nonresident international business travelers, improving tax compliance, educating taxpayers, making section 108(a)(1)(E) permanent, changing the grantor trust rules, and establishing procedures for some situations involving court-ordered criminal restitution.

FULL TEXT PUBLISHED BY TAX ANALYSTS

CALIFORNIA LAWYER ASSOCIATION

Taxation Section

2021 Washington, D.C. Delegation

May 10 - 11, 2021

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About the Delegation

For over 30 years, the Taxation Section (first as part of the California Bar Association, and now part of the California Lawyers Association) has sent an annual delegation to bring California tax lawyers and their ideas to Washington, D.C. Just prior to the American Bar Association Tax Section Meeting held in Washington, D.C., a group of selected delegation members from the Taxation Section of the California Lawyers Section will share their ideas and engage in lively discussions with key tax officials and staff members from the following government offices, depending on availability and interest:

- Internal Revenue Service
- National Taxpayer Advocate
- Treasury Department
- House Ways and Means Committee
- Joint Committee on Taxation

- Senate Finance Committee
- United States Tax Court
- The Department of Justice Tax Division

The Delegation serves a variety of functions. The most important is to make a substantive contribution to the federal tax laws. The Delegation also familiarizes government officials with the experience and concerns of California tax lawyers. Past Delegations have raised the awareness of government tax officials of the California bar and have enhanced our ability to play a significant role in federal tax policy.

Through the Delegation, we hope to encourage tax officials in Washington, D.C. to consider the California bar and its members as a useful resource. In addition, the Delegation benefits the individual Delegation members. It provides insight into how the government functions and the issues that concern those who formulate the tax laws and regulations, as well as an opportunity to develop relationships with government staffers who work in the respective member's areas of practice.

Finally, and possibly most noteworthy, are the facts that the papers have been published both in national and state-wide tax journals, as well as online in Tax Notes Today, and a number of the proposals have been adopted. Please note that publication is not guaranteed.

Tentative Agenda[1]

	May 10, 2021	**May 11, 2021**
9:00 am - 10:00 am	IRS Office of Chief Counsel[2]	Joint Committee on Taxation
10:00 am - 11:00 am	IRS Office of Professional Responsibility	Senate Finance

	May 10, 2021	May 11, 2021
11:00 am - 12:00 pm	Department of Treasury	Taxpayer Advocate
12:00 pm - 1:00 pm	Lunch Break	Lunch Break
1:00 pm - 2:00 pm	Breakout Sessions[3]	House Ways & Means
2:00 pm - 3:30 pm		Breakout Sessions[3]

Links

Please follow the links below to access the delegation:

- May 10, 2021 (IRS Office of Chief Counsel):
  https://irs.zoomgov.com/j/1604748040?pwd=eTN0NnRxOFI2cmI3NnZEUmJLSzVtUT09
  Meeting ID: 160 474 8040
  Passcode: 0s@QeY02
- May 10, 2021 (All Other Meetings):
  https://zoom.us/j/96926802459?pwd=ZHgxek1udHZsSUZKbGkyZWswZGJvUT09
  Meeting ID: 969 2680 2459Passcode: 341208
- May 11, 2021 (All Meetings):
  https://zoom.us/j/97989466635?pwd=ekZOaVVJSVRZaDFjeE1zOVdhU0Y1QT09
  Meeting ID: 979 8946 6635
  Passcode: 597751

Break Out Room

During the appointed dates and times, individual authors and papers will be available in breakout rooms through the Zoom platform as follows:

Room Number	Author(s)	Papers
1	Lorraine Cohen & Karen Beznicki	U.S. Composite Income Tax Reporting for Non-Resident International Business Travelers/Employees and Payroll Identification Number
2	Saba Shatara & Michael Day	Solidifying the Exclusion for Cancellation of Indebtedness Income Related to Home Loan Reductions: A Petition to Make Permanent IRC Section 108(a)(1)(E)
3	Richard S. Kinyon	Proposed Revision of the Income Tax "Grantor Trust Rules" (IRC sections 671-679)
4	A. Lavar Taylor & Rami M. Khory	Proposal to Establish Administrative Procedures for the Internal Revenue Service and the Department of Justice to Deal with Situations Where Court-Ordered Criminal Restitution Payable to the Internal Revenue Service Significantly Exceeds the Actual Tax Liability to Which the Restitution Relates
5	Elisabeth Sperow	Making Z Connection: How the IRS Can Reach and Educate A New Generation of Taxpayers
	Annette Nellen	Suggestions for Improving Tax Compliance Through Greater Tax System Transparency and Accountability.

Summary of Paper Topics and Authors

Author(s)	Title	Description
Lorraine Cohen & Karen Beznicki	U.S. Composite Income Tax Reporting for Non-Resident International Business Travelers/Employees and Payroll Identification Number	International employees routinely travel into the United States on business for short periods of time and often provide services for entities in a related entity group. Many companies actively track business travel and can identify when US employer withholding and reporting tax responsibilities exist, but do not have an effective mechanism to remit taxes. The proposal is to allow an employer to obtain a payroll reporting identification number for nonresident international business traveler employees providing services in the US that can be used to remit payroll withholding taxes. The proposal is to further create a mechanism where a US affiliate employer can file on a composite basis on behalf of specific US nonresident employees of a related entity group in lieu of W-2 reporting and individual tax return filing.
Annette Nellen	Suggestions for Improving Tax Compliance Through Greater Tax System Transparency and Accountability	This paper will explain the importance of transparency and accountability to taxpayers. In addition, several suggestions will be offered that can be implemented by the IRS or enacted into law by Congress. These ideas include an easy access to a taxpayer receipt, greater explanation of tax rules in forms rather than only how to find the number that goes on a

Author(s)	Title	Description
		particular line of a tax form. Many of these suggestions are low cost so can be implemented. Problems Addressed: Two important principles of good tax policy are described by the AICPA as follows: (1) Transparency and Visibility. Taxpayers should know that a tax exists and how and when it is imposed upon them and others, (2) Accountability to Taxpayers. Accessibility and visibility of information on tax laws and their development, modification and purpose, are necessary for taxpayers. Most tax rules do not meet these principles primarily due to the public's lack of understanding of tax systems and specific tax rules. For example, most people cannot list all the taxes they pay and the amount. They likely are unaware of the differences in the rules for deducting interest on a home mortgage versus student debt. Also, they have not been given sufficient information by lawmakers to know why differences exist or why these deductions are even part of the federal income tax.
Elisabeth Sperow	Making Z Connection: How the IRS Can Reach and Educate A New Generation of Taxpayers	This paper advocates for ways the Internal Revenue Service ("IRS") can help members of Generation Z become better informed and equipped to address their rights and responsibilities as taxpayers through the creation of an interactive mobile application. It is the culmination of work by students and

Author(s)	Title	Description
		faculty at California Polytechnic State University, San Luis Obispo.
Saba Shatara & Michael Day	Solidifying the Exclusion for Cancellation of Indebtedness Income Related to Home Loan Reductions: A Petition to Make Permanent IRC Section 108(a)(1)(E)	This proposal recommends that Congress consider making Section 108(a)(1)(E) a permanent provision. This proposal is in recognition of the fact that Section 108(a)(1)(E) is necessary to protect taxpayers who are forced to engage in loan modification or are facing potential foreclosure and, as noted in *Babin v. Commissioner*," is premised on the belief that it is inequitable 'to kick someone when he is down.'" The authors suggest that this is a timeless sentiment and not one suited for regular discussion for renewal. Finally, this proposal will attempt to demonstrate how making Section 108(a)(1)(E) permanent is consistent with the policies inherent to Section 108's exceptions, as well as the general policy considerations contained in the code.
Richard S. Kinyon	Proposed Revision of the Income Tax "Grantor Trust Rules" (IRC sections 671-679)	The purpose of this paper is to examine the way in which the income (including capital gains) of a domestic trust is taxed for federal income tax purposes during the lifetime of the U.S. resident settlor or grantor of the trust, and in particular to determine whether some or all of the so-called "grantor trust rules" in Subpart E of Subchapter J of the Federal Income Tax Law (IRC Sections 671 through 679) and related

Author(s)	Title	Description
		provisions should be modified or repealed, in whole or in part. Primarily as a result of the compression of the income tax rate brackets applicable to estates and trusts and the so-called "kiddie tax" in IRC Sections 1(e) and 1(g), respectively, enacted about 30 years ago, it is submitted that the bulk of those grantor trust rules are no longer needed to prevent the avoidance of income taxes, and ironically they are now utilized by taxpayers to avoid gift and save estate taxes.
A. Lavar Taylor & Rami M. Khory	Proposal to Establish Administrative Procedures for the Internal Revenue Service and the Department of Justice to Deal with Situations Where Court-Ordered Criminal Restitution Payable to the Internal Revenue Service Significantly Exceeds the Actual Tax Liability to Which the Restitution Relates	The paper proposes an administrative procedure for dealing with situations where the amount of criminal restitution in favor of the IRS as ordered by the District Court greatly exceeds the actual tax liability to which the restitution relates, as later determined by the IRS itself or by a court in a civil proceeding brought to determine the amount of taxes owed. Under existing law, taxpayers may not seek a reduction of court-ordered criminal restitution for which there is final court order, even though the IRS later agrees, or a court later determines in a civil proceeding, that the amount of taxes owed for civil purposes is significantly lower than the amount of criminal restitution relating to that tax liability as ordered by the District Court. This new procedure will permit taxpayers to avoid having to pay taxes, interest and penalties to

Author(s)	Title	Description
		the IRS where the IRS later agrees (as the result of the civil audit), or a court determines, that the amount owed as the result of the civil audit is less than the amount of criminal restitution ordered by the District Court for a given tax period. Under this procedure, taxpayers will be required to provide to the IRS proof that the taxpayer has paid to the IRS all amounts owed under Title 26 for a particular tax period, as agreed to by the IRS

US COMPOSITE INCOME TAX REPORTING FOR NON-RESIDENT INTERNATIONAL BUSINESS TRAVELERS

This proposal paper was prepared by Lorraine Cohen and Karen Beznicki.[1,2]

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EXECUTIVE SUMMARY

International employees who are United States (US) non-residents routinely travel to the US on business trips. These international business travelers (IBTs) often are not eligible for a US Social Security number (SSN) because they do not have a visa type that permits them to apply. While many companies actively track the business travel of their international employees and can identify when employer tax withholding and reporting responsibilities exist, they do not have an effective mechanism to remit taxes with respect to these employee populations since they are unable to remit the taxes through payroll without a valid SSN for these employees.

This paper proposes that the Internal Revenue allow a US affiliate employer to file a composite return on behalf of specific non-resident employees of a related entity group. The proposed solution would be similar to many existing state statutes that allow corporations and partnerships to file composite tax returns on behalf of non-residents directors/shareholders and partners.

In addition, the process for applying for an Individual Tax Identification Number (ITIN) is so onerous, it is not practical for business travelers to the United States to obtain them for the purpose of filing US tax returns for limited business travel. This proposed change would allow employers to allow IBTs who are not eligible for an SSN to be included on a composite return without an SSN or an ITIN. Alternatively, the proposed change would allow employers to apply for a U.S. Payroll Reporting Identification Number that could be used to remit payroll withholding and report payroll taxes for IBTs who are not eligible for an SSN.

DISCUSSION

I. INTRODUCTION

International employees who are US non-residents routinely travel into the US on business trips. These international business travelers (IBTs) are often not working in the US long enough to be placed on a short-term assignment but many companies still actively track these employees' business travel and can identify when employer tax withholding and reporting responsibilities exist. Although companies wish to comply with the tax reporting requirements for their IBTs, they currently do not have an effective mechanism to satisfy all the compliance requirements.

To operate payroll, employers must report their employees' US SSNs. IBTs from outside the US are often not eligible to apply for an SSN, even in situations when they are legitimately present in the US for work, because they do not have a visa type that permits application for an SSN.

Some states, like California and New York, allow Individual Tax Identification Numbers (ITINs) to be used for state employment tax and income tax payroll reporting purposes. However, ITINs cannot be used for federal employment tax and income tax reporting. Therefore, employers cannot remit US taxes to the IRS via payroll, as required.

IBTs traveling to and working in the US may also have a US income tax filing requirement to report income earned for services performed within the US.[5] If the IBT is a resident of a country that has an income tax treaty with the US, the IBT may be eligible for treaty benefits; however, they must obtain an SSN or an ITIN to claim such benefits.[6]

II. THE PROBLEMS ADDRESSED

Because employers cannot pay tax withholding for an IBT via payroll, and it is often considered too burdensome for non-US employees to file individual income tax returns, many employers and employees struggle to comply. A very limited number of non-US employees file US income tax returns to report ordinary business travel to the US. Collection of US tax from employers and/or non-US employees would require significant IRS effort via payroll and individual audits of foreign companies and foreign nationals.

No formal estimates of the uncollected tax revenue have been prepared, but it is certain that non-compliance in this area is widespread. The gap between tax revenue owed and the amount collected is significant.

III. CHALLENGE FOR EMPLOYERS

Employers are highly motivated to operate a compliant payroll system but cannot make payroll deposits for employment taxes and incomes that may be due for their IBTs to the US via their existing payroll processes. Employers may support their IBT employees in filing a federal individual tax return to obtain an ITIN and pay the tax. Nonetheless, this approach presents the following challenges for employers:

A. Withholding Obligation

Even if employees obtain an ITIN and file a federal tax return, it does not relieve their employers from the withholding obligation as ITINs are not permissible for payroll reporting.[7]

B. Burden of Compliance

Employers seek to remove or significantly reduce the time and effort burden on their employees to file and report US source income on US income tax returns for incidental business travel.

C. Tax Preparation Costs

There is a high cost for employers to pay tax service providers to prepare tax returns on behalf of the IBT employees.

D. Late-Filed Personal Income Tax Returns

Even where employers encourage individual compliance, employees cannot be fully compliant. Penalties and interest would result as no payroll withholding would have been possible and no estimated tax payments made until the ITIN is received, and the employee will have had to wait until the IRS issues the ITIN before filing the US return.[8]

E. Tracking Travel and Gathering Compensation Data

There is an inherent complexity in tracking an IBT's travel to the US. Even when an employer tracks an IBT's travel, employers must gather and analyze each IBT's compensation data to comply. This involves the manual process of contacting each IBT's foreign employer's payroll department and can be especially burdensome when there are a large population of IBTs with different foreign employers.

IV. DESIRED OBJECTIVE AND PROPOSED SOLUTION TO BE USED FOR INTERNATIONAL TRAVELERS WITHOUT AN SSN OR ITIN

The objective of this proposal is to create a mechanism that allows a US affiliate employer to file a composite income tax return for non-resident international inbound employees of a related entity group in lieu of the employee having to file an individual income tax return. The proposed solution is modeled after existing state laws and regulations for other types of composite returns.

V. BENEFITS FOR THE DEPARTMENT OF THE TREASURY AND EMPLOYERS

Changing the process or law to allow a US affiliate employer to file composite returns for IBTs could: (1) increase the IRS collection of withholding and final liability while reducing its audit effort and expense and (2) reduce the risk, cost and administrative effort for employers while increasing overall tax compliance.

VI. PROPOSED PROVISIONS

The proposal would include the following provisions:

A. Filing composite returns on behalf of IBTs.

Similar to many existing state laws which allow composite reporting for non-residents, the proposed law allows a US company to file a composite return (the "Return") to report US income tax on behalf of an IBT employed by a related legal entity.

B. Filing requirements and obligations.

The proposed law limits the employer's Return filing requirements to a single annual Return along with quarterly tax remittances containing provisional employee names. The annual Return in turn would fulfill the actual employer's legal withholding and reporting obligations without requiring the actual employer to apply for a US EIN.

Under the proposed process or law, IBTs are required to opt-in to be included on a Return before it is filed. The Return fulfills the IBT's personal income tax filing obligation unless the IBT later becomes a US resident alien or has an unrelated US income tax filing or foreign asset reporting obligation. If the IBT later files a US individual income tax return for the year, the proposed law allows taxes remitted on behalf of the IBT for that year to be credited against the IBT's personal income tax liability.

C. Taxpayer Identification or Proposed US Payroll Identification Number

The proposed law would allow IBTs who are not eligible for an SSN to be include on the Return, and provide that employers are not required to report an SSN or an ITIN for an IBT included on the Return.

Alternatively, the proposed change would allow for a composite filing using the US Payroll Reporting Identification Number. US employers would be able to apply for a US Payroll Identification Number on behalf of their foreign affiliate employees that could be used to remit payroll withholding and report payroll taxes for all IBTs who are not eligible for an SSN. The US Payroll Reporting Identification Number could be obtained on a composite basis and in advance of any payroll withholding and reporting obligations on behalf of the IBTs. When the IBT files a US non-resident income tax return for the year, allow taxes remitted on behalf of the IBT for that year to be credited against the IBT's personal income tax liability based on the US Payroll Reporting Identification Number.

VII. APPLICABLE STATUTES AND PROPOSED REVISIONS

To implement the proposed solution a number of key issues under current law will need to be addressed and some existing rules need to be revised.

A. Employer payroll tax return obligations

Under existing laws, employers cannot issue a Form W-2 for IBTs without providing the IBT's SSN; however, many IBTs are not eligible to obtain a US social security number.[9]

Under current law, foreign employers are required to withhold and report wages, and remit income taxes related to IBTs.[10] When the employer files payroll tax returns with the IRS, the employer is required to include the SSN of each employee included on the return or be liable for a penalty for omitting consequential information.[11],[12]

This proposal would allow remittance of income taxes to the IRS and allow US companies to fulfill filing requirements on behalf of non-resident employees of a related entity group by filing a composite payroll tax return. Under this proposal, SSNs would not be required for IBTs included on composite returns.

B. Personal Income Tax returns for IBTs

Existing laws for filing federal income tax returns require non-residents with US source income to file an individual income tax return on Form 1040NR.[13] To file these individual tax returns, IBT's must have a valid SSN or ITIN; however, some IBTs are not eligible to obtain an SSN and obtaining an ITIN can be difficult and especially burdensome for reporting incidental business travel, which may only result in a treaty based tax return. In lieu of non-resident IBTs filing an individual federal income tax return, the proposal is to amend the process or the Internal Revenue Code to allow employers to file a composite return for their participating IBTs and those of affiliated entities. IBTs included on such composite returns would not be required to provide an SSN or ITIN.

VIII. SIMILAR STATE LAWS

California may be a particularly challenging location for companies with international business travelers, because California taxes nonresidents on compensation for services performed in California and does not follow tax treaties between the United States and foreign countries for individual income tax relief.[14]

To ease the tax compliance and administrative burden for companies and employees, on September 18, 2020, California Assembly Bill 2660 (A.B. 2660) was signed into law. The new provisions of the California law allow companies the **option** of filing a group return for their foreign employees who travel to California for work and incur a personal income tax liability.[15]

For taxable years beginning on or after January 1, 2021, and before January 1, 2026, A.B. 2660 amends California Revenue and Taxation Code (CRTC) Section 18624 to “prohibit the Franchise Tax Board from requiring a nonresident alien, as defined, to provide a SSN or ITIN when filing a state tax return, statement, or other document if the nonresident alien is not eligible for or has not been issued a SSN or ITIN.”[16]

Additionally, A.B. 2660 adds new CRTC Section 18537, pursuant to which the FTB “shall provide for the filing of a group return by a taxpayer, or an entity authorized by the taxpayer to file on its behalf, for one or more electing nonresident aliens who receive taxable income . . . for services that take place in this state.”[17]

Furthermore, the "taxpayer, or an entity authorized by the taxpayer to file on its behalf, as the agent for the electing nonresident aliens, shall make the payments of tax, additions to tax, interest, and penalties otherwise required to be paid by, or imposed on, the electing nonresident aliens."[18] Amounts paid on behalf of the electing nonresident aliens are excluded from the nonresident alien's gross income.[19]

CONCLUSION

The tax law requires employers to pay employment and income taxes for non-resident IBT's, yet the law does not provide an effective mechanism for foreign employers to comply with these requirements. The proposed process or legislation would enable employers to file composite returns in lieu of W-2 reporting obligations and the income tax return filing obligations of their non-resident IBTs.

TAX POLICY, PRACTICE & LEGISLATION COMMITTEE

SUGGESTIONS FOR IMPROVING TAX COMPLIANCE THROUGH GREATER TAX SYSTEM TRANSPARENCY AND ACCOUNTABILITY

This proposal was prepared by Annette Nellen, member of the Tax Policy, Practice and Legislation Committee and Tax Executive Committee of the Taxation Section of the California Lawyers Association.[1] The author thanks reviewers Elisabeth Sperow and Beth Hodess for their helpful comments.[2]

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EXECUTIVE SUMMARY

Despite the significance of taxes to all individuals — both directly and indirectly, the understanding of taxes among the public is low. This indicates that our tax system does not meet at least two essential principles of good tax policy: transparency and accountability to taxpayers. Not meeting these principles can also lead tax systems to not measure up well against other principles such as simplicity, equity, and neutrality.

Low understanding of the tax system also means that most individuals lack understanding of the components of a basic income tax system. They are likely to think it must include special tax provisions they see on the basic Form 1040. Few individuals know the concept of tax expenditures and their relevance to understanding government spending and budgets.

