JANUARY 28, 2021

# U.S. Tax Laws: A Review of 2020 and a Look Ahead to 2021

Authors: Peter Glicklich, Gregg M. Benson and Heath Martin

## Review of U.S. Tax Developments in 2020

At the end of 2019, most U.S. tax practitioners expected that the most important U.S. tax developments in 2020 would cluster around two topics. First, the IRS was expected to continue issuing guidance under the monumental tax reform legislation enacted at the end of 2017, the *Tax Cuts and Jobs Act* (TCJA). Second, the presidential candidates were expected to propose changes to existing tax law as part of their political platforms.

Although there were significant developments in both of these areas, no one expected that the biggest tax headlines of 2020 would concern the COVID-19 pandemic and efforts by national governments to provide relief for their devastated economies. In the United States, that relief initially consisted of three legislative packages providing approximately $3 trillion worth of economic stimulus in the form of business loans, direct payments to taxpayers and other programs. Additional relief legislation was enacted at the end of December, and legislators continue to discuss further relief measures. Many of these relief provisions operate through changes in U.S. federal income tax law.

A brief review of tax developments in 2020 precedes our outlook for 2021.

### Federal Tax Legislation

In March, the U.S. Congress passed the following three major legislative packages to provide relief for persons affected by the COVID-19 pandemic:

- the *Coronavirus Preparedness and Response Supplemental Appropriations Act*, enacted on March 6, 2020;
- the *Families First Coronavirus Response Act*, enacted on March 18, 2020; and
- the *Coronavirus Aid, Relief, and Economic Security Act*, enacted on March 27, 2020 (CARES Act).

The CARES Act provided approximately $2.1 trillion in federal economic relief, mostly in the form of direct relief payments to individual taxpayers and loans to corporations and other small businesses. Some of this relief, however, came in the form of changes to a variety of tax provisions, including the relaxation of certain provisions of the TCJA.

Some significant tax-related provisions of the CARES Act are the following:

- **Section 163(j) Relaxation.** Under section 163(j),[1] as amended by the TCJA, a taxpayer's deduction for business interest expense is generally limited to 30% of the taxpayer's adjusted taxable income. The CARES Act increases that limitation to 50% for 2019 and 2020. In addition, a taxpayer may elect to use its adjusted taxable income from 2019 to determine its section 163(j) limitation for 2020, which would be useful for a taxpayer with unexpectedly low income in 2020.
- **Changes to NOL Rules.** Under the TCJA, a taxpayer's deduction for net operating losses (NOLs) is limited to 80% of the taxpayer's net income. The CARES Act suspends this limitation for tax years beginning before January 1, 2021. In addition, NOLs arising in tax years beginning after December 31, 2017, and before January 1, 2020, may be carried back for five years under the CARES Act.

- **Suspension of Limitation on Excess Business Losses.** The TCJA limited a non-corporate taxpayer's deduction for losses from a trade or business to $250,000 (indexed for inflation). Losses in excess of this limitation, referred to as "excess" business losses, become NOLs. The CARES Act suspends this limitation until tax years beginning after December 31, 2020.

The CARES Act also created the Paycheck Protection Program, which makes loans (known as PPP loans) available to small businesses to cover wage and other payroll payments, as well as certain other expenses, during the pandemic.[2] A PPP loan may be forgiven as long as the proceeds were used to pay qualifying expenses and the borrower did not lay off employees or reduce wages. The CARES Act provides that a forgiven PPP loan does not result in cancellation of indebtedness income. There was initially uncertainty whether expenses paid with a forgiven PPP loan are tax-deductible. The IRS took the position, first in May 2020 under Notice 2020-32 and then in November 2020 under Revenue Ruling 2020-27, that any expenses paid with respect to forgiven amounts of a PPP loan are not deductible. However, the *Consolidated Appropriations Act of 2021* (CA Act), which was signed into law on December 27, provides that expenses that are otherwise deductible for tax purposes will not be denied a deduction solely because such expenses were paid with forgiven PPP loan proceeds.

The IRS provided additional relief for non-U.S. individuals who were not able to leave the United States because of COVID-19-related travel restrictions, and as a result risked becoming subject to U.S. federal income tax. In Revenue Procedure 2020-20, the IRS allowed an individual to exclude from the "substantial presence test" for U.S. tax residency a single period of up to 60 consecutive days of presence in the United States starting on or after February 1, 2020, and on or before April 1, 2020, as long as the individual was present in the United States on those days because of a "COVID-19 Emergency Travel Disruption," such as cancelled flights, closed borders, lockdown orders or feeling unsafe travelling due to recommendations to implement social distancing and limit exposure to public spaces. The 60-day exclusion is also available for determining tax residency under a tax treaty.