There are various ways tax agencies and lawmakers can help individuals improve their tax and budget "literacy." Among other things, this includes inserting explanations into existing published documents such as commonly used individual tax forms, avoiding multiple or incomplete information that can increase confusion. The outcome should be an improved tax system in that increased tax and budget knowledge by taxpayers will help the system to better meet the principles of good tax policy. In addition, increased tax literacy can lead to better understanding of the role of taxes in generating government revenues and appreciation for the role of the tax system in government spending. Improved knowledge in these areas will also enable taxpayers to be more informed in understanding tax law changes and asking questions of elected officials and those running for office.

This paper presents suggestions to help improve tax and budget literacy among the public. The suggestions fall within these categories:

A. Tax returns, instructions and publications.

B. Taxpayer receipt.

C. K-12 education.

D. Celebrate Taxpayers Day.

Implementation considerations are also addressed.

DISCUSSION

I. INTRODUCTION

Individuals pay a variety of taxes at all levels of government and devote some time each year to tax compliance. Yet, the understanding of our tax and budget system by most taxpayers is low. For example, taxpayers are unlikely to be able to:

- State how much they pay to the U.S. Treasury for income taxes, employment taxes and various excise taxes, and their share of corporate income tax.
- Explain the rate structure for the income tax, and the exclusions, deductions, and credits (and the meaning of these terms).
- Explain where their tax dollars go.
- Understand their tax situation in relation to other taxpayers.
- Understand the taxes paid by their employer and other employers (whether for profit or non-profit).
- Know and understand the operation and benefit of various tax preferences provided for health care, housing, retirement savings or higher education expenses,[3] and other tax preferences, or know the role and effect of tax preferences in a tax system and within the government system of distributing various benefits.
- Explain the purpose of various tax incentives, or to distinguish between a tax preference (tax expenditure) and a provision that is part of the basic design of a particular tax (such as the standard deduction in the personal income tax).
- Explain how various tax preferences benefit themselves relative to individuals with different income levels or how to appropriately measure and compare the benefits.
- Name any of the Taxpayer Bill of Rights.[4]
- Know where to get more information about the federal tax structure or budget.

There are various ways that the IRS and other federal offices can assist taxpayers in improving their “tax literacy.” The outcome would be an improved tax system in that increased tax and budget knowledge of taxpayers will help the system to better meet the principles of good tax policy. Increased tax literacy can also lead to better understanding and appreciation of the role of taxes in generating government revenues but also the role of certain tax system features in contributing to government spending. Improved knowledge in these areas can lead to a more informed and compliant electorate. More taxpayers will understand the tax law and reform proposals helping them to ask good questions of elected officials and those running for office.

II. TAX POLICY

A. Definitions

Various formulations of principles of good tax policy exist. For example, the American Institute of Certified Public Accountants (AICPA) suggests a set of twelve principles of good tax policy.[5] These are explained as follows (taken verbatim from the AICPA report):

1. Equity and Fairness. Similarly situated taxpayers should be taxed similarly.

2. Certainty. The tax rules should clearly specify how the amount of payment is determined, when payment of the tax should occur, and how payment is made.

3. Convenience of Payment. Facilitating a required tax payment at a time or in a manner that is most likely convenient for the taxpayer is important.

4. Effective Tax Administration. Costs to collect a tax should be kept to a minimum for both the government and taxpayers.

5. Information Security. Tax administration must protect taxpayer information from all forms of unintended and improper disclosure.

6. Simplicity. Simple tax laws are necessary so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.

7. Neutrality. Minimizing 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 is important.

8. Economic Growth and Efficiency. The tax system should not unduly impede or reduce the productive capacity of the economy.

9. Transparency and Visibility. Taxpayers should know that a tax exists and how and when it is imposed upon them and others.

> 10. Minimum Tax Gap. Structuring tax laws to minimize noncompliance is essential.
>
> 11. Accountability to Taxpayers. Accessibility and visibility of information on tax laws and their development, modification and purpose, are necessary for taxpayers.
>
> 12. Appropriate Government Revenues. Tax systems should have appropriate levels of predictability, stability and reliability to enable the government to determine the timing and amount of tax collections.

The principles of good tax policy that are the focal point of this paper involve transparency and accountability (#9 and 11 on the AICPA list, respectively).

The AICPA combines transparency with visibility as necessary to allow taxpayers "to know the true cost of transactions." The Government Accountability Office (GAO) lists transparency as a criterion for a "good tax system" along with equity, economic efficiency, simplicity and administrability. Per the GAO:[6]

> "The transparency of a tax system refers to taxpayers' ability to understand how their liabilities are calculated, the logic behind the tax laws, what their own tax burden and that of others is, and the likelihood of facing penalties for noncompliance."

The AICPA states that accountability to taxpayers allows for "broader and more well-informed debate" about tax changes. The AICPA notes that to achieve this principle, taxpayers need "access to information for understanding sources and uses of tax revenues." The AICPA also suggests that accountability helps improve respect for the tax system.[7]

Achievement of the principles of transparency and accountability to taxpayers require that adequate and appropriate information be easily accessible and understandable to taxpayers.

B. Benefits of Increased Transparency and Accountability to Taxpayers

When a tax system meets the principles of transparency and accountability to taxpayers, it is more likely to also meet other principles of good tax policy. For example, if individuals better understood the concepts of progressivity and regressivity, they might question lawmakers about deductions, exclusions or exemptions that provide greater benefits to higher income taxpayers relative to lower income taxpayers, and the effect on overall progressivity of the system. They might demand changes that allow the tax system to better achieve principles of good tax policy. They might also seek changes in what government subsidies are provided via direct spending versus the tax system (tax expenditures), and even question and suggest changes as to the design and value of various subsidies.

The GAO notes that lack of transparency coupled with complexity "exacerbate doubts about the current tax system's fairness." The GAO further notes that because our tax systems rely on voluntary compliance, low understanding and its side effects can harm compliance.[8]

Improved transparency and accountability to taxpayers will also improve awareness and understanding of the Taxpayer Bill of Rights. For example, many suggestions offered in this paper tie to the first right to be informed. As explained on the IRS website:[9]

> "Taxpayers have the right to know what they need to do to comply with the tax laws. They are entitled to clear explanations of the laws and IRS procedures in all tax forms, instructions, publications, notices, and correspondence. They have the right to be informed of IRS decisions about their tax accounts and to receive clear explanations of the outcomes."

III. SUGGESTIONS FOR IMPROVING TRANSPARENCY AND ACCOUNTABILITY TO TAXPAYERS

This section offers suggestions to help our federal tax system better achieve the tax principles of transparency and accountability to taxpayers. Another way to consider the goal of these suggestions is that they should improve an individual's tax and budget (or fiscal) literacy.

The suggestions are offered within broad categories. The suggestions vary in terms of the party responsible for implementation, execution and maintenance costs, parties reached, and intricacy. Some suggestions are unlikely to work until tax and budget literacy levels have been raised. For example, telling an individual how much they saved in income tax due to various tax preferences is unlikely to have a positive impact until individuals first understand what tax preferences (tax expenditures) are, why they exist, how they are evaluated, and more.

The suggestions address not only the delivery or access approach for the information, but also the types of information that should help improve fiscal literacy.

Categories of suggestions:

A. Tax returns, instructions, publications, and websites.

B. Taxpayer receipt.

C. K-12 education.

D. Celebrate Taxpayers Day.

A.Tax Returns, Instructions, Publications and Websites

1. Modifying Existing Forms, Instructions, Publications and Websites

Tax returns include terminology best understood by someone knowledgeable in taxation. Some individuals may not know terms have special definitions, such as head-of-household or dependent. Given wide access to the Internet, providing an online tax form with explanations that "pop up" when the user scrolls over a line, would be extremely helpful to individuals, rather than only providing an online "static" form. While individuals can look for the instructions to the form, this approach dates to what made sense when we could only look at these items in paper form.

The IRS posts all tax forms on its website for education and access purposes. Making these forms as user friendly and informative as possible is a good use of technology and for promoting a stronger understanding of tax rules and compliance requirements.

The Internet and web browsing allow for enhanced access to information. For example, when an individual scrolls over "Filing Status" on Form 1040 online, a pop-up (or "mouseover") could explain the basics and note that for more information, they should scroll over each of the listed options for filing status. Where lines require individuals to insert figures from other forms, the pop-up can let them know where to get that information. The pop-up for "tax due" on the "amount you owe now" line could remind the filer to review their withholding and estimated taxes for the current year to avoid tax due for the current year. Pop-ups could also provide tips for areas where mistakes are common and how to avoid them.

While some lines may require more than a pop-up window, the basic information could be in the pop-up window with a link provided for where more information may be obtained. In addition, reminders could be given about the need to maintain proper records, the filer's responsibility for filing a correct return, and where they can get more information to help them with their tax compliance obligations.

The pop-up per line approach to explaining tax return information can also provide information beyond a compliance focus. For example, where appropriate, the pop-up could state at the end, for example, of each filing status, "approximately X% of filers claim the single status."

The pop-up information approach could remove the need to have separate instructions, although providing them in pdf should still be an option for individuals who want to look at the complete instructions in a single document.

Online publications could also have pop-ups to explain terminology to reduce the need to skip around in the publication. Use of modern technology can make these resource more user-friendly.

Any web-based resource should also be available for viewing on a smartphone as that is how many individuals access information. Consideration must be given to ensuring these website features are ADA-compliant.

2. Limit Confusion and Frustration for Taxpayers and Tax Advisers by Avoiding Repetition of Information, Triple Check for Completeness and Highlight Any Changes Made

Avoid Duplicative Information: The IRS website contains a vast amount of information. This can make it difficult to find complete and accurate information because numerous "hits" are produced from a search. Some items are entirely or partially duplicative which can create confusion and frustration when taxpayers think the items are different, but they turn out to be the same.

A recent example involves the American Rescue Plan Act change to waive the requirement to repay an advance Premium Tax Credit that is larger than what the taxpayer is eligible for based on household income. The explanation from the IRS was provided at these locations:

1. IR-2021-84 (4/9/21), IRS suspends requirement to repay excess advance payments of the 2020 Premium Tax Credit; those claiming net Premium Tax Credit must file Form 8962.

2. Website: Suspension of Repayment of Excess Advance Payment of the PTC (posted 4/9/21).

3. FS-2021-08 (April 2021), More details about changes for taxpayers who received advance payments of the 2020 Premium Tax Credit (posted 4/9/21).

4. COVID Tax Tip 2021-55 (4/22/21), IRS suspends requirement to repay excess advance payments of the 2020 premium tax credit. This tip also includes links at the end:

- About Form 8962, Premium Tax Credit
- More details about changes for taxpayers who received advance payments of the 2020 Premium Tax Credit [this is FS-2021-08 noted above as item 3]
- Suspension of Repayment of Excess Advance Payment of the PTC [this is the website noted above as item 2]

Item 2 above appears to have the most concise and useful information of the four information sites. It begins by noting a change included the American Rescue Plan Act affects tax year 2020. It next offers a brief explanation and then two paragraphs on what to do for filing your 2020 return.

Aim to Avoid Incomplete or Confusing Information: Taxpayer and tax practitioner time is sometimes ineffectively used due to incomplete or confusing information provided on the IRS website or form instructions. No doubt, the law grows more complex with each new law and by new types of transactions. Yet, given the millions of people who rely on the IRS website, publications, forms and instructions, all efforts to be as complete as possible will help reduce compliance errors and lessen disrespect and frustration with our tax system.

Two recent examples follow:

- IR-2021-83 (4/9/21), IRS reminds foreign bank and financial account holders that the FBAR deadline remains April 15. This news release states that FBARs are due April 15 and that the extension for the 2020 Forms 1040 to May 17 does not apply to the FBAR form. This news item as originally released made no mention that FinCEN provides an automatic extension of the FBAR form to October 15. Before the addition of the statement highlighted in red below, the author of this paper saw this topic debated on a tax practitioner website because some worried that something had changed such that the October due date (the effective date given an automatic extension to October 15 that has been existence for several years) was no longer available or some action was now required to get the extra time.

IR-2021-83 as originally released [web as originally released per Wayback Machine]	**IR-2021-83 as later fixed [web at 4/28/21]**
WASHINGTON — The Internal Revenue Service is reminding U.S. citizens, resident aliens and any domestic legal entity that the deadline to file their annual Report of Foreign Bank and Financial Accounts (FBAR) is still April 15, 2021.The extension of the federal income tax filing due date and other tax deadlines for individuals to May 17, 2021, does not affect the FBAR requirement.	WASHINGTON — The Internal Revenue Service is reminding U.S. citizens, resident aliens and any domestic legal entity that the deadline to file their annual Report of Foreign Bank and Financial Accounts (FBAR) is still April 15, 2021.The extension of the federal income tax filing due date and other tax deadlines for individuals to May 17, 2021, does not affect the FBAR requirement. However, filers missing the April 15 deadline will receive an automatic extension until October 15, 2021, to file the FBAR. They don't need to request the extension.

Likely, a second and third review of this news release before it was posted would have uncovered that it should state that despite the May 17 due date for 2020 Forms 1040, the FBAR remains due April 15 but continues to have an automatic extension to October 15.

- The virtual currency question on page one of the 2020 Form 1040, reads:

> "At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency?
>
> ▢Yes▢No"

> The instructions provide examples of virtual currency transactions (pages 16 to 17). Despite the words "otherwise acquire" in the question, there is no example of a purchase of virtual currency. FAQ 5 added to the IRS website on March 2, 2021 states that if a taxpayer's only virtual currency transactions in 2020 were purchases of virtual currency using real currency, a yes answer is not required. No explanation is offered of what "otherwise acquired" means and why a "purchase" is not an acquisition. Also, not all taxpayers and tax advisers know to look for an FAQ when the Form 1040 instructions already address a line on the tax form, so are likely to check "yes" for purchase of virtual currency using US dollars. The instructions also state: "Regardless of the label applied, if a particular asset has the characteristics of virtual currency, it will be treated as virtual currency for Federal income tax purposes." There is no explanation of what this means and no FAQ.

Additional review of crucial information would help taxpayers and tax practitioners. Consideration should be given to using volunteer tax practitioners to assist in this immense effort of providing appropriate compliance information to taxpayers.

Highlight Changes Made to Website Information: As illustrated by the FBAR news release described above, corrections are sometimes made to IRS websites. Another recent example was a posting on March 12, 2021, the day after enactment of the American Rescue Plan Act (P.L. 117-2; 3/11/21). The posting appeared on the website: Post-Release Changes to Tax Forms, Instructions, and Publications. It was labeled "New Exclusion of up to $10,200 of Unemployment Compensation." The website explained that for 2020 the American Rescue Plan Act excludes up to $10,200 of unemployment compensation (the Act added IRC Section 85(c)). The version posted on March 12 explained that the $150,000 threshold included unemployment compensation. On March 23, a new posting on this topic was made with the same heading but with a revised worksheet where unemployment compensation was not included in the $150,000 threshold amount. No explanation was offered about this change in interpretation of IRC Section 85(c). Also, the March 12 website posting was removed as if it had never been there.

The wording of new Section 85(c) is confusing because it states that adjusted gross income is to be computed without regard to Section 85 so both the inclusion and exclusion are ignored, which is puzzling.

To highlight the law's complexity, it would be more transparent and provide greater accountability to taxpayers, to note that a website has been updated or modified to correct a mistake or to clarify a point and to note the date of the change. This makes it more obvious to users that what they may have read earlier has indeed changed and the reason for the change.

3. New Tax Forms or Schedules to Promote Tax System Literacy

A few new tax forms or schedules should be considered if they can help improve understanding of how tax systems work.

Tax preferences highlighted: One idea is to have a form that lists all tax preferences so a taxpayer can easily see the tax savings they obtain from these special rules. The form could list the most common preferences such as (a) exemptions for employer-provided health insurance, fringe benefits and tax-exempt interest income, (b) itemized deductions (Schedule A), and (c) tax credits. Instructions could list all such items, which can easily be over 70 items at the federal level. Taxpayers would report the amount of the exemption, deduction, credit or special rate. Instructions would explain what original form (or other source) has the information. The total would be multiplied by the taxpayer's marginal tax rate to show the tax reduction received, or the tax table can be used to compute the tax savings. Tax preparation software would make this tax preferences form seamlessly simple to prepare.

Another potential benefit of such a form is that it could be used if the federal government implements an across-the-board spending cut such as due to an economic recession. Typically, such a cut only addresses direct spending rather than also tax expenditures. Given that tax expenditures exceed direct, discretionary spending today,[10] significant spending escapes cuts and an opportunity to highlight to taxpayers that spending exists in the tax system is missed. The tax preference amounts from the Form 1040 (or Form 1120) could be totaled, multiplied by the taxpayer's marginal tax rate, and multiplied by the spending cut percentage (such as 5 percent), with that amount added to the taxpayer's tax liability for the year. This exercise would improve tax and budget literacy to highlight that not all spending is direct spending in agency budgets, but that spending also exists in the tax system.

Elections: Another new form to consider is an Elections form to be used for making all possible elections. Today, there are numerous elections such as under Section 179 (expensing), Reg. 1.263(a)-1(f) (de minimis safe harbor), Rev. Proc. 2019-38 (Section 199A rental real estate safe harbor) and several others. A benefit of this type of form is simplification of the election process by having elections made by checking the appropriate box on the Elections Form. It also helps taxpayers understand the tax system better by listing all elections in one place to reduce the likelihood of overlooking one.

Reconciliation of information returns: Another new form to consider enables taxpayers to easily add a reconciliation to the return to explain an erroneous information report or one that requires adjustment. For example, if an individual receives a 1099-K from a crowdsourcing website but the amount received is a non-taxable gift, the form will allow for the individual to list the amount and to reduce it by the non-taxable portion. Or a taxpayer may have received a Form 1099-C, Cancellation of Debt, but be unaware of possible cancellation of debt exclusions under Section 108. The new form would help remind the filer of this possible exclusion (and could replace the individual's need to use Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness).

B. Taxpayer Receipt

A few states and the White House under President Obama[11] offered a taxpayer receipt to interested parties who visited the taxpayer receipt website. The California Franchise Tax Board last offered one for 2017.[12] Taxpayers entered their California state income tax figure from Form 540 and clicked the button for “Get CA Tax Receipt.” This produced a screen image showing how the tax payment allocated among broad spending categories of the state budget, such as health services, K-12 education, higher education, environmental protection, and government operations.[13]

This simple taxpayer receipt is good but limited. It could be improved by such changes as:

- Have taxpayers enter all of the federal taxes they pay as shown on their Form 1040 and Forms W-2 (employment taxes). Such taxes can be estimated by the online tool based on income, miles driven (for the gasoline excise tax), certain purchases, such as alcohol, etc.

- Show the taxpayer's marginal and effective income tax rates.
- Show the tax preferences claimed by the individual and how much they saved due to these rules. The receipt can also include how key preferences are used among different income levels and the “cost” of these tax expenditures. The data on how the expenditures are used should include numerous income levels including the top 1.0, 0.1 and 0.01 percent of individuals with the highest income and the dollar amount and total percent each level uses of the particular tax expenditure. At least the top 20 individual tax expenditures should be included with a link to the entire list and an explanation (such as from the Joint Committee on Taxation website).
- Include taxes paid indirectly (tax incidence). For example, what is the individual's share of the corporate income tax and the employer's share of employment taxes? An explanation of “tax incidence” should also be provided. The Texas Comptroller's Tax Exemptions and Tax Incidence Report explains taxes collected at the state and local levels, tax expenditures data and explanations, and the incidence of each tax. For example, the report for 2020 shows the incidence of the school property tax by household income quintile. It shows the average amount paid, percent of total tax paid and the tax as a percent of the individual's income.[14]

Final Incidence of Tax - By Household Income Quintile

Quintile	Household Income	Amount	Percent of Total Tax Paid	Tax as Percent of Total Income
Quintile 1	Less than $31,951	$2,573.9	6.3%	6.9%
Quintile 2	31,951 - 56,449	3,509.7	8.6%	3.8%
Quintile 3	56,449 - 91,375	5,027.2	12.3%	3.2%
Quintile 4	91,375 - 156,718	6,939.3	17.0%	2.6%
Quintile 5	156,718 and higher	13,982.2	34.2%	1.9%
Residents		32,032.4	78.4%	
Exported		8,805.6	21.6%	
Total		**$40,838.0**	**100.0%**	

Estimated Equity of Tax

Suits Index	-0.113

Note: Totals may not add due to rounding.

The above information helps individuals see they pay some taxes indirectly (such as renters indirectly paying property taxes directly imposed on the property owner). Such information provides a better picture of everyone's tax obligations and contributions. The tax incidence information requires background information on how taxes are paid directly and indirectly (from an economic perspective). Without this background information in layperson terms, the data may only confuse taxpayers.

The incidence information showing taxes paid indirectly could be explained and provided on the taxpayer receipt.

- Show what income quintile the taxpayer is in and its dollar size range, among other quintiles.

- Show what the spending breakdown would have been based on the federal budget of five years ago to highlight significant changes.
- Include the names and email addresses of their elected officials so they can ask questions or seek additional information.

To help more individuals know of the receipt option, the URL and brief explanation of the tool and its benefits can be noted on the IRS main website, an email receipt or window provided once a return is e-filed, and listed on the website of a few other government agencies that individuals frequently visit, as well as the websites of members of Congress.[15]

The receipt could also be "pushed" to individuals such as through email (if the individual included it on their Form 1040). H.R. 1323, Taxpayer Receipt Act (117th Congress), calls for the Treasury Department or IRS to provide "to each individual filing a Federal income tax return for a calendar year, a one-page estimate of how the taxpayer's money was spent by the Government during the immediately preceding calendar year"[16] It does not state how the receipt is to be provided. Use of the U.S. Post Office should be avoided due to the cost of printing and mailing and because many individuals would prefer to receive the information electronically. H.R. 3855 (114th Congress) suggested that the IRS explore use of modern technologies such as email and interactive programs on its website to enable taxpayers to obtain the receipt. There would still be a need to ensure individuals know of the site, such as via a message sent after e-filing.

Provision of a taxpayer receipt via an "IRS Tax App" (also see Section IV later), based on the current IRS2Go Mobile App, should be a low-cost approach for providing the receipt. Occasional reminder messages could be delivered via the app to remind taxpayers of the opportunity to get a receipt and the benefit of the information to them.

C. K-12 Education

Understanding taxation — a topic that affects everyone, need not wait until a person gets their first job and completes an income tax return. We have all likely heard stories of the high school student or graduate surprised that their first paycheck is less than expected. For a student to study government operations in various grades from 4th to 12th and not know about income and other taxes, is simply wrong. How can someone learn how government functions without knowing where the resources for its operation come from and their role in that funding?

It should be simple to find many places where various tax topics can be included in the curriculum. For example, math problems can include not only calculating a worker's gross earnings, but their net earnings.

Likely similar to other states, the California Common Core for Grade 7 math includes the following as a focal area:[17]

> "Students extend their understanding of ratios and develop understanding of proportionality to solve single- and multi-step problems. Students use their understanding of ratios and proportionality to solve a wide variety of percent problems, including those involving discounts, interest, taxes, tips, and percent increase or decrease."

A sample 6th grade math problem from the State of Louisiana involves an individual who earns $6 per hour plus a $30 bonus for the week. If she works 32 hours in the week, how much did she earn.[18] This problem (and many like it in many grades) overlooks an opportunity to define "gross earnings" and "net earnings" and to also have students calculate federal and state taxes withheld. The supplements to this simple gross earnings problem would also enable students to use percentages (such as to calculate FICA and Medicare taxes, and state and local taxes), and use tax tables.

Math students could also visit the IRS website for the information they need. A section on the website for teachers and students of various grades could provide basic tax information at the appropriate age level. The information should be suitable for various grade levels and subjects including math, social studies, civics, history, and classes where students may be reporting on current events.

State tax agencies and professional tax organizations (such as state CPA societies, AICPA, and tax practitioner associations) could provide tax problems for various grade levels along with answers and explanations. Perhaps the IRS could serve as a repository for the information with links to organizations that can provide more (such as Junior Achievement, various educational organizations, and community organizations that might promote and create resources through their own means).

Besides promoting tax and budget literacy through math courses, civics courses should include lessons on where government revenues come from, the basics of different taxes, who pays these taxes and how, and an individual's role and responsibilities in the tax system. Again, appropriate government agencies and members of Congress could include links on their websites for students with the information appropriate for various specified grade levels.

The IRS has a website, Understanding Taxes,[19] with information directed to teachers and students. It includes lesson plans and fact sheets. The information is detailed and clear, including definitions of key terms. Unfortunately, the website is not maintained. For example, the lesson on dependents includes the dollar amount for the dependency exemption for 2014.

This IRS educational website is well-developed and extensive resources likely were devoted to creating it. This is an outstanding foundation for helping educate primary and secondary school students on taxation basics and providing significant resources for teachers. Consideration should be made to finding resources to maintain the site as doing so should help students become more compliant taxpayers and build respect for the tax system by removing a good amount of the mystery that exists due to lack of education about taxes.

D. Celebrate Taxpayers Day

Celebratory events should also be considered, such as making a specific day “Celebrating Taxpayers Day.” The City of Philadelphia Department of Revenue annually, such as on February 28, 2020, honors taxpayers for paying on time. Department of Revenue employees are available, information is displayed, and “fun prizes,” and refreshments are available.[20]

A 2015 report from the Organization for Economic Cooperation and Development (OECD) describes various educational and celebratory events used in 28 developing countries to build “tax culture” and promote positive tax morale.[21] Examples include:

- Nigeria created a soap opera for television called “Binding Duty” that includes well-known actors, scripts with accurate tax information, and “dramatic flair [on] how the old order of inefficient and corrupt tax collection has changed, that it pays to be compliant, and that everyone has a responsibility to contribute to the development of their community and country."[22]

- Guatemala uses "tax lotteries" where individuals deposit official VAT receipts with the possibility of winning a prize. The government also produces "tax dramas" featuring honest Simón, a good taxpayer. These dramas are shown on television, YouTube and at public events. Also, since 2008, the country holds annual "Strength Lies in Numbers" festivals each April. The goal is to strengthen a culture of tax compliance and citizenship. The festivals also promote art and culture.[23]
- Rwanda holds an annual Taxpayers' Day to celebrate tax compliance and help citizens understand the connection between taxes and economic development. A report is published to help people understand data on tax revenues and challenges facing the tax agency. The president of Rwanda officiates at the celebration.[24]

While the events described in the 2015 OECD report take place in developing countries, the ideas should not be viewed as relevant only in these countries.[25] While a key theme in these locations is to improve tax compliance and understanding of how that helps the country advance, that message is not only relevant in developing countries, but also needed in the U.S. The IRS estimates that the annual federal tax gap is about $441 billion[26] and tax gaps exist in every U.S. subnational taxing jurisdiction as well. Also, as noted in this paper, there are numerous tax technical topics where understanding is low, coupled with weak understanding of tax system design (tax policy) and the interaction of tax systems and government budgets. Ideas on how to improve tax and budget literacy, should be considered for celebrate taxpayers day due to the benefits to overall tax compliance and effective tax systems. In addition, occasional thanking of taxpayers for their voluntary compliance should help build and support positive tax morale.[27]

IV. Implementation Considerations

Some suggestions offered in this report should be made via legislation to ensure adequate funding and greater attention to the effort.

Not all individuals will pursue the tax information from the IRS and elected officials, perhaps thinking they will not understand it, or it isn't relevant to them. Messaging and delivery format will be important. The IRS current use of social media could be expanded. Non-traditional approaches should garner attention. For example, wording for the tax and budget literacy information could be like:

- "Where do my tax dollars go and how many dollars am I providing?"
- "Why should I care?"
- "How does my marginal and average tax rates compare to those of President Biden?"
- "Which provides the greater tax savings: the earned income tax credit, the tax credit for the purchase of certain hybrid cars, or interest on a $750,000 mortgage?"

While websites are the likely repository to inform transparency, "apps" should also be considered to address the way many individuals access information via their smartphone. In addition, the functionality of a secure app can not only provide information but allow individuals to access their tax information. The app could also push out reminders about estimated tax payments, occasional tax tips pertinent to the app owner, and information on Celebrate Taxpayers Day.

TAX POLICY, PRACTICE & LEGISLATION COMMITTEE

MAKING Z CONNECTION: CHANGES THE IRS SHOULD IMPLEMENT TO REACH GENERATION Z[1]

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EXECUTIVE SUMMARY

We live in the most technologically advanced society in the world. But we continue to leave a myriad of taxpayers in the dark when it comes to filing their income tax returns with a lack of easily accessible information and preparation methods. This paper highlights some steps the Internal Revenue Service ("IRS") can take to reach the newest generation of taxpayers, Generation Z ("Gen Z"), while expanding their understanding of their rights and responsibilities as taxpayers, and ways the IRS can improve the tax filing process in general.

At the start of the 2020-2021 academic year, our team endeavored to learn what young taxpayers and workers think of the current tax education and preparation methods and how they believed they should be improved. To gather sufficient data, we created and conducted an anonymous, on-line, non-scientific survey of over 150 students, employees, and young adults to ascertain their confidence in obtaining adequate tax information and filing their own returns as well as the media through which they would prefer to file. Our survey as well as research we conducted, found that Gen Z has a profound lack of knowledge of their rights and responsibilities as taxpayers. This generation is coming of age with a technological familiarity surpassing all previous generations which makes them ideally situated to help the IRS expand and improve in ways that will benefit everyone.

In collecting these data, we assess the methodologies of interest to our sample population and determine the best ways the IRS should proceed to create a modernized way of educating and preparing the newest generation of taxpayers to ensure they are filing timely and accurate returns. We also evaluate the systems that are already in place and suggest ways they can be improved. Throughout the paper, we include data and diagrams to clearly delineate the gap in current tax preparation systems. We posit a mobile, user-friendly interface which could fill this need not only for Gen Z, but for all taxpayers looking to decrease or even eliminate the time and money currently dedicated to preparing their annual tax returns.

Our conclusions argue in favor of expanded tax education in American schools, an improved IRS App, preferably with voice assistance, and an electronic IRS prepopulated and created tax return.

DISCUSSION

> *Whereas tax policy has always played an important role in everything from funding public services to incentivizing public and organizational behavior, the increasing digitalization of the global economy has seen greater focus . . . to address the impact . . . on taxation.*
>
> *Kate Barton; Ernst & Young, EY Global*[2]

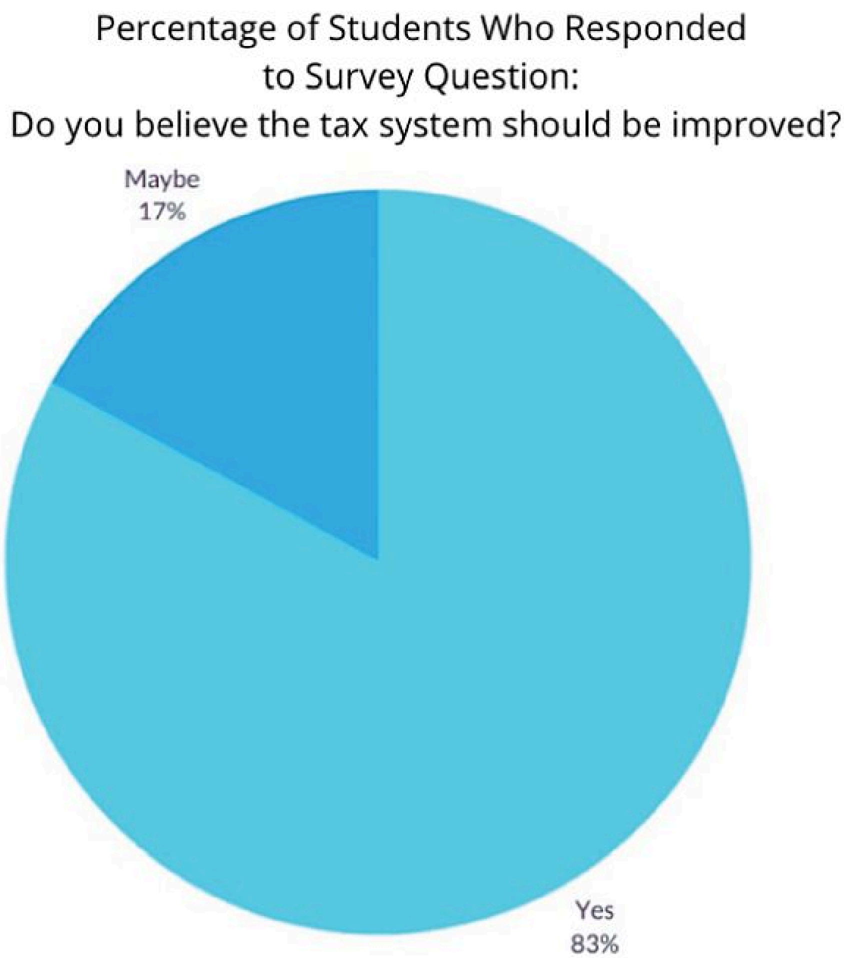
I. INTRODUCTION

"No taxation without representation" was the passionate refrain of the American colonists in the mid-1700s in a feverish outcry against the perceived injustices of the British government.[3] The colonists argued that they should not be obligated to pay taxes to a government that grants them no place in its policies or procedures. While there are areas where this problem of underrepresentation endures, the great majority of citizens in the United States today are granted representation in government. In return, these citizens pay federal and — for most — state income taxes to help fund programs and initiatives such as education, infrastructure, national defense, Social Security, and Medicare.

Despite this representation, there is a large proportion of the tax-liable population that does not feel represented in a different way. Gen Z is the newest group to be entering the workforce, comprising ages 10 to 24 years. They account for over 68 million citizens in the United States — more than double the population of the state of Texas.[4] The disenfranchisement experienced by Gen Z stems from the lack of modern, accessible information and methods for tax education and tax filing. A recent *Forbes* article took note that approximately 10 percent of tax-paying Americans still use paper-and-mail filing, indicating that the other 90 percent e-file either with assistance from a tax accountant or online software such as Turbo Tax or H&R Block or a free in-person program such as the Volunteer Income Tax Assistance (VITA) program which has sites throughout the country.[5] These resources are helpful, but they are not comprehensive nor contemporary in their offerings. Today, a person can pay their bills with a few smart phone clicks or simply ask their phone a question and get an immediate answer, but a person cannot file their tax return with a few clicks of a button or get an IRS answer with a simple question. Rather, they often must dive deep into their internet searches to understand factors as simple as their proper filing status or filing requirements.

Many people opt for online filing with services like Turbo Tax or H&R Block, but these systems contain numerous additional features that draw in unknowing users as well as their pocketbooks. Currently, the IRS provides links to free filing services on its website as part of its Free Filing Program, but studies show there are serious limitations with its offerings.[6] Often these free filing options include features that unsuspecting users can add which are not free. For example, those filing with less than $72,000 in income must complete a questionnaire and then are directed to a list of websites to file the return. The resources are useful, but they also rely on the taxpayer understanding whether they qualify for certain credits like the Earned Income Tax Credit ("EITC"). For those above the $72,000 threshold, taxpayers are directed to yet another website offering "fillable forms" that can make unknowing users vulnerable to potential cyber-attacks from the numerous sites linked to the IRS host page.[7] These individuals are also told they need to know how to complete paper forms which may seem puzzling given they are accessing information online.[8]

What Gen Z needs is a comprehensive, professional platform for filing their taxes that informs them of their filing status, all applicable credits, and an assessment of their tax liability with information about payment methods. If paying your bills online is as easy as clicking a button, shouldn't filing your taxes be as well? The chart below displays the overwhelming percentage of students and young employees in our study who believed the current tax system should be improved. Of those surveyed 83 percent said yes it should be improved, 17 percent said "Maybe" it should be improved and only 1 of 143 respondents said "No" need for improvement.



To gather data on the topic of interest, our team created and distributed a comprehensive, anonymous survey to students at California State University, San Luis Obispo, San Jose State University, and University of California, Berkeley during November of 2020. An analysis of these findings in conjunction with other research informed our recommendations.

II. EXPANDING TAX EDUCATION — THE NEED

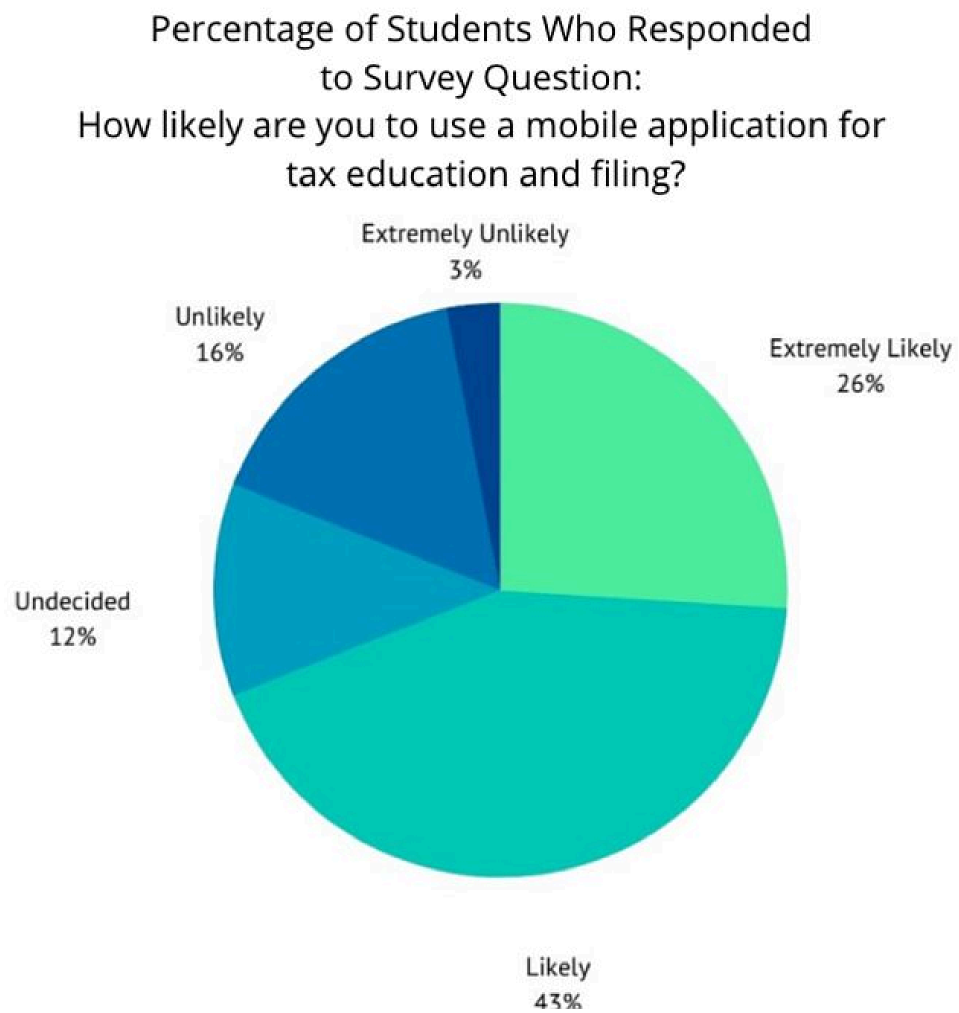
While the Right to be Informed is the first right listed in the Taxpayer Bill of Rights,[9] significantly, our research disclosed that Gen Z has little knowledge of the tax system in general and even less of their rights and responsibilities as taxpayers. This finding is particularly concerning given that our research focused on college students, most of whom were business students, who one would think might have a greater understanding of tax issues than others their age. One reason for this lack of knowledge is that high school classes provide minimal, if any, information on taxes and general financial obligations Americans have once they enter the workforce. A recent article published by the *Daily Titan*, the newspaper for California State University, Fullerton, reported that the most common piece of information students know about taxes is the April 15th filing deadline (although depending on the year it may fall on a different day or as in recent years even a different month).[10]

In addition to our original research, we also pulled surveys from various financial and accounting organizations including PricewaterhouseCoopers (PwC) and Charles Schwab, and each had insightful data to contribute to our findings. Tellingly, PwC stated that 78 percent of teachers believe a financial curriculum should be included in high school;[11] while Charles Schwab noted that 86 percent of students wished they had been taught about taxes in elementary or high school.[12] Granted, elementary school may be early for financial literacy and tax filing lessons, but it would not be too early to introduce the concept of taxes and how they are beneficial to our country and to provide a general overview of how liabilities are calculated during government or math lessons. While early education would be beneficial, the key audience would be older students and most middle and high school curricula has ample space to add a mandatory financial literacy course. In fact, the Home School Legal Defense Association wrote that most high schools allow one-to-three electives *per year*; removing just one year's elective offering makes room for a financial literacy class that can teach numerous essential life skills, including tax planning and preparation.[13]

According to *Phi Delta Kappan*, a journal for high school educators, each state has significant weight in molding their respective curriculum and standards.[14] The IRS, as a federal department, can recommend certain education requirements, like a tax course, and the ability to work in conjunction with other federal agencies such as the Department of Education to provide materials and incentives for high schools to include such a course in its curriculum. The IRS could also coordinate with state agencies to provide appropriate materials to use. Alternatively, teaching resources could be provided to teachers to include in math and civics classes. While the IRS does have a comprehensive website for teachers with lessons and materials that can be used to assist in the teaching of taxes to younger students, it is not kept updated nor well promoted.[15] In fact, a recent visit showed it had not been updated since 2014 despite all the significant changes in tax law that have occurred since then. An easy place to start would be to seek volunteers to keep the materials current and engaging and to publicize these materials to teachers.