In the final days of 2020, after months of negotiations, Congress enacted the CA Act, which among other things, provided $900 billion in additional COVID-19-related stimulus and relief to businesses, organizations and individuals. The CA Act built on certain provisions of the CARES Act by providing supplemental federal unemployment benefits of $300 per week, direct payments of $600 to individuals making up to $75,000 per year, and additional funding for forgivable PPP loans. As noted above, the CA Act clarified that expenses paid with PPP loan proceeds are deductible even if the PPP loan is forgiven. The CA Act also provided extensions for various temporary tax provisions that were expiring, including the following:

- extension of the CFC look-through rule for payments of dividends, interest, rents and royalties through 2025;
- extension of the "production tax credit" for renewable energy projects that begin construction before the end of 2021, provided, however, that the credit for qualified wind facilities for which construction begins before the end of 2021 remains reduced by 40%; and
- extension of the 26% "investment tax credit" for solar energy property when construction begins before the end of 2022 (with a 22% credit for solar facilities for which construction begins before the end of 2023, and a 10% credit for solar facilities for which construction begins after 2023).

## Federal Administrative Developments

The IRS and the Treasury Department continued their multi-year project of issuing regulatory guidance under the TCJA. By the end of 2020, almost all of the expected regulations were issued.

### 1. Finalized and Proposed Regulations Under the TCJA

During 2020, the IRS finalized several packages of regulations under the TCJA that had been proposed since the TCJA was enacted in 2017. In many cases, the IRS proposed new regulations concurrently with finalizing the previously proposed regulations. Regulatory developments under the TCJA during 2020 include the following:

- **Hybrid Entities and Transactions.** The IRS finalized regulations that had been proposed in 2018 on the TCJA's hybrid provisions. In addition, the IRS proposed several new provisions involving hybrid entities and transactions. These proposed regulations provide that certain hybrid arrangements can be subject to the anti-conduit financing rules, which allow the IRS to disregard intermediate entities that are included in a holding structure solely to obtain tax benefits. In addition, these proposed regulations provide detail on how subpart F income and "global intangible low-taxed income" (GILTI) are treated with respect to hybrid instruments.

- **Unrelated Trades or Businesses of Tax-Exempt Organizations.** The TCJA provided that a tax-exempt entity with more than one unrelated trade or business cannot use losses from one trade or business to offset income of another trade or business. The IRS proposed, and subsequently finalized, regulations on how a tax-exempt organization should delineate its trade or business activities for the purposes of this rule. These rules require a tax-exempt organization to separate its investment activities and then classify its remaining trade or business activities on the basis of a coding system published by the North American Industry Classification System (generally known as NAICS codes).
- **Like-Kind Exchanges.** The TCJA limited like-kind exchanges under section 1031 to exchanges of real property. The IRS proposed and then finalized regulations that implement this limitation. These regulations provide a definition of "real property" for the purposes of section 1031 that is similar to the definition of real property for the purposes of the REIT rules.
- **High-Tax Exceptions to GILTI and Subpart F Income.** The IRS finalized regulations providing that a taxpayer may elect to exclude certain foreign income from the GILTI calculation if that income is subject to a foreign tax rate that is more than 90% of the U.S. corporate tax rate. For the purpose of this rule, foreign tax rates are determined separately for different tested units. A "tested unit" of a "controlled foreign corporation" (CFC) generally is defined as the CFC itself, an interest in a pass-through entity held by the CFC or a branch of the CFC. At the same time, the IRS proposed regulations to conform the already-existing high-tax exception for subpart F income to the new high-tax exception for GILTI.
- **Limitation on the Deductibility of Business Interest Expense.** The IRS finalized regulations under section 163(j) that had been the subject of much speculation and anticipation since they were proposed in 2018. These regulations were generally taxpayer favourable, although tax practitioners were disappointed that the final regulations retained an 11-step process for applying the limitation to partnerships – a provision that had been criticized as excessively complex. At the same time, the IRS proposed new regulations under section 163(j), including regulations on how to apply the increase of the section 163(j) limitation to 50% (from 30%) under the CARES Act.
- **Three-Year Holding Period for Carried Interests.** The TCJA included a provision that requires a three-year holding period for the holder of a carried interest in an investment partnership to qualify for long-term capital gain treatment. The IRS proposed regulations clarifying that, even though the statute exempts corporations from this three-year holding period, that exemption does not apply to S corporations and "passive foreign investment companies" (PFICs) with respect to which a "qualified electing fund" election has been made; the regulations thus nullify a widely discussed strategy for avoiding the three-year holding period. The proposed regulations also provide detailed rules on the determination of the holding period and the computation of the amount of gain recharacterized under this provision. The IRS finalized these proposed regulations in the first few days of January 2021.