III. MODERNIZING THE IRS — THE NEED

Even more important than tax education in United States high schools, the IRS should implement modernization, so it becomes more accessible for the upcoming generation of workers. In April of 2019, the IRS announced a Modernization Plan that focuses on continuing the move towards digital filings and documentation as well as improved cyber security.[16] The Modernization Plan calls for two three-year phases of modernization that began in fiscal year 2019, and the projected price tag for this plan ranges from $2.3 to $2.7 billion over the six-year period.[17] An obstacle for this initiative is its lack of specificity in defining its goals for the improvement of the “Taxpayer Experience” and “Core Taxpayer Services and Enforcement.” Particularly with the “Taxpayer Experience,” the IRS states that its aim is to “expand digital options, improve traditional channels, and provide simplified and proactive services for taxpayers and their representatives” these are all good goals which are in alignment with our recommendations. The need for this modernization plan is also supported by the Taxpayer Advocate's 2020 Annual Report to Congress which included “Failure to Expand Digitalization Technology Leaves Millions of Taxpayers Without Access to Electronic Filing and Wastes IRS Resources” and “Antiquated Technology Jeopardizes Current and Future Tax Administration, Impairing Both Taxpayer Service and Enforcement Efforts” as the fifth and sixth most serious problems facing taxpayers in 2020.[18] In addition, President Biden recently announced his plan to expand the IRS significantly through an $80 billion funding boost to increase IRS staffing and make technological advancements.[19] Thus, these goals of modernizing filing technology and techniques are aligned with the interests of taxpayers, the IRS, and the White House. It is also important to note that the objective of all entities is to provide greater access to accurate information and an easier way to submit tax returns. For this modernization plan to be effective, the IRS must understand the issues with the current filing systems and why a digital, *mobile* method of tax knowledge and preparation is the best step moving forward. The graph below shows that a combined 69 percent of respondents said they would be either “Likely” or “Extremely Likely” to use a mobile app for these purposes.



The IRS has a mobile application, IRS2GO as do other states such as the California Franchise Tax Board's FTB Mobile. As of the writing of this article, the IRS app has 3 stars in the App Store and 2,200 reviews,[20] and the FTB Mobile app has 4 stars and a mere eight reviews.[21] Each of these apps illustrates the government's important move towards modernizing and creating more ways for individuals to understand the tax system. However, neither of these apps allows for assistance with the actual filing process, and most of the information is a general recommendation as opposed to a personalized, individual analysis of each user and what he or she may owe. While the IRS does have the Interactive Tax Assistant which provides a wealth of information, using it is not as straightforward as asking a question. To a generation that is used to getting answers by simply asking a question to voice assisted devices such as Siri or Alexa, these applications are cumbersome. For example, entering “filing status” in the query box on the Interactive Tax Assistant brought up 27 matching items which a person would then need to scroll through and read to find the answer they wanted.[22]

Other apps that aim to help with understanding the tax filing process include TurboTax, MyBlock (by H&R Block) and Texas Tax Refund. Each of these applications is helpful for the knowledgeable taxpayer who does not mind paying to file their return but not for others. In addition, often the income students and young adults have today is from gig economy work and thus considered "extra" income by these programs thus creating a charge on these "freemium" apps. Income that many young workers earn from rideshare or food delivery or even babysitting or dog walking is considered a taxable source of self-employment income, leading to a higher tax burden if proper accounting is not allotted to these tax obligations, which comes as a surprise to many Gen Z members when they file their returns.[23] With these paths, it appears the two current options tax filers are presented with are free tax help that is not specific to one's situation or costly tax advice contingent on the type of one's income.

H&R Block conducted a survey in early 2020 analyzing the commonplace problems Gen Z tax filers experience. According to their research, more than 62 percent of Gen Z have never filed their own tax return.[24] Even more disheartening, only 49 percent have been taught anything about taxes, and 39 percent believe they would score a "C" if given a tax pop quiz.[25] These figures reveal the lack of knowledge and overall preparedness of Gen Z addressed above; yet, in spite of this lack of financial literacy, the individuals making up this generation want to do well by their income *and* their refunds: when asked what they plan to use their potential 2020 tax refunds on, 56 percent of Gen Zers said they would put it away for savings, 40 percent stated they would use it to pay bills and 31 percent would use it to pay off debt.[26] While Gen Z is not the first generation of taxpayers to grow up without a comprehensive understanding of their rights and obligations as taxpayers, because of their growing up with an understanding and comfort of technology for all types of transactions and educational assistance, they are uniquely situated to become easily instructed and tax compliant using technology.

Gen Z has the potential to raise substantial tax revenues for the government, yet, as H&R Block research shows, they are simply lacking a sufficient understanding of the tax system and often avoid diving in to learn more because of its apparent complexities.[27] The students assisting with the researching and writing of this project are all studying accounting, most of whom learned the fundamental tax policies and procedures affecting them in an introductory tax class in college and were astounded by the sheer amount of information that there is to know. Surveying over 150 students and young adults as mentioned earlier, the questions also inquired about the overall difficulty of obtaining relevant tax information. When asked to rank the difficulty of finding accurate tax information on a range of "Extremely Easy" to "Extremely Difficult," 39 percent of those surveyed reported that they find it either "Difficult" or "Extremely Difficult" to find such information. Inquiring further, the research team asked how important these respondents felt obtaining and understanding accurate tax information was for their future. Responding with their level of agreement or lack thereof with the statement, "Being well informed about taxes is important to my future," 73 percent of those surveyed replied "Highly Agree" and the remaining 27 percent selected "Agree."

Survey Question: Please rate the following criteria: How would you describe the difficulty in obtaining accurate tax information?					
Age Range:	Extremely Difficult	Difficult	Moderate	Easy	Extremely Easy
18-19	1	4	7	1	
20-21	7	22	25	7	
22-23	4	14	18	4	1
24-25	2	5	5	2	
26+	3	3	12	3	1
Grand Total	**17**	**48**	**67**	**17**	**2**

The data reveal that the majority of Gen Z have tax issues centering around a difficulty of locating accurate information. As mentioned above, while there are the free IRS and Franchise Tax Board mobile applications (IRS2GO and FTB Mobile), and commercial tools such as TurboTax and H&R Block, each of these have their drawbacks. These services are headed in the right direction to help taxpayers; however, the IRS should go one step further by targeting the upcoming generation of workers/tax revenue generators by improving use of the tools already in its possession to make obtaining accurate information as easy as asking a simple question.

IV. IMPROVING E-FILING OF TAX RETURNS — THE PLAN

While the limited presence of some mobile apps geared towards tax filers is better than none, the current capabilities of technology and the direction in which society is moving leaves many wondering: Why can't there be an easier, more efficient way to file taxes? Especially when the IRS stands to benefit from over 68 million additional returns.[28]

The General Accounting Office ("GAO") noted that the IRS's reliance on manual processes for paper returns in 2020 led to a significant backlog that is estimated to cost the IRS $3 billion in increased costs for items such as interest payments on delayed refunds.[29] Thus any improvements that encourage and enable taxpayers to file electronically should reap large gains for the IRS. The IRS Modernization Plan highlights the agency's aim to expand its Information Technology ("IT") services and automate many features of the tax preparation process to allow for real time tax processing. Our team proposes that the budget for modernization — $2.3 billion to $2.7 billion over the next six years — include a new approach to tax preparation altogether.[30] Studying mobile applications like the Starbucks, Amazon and Banking apps where one can order a latte or a necklace or deposit a check at the click of a button on a smartphone because the necessary information is saved and programmed into the app, the team realized that if transactions such as these can transpire in a matter of 10 minutes or less, should filing taxes not be just as simple?

The capabilities of these apps and the speed with which they turn a request into a product stems from their ability to use the information consumers provide and store in a secure manner for future use. The functions of the proposed IRS mobile app are incredibly similar: an easy-to-use interface that can gather taxpayer information and educate the user on the tax filing process, their tax implications, and routes they should take regarding credits and/or deductions as well as a feature to e-file their return. These methods promote greater efficiency compared to paper filing. The app would be able to gather taxpayer information by allowing for the scanning documents such as their W-2 or 1099 or with the taxpayer manually inputting their information from these documents. Another alternative would be for the IRS to create a "tax cloud" for taxpayers. This secure digital file would contain all the W-2 and 1099 information that the IRS has gathered for them already along with other key information taxpayers could add with a scan of their smartphone such as mortgage interest and charitable contributions.[31] In addition, information provided via a scan or manual inputs would allow the app to determine the age, income, and employer information to inform the taxpayer of their best filing status and corresponding credits or deductions and save this information for future years with the ability to edit as needed. The app could then prepopulate the return with electronically stored information which has the potential additional benefit of reducing mistakes made while manually entering information, thus reducing time, money and emotional stress spent on audits for things like improperly entered numbers and math errors.

The IRS could even go one step further and take the route proposed in the Tax Filing Simplification Act of 2019 and electronically prepare the returns for the taxpayers.[32] Countries in Europe that have adopted this approach of prepopulating returns for their citizens have reported that their taxpayers spend an average of 15 minutes or less to prepare their returns compared to the eight hours and $110 the average American spends.[33] Taxpayers would still have the option of having an accountant review the IRS generated return if they wished or did not trust the IRS to file for them, but for those who were comfortable with the proposed return they could just click a button to approve and file. Although the GAO evaluated and rejected the idea of the IRS filing returns on behalf of taxpayers back in 1996,[34] much in the world has changed since then and it is worth another look through the lens of advancing technology. It makes sense that the easier and cheaper it is for Americans to file their taxes the greater the compliance and the greater the return for everyone.

V. THE BENEFITS

Non-compliance is a huge issue for all Americans. *Investopedia* calculated that roughly $131 billion in back taxes are owed to the IRS in 2018 alone, noting that the discrepancy is frequently attributed to taxpayers claiming they do not have enough time to spend on filing their taxes.[35] Providing a near effortless, efficient method of filing taxes with a few taps of one's smartphone can minimize the lack of time complaints and greatly increase the number of timely and accurate filings. While a mobile app is geared towards the younger generation and specifically Gen Z given their imminent transition into the workforce, the features of this plan would provide benefits to all taxpayers. As of 2019, the percentage of smartphone users in the U.S. aged 30-49 was 92 percent and those in the 50-64 age bracket, 79 percent and 65 and over, 53 percent.[36] The smallest usage was still greater than 50 percent; therefore, an overwhelming majority of Americans could benefit from smartphone enabled tax education and an improved, practical method of filing via smartphones. In fact, a survey conducted in February of 2020 found that 1 in 4 Americans do not understand how their tax liability is computed.[37] What's more, 90 percent of those questioned in a *CNBC* study were not aware of the different tax brackets affecting individuals and households.[38] These figures should be eye-opening to the IRS and tax software companies because there is a clear discrepancy between what resources are offered during tax preparation and what information taxpayers truly understand and put into practice. By creating a one-stop shop for information and filing needs the IRS would get closer to having an informed and compliant population.

The proposed app is a natural progression of the IRS2GO app which already allows payments to be made to the IRS electronically. With a move towards digitization and the storage of the sensitive information found on a tax return, there are legitimate concerns over the security measures in place to ensure that predatory hackers are not gathering data from each user, so thorough identity checking systems would need to be implemented like multi-factor authentication (“MFA”). At the end of 2019, the *HIPAA Journal* studied the effects of MFA included in companies' online and mobile operations and found that 57 percent now rely on this feature to improve security.[39] Likewise, Microsoft's Director of Identity Security, Alex Weinert, noted that companies that employ this added safety measure are 99.9 percent less likely to be compromised.[40] The effectiveness of these security measures combined with the secure and widespread use of online banking and investing apps like Bank of America Mobile Banking and Acorns: Invest Spare Change, provide substantial evidence for users to feel comfortable with a mobile filing application. As of February 2021, Statista reported an astonishing 57 million Americans use mobile banking, and, in response, 86 percent of U.S. banks are now offering bill payment and transfers via mobile apps.[41] Surprisingly, a 2019 *Forbes* study revealed that mobile banking is more secure than online banking on a desktop or laptop computer because the cellular devices require multi-factor authentication and various login measures that are not included on bank websites.[42] Additionally, it is easier for a hacker to install viruses on a computer than on a cellphone. In 2019, there were 67,500 attacks on personal data through mobile devices; by comparison, AV-TEST, an independent IT-security institute, has discovered over 1 billion malwares over the last 10 years, with 350,000 malicious programs and potentially unwanted applications uncovered *daily* that host themselves in desktop and laptop computers.[43]

VI. CONCLUSION — CALL TO ACTION

Ultimately, the evidence in favor of a shift towards a simpler, streamlined method of learning about and filing taxes is overwhelming both in the benefits it will provide members of Gen Z, the IRS, all taxpayers, and the United States. A growing population consisting of upwards of 68 million taxpayers is not a small sample. It should be a priority of the IRS to inform, empower and encourage the students, graduates and young adults entering the workforce that comprise this group (and the even more tech reliant generation that follows them) to understand their rights and responsibilities as taxpayers and to proudly pay their taxes in an efficient, effective way. We believe that the provision and allocation of IRS resources for the development of a modernized, safe, mobile app that both educates people and executes the tax filing process is a crucial addition to the current services currently provided. Because it is an American tradition *and* expectation to pay taxes every year, improving this process should be at the forefront of a modernization plan. Because financial responsibility is a key component in transitioning from youth to adulthood, citizens should feel comfortable and confident in their knowledge of taxes and how to obtain credible information. Because taxation, as Founding Father Benjamin Franklin once famously said, is one of the only certainties in life, tax education and preparation should be made modern and manageable for all.[44]

TAX PROCEDURE & LITIGATION COMMITTEE

SOLIDIFYING THE EXCLUSION FOR CANCELLATION OF INDEBTEDNESS INCOME RELATED TO HOME LOAN REDUCTIONS: A PETITION TO MAKE PERMANENT IRC SECTION 108(a)(1)(E) [1],[2],[3]

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EXECUTIVE SUMMARY

In 2009, foreclosure threatened millions of American homeowners in what was the biggest housing crisis since the Great Depression. Although the climate of bankruptcies and mortgage foreclosures improved during much of the following decade, the current COVID-19 pandemic has thrust many homeowners back into a state of financial uncertainty. Despite mortgage relief programs, such as foreclosure moratoriums, designed to protect homeowners during such unprecedented times, the fears of bankruptcy and foreclosure still loom for many Americans. Preventing the recognition of discharged debt as income through section 108 of the Internal Revenue Code[4] is one particularly effective avenue for addressing the issues of bankruptcy and foreclosure. Specifically, section 108(a)(1)(E), created through the Mortgage Forgiveness Debt Relief Act of 2007 and the Emergency Economic Stabilization Act of 2008 and discussed in greater detail below, allows taxpayers to exclude from taxable income cancellation of “qualified principal residence indebtedness” through January 1, 2026.[5]

Although section 108(a)(1)(E) was initially authorized to last until January 1, 2010, the United States Congress (“Congress”) has repeatedly extended 108(a)(1)(E) due to its recognition of the lasting effect of the mortgage crisis and the fact that taxpayers with mortgages higher than the value of their home — i.e., homes with “negative equity” — still require relief from the potential CODI when forced to restructure mortgage debts or when facing home foreclosure. Congress has voted to extend the applicability of Section 108(a)(1)(E) each time the provision is set to expire.

Accordingly, as explained in greater detail below, this proposal recommends that Congress consider making section 108(a)(1)(E) a permanent provision. This proposal recognizes that section 108(a)(1)(E) is a crucial tool that may help protect taxpayers who are facing potential foreclosure and, as noted in *Babin v. Commissioner*, “is premised on the belief that it is inequitable 'to kick someone when he is down.'”[6] Finally, this proposal will attempt to demonstrate how making section 108(a)(1)(E) permanent is consistent with the policies inherent to section 108's exceptions, as well as the general policy considerations contained in the code.

DISCUSSION

I. INTRODUCTION

As noted above, this proposal recommends that Congress consider making Section 108(a)(1)(E) a permanent provision. This proposal will first explore the background and rationale for cancellation of indebtedness income ("CODI"), as well as the history of Section 108(a)(1). Next, the proposal will demonstrate the need to make Section 108(a)(1)(E) permanent, noting that: (1) the housing market conditions indicate an immediate and future need for Section 108(a)(1)(E); (2) COVID-19 has increased the need for relief for American mortgage holders; (3) making Section 108(a)(1)(E) permanent is consistent with and furthers already existing policies established by Section 108 generally as well as the provisions of the IRC that encourage home ownership; and (4) the need for constant renewal poses a danger to taxpayers. This proposal will also discuss potential challenges to enacting Section 108(a)(1)(E) permanently.

II. BACKGROUND OF CODI AND SECTION IRC SECTION 108

A. The Tax Treatment of Loans and Cancellation of Debt Income Generally

As a preliminary matter, Section 61 of the IRC requires individuals to recognize all income from whatever source derived, including income from discharge of indebtedness.[7] This principle comes from the idea that gross income is based on the presence of some accession to wealth or economic benefit to the taxpayer.[8] In keeping with this tenet of tax law, taxpayers do not generally recognize the proceeds from a loan as income.[9] Instead, gross income excludes borrowed funds because the obligation to repay the loan offsets the accession of wealth despite the fact that the taxpayer immediately increases his or her assets and can use the loan amount without restriction.[10] Thus, analyzing a borrowing transaction in its totality, the wealth of taxpayers who take loans to purchase their homes is not increased when the taxpayer takes the loan because these taxpayers have a corresponding obligation to repay said loan. Additionally, the taxpayer may not deduct its principal payments from income,[11] which means the repayment of such a loan has no effect on the taxpayer's tax liability.

With respect to funds borrowed by taxpayers for the purpose of purchasing property, and specifically in the context of home loans for principal residences, the taxpayer's basis in the property is generally equal to the full purchase price, which includes within it any loan amounts used towards the purchase.[12] Full ownership requires repayment of the loan and therefore the full loan amount is included as the cost of the property.[13] On the sale of the property, the borrower's gain is calculated as the sales proceeds minus the basis as defined above.[14] Therefore, because taking a loan does not result in a realization event[15] and property bought with borrowed funds takes a basis equal to "the full value of the consideration provided," debtors must face the tax consequences after discharging a portion of their debt obligation for less than full payment.[16,17] These consequences arise under Section 61(a)(12), which holds that if debt owed is renegotiated or a portion is otherwise canceled for less than its original amount, the taxpayer generally must recognize gross income equal to the amount of debt canceled.[18]

While the general rule holds that canceled debt is recognizable income,[19] Section 108 lists a number of exceptions that allow taxpayers to prevent recognition of income derived from this discharge of indebtedness.[20]

B. IRC Section 108(a)(1)(E): Background and Current Permutation

Section 108(a)(1)(E) emerged primarily as a result of the sub-prime mortgage loan crisis in the mid to late 2000's.[21] Congress was concerned that taxpayers forced to restructure mortgage debts or facing home foreclosures would also recognize income from the cancellation of indebtedness.[22] Thus, through the Mortgage Forgiveness Debt Relief Act of 2007 (which was amended by the Emergency Economic Stabilization Act of 2008), Congress created 108(a)(1)(E), which originally excluded from gross income the cancellation of "qualified principal residence indebtedness" if the cancellation occurred on or after January 1, 2007 and before January 1, 2010.[23] For these purposes, "qualified principal residence indebtedness" was limited to acquisition indebtedness — indebtedness incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, secured by such residence[24] — considered with respect to a taxpayer's principal residence[25] and not exceeding $1,000,000.[26]

Although Section 108(a)(1)(E) was a new provision at the time it was enacted, the concepts underlying it were not. Instead, Section 108(a)(1)(E) was created upon a preexisting framework of beneficial tax rules regarding principal residences constructed by Section 121.[27] Moreover, Section 108(a)(1)(E) does not apply to indebtedness on a home that is not the taxpayer's principal residence, nor does it apply to home equity indebtedness. [28] Indeed, this provision applies only if the debt cancellation is due to a decline in (1) the value of the home, or (2) the taxpayer's financial condition.[29] When a taxpayer uses the section 108(a)(1)(E) exclusion, instead of recognizing the CODI in the year of the event, the basis in the qualifying property is reduced by the excluded amount.[30]

Since its inception in 2007, Section 108(a)(1)(E) has been renewed and extended eight times — in 2008, 2010, 2013, 2014, 2015, 2018, 2019, and 2020.[31] Each time, these extensions served to protect taxpayers from recognizing CODI when seeking out a loan modification. The current permutation of Section 108(a)(1)(E) is provided in pertinent part below:

> **(1) In general.** Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if —
>
> > **(E)** the indebtedness discharged is qualified principal residence indebtedness which is discharged —
> >
> > > **(i)** before January 1, 2026, or
> > >
> > > **(ii)** subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.

As provided, the law extends this taxpayer protection through the end of 2025, unless further extended.

III. THE PROBLEM AND PROPOSAL: MAKE IRC SECTION 108(a)(1)(E) PERMANENT

This proposal recommends that Congress consider making IRC Section 108(a)(1)(E) a permanent provision by removing the expiration date contained in subparagraphs (i) and (ii). Such an action seeks to address one simple problem: taxpayers with mortgages higher than the value of their home — i.e., homes with "negative equity" — still require relief from the potential CODI if they restructure mortgage debts or are facing home foreclosure. Making this provision permanent would acknowledge that, like other provisions in Section 108 (*e.g.*, those addressing bankruptcy and insolvency), those facing the threat of losing their home warrants protection from an additional, and potentially crippling, tax burden. Further, allowing this provision provides an alternative to those taxpayers who would not otherwise qualify under the insolvency exemption for CODI or who are unable or do not wish to use the bankruptcy exemption.

IV. RATIONALE FOR MAKING SECTION 108(a)(1)(E) PERMANENT

As discussed in further detail below, we recommend Congress consider making Section 108(a)(1)(E) a permanent provision because doing so: (1) fulfills the current needs of taxpayers engaged in the housing and mortgage markets; (2) is consistent with the policies underlying the other paragraphs of Section 108(a)(1) — *i.e.*, recognizing that there are certain contexts in which the IRC should be flexible regarding CODI and offering relief for certain taxpayers with an inability to pay or that suffer a serious economic difficulty; (3) furthers and supports the policy of encouraging taxpayers to purchase a home, which underlies many IRC sections; and (4) puts a stop to the need to constantly renew a provision that serves a need in the U.S. housing market currently and in the foreseeable future.

A. The Current Housing/Mortgage Market Conditions Demonstrate a Need for Making Section 108(a)(1)(E) a Permanent Provision

i. Covid-19 Has Increased the Need for Certainty

As the COVID-19 pandemic continues to impact homeowners across the country, the need for financial stability is intensified for those with outstanding mortgage balances. In response to the unprecedented financial turbulence caused by the global pandemic, the Biden administration extended a federal moratorium on home foreclosures, which was first implemented by the Trump administration in 2020,[32] through June 30, 2021 and deferred payment requirements for Americans behind on their mortgages.[33] By one estimate, some 2.7 million homeowners who are in active mortgage forbearance plans stand to benefit from the moratorium extension alone.[34]

According to Black Knight, a mortgage data firm, properties with foreclosure filings in 2020 represented 0.16 percent of all U.S. homes.[35] Although foreclosures fell to record lows in 2020, as of January 2021, Black Knight estimated some 2.15 million American homeowners were at least 90 days past due on their mortgage payments.[36] These figures suggest that moratoriums and payment deferral programs have helped prevent a number of foreclosures. However, as these programs end, a significant increase in the number of foreclosures could potentially occur. Accordingly, due to the current uncertainty regarding both the global economy and pandemic, some observers believe we may be in store for another housing crisis.[37]

ii. Even Absent the COVID-19 Pandemic, Many Americans are Still Feeling the Effects of the 2009 Housing Crisis

While the rate of bankruptcies and mortgage foreclosures has improved since 2009, bankruptcy and foreclosure still affect homeowners across America. As of Q3 2020, approximately 1.6 million homeowners in the United States owned homes with negative equity, which amounted to approximately 2.9 percent of all mortgaged homeowner properties.[38] Although these figures are a marked improvement from 2009–2012, they are not insignificant.

To the extent taxpayers are taking part in home loan modification programs, which assist Americans facing the consequences of negative equity, the assistance can be somewhat negated by the potential tax implications from the discharge of indebtedness. If Section 108(a)(1)(E) is allowed to expire such taxpayers will not be protected from CODI. As discussed below, the continued existence and creation of new loan modification programs signals the importance of a more permanent solution.

iii. Continued Existence, Creation, and Utilization of Loan Modification Programs Supports the Need for Permanent Protection From CODI

The Home Affordable Modification Program ("HAMP") first launched in 2009 and served to provide relief to those affected by the housing crisis by allowing borrowers to lower their monthly payments and, as a result, avoid foreclosure.[39] HAMP provided modifications that allowed borrowers significant payment reductions tied to their income.[40] Like Section 108(a)(1)(E), HAMP was repeatedly extended as the need to assist taxpayers with the burdens of a home with negative equity continued long past the original need.[41] As the Director of the Federal Housing Financing Agency remarked at the Annual Economic Summit in 2015:

> Although the number of new borrowers entering [HAMP and the Home Affordable Refinance Program ("HARP")] continues to decline, in part because many eligible borrowers have already taken advantage of them and in part because of recovering house prices, lenders and servicers are continuing to approve new HAMP modifications and HARP refinances. Extending HAMP and HARP through the end of 2016 will provide real relief for borrowers who continue to face challenges either paying their mortgage or refinancing their loan.[42]

Although HAMP has now expired, programs such as the FHA Home Affordable Modification Program[43] and the Fannie Mae/Freddie Mac Flex Modification Program[44] address borrowers with negative equity.

iv. To the Extent the Housing Market Conditions Stagnate or Regress Section 108(a)(1)(E)'s Protections Will Be Necessary for Taxpayers

As noted above, as of Q3 2020, approximately 2.9 percent of all mortgaged homeowner properties had negative equity, which represents a significant number but also marks an improvement from years prior. However, there is no guarantee that this trend will continue, and in fact, there are several signals that suggest it may not. First, home prices are rapidly rising. The national average home price hit $397,800 in Q3 2020, which was 23 percent higher than the previous record high in Q1 2007 of $322,100.[45] Similarly, the S&P Homebuilders Select Industry Index, which tracks the stock prices of homebuilders, has risen 14.47 percent from January 2011 to January 2021, which is another indicator of rising home prices.[46]

Second, there has been an increase in the prevalence of unregulated mortgage brokers. As of 2018, 53.6% of U.S. mortgages were originated by unregulated mortgage brokers and five of the ten largest mortgage lenders were not banks.[47] By comparison, in 2010, just three banks (Wells Fargo, Bank of America, and Chase) originated 56% of all mortgages.[48] Notably, unregulated mortgage brokers are not subject to the same regulations as banks.

Third, despite being much lower than it was in 2007, the average debt-to-income ratio for loans issued to homebuyers increased to 35.1 percent in 2017 from 34 percent in 2016.[49] Additionally, as of 2019, the average unpaid balance of a new mortgage equaled approximately $285,434 according to data from the Consumer Financial Protection Bureau.[50]

Accordingly, although the percentage of homeowners with negative equity has been improving the past few quarters, there is no guarantee this trend will continue. Further, regardless of which direction this trend goes, the facts remain that: (1) a significant number of homeowners still have negative equity today; (2) that number is even greater if you include those with effective negative equity; (3) loan modification programs are still necessary, and continue to be created and used by taxpayers; and (4) these programs may result in CODI for homeowners already facing financial hardship potentially caused by the conditions just described. In short, although the housing/mortgage market is objectively healthier than it was during the housing crisis, the conditions Section 108(a)(1)(E) was created to address are still present today and could potentially last into the foreseeable future. Thus, making Section 108(a)(1)(E) permanent could help alleviate the problems created by these factors.

B. Making Section 108(a)(1)(E) a Permanent Provision is Consistent With Policies Already Established by the IRC

Making Section 108(a)(1)(E) a permanent provision is also recommended because doing so: (1) is consistent with the policies underlying the other provisions of Section — *i.e.*, the recognition that there are certain contexts in which the IRC should be flexible regarding CODI and the desire to offer relief to certain taxpayers with an inability to pay or that suffer financial hardship; and (2) furthers the policy of encouraging taxpayers to purchase a home, which underlies many IRC sections.[51]

i. Making Section 108(a)(1)(E) Permanent is Consistent with the Policies Underlying the Exceptions for Discharge in Bankruptcy and Insolvency

Section 108(a)(1)(A) excludes from the debtor's gross income any CODI and discharge of taxpayer indebtedness due to bankruptcy.[52] Similarly, section 108(a)(1)(B) excludes cancellation of debt income realized while the debtor is insolvent.[53] Generally, loan proceeds are not included in a taxpayer's gross income because there is a corresponding obligation for the taxpayer to repay that amount, which means the taxpayer has not experienced an accession of wealth. If that obligation is discharged, however, then the taxpayer has experienced an accession of wealth that should be taxed. In other words, these rules codify the policy that a taxpayer should be taxed only on an actual accession to wealth. Along those same lines, Sections 108(a)(1)(A) and (B) exclude CODI from gross income when a taxpayer is bankrupt or insolvent because “no accession to income has occurred if after the debt cancellation, the taxpayer remains insolvent since no assets have been freed.”[54] Further, the attribute reduction mechanism of Sections 108(a)(1)(A) and (B) demonstrate the importance of considering a taxpayer's economic reality and offering relief to certain taxpayers with an inability to pay or that suffer a serious financial hardship because once a taxpayer has no remaining basis to reduce, the otherwise includible CODI simply disappears.

Accordingly, the existence and operation of Sections 108(a)(1)(A) and (B) make several things clear as it relates to policy and intent in this area. First, a taxpayer should only be taxed on its gain/accession to wealth. Second, a taxpayer's economic reality should be considered when determining whether there has been an accession of wealth. Third, there is an active interest in offering relief to taxpayers with an inability or difficulty to pay due to an economic event such as bankruptcy or insolvency. Fourth, the IRC should be flexible enough to offer relief to such a taxpayer. As more eloquently provided in *Babin v. Commissioner*, “the insolvency exception, among other things, is premised on the belief that it is inequitable 'to kick someone when he is down.'”[55]

Making Section 108(a)(1)(E) permanent conforms with the policies prescribed above. The provision applies only if the debt cancellation is due to a decline in the value of the home or the taxpayer's financial condition. In other words, just like Sections 108(a)(1)(A) and (B), Section 108(a)(1)(E) operates to only tax a taxpayer on its accession to wealth while simultaneously considering the taxpayer's economic reality, *i.e.*, its home equity in this context. Further, when a taxpayer uses the Section 108(a)(1)(E) exclusion, the basis in the qualifying property is reduced by the excluded amount. Again, like Sections 108(a)(1)(A) and (B), this feature demonstrates Section 108(a)(1)(E)'s ability to be flexible. Not only does this mechanism offer immediate relief to taxpayers with an inability to pay, such as homeowners with an underwater mortgage, by allowing for attribute reduction as opposed to income inclusion, it also preserves the gain to be taxed later when the taxpayer should have more liquidity. Further, it provides taxpayers an alternative exemption to CODI, which does not necessitate meeting the stringent requirements of the insolvency exemption and does not require them to declare bankruptcy to avoid CODI.

ii. Exception for Reduction of Certain Purchase Price Debt Obligations and its Underlying Policies Support the Permanence of Section 108(a)(1)(E)

Another rationale supporting the permanence of Section 108(a)(1)(E) is that it uniquely relates to home mortgages, which differ greatly from other debt obligations. Consider Section 108(e)(5),[56] which provides that CODI is not recognized as a result of the reduction of an obligation from the purchaser to the seller of a property.[57] Instead, this reduction or cancellation of purchase money debt is treated as a reduction of the purchase price, which in turn reduces the basis of the property.[58] This would function in a similar manner to section 108(a)(1)(E) in converting an event that would be taxable currently into one which instead affects basis and thus could create additional income only when the home is later transferred.

Section 108(a)(1)(E) allows taxpayers to modify the loans on their primary residence through bargaining and restructuring loan agreements with banking institutions.[59] If Section 108(a)(1)(E) did not exist, reductions of primary mortgage loans would instead be recognized as income, and ultimately tax liability.[60] Indeed, bargaining for a loan reduction or modification would be a less attractive option without Section 108(a)(1)(E) due to the possibility of immediate tax liability that may negate much of the benefit of loan modification. Accordingly, Section 108(a)(1)(E) increases the desirability of bargaining by eliminating the risk of immediate recognition of CODI.

Section 108(a)(1)(E) also encourages lending institutions to bargain for the reduction of loans by allowing for greater recuperation of the loan amount. Lending institutions are better able to recover taxpayer debt because bargaining between parties under Section 108(a)(1)(E) can lead to tax-minimizing results (as seen above), providing taxpayers with an increased ability to repay a greater portion of the incurred debt. This may in many cases lead to a better return than liquidation of the collateral through foreclosure. Additionally, having a Section 108 exclusion specific to the housing/mortgage context aligns with the fact that this area is distinct from other types of debt and deserves due consideration. As such, making Section 108(a)(1)(E) permanent acknowledges the need to address the unique nature of a home mortgage as a constant, rather than something solely linked to variability in the housing market.

iii. Making Section 108(a)(1)(E) Permanent is Consistent with IRC Provisions That Encourage Homeownership

In 2007, Rep. Charles Rangel, Chairman of the House Committee on Ways and Means, said “[i]t's just not right or fair that families struggling through a foreclosure would then face a tax bill in addition to losing their homes when they have seen no increase in their net worth.”[61] This perspective informs the design of today's Tax Code, which encourages home ownership. For instance, homeowners enjoy tax incentives for housing unavailable to renters, such as the ability to deduct home mortgage interest and property taxes, while renters may not deduct rent payments. Similarly, homeowners receive a mortgage interest deduction under Section 163(h)(2)(D), which permits taxpayers to deduct the interest payments made on a mortgage loan.[62] Congress acknowledged the mortgage interest deduction as benefiting home ownership and has maintained the deduction for precisely that reason.[63] In addition to the mortgage interest deduction, home ownership provides for similar benefits in the form of the property tax deduction,[64] a deduction for interest paid on home equity debt,[65] and other credits and expenses.[66] Thus, the Code can be viewed as encouraging homeownership.

C. Section 108(a)(1)(E) has Now Been Extended Eight Separate Times

Lastly, Section 108(a)(1)(E) was created through the Mortgage Forgiveness Debt Relief Act of 2007 and the Emergency Economic Stabilization Act of 2008 with an initial expiration date of January 1, 2010.[67] Since its inception, it has been extended eight times, most recently through P.L. 116-260, which extended the expiration date to January 1, 2026.[68] The repeated extension of Section 108(a)(1)(E) clearly demonstrates that Congress believes it is needed, effects a material beneficial impact, and will continue to do so for the foreseeable future. Moreover, in the uncertain economic climate of a pandemic-altered housing market, the extension codified in P.L. 116-260 signals Congressional intent to provide prolonged relief and assistance to America's most impacted homeowners. Thus, after almost 14 years of existence and repeated extensions, Section 108(a)(1)(E) should be made permanent.

V. CHALLENGES TO MAKING SECTION 108(a)(1)(E) PERMANENT

A. Potential Effects to Revenue

While the authors do not believe there are significant drawbacks to making Section 108(a)(1)(E) permanent, we nevertheless will attempt to address potential concerns interest parties can raise. First, while this paper does not attempt to address the numerical impact of permanently adopting this provision, there is a potential for some possible negative revenue impact, as Congress will not collect tax on amounts recognized by the discharge of this form of indebtedness. However, as a preliminary matter, this exemption has been and will be in place for a 17-year period, and therefore this is not a current source of revenue for the U.S. and will not be for some time. Second, Congress should consider whether this is a source of revenue it wishes to cultivate, specifically when it is triggered only when a U.S. taxpayer is in a position to qualify for one of the relevant home loan modification relief provisions (*e.g.,* when the taxpayer is on the brink of foreclosure on their primary residence). This necessarily is tax imposed on income earned by taxpayers in their worst moments. Third, application of Section 108(a)(1)(E) causes a reduction in basis; thus, tax is deferred, not necessarily erased.[69] Lastly, the revenue impact may be somewhat muted, as fewer modifications are occurring after the termination of HAMP. Thus, the authors anticipate any fiscal impact to be minimal.

B. Relief Provisions Were Thought to be Temporary

A second challenge to permanently enacting Section 108(a)(1)(E) is the idea that the provision was meant to only be temporary and that a permanent extension goes beyond the original mandate of the provision. As noted above, Section 108(a)(1)(E) was created through the Mortgage Forgiveness Debt Relief Act of 2007 and the Emergency Economic Stabilization Act of 2008 with an initial expiration date of January 1, 2010.[70] While the presence of this initial expiration date suggests an intent that Section 108(a)(1)(E) be temporary, Section 108(a)(1)(E) was created to address unrest in the housing market and to help American homeowners forced to restructure mortgage debts or facing home foreclosures — a goal which is not, in and of itself, a temporary one.

In other words, there may always be a need for Section 108(a)(1)(E). Furthermore, the fact that Congress has extended Section 108(a)(1)(E) eight times since its inception, keeping it in existence for nearly 17 years, evidences that it may agree. Notably, these extensions did not always occur during a state of emergency or crisis. Rather, there is a recognition that such an exclusion might be necessary, even in the best of times, to prevent significant ill effects to those taxpayers facing a large burden imposed on the privilege of receiving much needed assistance. Accordingly, the fact that Section 108(a)(1)(E) initially had an expiration date should not, in and of itself, have any bearing on whether it should apply indefinitely.

VI. CONCLUSION

In conclusion, since the 2009 Housing Crisis, there has been and continues to be a need for Section 108(a)(1)(E)'s exclusion of income earned from the discharge of principal home mortgage indebtedness. Further, making Section 108(a)(1)(E) a permanent provision is consistent with policies already established by Congress and the IRC, both with respect to the rationales employed for the exemptions for discharge in bankruptcy and insolvency — and other sub-provisions in Section 108 — as well as with those provisions in the IRC that encourage home ownership. Congress has acknowledged the importance of this provision by extending Section 108(a)(1)(E) eight times since 2008, keeping it effective through January 1, 2026. Given the significance of this provision for those taxpayers who utilize it, as well as the lack of significant rationales in opposition, Congress should consider making Section 108(a)(1)(E) permanent.

The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association, the Taxation Section, or of Deloitte Tax LLP.

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PROPOSED REVISION OF THE INCOME TAX "GRANTOR TRUST RULES"AND CORRESPONDING PROVISIONS OF THE ESTATE AND GIFT TAX RULES (IRC Sections 671 - 679, 2035 - 2038, and 2511)[1]

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EXECUTIVE SUMMARY

The purpose of this paper is to examine the way in which the net income (including capital gains) of a domestic trust is taxed for federal income tax purposes during the lifetime of the U.S. resident settlor or grantor of the trust, and to recommend a revision of the so-called "grantor trust rules" in Subpart E of Subchapter J of the Federal Income Tax Law (IRC Sections 671 through 679) and the corresponding provisions of the estate and gift tax rules relating to irrevocable transfers in trust (IRC Sections 2035 - 2038 and 2511). Primarily as a result of the compression of the income tax rate brackets applicable to estates and trusts and the so-called "kiddie tax" in IRC Sections 1(e) and 1(g), respectively, enacted about 30 years ago, it is submitted that the bulk of those grantor trust rules are no longer needed to prevent the

avoidance of income taxes, and ironically they are now utilized by taxpayers to avoid gift and save estate taxes.

The income tax grantor trust rules are substantially different from the estate, gift, and generation-skipping transfer ("GST") tax rules in IRC Sections 2035 through 2038, 2511, and 2642(f), relating to gratuitous transfers of property in trust. Consequently, an irrevocable transfer of property in trust that is complete for gift tax purposes may be treated as being incomplete for income tax purposes, and a transfer that is complete for income tax purposes may be treated as incomplete for gift tax purposes; and a transfer in trust that is complete for gift tax purposes may not prevent the trust property from being included in the grantor's gross estate for estate purposes or allow the grantor's GST exemption to be allocated to the trust for GST tax purposes. The compression of the income tax rate brackets without eliminating most of the income tax grantor trust rules referred to above, and Revenue Ruling 85-13, 1985-7 I.R.B. 28,[2] have led to the widespread establishment of so-called (1) Intentionally Defective Grantor Trusts ("IDGTs") that are irrevocable trusts resulting in a completed transfer for gift and estate tax purposes but an incomplete transfer for income tax purposes, enabling the grantor to (a) make a tax-free gift to the IDGT by paying the income tax attributable to the trust's taxable income and (b) avoid the recognition of gain or loss on a sale or exchange of property between the grantor and the trust, and (2) Incomplete Non-grantor Gift ("ING") trusts in states with no or low income tax rates applicable to undistributed trust income, enabling a grantor residing in relatively high income tax rate states to avoid paying state income taxes on the trust's income even though the grantor is treated as still owning the trust property for gift and estate tax purposes. Both the income tax grantor trust rules and the estate and gift tax rules relating to transfers in trust have been in the law for many decades without substantial revisions. This paper describes a proposal to revise those provisions by correlating the income tax grantor trust rules with revised estate and gift tax relating to transfers in trust.

The federal income tax law generally taxes net income with respect to property to the person to whom the property belongs. In the estate planning context, income with respect to property owned by an individual is taxed to the individual; and if that individual (a donor) makes a completed gift of property to another individual (a donee), outright and free of trust and any other restrictions, the net income with respect to that property thereafter is taxable to the donee. However, if a completed gift of property is made to an irrevocable trust, the person to whom the net income with respect to the trust property is taxable is either the grantor, the trust, one or more beneficiaries of the trust, and/or a person other than the grantor who is treated as the owner of the property because of powers exercisable or previously exercised by that other person.

In order to determine who should be taxable on the net income with respect to property given to an irrevocable trust, it seems logical and appropriate to

(i) generally correlate the income tax grantor trust rules with the gratuitous transfer tax grantor trust rules, in furtherance of the principal referred to above, i.e., that the net income with respect to property is generally taxable to the person to whom the property belongs, and (ii) revise and simplify the way in which property ownership is determined for both income and gratuitous transfer tax purposes.