In addition to the new provisions outlined above, the IRS finalized a long list of previously proposed regulations with only minor changes. These regulations include regulations on the section 199A deduction, the "foreign derived intangible income" and GILTI deductions, the ownership attribution rules for CFCs, the base erosion and anti-abuse tax, bonus depreciation, source of income rules for property produced within the United States and sold outside the United States or vice versa, foreign tax credits, withholding on dispositions of interests in partnerships that hold ECI-generating property, and income tax accounting for advance payments and revenue recognition.

### 2. Other New Regulations

In addition to regulations providing guidance under the TCJA, the IRS also issued regulations interpreting some other provisions of the Code, including the following:

- **Section 385.** In 2016, the IRS issued complex final and proposed regulations under section 385 that recharacterize related-party debt as equity in certain circumstances. In 2020, the IRS finalized the regulations under section 385 that had been proposed in 2016. Tax practitioners were disappointed that the regulations finalized in 2020 retained a controversial provision known as the "72-month per se funding rule," even though the IRS had promised to eliminate that provision in 2019. Some commentators believe that this rule is retroactive, and therefore unconstitutional.

- **Passive Foreign Investment Companies.** The IRS issued final and proposed regulations on a variety of topics under the PFIC rules, including clarifications of how assets and income are classified as active or passive and how look-through rules are to be applied for the purpose of determining whether a non-U.S. corporation is a PFIC. The final and proposed regulations also provide guidance on how to apply the PFIC rules to insurance companies.
- **SALT Deduction Limitation.** The TCJA capped at $10,000 the deduction for state and local taxes available to individual taxpayers. In November 2020, the IRS released Notice 2020-75, which states that the IRS intends to issue regulations providing that certain pass-through businesses can claim an entity-level deduction for certain specified income tax payments, whether mandatory or elective. The notice, which can be relied on by taxpayers until regulations are issued, provides that an owner of a pass-through business will treat such tax payments as a reduction in such owner's share of business income. Moreover, the notice provides that such entity-level tax payments are not to be taken into account in determining the $10,000 SALT limit applicable to an individual owner of such entity. Many states, such as Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island and Wisconsin, have already enacted entity-level taxes on pass-through entities, while other states, such as New York, are considering legislation to enact such a tax.

## Tax Cases

A number of interesting tax cases were heard in 2020. A few highlights follow:

- ***Coca-Cola.*** The IRS won a transfer pricing case in *Coca-Cola Co. v Commissioner* after losing almost every transfer pricing case that it has litigated in the last 30 years. The case involved the transfer pricing method used to determine profits allocated to Coca-Cola's foreign "supply points," which are facilities controlled by Coca-Cola, where beverage concentrate is manufactured using Coca-Cola's secret formula. The Tax Court held that the comparable price method was the best transfer pricing method, and compared the supply points' profit allocation with the pricing contracts for independent bottling companies that convert the concentrate into drinkable beverages by adding water. The Tax Court found that the supply points and the bottling companies were comparable because "the manufacturing activity in both cases was routine, consisting largely of mixing ingredients according to detailed protocols supplied by [Coca-Cola Co.]."

  After the IRS's victory in *Coca-Cola*, tax practitioners are wondering whether the tide has turned for taxpayers in transfer pricing cases. Last year we reported that the Ninth Circuit reversed the IRS's loss in *Altera Corp. v Commissioner*, a case about the validity of transfer pricing regulations. In 2020, the U.S. Supreme Court declined to hear the taxpayer's appeal in *Altera*, solidifying the IRS's victory in this case. In 2021, all eyes will be on *Medtronic Inc. v Commissioner*, another large transfer pricing case that has been remanded back to the Tax Court for further consideration. The transfer pricing policies of many multinational enterprises are predicated on the IRS's decades-long losing streak in these cases, so a change in luck for the IRS may mean that taxpayers need to reconsider their profit allocation strategies.
- ***CIC Services.*** This year, the U.S. Supreme Court granted *certiorari* to hear *CIC Services, LLC v IRS*. This case hinges on the interpretation of the *Anti-Injunction Act*, which prohibits taxpayers from suing the IRS until after a tax has been collected. In *CIC Services*, a taxpayer is suing the IRS to challenge the validity of certain reporting requirements for captive insurance companies. The taxpayer in *CIC Services* is arguing that it should be allowed to sue the IRS before the IRS enforces the reporting requirements, because the fact that the taxpayer would risk criminal penalties by not complying with the reporting requirements means that the taxpayer does not have meaningful access to the courts to review those reporting requirements. A victory for the taxpayer before the Supreme Court may open the door to more aggressive litigation by taxpayers against the IRS.