> "For example, under current law, if the grantor of an IDGT transfers $1,000,000 to the trust and the money is invested in property that produces net income (including capital gains) totaling $2,000,000 during the period that the trust is a grantor trust, the grantor rather than the trust would be liable for the amount of the tax attributable to the trust's $2,000,000 of net income because of the grantor-trust provisions of the code. Because the grantor would have no right of reimbursement from the trust for paying the tax attributable to its net income, this would result in a reduction in the value of the grantor's gross estate for estate tax purposes equal to the amount of the tax paid. In effect, the grantor would be enhancing the value of the trust (effectively making a gift tax-free gift) as the trust is able to grow tax-free because the grantor, not the trust, is liable for the tax attributable to the trust's net income. However, the value of this enhancement would not be subject to gift tax because the grantor-trust provisions require the grantor to pay the tax attributable to the trust's net income. Because current law also treats the grantor as owning the trust property for income tax purposes, the grantor and the trust would be able to sell or exchange appreciated assets with each other without any recognition of gain. Under this proposal, (1) no such tax-free gift would be possible because by definition a grantor trust would be an incomplete gift for gift and estate tax purposes, and (2) no such tax-free exchange

> would be possible because the grantor would not be treated as owning the trust property."

DISCUSSION

I. DETERMINATION OF PROPERTY OWNERSHIP FOR INCOME AND GRATUITOUS TRANSFER TAX PURPOSES.

A. Complete Gifts for Income and Gratuitous Transfer Tax Purposes.

Under current law, the rules for determining whether a gift of property in trust is complete for income tax purposes are very complicated. Those rules incorporate definitions and other provisions relating to adverse parties and specified nonadverse related or subordinate parties (including corporations or employees of corporations in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, subordinate employees of corporations in which the grantor is an executive, and in certain situations, presumptions of subservience unless a party is shown not to be subservient by a preponderance of the evidence).

By comparison, under current law (i) a gift of property in trust generally is incomplete for gift tax purposes so long as the grantor has a significant beneficial interest in the trust and/or a significant power to affect the beneficial enjoyment of the trust property, and (ii) trust property generally is included in the grantor's gross estate for estate tax purposes if the grantor has a significant beneficial interest in the trust at the time of his or her death and/or a significant power to affect the beneficial enjoyment of the trust property at that time. Determining whether the grantor has such a significant beneficial interest or power also can be complicated.

In an effort to correlate and simplify income and gratuitous transfer tax laws, it is submitted that the power of the grantor of a trust to affect the beneficial enjoyment of the trust property generally should be irrelevant with respect to the completion of the gift by the grantor for income and gift tax purposes and the inclusion of the trust property in the grantor's gross estate for estate tax purposes. Therefore, a lifetime gift of property to an irrevocable trust of which neither the grantor nor his or her spouse has a significant beneficial interest as of the date of the transfer generally should be treated as a completed gift for both income and gift tax purposes, and the value of the trust property generally should not be included in the grantor's gross estate on his or her later death for estate tax purposes.

(1) Grantor's Power to Affect the Beneficial Enjoyment of Trust Property.

In support of the proposition that the power of the grantor to affect the beneficial enjoyment of the trust property generally should be irrelevant for income and gratuitous transfer tax purposes, in the November 1984 Treasury Department Report to the President, entitled "Tax Reform for Fairness, Simplicity, and Economic Growth," Volume 2, Chapter 19, Section 19.01 (the Proposal for the Unification of Gift and Estate Taxes), on p. 379, the Treasury Department proposed the following:

> Retained powers. In determining whether a gift is complete for transfer tax purposes, the proposal would treat a retained power to control the beneficial enjoyment of the transferred property as irrelevant where the power could not be used to distribute income or principal to the donor. Thus, the fact that the transferor as trustee or custodian can exercise control over the identity of the distributee of the property or over the amount or timing of a distribution would be irrelevant in determining whether a gift is complete (although such factors may be relevant in determining whether the transfer qualifies for the annual gift tax exclusion). Under this rule, a transfer would be complete for gift tax purposes where the grantor creates an irrevocable trust but retains the absolute right to determine who (other than himself) will receive the trust income or principal.

The power of the grantor of a trust to affect the beneficial enjoyment of the trust property by determining which beneficiaries will receive trust income and/or principal, and how much, should be irrelevant for purposes of determining whether a transfer in trust is complete for tax purposes, for the following reason: The grantor of a trust will often name as trustee a friendly individual or trust company, neither being a "related or subordinate party" as defined in IRC Section 672(c), but who, because of a close personal or business relationship with the grantor, will administer the trust in accordance with his or her wishes. In light of that reality, it seems appropriate to acknowledge that reality and simply let the grantor of a trust, acting in a fiduciary capacity, exercise the power to affect the beneficial enjoyment of the trust property without treating the transfer as incomplete for tax purposes, as long as that power cannot be exercised in favor of the grantor or his or her spouse, directly or indirectly, alone or in conjunction with any other person.[3]

(2) Grantor and/or Grantor's Spouse's Beneficial Interest

One way to determine whether the grantor and/or his or her spouse has a significant beneficial interest in the trust, as of the date of the gift, would be to determine whether (i) the value of their interest exceeds 5% of the fair market value of the property transferred, and (ii) either of them currently is, or in the future may be, able to deal with the trust on other than an arms-length basis, e.g., to (A) purchase, exchange, or otherwise deal with any trust property for less than full and adequate consideration in money or money's worth, or (B) borrow any trust property without adequate interest and security. However, a transfer of property to a trust qualifying for the gift tax marital deduction should be treated as a completed gift for gratuitous transfer tax purposes.

The value of the beneficial interest of the grantor and/or his or her spouse, as of the date of the gift, might be determined by assuming the maximum exercise of discretion in favor of the grantor and/or his or her spouse, as is currently provided by IRC Section 673(c) (Special Rule for Determining Value of Reversionary Interest). This 5% threshold is similar to the 5% threshold with respect to reversionary interests under IRC Section 2037. Under Section 2037 the trust property is included in the grantor's gross estate if the value of the reversionary interest exceeds 5% of the value of the trust property immediately before the date of the grantor's death rather than the date of the gift.[4]

(3) Incomplete Gifts for Income and Gratuitous Transfer Tax Purposes.

On the other hand, it would seem appropriate to provide that property transferred to a revocable trust, or to an irrevocable trust of which the grantor and/or his or her spouse has a significant beneficial interest generally (a) should not be a completed gift for income and gift tax purposes, and (b) any remaining portion of the trust property at the grantor's death should be included in his or her gross estate for estate tax purposes. However, any distribution from the trust to a beneficiary other than the grantor or another trust that also is an incomplete gift for gift tax purposes, and any portion of the trust property that otherwise ceases to be an incomplete gift for gift tax purposes during the grantor's lifetime, should be treated as a completed gift by the grantor at that time for gift tax purposes.

(4) Alternative Methods for Determining Whether a Gift in Trust is Complete for Income and Gratuitous Transfer Tax Purposes.

(a) *A Completed Gift Only If Neither the Grantor Nor the Grantor's Spouse Has Any Beneficial Interests in or Certain Powers With Respect to the Trust.*

Because of the difficulty in many cases of determining whether the value of the beneficial interest of the grantor and his or her spouse exceeds 5% of the fair market value of the property or is otherwise significant as of the date of the gift, a better way to determine whether a gift in trust is complete for tax purposes (resulting in a "Completed Gift Trust") might be to provide that such a gift would only be treated as complete if neither the grantor nor his or her spouse can ever, directly or indirectly, have (1) a beneficial interest in the trust, mandatory or in the discretion of the trustee, a protector or any other person, pursuant to the exercise of a non-general power of appointment, or otherwise pursuant to a non-taxable gratuitous transfer; or (2) the power to deal with the trust on other than an arms-length basis (e.g., purchase, exchange, or otherwise deal with any trust property for less than full and adequate consideration in money or money's worth, or borrow any trust property without adequate interest and security) or exercise any power with respect to the trust, individually, as a trustee, or otherwise, in other than in a fiduciary capacity.

The trust instrument of a Completed Gift Trust probably should be required to so provide, and any later violation of these prohibitions probably should result in the trust property thereafter being treated as belonging to the grantor for tax purposes. A trust failing to meet these requirements, as well as a Completed Gift Trust with respect to which any of those prohibitions is violated, would be an "Uncompleted Gift Trust"); provided, however, that a trust qualifying for a marital deduction should be treated as a Completed Gift Trust.

(b) *A Completed Gift Only for Beneficial Interests Vested in Beneficiaries Other Than the Grantor and the Grantor's Spouse.*

Another way to determine whether a gift in trust is complete for tax purposes (resulting in a "Completed Gift Trust") might be to simply provide that in general, a trust established during the grantor's lifetime would be an Uncompleted Gift Trust for tax purposes regardless of whether the grantor or his or her spouse has a beneficial interest in, or a power to affect the beneficial enjoyment of, the trust property. However, a trust in which the interest of a beneficiary or beneficiaries other than the grantor or the grantor's spouse is vested would be treated as a Completed Gift Trust. This alternative would enable the state of residency of the grantor of an Uncompleted Gift Trust, or the vested beneficiary of a Completed Gift Trust, to tax the trust income and/or property because that grantor or vested beneficiary would be treated as the owner of the trust property for tax purposes. This alternative also would make a wealth tax more effective because the grantor of an Uncompleted Gift Trust, or the vested beneficiary of a Completed Gift Trust, would be treated as the owner of the trust property for purposes of imposing the wealth tax.

(1) During the grantor's lifetime —

(A) the DNI mechanism would be inapplicable, and payments and distributions of money or other property to the beneficiaries would not carry out trust income,

(B) the income, deductions, and credits against tax attributable to an Uncompleted Gift Trust would be included in the grantor's income tax return, but the additional tax attributable to the trust would be charged to it,

(C) the income, deductions, and credits against tax attributable to a Completed Gift Trust would be included in the vested beneficiary's income tax return, but the additional tax attributable to the trust would be charged to it,

(D) distributions of money or other property to beneficiaries other than the grantor of an Uncompleted Gift Trust would be completed gifts to them by the grantor,

(E) because the grantor would be treated as the owner of the property in an Uncompleted Gift Trust, and the vested beneficiary would be treated as the owner of the property in a Completed Gift Trust, transactions between the grantor and the Uncompleted Gift Trust, and between the vested beneficiary and the Completed Gift Trust, would be disregarded for income and gratuitous transfer tax purposes, and

(F) the Uncompleted Gift Trust property would be included, and the Completed Gift Trust property would not be included, in the grantor's gross estate upon his or her death.

(2) Following the grantor's death the DNI mechanism would be applicable to a trust other than a Completed Gift Trust, whether established during the grantor's lifetime or after his or her death.

B. Income Taxation of Trusts.

The grantor's income tax liability should be determined as though he or she owned the property of an Uncompleted Gift Trust, and the trust should be disregarded for income tax purposes. The income tax liability of a Completed Gift Trust generally should be determined in the usual manner, in accordance with its applicable (compressed) rate brackets, including any deduction for DNI distributed to beneficiaries.[5]

C. Income Taxation of Trusts Over Which a Beneficiary Has a General Power of Appointment or Withdrawal.

If a beneficiary has a general power of appointment or withdrawal over all or a portion of a trust, the beneficiary should be treated as though he or she were the grantor with respect to the trust or that portion. If such a beneficiary releases the power or allows it to lapse but the beneficiary and/or his or her spouse has a significant beneficial interest in the trust or that portion as of the date of the release or lapse, the release or lapse should be treated as an incomplete gift by the beneficiary; and the income of the trust or that portion generally should be taxed as though the beneficiary were the grantor with respect to the trust or that portion, as provided in Subpart B of this paper, above. However, if a beneficiary has the power to withdraw $5,000 or 5 percent of the value of the trust property annually, whichever is greater, as provided in IRC Section 2514(e), or the grantor and/or his or her spouse does not have a significant (or any) beneficial interest in the trust or that portion as of the date of the release or lapse of the power, the release or lapse should be disregarded for both income and gratuitous transfer tax purposes.

D. Income Taxation of *Clifford* Trusts.

The income of a *Clifford* trust with respect to which the grantor has retained a reversionary interest having an actuarial value in excess of 5% of the value of the property as of the date of the transfer of the property to the trust, should be taxed as provided in Subpart B of this paper, above, regardless of whether the initial term interest in the trust is a completed gift for gift tax purposes. However, if that term interest is treated as a completed gift for gift tax purposes, distributions with respect to that term interest should not be treated as further gifts by the grantor.

E. Income Taxation of Grantor Retained Interest Trusts.

The establishment of a grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT), or qualified personal residence trust (QPRT) generally should be treated as provided in Subparts A(3) and B of this Part 0, above, until the first to occur of the end of the fixed term or the grantor's death. However, if the remainder beneficiary(s) has (have) a vested remainder interest in the trust as of the date of the transfer, the actuarial value of that interest (a) should be treated as a completed gift for gift tax purposes, (b) if the grantor dies during the fixed term, only the actuarial value of the remaining fixed term at the date of the grantor's death should be included in the grantor's gross estate for estate tax purposes, and (c) if the grantor does not die during the fixed term, the trust thereafter should be treated as a Completed Gift Trust in the same manner as provided in Subpart B of this Part 0, above.

F. Proceeds of Life Insurance Policies Owned by Trusts.

If the power of the grantor of a trust to affect the beneficial enjoyment of the trust property is going to be disregarded and the determination of whether a gift, in trust, is complete for gratuitous transfer tax purposes will only depend on whether the grantor and his or her spouse have a significant beneficial interest in the trust property, or no beneficial interest at all, any incidents of ownership other than the power to name oneself as the beneficiary, directly or indirectly, alone or in conjunction with any other person, of any insurance policies on the life of the powerholder owned by a Completed Gift Trust also should be disregarded.

G. Income Taxation of Charitable Lead Trusts.

The income with respect to a charitable lead annuity trust (CLAT) or charitable lead unitrust (CLUT) generally should be taxed as a Completed Gift Trust in the same manner as provided in Subpart B of this Part 0, above. However, an exception might be made to obtain grantor-trust treatment where the grantor elects to take an upfront income tax deduction for the present actuarial value of the charitable lead interest.

H. Income Taxation of Charitable Remainder Trusts.

The income with respect to a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) probably should be taxed in the same manner as under present law.

II. TRANSITION RULE

All new trusts established after the effective date of the new law and additions to existing trusts after the effective date should be treated as provided under the new law.

An existing trust that was treated as a completed gift for gift tax purposes under the old law should continue to be treated as a completed gift for gift tax purposes. With regard to the taxable year of the effective date and subsequent taxable years, an existing trust that was treated as a grantor trust for income tax purposes should continue to be treated as a grantor trust unless that status is discontinued; however, the trust should be liable for the tax attributable to the trust's net income for the entire year, and sales or exchanges of appreciated property between the grantor and the trust following the effective date generally should be taxable.

ADMINISTRATIVE PROCEDURE FOR THE INTERNAL REVENUE SERVICE AND THE DEPARTMENT OF JUSTICE WHEN COURT-ORDERED CRIMINAL RESTITUTION PAYABLE TO THE INTERNAL REVENUE SERVICE SIGNIFICANTLY EXCEEDS THE ACTUAL TAX LIABILITY TO WHICH THE RESTITUTION RELATES

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EXECUTIVE SUMMARY

Pursuant to 18 U.S.C. § 3663, District Courts have the ability to order restitution payable to the IRS under a number of circumstances. The most frequent circumstance is where a criminal defendant agrees to pay tax-related restitution as part of a plea agreement. In these rulings, a District Court's Order fixing the amount of restitution to be paid cannot be altered once it becomes final.

The amount of court-ordered restitution to the IRS should not exceed the amount of the taxes (including interest and penalties) relating to the taxpayer's unlawful conduct. Sometimes, however, the amount of the taxes relating to the unlawful conduct are later determined to be materially less than the amount of tax-related restitution ordered by the District Court. When this happens, taxpayers cannot ask the District Court to reduce the court-ordered restitution, even though the actual tax liability upon which the restitution is based is significantly less than the amount of that restitution. Since most criminal tax cases are resolved via plea bargains in which defendants agree to pay restitution to the IRS, restitution payable to the IRS is now relatively commonplace in criminal tax cases.

There is a legal basis for establishing an administrative remedy for this situation. 18 U.S.C. § 3664(g)(1) provides that "[n]o victim shall be required to participate in any phase of a restitution order." Based on this language, the IRS can advise the Department of Justice that the IRS no longer wishes to receive further restitution payments from DOJ, and the IRS can administratively cease all collection activity with respect to all related restitution-based assessment(s), once the taxpayer has fully paid all Title 26 liabilities to which the restitution order relates.

Thus, this paper proposes a procedure that permits taxpayers to notify the IRS that they believe that all Title 26 liabilities to which a criminal restitution order relates have been fully paid. If the IRS agrees with the taxpayer, IRS would notify the Department of Justice that the IRS no longer wishes to receive restitution payments from DOJ because the Title 26 liabilities to which the restitution order relates have been fully paid. The DOJ, if it agrees with the IRS and the taxpayer, would, along with the IRS, cease all active collection measures to collect the remaining restitution.

DISCUSSION

I. INTRODUCTION

This proposal addresses the relationship between tax-related criminal restitution awarded and enforced pursuant to 18 U.S.C. §§ 3663 and 3664 and Title 26 civil tax liabilities which form the basis of tax-related restitution awards. The criminal restitution rules under Title 18 of the United States Code allow District Courts to impose restitution in favor of the IRS in criminal tax cases. Tax-related restitution obligations are supposed to be based on the underlying tax obligations that are related to the taxpayer's criminal conduct. Situations arise however, where the amount of the criminal restitution ends up materially exceeding the underlying tax obligation to which the restitution relates. This paper proposes a simple, inexpensive, administrative mechanism which would allow the government to avoid “over collecting” the true amount owed by a taxpayer in situations where the amount of unpaid taxes to which a restitution order relates ends up being materially lower than the amount of tax-related restitution ordered by the District Court. Taxpayers would be allowed to seek and obtain administrative relief from a restitution obligation that is excessive.

The scope of this proposal is quite narrow. It is only intended to cover court-ordered criminal restitution that is based on taxes owed to the IRS. It is not intended to cover restitution payable to any government agency other than the IRS or restitution payable to private parties.

II. THE LAW CURRENTLY PERMITS THE GOVERNMENT TO COLLECT TAX-RELATED RESTITUTION THAT EXCEEDS THE AMOUNTS REQUIRED TO MAKE THE IRS WHOLE, CONTRARY TO THE PURPOSE OF RESTITUTION

The current law permits the government to collect tax-related restitution imposed under 18 U.S.C. § 3663 in situations where the amount of tax-related restitution exceeds the amounts needed to make the IRS whole. The authors propose an administrative remedy that allows taxpayers who are liable for tax-related restitution to avoid paying restitution in excess of the amount required to make the IRS whole and to permit the government to avoid collecting taxes in excess of the true amounts owed.

A. Current Law

Pursuant to 18 U.S.C. § 3663, District Courts have the ability to order restitution payable to the IRS under a number of circumstances. The most frequent circumstance is when a criminal defendant agrees to pay such restitution as part of a plea agreement.[3] Since most criminal tax cases are resolved via plea bargains in which defendants agree to pay restitution to the IRS, restitution is now relatively commonplace in criminal tax cases.

Defendants who agree to pay restitution to the IRS can either agree to the amount of restitution to be paid or litigate the amount of restitution to be paid in District Court. The District Court's order fixing the amount of restitution generally cannot be altered once it becomes final.[4] The Attorney General is charged with collecting the amount of restitution owed.[5] Generally, the Financial Litigation Unit of the relevant U.S. Attorney's office collects unpaid restitution obligations owed to the IRS.

The IRS is permitted to make a “restitution based assessment” equal to the amount of court-ordered restitution.[6] The IRS may undertake its own collection action to collect the restitution-based assessment, independent of efforts by the Attorney General to collect the court-ordered restitution.[7] All restitution amounts collected by DOJ are remitted to the IRS for application to the outstanding tax liability. All amounts independently collected by the IRS or received by the IRS from DOJ reduce the restitution obligation being collected by DOJ, the restitution-based assessment, and the underlying tax liability to which the restitution relates.[8] There is not supposed to be any “double collecting” or “triple collecting.” Nevertheless, to the extent that the amount of restitution obligation and the related restitution-based assessment exceed the tax liability to which the restitution relates, both IRS and DOJ may continue to pursue collection action against the taxpayer for the unpaid restitution amounts after the tax liability to which the restitution relates has been paid in full.[9]

A taxpayer against whom a restitution-based assessment has been made may not challenge the existence or amount of the restitution in any proceeding under the Internal Revenue Code.[10] The Tax Court has interpreted this provision as permitting challenges to the amount of a restitution-based assessment only to the extent that the assessment is inconsistent with the District Court's restitution Order.[11]

B. The Purpose of Restitution

"The court shall order . . . that the defendant make restitution to the victim of the offense."[12] For purposes of criminal tax restitution, a "victim" has been defined as the following: “A person directly and proximately harmed as a result of the commission of an offense for which restitution may be ordered including, in the case of an offense that involves as an element a scheme, conspiracy, or pattern of criminal activity, any person directly harmed by the defendant's criminal conduct in the course of the scheme, conspiracy, or pattern.”[13] Put simply, a victim is one who is directly harmed by the defendant's criminal conduct in the course of a scheme.

Although criminal restitution is technically not a tax, the Department of Treasury has the authority to “assess and collect the amount of restitution . . . for failure to pay any tax . . . in the same manner as if such amount were such tax.”[14] This provision is significant because Congress explicitly intended to establish a connection between restitution and taxes owed by taxpayers to the Internal Revenue Service. In other words, restitution is a legal remedy that requires a criminal defendant to pay money to a victim to redress the victim's loss. Per the definition discussed above, the Internal Revenue Service is the victim in criminal tax cases as it is directly harmed by the defendants' conduct.

However, under current law, the amount of restitution is not necessarily equal to the amount of income taxes owed under the Internal Revenue Code. Rather, restitution is an amount decided upon and ordered by the District Court, which potentially exceeds the amount that redresses the victim's loss and returns the victim to status quo. As such, the current law permits a situation where the criminal restitution to be paid to the IRS significantly exceeds the defendant's actual civil tax liability under Title 26.

III. PROBLEMS ADDRESSED

A. Affected Taxpayers

The current law affects all criminal defendants in tax cases who are required to pay restitution because of a District Court order. In theory, under present law, every criminal tax defendant is subject to "over collection" if the amount of criminal tax restitution exceeds their Title 26 civil tax liability. This proposal allows the IRS to be made whole while also avoiding instances of "double collecting" and "triple collecting".

B. Over Collecting on the True Amount Owed by Taxpayers

In theory, the amount of court-ordered restitution should not be greater than the amount of tax (including interest and penalties) owed by the taxpayer. Sometimes, however, the amount of the Title 26 income taxes owed (including interest and penalties) end up being significantly less than the amount of tax restitution ordered by the District Court.[15]

As an illustration, the taxpayer in *Russell v.* Commissioner, T.C. Memo 2019-146 was criminally convicted for income tax evasion and was ordered to pay $1,158,941.99 in restitution to the IRS for the year 2000.[16] However, the defendant was only assessed $242,716 (including the civil fraud penalty and additions to tax) in relation to the underreporting of income on his 2000 tax return. Despite the stark discrepancy between the tax loss to the government and the court-ordered restitution, the taxpayer had no ability to seek a reduction in the court-ordered restitution, even though the actual tax liability was significantly less than the amount of court-ordered restitution.[17] Thus, in situations similar to that in *Russell*, taxpayers are essentially "stuck" with a restitution order that exceeds the amount they ever owed the IRS.

The fixing of a criminal restitution amount should not be treated as a substitute for determining a taxpayer's civil liability following the resolution of the criminal case. However, in cases where the amount of criminal restitution exceeds the civil tax liability, it is the DOJ's (and possibly the IRS') willingness to pursue collection of unpaid criminal restitution from the ordered restitution, and not the IRS' civil tax assessments under Title 26, that effectively determines the amounts which can be collected. Therefore, an administrative remedy is needed to facilitate the goal of making the IRS whole without collecting more than is properly owed.

IV. PROPOSED ADMINISTRATIVE REMEDY

It is important to note that there is a legal basis for establishing an administrative remedy for situations where criminal restitution exceeds the amount actually owed under Title 26. 18 U.S.C. § 3664 (g)(1) provides that "[n]o victim shall be required to participate in any phase of a restitution order." Based on this language, once the Internal Revenue Service has acknowledged that a criminal defendant taxpayer paid all amounts it is owed under Title 26, the IRS can elect to not receive further restitution payments from the Department of Justice.

Case law has established civil and tax penalties determined by the IRS are independent of the criminal restitution ordered by a federal District Court in an earlier criminal case.[18] While Congress did not allow a District Court to amend a final restitution order, Congress has never endorsed a system under which the IRS is permitted to collect more than it is owed. Thus, where the administrative or judicial process of determining the amount of taxes (including interest and penalties) owed results in the taxpayer owing less in taxes than the amount of criminal restitution ordered by the District Court, allowing the government to collect restitution that exceeds the total amount of related civil taxes, interest, and penalties is at odds with the fundamental purposes of the Internal Revenue Code.

In line with the goal of determining and collecting the proper amount of taxes owed, the proposed administrative procedure would permit taxpayers to demonstrate to the IRS that, notwithstanding the fact that some portion of criminal restitution remains unpaid, all civil tax liabilities to which the criminal restitution relates (including interest and penalties) have been paid in full and to request that the IRS (1) cease all active collection efforts with respect to the unpaid portion of the restitution-based assessments under 26 U.S.C. § 6201(a)(4)(c) and (2) notify DOJ that the IRS no longer wishes to participate in the collection of the restitution order pursuant to 18 U.S.C. § 3664(g)(1). The procedures for making such a request can be established by issuing a Revenue Procedure. The Revenue Procedure would set forth where the request should be sent and what information and documents should be submitted to the IRS.

The IRS would then determine whether it agrees with the taxpayer and, if it does agree, the IRS would notify the DOJ that it no longer wishes to receive restitution payments because the underlying civil tax liability has been paid in full. The right for victims, such as the IRS, to elect not to receive restitution payments is undisputed.[19] The DOJ upon receipt of the notification, would determine whether it agrees with the IRS and taxpayer. If the DOJ were in agreement with these findings, the IRS (and, presumably, the DOJ) would cease all active collection measures to collect the remaining unpaid restitution. While the criminal restitution obligation would not legally cease to exist until the 20-year period for collection of restitution has expired, the cessation of active collection measures to collect on the restitution obligation would be consistent with the fact that the civil tax obligation to which the criminal restitution relates has been fully paid.

This proposal aims to prevent situations in which taxpayers are "stuck" with a restitution order that exceeds the actual tax liability to which the restitution order relates. Thus, this new procedure would permit taxpayers to avoid having to pay taxes, interest, and penalties to the IRS where it is determined (as the result of a civil audit), or a final court judgment, that the total amount owed for Title 26 taxes is less than the amount of the related criminal restitution ordered by the District Court for a given tax period.

A. Feasibility of the Proposal

Every day, the IRS conducts civil tax audits with the goal of assessing the proper amount of taxes owed by taxes. Moreover, in the aftermath of civil tax audits, taxpayers can dispute the amount of the asserted income tax deficiencies through normal means, including litigation in the Tax Court. This even holds true in criminal tax cases. The IRS has the right to conduct a civil examination of the tax returns for the years related to the criminal investigation to determine whether the correct amount of tax owed under the Internal Revenue Code differs from the criminal restitution. As such, the IRS currently conducts these administrative procedures of its own volition.[20] In these audits, all items affecting the tax return(s) in question are subject to adjustments. It is not unusual or out of the ordinary for adjustments to be made in a civil audit following the conclusion of the criminal tax case.

Last, taxpayers would have the burden to prove that the criminal restitution amount exceeds the taxes owed under Title 26 and that Title 26 liabilities have been paid in full. Until a taxpayer comes forward with a request under the new Revenue Procedure, the IRS faxes no administrative burden whatsoever. The IRS would not have to independently monitor cases to determine whether all Title 26 liabilities have been fully paid while Title 18 court-ordered restitution remains unpaid.

Thus, as the IRS would only have to deal with legitimate requests from taxpayers who provide the necessary information, the administrative procedure proposed by the authors is feasible.

B. Collateral Consequences

The authors do not anticipate any meaningful adverse collateral consequences to the IRS or the DOJ if this procedure is adopted. While the IRS will have some additional work in responding to requests submitted under the new Revenue Procedure, the IRS will have less work to do in collecting the restitution-based assessment if the IRS grants the taxpayer's request.

The adoption of these procedures would assist the IRS in achieving its goal of assessing and collecting only the correct amount of tax. In addition, there may be less pressure on criminal practitioners who might otherwise feel obligated to turn a District Court restitution hearing into a lengthy trial over the merits of the taxpayers' civil tax liability.

Thus, adoption of the proposed remedy would allow the IRS to remedy any unfairness resulting to individual taxpayers without requiring the IRS to bear a significant burden.

VI. CONCLUSION

Under existing law, taxpayers may not seek a reduction of court-ordered criminal restitution for which there is final court order. To align with the purpose of ensuring that the IRS does not collect more than what is owed by a taxpayer, this paper proposes an administrative procedure for dealing with situations where taxpayers are “stuck” with a restitution order that exceeds the amount they owe the IRS. The purpose of criminal restitution is for criminal defendants to make the victims “whole” by redressing their loss. That purpose is not furthered by requiring criminally convicted taxpayers to pay more to the IRS than they actually owe.

This new procedure will permit taxpayers to seek redress in situations where the restitution amount exceeds the total civil tax liability to which the restitution relates. Under this procedure, taxpayers would be required to provide to the IRS proof that the taxpayer has paid all amounts owed under Title 26 for a particular tax period along with proof that the excessive portion of the taxpayer's criminal restitution obligation remains unpaid.

As the burden would be placed upon the taxpayer to both submit a request and to submit evidence to substantiate their request, the IRS would not face a significant administrative burden under this proposed procedure. The result would be a system that avoids potentially significant unfairness when there is a disparity between the amount of restitution ordered by the District Court and the total civil tax liability to which the restitution relates.

The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Taxation Section.

FOOTNOTES

[1]All times East Coast.

[2]This event will be hosted by the IRS Office of Chief Counsel using ZoomGov. https://irs.zoomgov.com/j/1604748040?pwd=eTN0NnRxOFI2cmI3NnZEUmJLSzVtUT09 Meeting ID: 160 474 8040; Passcode: 0s@QeY02

[3]Individual sessions available for respective papers.

[1]The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association.

[2]Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

[3]Delegation Paper does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

[4]Delegation Paper does not constitute tax, legal, or other advice from Deloitte Tax LLP, which assumes no responsibility with respect to assessing or advising the reader as to tax, legal, or other consequences arising from the reader's particular situation.

[5]I.R.C. § 871(b)(1)

[6]Treas. Reg. § 301.6114-1(a)(1)

[7]I.R.C. § 3402(a)(1)

[8]I.R.C. §§ 6601, 6651, 6654

[9]I.R.C. § 6051(a)(2)

[10]I.R.C. § 3401(d)

[11]Treas. Reg. §31.6011(b)-2(c)

[12]I.R.C. § 6721(a)

[13]I.R.C. § 871(b)(1)

[14]See CAL. REV. & TAX CODE § 17951; CAL. CODE OF REGS., TIT. 18, §§ 17951-1, 17951-2, 17951-5; Container Corp. v. Franchise Tax Bd., 463

US 159, 196-197 (1983); Appeal of M.T. de Mey van Streefkerk, 85-SBE-135, Nov. 6, 1985; FTB Publication 1031 (2019) at 10; FTB Publication 1001 (2019) at 4; FTB Residency and Sourcing Technical Manual, § 3720.

[15]A.B. 2660, 2019-2020 REG. SESS. (CAL. 2020)

[16]See A.B. 2660, 2019-2020 REG. SESS. (CAL. 2020), LEGISLATIVE COUNSEL'S DIGEST; see A.B. 2660 §§ 2 and 3 (adding Cal. Rev. & Tax Code § 18537 and amending Cal. Rev. & Tax Code § 18624 to add new subsections (f) and (g)).

[17]See A.B. 2660 § 2 (new Cal. Rev. & Tax Code § 18537(a)).

[18]See A.B. 2660 § 2 (new Cal. Rev. & Tax Code § 18537(c)).

[19]See A.B. 2660 § 1 (new Cal. Rev. & Tax Code § 17132.1(a)).

[1]The comments contained in this paper are the individual views of the author who prepared them, and do not represent the position of the California Lawyers Association or its Taxation

Section. This paper is based on a similar one presented at the California Lawyers Association Tax Section's 2018 Sacramento Delegation project and written up in the *California Tax Lawyer*, Jan. 2020, Vol. 28, No. 3, in an article entitled, "Suggestions for Improved Transparency and Accountability for California Taxes Via Improved Tax and Budget Literacy."

[2]Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

[3]A 2015 survey by NerdWallet concluded that Americans earn an "F" in their understanding (or lack thereof) on personal finances related to income taxes. Questions asked in the survey included use of IRAs and other retirement plans, 529 education plans, what qualifies as a charitable contribution deduction. NerdWallet, "Americans Failing on Basic Income Tax Knowledge," Feb. 24, 2015; https://www.nerdwallet.com/blog/taxes/americans-failing-basic-tax-knowledge/.

[4]This statement refers to the federal Taxpayer Bill of Rights available at IRC section 7508(a)(3) and https://www.irs.gov/taxpayer-bill-of-rights.

[5]AICPA, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals, 2017; https://www.aicpa.org/ADVOCACY/TAX/downloadabledocuments/tax-policy-concept-statement-no-1-global.pdf.

[6]GAO, Understanding the Tax Reform Debate: Background, Criteria, & Questions, GAO-05-1009SP, Sept. 2005, pages 4-5; https://www.gao.gov/assets/210/202725.pdf.

[7]AICPA, *supra*, p. 13.

[8]GAO, *supra*, p. 1.

[9]IRS, Taxpayer Bill of Rights; https://www.irs.gov/taxpayer-bill-of-rights.

[10]Congressional Budget Office, *An Overview of the Economic Outlook: 2021 to 2031*, Feb. 2021; https://www.cbo.gov/publication/56970. The appendix of this report focuses on tax expenditures, noting that for fiscal year 2021, the "value" of over 200 individual and corporate

income and payroll tax expenditures totaled $1.8 trillion which exceeds estimated discretionary spending for that year.

[11]Campaign to Cut Waste, Online Tax Receipt; https://obamawhitehouse.archives.gov/21stcenturygov/tools/tax-receipt. This operated similarly to the Franchise Tax Board receipt. The website asked for the taxpayer's income, Social Security and Medicare taxes and then produced a “receipt” showing the percentage and dollar amount that was used within broad categories of government direct spending.

[12]FTB, 2017 Income Tax Receipt; https://web.archive.org/web/20181202012434/https://www.ftb.ca.gov/individuals/taxreceipt/index.shtml.

[13]Transparent.utah.gov provides a taxpayer receipt that requires users to enter their state income tax and state sales tax information. Like the FTB receipt, the Utah receipt shows how the dollars were used among broad expenditure categories. The site appears not to be maintained though as most links go to a website Utah.gov/transparency/ that do not work. See https://www.utah.gov/taxpayer-receipt/.

[14]Texas Comptroller, Tax Exemptions & Tax Incidence, Dec. 2020, page 64; https://comptroller.texas.gov/transparency/reports/tax-exemptions-and-incidence/2020/96-463.pdf. The Comptroller also reports a “Suits Index” as part of the tax incidence of each tax. This index shows ranges of +1.0 (progressive) to -1.0 (regressive tax), with 0.0 indicating a “perfectly proportional” tax for all income quintiles (see page 44 of the report).

[15]For more on taxpayer receipts, see Nellen, “Transparency for Individual Taxes,” *AICPA Tax Insider*, April 14, 2016; https://www.thetaxadviser.com/newsletters/2016/apr/transparency-for-individual-taxes.html.

[16]This bill has been introduced before, such as H.R. 6458 (111th Congress). The taxpayer receipt called for in this bill includes a table of the ten most costly tax expenditures.

[17]California State Board of Education, California Common Core State Standards — Mathematics, p. 46; https://www.cde.ca.gov/be/st/ss/documents/ccssmathstandardaug2013.pdf.

[18]Louisiana Dept. of Education, Grade 6 Math Practice Test 2013-2014, p. 13, problem 22; https://www.louisianabelieves.com/docs/assessment/practice-test-math-grade-6.pdf.

[19]IRS, Understanding Taxes; https://apps.irs.gov/app/understandingTaxes/teacher/index.jsp.

[20]City of Philadelphia, Video: Taxpayer Appreciation Day, March 2, 2020; https://www.phila.gov/2020-03-02-video-taxpayer-appreciation-day/. The event appears to be held at the Department of Revenue office location.

[21]OECD, *Building Tax Culture, Compliance and Citizenship: A Global Source Book on Taxpayer Education*, 2015.

[22]OECD, *supra*, p. 143.

[23]OECD, *supra*, pages 84-86.

[24]OECD, *supra*, pages 153-154.

[25]Additional reasons for such a day are noted in the author's blog: "How about making April 30th Celebrating Taxpayers Day? (4/16/19); http://21stcenturytaxation.blogspot.com/2019/04/how-about-making-april-30-celebrating.html.

[26]IRS, The Tax Gap; https://www.irs.gov/newsroom/the-tax-gap. At an April 13, 2021 hearing before the Senate Finance Committee, IRS Commissioner Rettig estimated that the annual tax gap might be as high as $1 trillion. This statement was made about 43 minutes into the hearing in response to a question from Senator Wyden. See hearing video at https://www.finance.senate.gov/hearings/the-2021-filing-season-and-21st-century-irs.

[27]Thank you to taxpayers seem uncommon in the U.S. However, IRS Commissioner Rettig released a message to taxpayers on April 12, 2019 that included thanking taxpayers for filing and paying their taxes and reminding them of the importance of this civic duty. IRS, "IRS Commissioner Chuck Rettig's Message to taxpayers: Thank you for filing," April 12, 2019; https://www.irs.gov/newsroom/irs-commissioner-chuck-rettigs-message-to-taxpayers-thank-you-for-filing.

[1]Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been specifically engaged by a client to participate on this project.

[2]Kate Barton, *How Millennials — and Gen Z — Will Transform Tax*, BLOOMBERG TAX, 2020, https://news.bloombergtax.com/financial-accounting/how-millennials-and-gen-z-will-transform-tax (last visited Feb 23, 2021).

[3]*TAXATION WITHOUT REPRESENTATION*, INVESTOPEDIA, https://www.investopedia.com/terms/t/tax_without_representation.asp (last visited Feb 23, 2021)

[4]U.S. Census Bureau, RESIDENT POPULATION IN THE UNITED STATES IN 2019, BY GENERATION (2019), https://www.statista.com/statistics/797321/us-population-by-generation/ (last visited Feb 23, 2021).

[5]Kelly Phillips Erb, *IRS Faces Huge Backlog Of Unopened Mail As Workforce Returns*, FORBES, 2020, https://www.forbes.com/sites/kellyphillipserb/2020/06/19/irs-faces-huge-backlog-of-unopened-mail-as-workforce-returns/ (last visited Feb 23, 2021).

[6]Ventry, Dennis J., *The Failed Free File Program Should Be Reformed, Not Codified*, July 16, 2018, UC Davis Legal Studies Research Paper, Volume 160, Number 3, p. 317 (last visited Apr 19, 2021).

[7]*Ibid*.

[8]Free File: Do your Federal Taxes for Free: Internal Revenue Service, FREE FILE: DO YOUR FEDERAL TAXES FOR FREE | INTERNAL REVENUE SERVICE, https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free (last visited Mar 2, 2021).

[9]Taxpayer Bill of Rights, INTERNAL REVENUE SERVICE (2020), https://www.irs.gov/taxpayer-bill-of-rights (last visited Apr 28, 2021)

[10]Lauren Diaz, *Adults will never learn how to do taxes if schools don't teach them*, DAILY TITAN, February 27, 2018, https://dailytitan.com/opinion/adults-will-never-learn-how-to-do-taxes-if-schools-don-t-teach-them/(last visited Feb 23, 2021).

[11]Schuyler, Shannon, *Bridging the Financial Literacy Gap: Empowering Teachers to Support the next Generation,* Price Waterhouse Cooper, 2016, www.pwc.com/us/en/about-us/corporate-responsibility/library/pwc-financial-education-report.html (last visited Apr 30, 2021).

[12]Charles Schwab*, Teens and Money Survey Findings: 2011,* Schwab Moneywise: Studies & Findings, 2011, www.schwabmoneywise.com/public/moneywise/tools_resources/studies_findings (last visited Apr 30, 2021).

[13]HSLDA February 28 et al., ELECTIVES: THE ZING IN YOUR HIGH SCHOOL PLAN HSLDA (2020), https://hslda.org/post/electives-the-zing-in-your-high-school-plan (last visited Feb 23, 2021).

[14]Julie Underwood, *Under the Law: The legal balancing act over public school curriculum*, 100 PHI DELTA KAPPAN 74–75 (2019).

[15]Understanding Taxes Teacher, INTERNAL REVENUE SERVICE (2021), https://apps.irs.gov/app/understandingTaxes/teacher/index.jsp (last visited Apr 28, 2021).

[16]IRS Modernization, INTERNAL REVENUE SERVICE (2020), https://www.irs.gov/newsroom/irs-modernization (last visited Apr 19, 2021).

[17]IRS Modernization Plan provides plan to improve services for taxpayers, tax community, INTERNAL REVENUE SERVICE (2019), https://www.irs.gov/newsroom/irs-modernization-plan-provides-plan-to-improve-services-for-taxpayers-tax-community (last visited Feb 23, 2021).

[18]Taxpayer Advocate Service 2020 Report to Congress, INTERNAL REVENUE SERVICE (2021) https://www.taxpayeradvocate.irs.gov/wpcontent/uploads/2021/01/ARC20_MostSeriousProblems.pdf (last visited Apr 5, 2021).

[19]Richard Rubin, *Biden to Seek $80 Billion to Bolster IRS, Tax Enforcement,* THE WALL STREET JOURNAL https://www.wsj.com/articles/biden-to-seek-80-billion-to-bolster-irs-tax-enforcement-11619539465?mod=article_inline (last visited Apr 28, 2021).

[20]IRS2GO, APP STORE PREVIEW, https://apps.apple.com/us/app/irs2go/id414113282 (last visited Mar 2, 2021).

[21]FTB Mobile, APP STORE PREVIEW, https://apps.apple.com/us/app/ftb-mobile/id1272359471 (last visited Mar 2, 2021).

[22]Internal Revenue Service, https://www.irs.gov/ita-index-search?search=filing+status (last visited Mar 2, 2021).

[23]Julianna Lopez, Self-Employed? Everything You Need to Know About Taxes (Oct 19, 2020), https://www.businessnewsdaily.com/9315-self-employed-tax-guide.html, (last visited Apr 18, 2021).

[24]Financially Responsible Gen Z Not Tax-Savvy., H&R BLOCK (2020), https://www.hrblock.com/tax-center/wp-content/uploads/2020/01/HR-Block-Gen-Z-Survey-Report-1.pdf (last visited Feb 23, 2021).

[25]*Ibid.*

[26]*Ibid*.

[27]*Ibid*.

[28]U.S. Census Bureau, RESIDENT POPULATION IN THE UNITED STATES IN 2019, BY GENERATION (2019), https://www.statista.com/statistics/797321/us-population-by-generation/ (last visited Feb 23, 2021).

[29]*Tax Filing: Actions Needed to Address Processing Delays and Risks to the 2021 Filing Season,* GAO@100 https://www.gao.gov/products/gao-21-251 (last visited Apr 27, 2021).

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[34] *Tax Administration: Alternative Filing Systems,* GAO@100 https://www.gao.gov/products/ggd-97-6 (last visited Apr 28, 2021).

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[37] Ashley Hanley, SURVEY FINDS 1 IN 4 AMERICANS DON'T UNDERSTAND HOW TAXES ARE DETERMINED, KTOE (2020), http://ktoe.com/2020/02/27/survey-finds-1-in-4-americans-dont-understand-how-taxes-are-determined/ (last visited Feb 23, 2021).

[38] Shawn M Carter, 90% OF AMERICANS COULDN'T ANSWER THIS STRAIGHTFORWARD TAX QUESTION CNBC (2019), https://www.cnbc.com/2019/03/19/90-percent-of-americans-couldnt-answer-this-straightforward-tax-question.html (last visited Feb 23, 2021).

[39] Steve Alder, *57% Rely on Multi-Factor Authentication to Improve Security but MFA is Not Infallible*, HIPAA JOURNAL (2019), https://www.hipaajournal.com/57-rely-on-multi-factor-authentication-to-improve-security-but-mfa-is-not-infallible/ (last visited Feb 23, 2021).

[40] *Ibid*.

[41] Statista Research Department, MOBILE BANKING IN THE U.S. — STATISTICS & FACTS (2021), https://www.statista.com/topics/2614/mobile-banking/ (last visited Feb 23, 2021).

[42]Victor Chebyshev, MOBILE MALWARE EVOLUTION 2019 SECURELIST (2020), https://securelist.com/mobile-malware-evolution-2019/ (last visited Feb 23, 2021).

[43]Malware Statistics & Trends Report: AV-TEST, AV-TEST | THE INDEPENDENT IT-SECURITY INSTITUTE (2021), https://www.av-test.org/en/statistics/malware/ (last visited Feb 23, 2021).

[44]NCC Staff, BENJAMIN FRANKLIN'S LAST GREAT QUOTE AND THE CONSTITUTION NATIONAL CONSTITUTION CENTER — CONSTITUTIONCENTER.ORG (2020), https://constitutioncenter.org/blog/benjamin-franklins-last-great-quote-and-the-constitution (last visited Mar 2, 2021).

[1]The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association, the Taxation Section, or Deloitte Tax LLP.

[2]Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper. No author has a direct personal or financial interest in the issue addressed in this paper.

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[4]All “section” references herein are to the Internal Revenue Code unless otherwise provided.

[5]Congress enacted Public Law No. 116-260 on December 27, 2020, which extends the expiration of IRC § 108(a)(1)(E) to January 1, 2026.

[6]*Babin v. C.I.R*, 23 F.3d 1032 (T.C. 1984)

[7]IRC § 61(a)(12) (2013).

[8]Martin McMahon and Daniel Simmons, *A Field Guide to Cancellation of Debt Income*, 63 TAX LAW. 415 (2010).

[9]Comm'r v. Tufts, 461 U.S. 300, 307 (1983).

[10]*Id.*

[11]*Id.*

[12]IRC § 1012 (2013); *Woodsam Assocs. v. Comm'r*, 198 F.2d 357, 359 (2d Cir. 1952).

[13]McMahon & Simmons, *supra* note 29, at 418; *see also* Crane v. Comm'r, 331 U.S. 1 (1947);

[14]*Id.* (citing *Crane v. Comm'r*, 331 U.S. 1, 11 (1947); *Tufts*, 461 U.S. at 308-09; *Brons Hotels, Inc. v. Comm'r*, 34 B.T.A. 376, 381 (1936)).

[15]A realization event occurs under IRC section 1001 when there is an exchange where the taxpayer receives money or other property in the transaction. See *Helvering v. Bruun*, 309 U.S. 461 (1940). The Supreme Court said a "gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction." *Id.* at 469.

[16]McMahon & Simmons, *supra* note 29, at 418-19.

[17]There are other theories regarding CODI, including the transactional approach, however it is the authors' opinion that the theories discussed in this proposal are most relevant to the current inquiry.

[18]Section 61(a)(12) reflects the codification of the Supreme Court's decision in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). IRC § 61(a)(12) (2013). There the Court held that the taxpayer has realized a clear gain from the offset of their obligation to repay once their bonds were extinguished. *Kirby*, 284 U.S. at 2.

[19]IRC § 61(a)(12) (2013).

[20]*See generally* IRC § 108 (2013).

[21]*See* H.R. Rep. No. 110-356, at 4-5 (2007).

[22]*Id.* ("The recent unrest in the housing market has prompted concern over the tax consequences associated with discharges of indebtedness in connection with restructuring acquisition indebtedness and home foreclosures . . . The Committee believes that where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure, that it is inappropriate to treat discharges of acquisition indebtedness as income.").

[23]IRC § 108(a)(1)(E) (2013). Pursuant to section 108(a)(2)(C) the qualified principal residence indebtedness exclusion applies over the insolvency exclusion, unless the taxpayer elects otherwise.

[24]IRC § 163(h)(3)(B) (2013); IRC §108(h)(2).

[25]Treas. Reg. § 1.121-1(b)(2) provides a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence. Treas. Reg. § 1.121-1(b)(2) No particular factor is conclusive.

[26]IRC § 108(h)(2) (2013); It should be noted that the Tax Cuts and Jobs Act of 2017 ("TCJA") reduces the limit to $750,000 (or $375,000 if you are married filing separately) (see Pub. L. 115–97, 131 Stat. 2054 (2017).

[27]Section 121 imposes a $250,000 limit on gains excludable from gross income pursuant to the sale of a principal residence (or $500,000 for certain married couples filing jointly) (IRC § 121(b) (2013)).

[28]It should be noted that the TCJA disqualified "home equity indebtedness" as "qualified residence interest" for purposes of Section 163 for taxable years 2018 through 2025. Pub. L. 115–97, 131 Stat. 2054 (2017).

[29]IRC § 108(h)(3) (2013); *see also*, McMahon & Simmons, *supra*, at 467.

[30]IRC § 108(a)(1)(E) (2013). This basis reduction will not necessarily result in any subsequent income recognition if, for instance, the taxpayer does not sell the residence or if the gain is excludable under Section 121.

[31]Unlike previous extensions that were typically one to two years in length, the most recent extension now spans an additional five years, through January 1, 2026.

[32]Neil Haggerty and Hannah Lang, *Trump Administration to halt foreclosures as pandemic worsens*, AMERICAN BANKER (Last visited February 26, 2021) https://www.americanbanker.com/news/trump-announces-foreclosure-halt-through-april-for-hud-backed-loans.

[33]Ken Thomas and Andrew Ackerman, *Biden Administration Extends Covid-19 Mortgage Relief*, THE WALL STREET JOURNAL (Last visited February 19, 2021) https://www.wsj.com/articles/biden-administration-extends-covid-19-mortgage-relief-11613485250.

[34]*Id*.

[35]Jeff Ostrowski, Foreclosures Fell to Record Low in 2020 — With a Huge Asterisk, BANKRATE (Last visited February 19, 2021) https://www.bankrate.com/mortgages/foreclosures-fell-to-record-low-in-2020/#:~:text=Properties%20with%20foreclosure%20filings%20in,was%202.23%20percent%2C%20in%202010.

[36]36. *Id.*

[37]Emily Benfer, et al., *The COVID-19 Eviction Crisis: An Estimated 30-40 Million People in America Are at Risk*, THE ASPEN INSTITUTE, (last visited February 26, 2021) https://www.aspeninstitute.org/blog-posts/the-covid-19-eviction-crisis-an-estimated-30-40-million-people-in-america-are-at-risk/.

[38]*Home Equity Reaches Record Highs: Homeowners Gained Over $1 Trillion In Equity in Q3 2020, CoreLogic Reports*, CORELOGIC PRESS RELEASE, (last visited Feb. 26, 2021) https://www.corelogic.com/news/home-equity-reaches-record-highs-homeowners-gained-over-1-trillion-in-equity-in-q3-2020-corelogic-reports.aspx.

[39]*See Prepared Remarks of Melvin L. Watt Director of FHFA*, Greenlining Institute 22nd Annual Economic Summit (May 8, 2015).

[40]Home Affordable Modification Program authorized by the Emergency Economic Stabilization Act of 2008, Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008).

[41]*See Prepared Remarks of Melvin L. Watt Director of FHFA*, Greenlining Institute 22nd Annual Economic Summit (May 8, 2015).

[42]*Id*.

[43]FHA-Home Affordable Modification Program (FHA-HAMP), Programs of HUD available at https://www.hud.gov/hudprograms/fhahamp. This program helps struggling homeowners modify their mortgage by reducing their interest rate, extending their loan term, or adding late payments to the principal mortgage balance.

[44]*See Fannie Mae Flex Modification Fact Sheet*, FANNIE MAE, (last visited Feb. 11, 2020) https://singlefamily.fanniemae.com/media/9016/display. This program allows homeowners to reduce mortgage payments by 20% and, depending on how long a homeowner is delinquent, get to a 40% front-end debt-to-income ratio, which is the percentage of gross monthly income used to make mortgage payments.

[45]According to the Case Shiller home Price Index, *S&P/Case-Shiller U.S. National Home Price Index*, FEDERAL RESERVE OF ST. LOUIS (last visited Apr. 1, 2021) https://fred.stlouisfed.org/series/ASPUS.

[46]*See S&P Homebuilders Index*, S&P DOW JONES INDICES (last visited April 1, 2021) https://us.spindices.com/indices/equity/sp-homebuilders-select-industry-index.

[47]*Data Point: 2018 Mortgage Market Activity and Trends*, CONSUMER FINANCIAL PROTECTION BUREAU (last visited Dec. 24, 2019) https://files.consumerfinance.gov/f/documents/cfpb_2018-mortgage-market-activity-trends_report.pdf; *Here Are the Top 10 Mortgage lenders of 2018*, HOUSINGWIRE (last visited Nov. 6, 2018) https://www.housingwire.com/articles/50103-here-are-the-top-10-mortgage-lenders-of-2018/; *see Is the Real Estate Market Going to Crash?,* THE BALANCE (last visited 2020) https://www.thebalance.com/is-the-real-estate-market-going-to-crash-4153139.

[48] *3 Biggest Lenders Close over Half of U.S. Mortgages*, MORTGAGE DAILY (last visited 2021) https://www.prnewswire.com/news-releases/3-biggest-lenders-close-over-half-of-us-mortgages-116219989.html

[49] *U.S. Mortgage Market Statistics:* 2018, MAGNIFYMONEY (last visited Feb. 10, 2020) https://www.magnifymoney.com/blog/mortgage/u-s-mortgage-market-statistics-2018/ (citing Fannie Mae and Freddie Mac).

[50] U.S. Mortgage Market Statistics: 2020, LENDING TREE (last visited April 1, 2021) https://www.lendingtree.com/home/mortgage/u-s-mortgage-market-statistics/.

[51] *See e.g*. IRC § 163(h)(2)(D) (2018).

[52] IRC § 108(a)(1)(A) (2013).

[53] IRC § 108(a)(1)(B) (2013). Insolvency is defined by section 108(d)(3) as "the excess of liabilities over the fair market value of assets." IRC § 108(d)(3) (2013). With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

[54] *Babin v. Comm'r*, 23 F.3d 1032, 1035 (6th Cir. 1984); *see* Lakeland Grocery Co., 36 B.T.A. at 292.

[55] *Id*.

[56] The purchase price reduction exception is unavailable when the reduction occurs due to bankruptcy or insolvency.

[57] IRC § 108(e)(5) (2013).

[58] McMahon & Simmons, *supra* note 29, at 452.

[59] Banks are now encouraged to work with homeowners to make efforts in reducing eligible participants mortgage obligations; see *Principal Reduction Alternative (PRA)*, MAKING HOME AFFORDABLE http://www.makinghomeaffordable.gov/programs/lower-

payments/Pages/pra.aspx (last updated March 21, 2013, 10:52 A.M.) ("HUD-approved housing counselors will help [taxpayers] understand [their] options, design a plan to suit [their] individual situation, and prepare [their] application[s]. Research shows that homeowners who work with housing experts . . . are more successful and have better long-term outcomes.").

[60]*See generally* 2007 Tax Notes Today 194-1 (2013) (statement of Rep. Charles Rangel, Chairman of H. Comm. on Ways and Means).

[61]2007 Tax Notes Today 194-1 (statement of Rep. Charles Rangel, Chairman of H. Comm. on Ways and Means).

[62]*Id* (citing MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R41596, SELECT TAX BENEFITS FOR HOMEOWNERS: ANALYSIS AND OPTIONS.

[63]*Id*; *see also* IRC § 163(h) (2013); Roger Lowenstein, *Who needs the Mortgage-Interest Deduction?*, NY Times (March 5, 2006) http://www.nytimes.com/2006/03/05/magazine/305deduction.1.html.

[64]26 U.S.C.S. § 164(3).

[65]26 U.S.C.S. § 163(a).

[66]Two examples include a deduction for expenses for a home office per 26 U.S.C. § 280A(c) and tax credits for buying and installing renewable energy sources in one's home. 26 U.S.C. § 48.

[67]Pub.L. 110–142, 121 Stat. 1803 (2007); Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008).

[68]Pub.L. 110–142, 121 Stat. 1803 (2007); Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008); Pub.L. 112-240, 126 Stat. 2313 (2012); Pub.L. 113-295, 128 Stat. 4010.(2014); Pub.L. 114-113, 129 Stat. 2242 (2016); Pub.L. 115-123, 132 Stat. 64 (2018); Pub. L. 116-94, 133 Stat. 3227 (2019); Pub. L. 116-260, 134 Stat. 1182 (2020).

[69]The authors acknowledge that, to the extent the property is passed intestate, that there may be an intergenerational step-up in basis; however, this (1) does not apply in all instances and (2) goes beyond the scope of this Article.

[70]Pub.L. 110–142, 121 Stat. 1803 (2007); Pub.L. 110–34

[1]This proposal is based on a section of a Report of the American College of Trust and Estate Counsel ("ACTEC") Tax Policy Study Committee Grantor Trust Project, of which Mr. Kinyon is the principal author.

[2]That ruling declined to follow *Rothstein v. United States*, 735 F.2d 704 (2d. Cir. 1984), and held that a sale or exchange of assets between a grantor and his or her grantor trust was not a sale or exchange for federal income tax purposes.

[3]At a minimum, if property is transferred to an UTMA custodianship or an IRC Section 2503(c) or 2642(c)(2) trust, or is otherwise vested in another individual, it should be treated as a completed gift by the grantor for both income and gift tax purposes, and the property should not be included in the grantor's gross estate for estate tax purposes, even if the grantor is acting as the custodian or trustee and can control the timing of the beneficiary's enjoyment of the property, whether limited by an ascertainable standard of not. Furthermore, property transferred (i) to a "family-pot trust" in which the only beneficiaries are the issue of the grantor or another individual, and maybe also the grantor's ancestors and/or qualified charitable organizations, or (ii) to a "dynasty trust" for the primary benefit of a child of the grantor or another individual, of which the child's issue may be secondary beneficiaries, also should be treated as a completed gift by the grantor for both income and gift tax purposes, and not be included in his or her gross estate for estate tax purposes, even if the grantor is acting as the trustee and has the power to determine which beneficiaries will receive the income and/or principal of the trust and how much, whether limited by an ascertainable standard or not.

[4]Retaining the rule under IRC Section 2037 would be an exception to the general rule referred to above that property transferred in trust resulting in a completed gift for gift tax purposes generally should not result in the trust property later being included in the grantor's gross estate for estate tax purposes. However, an appropriate exception to that principle might be where a transfer in trust is treated as a completed gift for gift tax purposes because neither the grantor nor his or her spouse has a significant beneficial interest in the trust at the time, but on the date of the grantor's death the grantor and/or his or spouse does have a significant beneficial interest in the trust. For example, if an existing reversionary interest of a

"*Clifford*" trust has increased in value, or a trust protector or other person, or the holder of a special power of appointment, has added (or has the power to add) the grantor and/or his or her spouse as a beneficiary or beneficiaries of the trust, or to a class of beneficiaries designated to receive trust income or corpus (*cf.* the last sentence of IRC Section 674(b)(5)), making his, her, or their beneficial interest(s) in the trust significant or giving him, her, or them the ability to deal with the trust on other than an arms-length basis, the trust property probably should be included in the grantor's gross estate, with an appropriate credit allowed for any gift tax paid and/or unified credit used with respect to property remaining in the trust at that time.

[5]Because of the harsh income tax liability with respect to Completed Gift Trusts, the beneficiary and the trustee of certain trusts, such as (1) an IRC Section 2503(c), a 2642(c)(2) trust, a terminating trust following the terminating event, or any other trust of which one or more beneficiaries have vested interests, might be allowed to elect to have the trust's undistributed taxable income taxed at the vested beneficiary's marginal income tax rates; and (2) a "family-pot trust" or "dynasty trust," described in footnote 2, above, also might be allowed to elect to have the trust's undistributed taxable income taxed at the marginal income tax rates of (a) the issue of the grantor or other individual, determined on a per stirpes basis, or (b) the child of the grantor or other individual who is the primary beneficiary, respectively, similar to the "kiddie tax" under IRC Section 1(g).

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[2]Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this project.

[3]18 U.S.C. § 3663(a)(3).

[4]18 U.S.C. § 3664(o); *United States v. Puentes*, 803 F.3d 597, 607 (11th Cir. 2015).

[5]18 U.S.C. § 3612.

[6]26 U.S.C. § 6201(a)(4)(C).

[7] *Carpenter v. Commissioner*, 152 T.C. 202 (2019).

[8] *Klein v. Commissioner of Internal Revenue*, 149 T.C. No. 15 (2017); *Reynolds v. Commissioner of*

[9] Where the Title 26 tax liability to which the restitution relates exceeds the amount of the restitution and restitution-based assessment, IRS can continue to collect the unpaid tax liability. Nothing in this proposal is intended to limit in any way the ability of the IRS to pursue collection action in that situation.

[10] 26 U.S.C. § 6201(a)(4)(C).

[11] *Carpenter v. Commissioner*, *supra,* 152 T.C. at 220.

[12] 18 U.S.C. § 3663A(a)(1).

[13] *Id*.

[14] 26 U.S.C. § 6201(a)(4)(A).

[15] *Russell v. Commissioner*, T.C. Memo 2019-146 (2019).

[16] *Id*. at 6.

[17] *United States v. Grant*, 715 F.3d 552, 558 (4th Cir. 2013); 18 U.S.C. § 3664(o).

[18] *Morse* v. Commissioner, 419 F.3d 829, 833-835 (8th Cir. 2005); *Laciny v. Commissioner*, T.C. Memo 2013-107, 1, 13; *Cantrell v. Commissioner*, T.C. Memo 2017-170, 1, 17-18.

[19] *United States v. Speakman*, 594 F.3d 1165, 1177 (2010); 18 U.S.C. § 3664(g)(1).

[20] *Dung T. Le v. Commissioner*, T.C. Memo 2020-27, 1, 22 (2020); *Catlett v. Commissioner*, T.C. Memo 2019-86, 1, 12 (2019).

END FOOTNOTES

DOCUMENT ATTRIBUTES

CODE SECTIONS	SEC. 108 INCOME FROM DISCHARGE OF INDEBTEDNESS SEC. 671 TRUST INCOME, DEDUCTIONS, AND CREDITS ATTRIBUTABLE TO GRANTORS AND OTHERS AS SUBSTANTIAL OWNERS
JURISDICTIONS	UNITED STATES
SUBJECT AREAS / TAX TOPICS	CANCELLATION OF DEBT INCOME COMPLIANCE INFORMATION REPORTING PRACTICE AND PROCEDURE TRUSTS AND ESTATES TAXATION
INSTITUTIONAL AUTHORS	CALIFORNIA LAWYERS ASSOCIATION
TAX ANALYSTS DOCUMENT NUMBER	DOC 2021-24989
TAX ANALYSTS ELECTRONIC CITATION	2021 TNTF 120-24