## Updates on Tax Treaties

Last year we reported that, after years of being blocked by Senator Rand Paul, the Senate finally ratified protocols to tax treaties with Japan, Luxembourg, Spain and Switzerland. At the beginning of 2020, tax practitioners expected progress to continue, starting with the pending treaties with Chile, Hungary and Poland. As 2020 drew to a close, however, no further action was reported with respect to tax treaties.

**State-Level Developments**

In 2020, states asserted themselves by finding new ways to expand their tax jurisdictions.

In 2018, in *South Dakota v Wayfair*, the U.S. Supreme Court overturned long-standing limitations on state sales tax jurisdiction. Throughout 2019 and 2020, states implemented "economic nexus" statutes reflecting the approach taken by South Dakota in *Wayfair*. These statutes base sales tax jurisdiction on the amount or number of sales by an out-of-state business to a state's residents, regardless of whether that business has a physical presence in the state. As of this writing, the only states with a sales tax that have not adopted an economic nexus rule are Florida and Missouri. The standard used to determine nexus varies by state, with Kansas taking the most aggressive position – Kansas's economic nexus statute provides that a single sale to an in-state buyer is sufficient to establish nexus.

Even though federal law limiting state income tax nexus has not been changed, states and localities are beginning to apply the *Wayfair* approach to income tax jurisdiction. Hawaii, Massachusetts, Oregon, Pennsylvania and the city of Philadelphia have enacted economic nexus statutes for income tax purposes, and Texas has adopted an economic nexus statute for its corporate franchise tax. As states continue to expand their income tax jurisdiction, Congress or the Supreme Court may have to revisit existing law.

The increase in remote work during the pandemic may create a windfall for state taxing authorities. Individual employees who are working remotely in a different state than they used to may become subject to income taxation in that state. Many states have issued temporary relief, under which the state will hold off asserting nexus against these individuals until the pandemic is over. Remote workers may find themselves under increased scrutiny when these relief measures expire. Some states, like New York, are not even offering temporary relief. In October, New Hampshire filed a case against Massachusetts in the U.S. Supreme Court, with other states (e.g., New Jersey and Connecticut) joining the suit, to prevent non-resident state taxation of employees who, if not for the pandemic requiring them to work remotely from their residence state, would be commuting to work across state lines. If the Supreme Court takes up this challenge, the case will be of major interest to states that are competing with each other for billions of dollars of tax revenue on account of the unprecedented financial crisis.

The rise of remote work may affect business taxes as well as individual taxes. State business income tax nexus traditionally depends on the location of a company's sales, payroll and real estate. When employees work remotely from a different state from the business, the business may have enough nexus with that state to become subject to income tax. For example, a company headquartered in New York City may find itself subject to taxation in New Jersey or Connecticut if enough employees work remotely from one of those states. The location of a company's employees may become irrelevant, however, for states that adopt a *Wayfair*-style corporate nexus standard that disregards payroll and real estate for nexus purposes.

Some states are using the pandemic as an excuse to raise taxes outright. For example, New Jersey has enacted a "millionaire's tax" that increases the New Jersey state income tax rate for individuals who make more than $1 million per year to 10.75%. Other states are sure to adopt similar measures as they run out of money to address the pandemic.

**International Developments Affecting the United States**

The most significant news in the international tax policy arena in 2020 was the OECD's release of the "Blueprint" for Pillar One of its proposals to address tax challenges arising from the digital economy, which complements the OECD's description of Pillar Two, which was released previously. Pillar One consists of a new nexus standard and allocation methodology for sharing tax jurisdiction over digital businesses that may not, in its drafters' view, be adequately covered by traditional nexus and allocation rules. Pillar Two seeks to subject all large international businesses to a minimum rate of tax with a system that allows countries to benefit from another country's failure to exercise the full extent of its agreed tax rights, in an approach that is tainted by fundamental defects and has elicited calls for it to be abandoned. The Blueprint provides more detail than previous OECD publications on the Pillars, although much remains to be determined.

Pillar One is notable for its innovative approach to international tax rulemaking and the depth and comprehensiveness of its policy goals. These features of Pillar One give rise to eye-watering complexity in the proposed rules. Pillar Two is nothing more than a knockoff of the U.S. GILTI regime. The public has already criticized Pillars One and Two on these and other grounds, and national governments may balk at applying the Pillars in whatever form they ultimately take.

One guiding principle of the OECD's base erosion and profit shifting (BEPS) project (which includes the Pillars) is that a new international tax system should be determined by a consensus-based process. Perhaps because of this, progress is slow – the BEPS project began in 2012 and rules that could actually be implemented still seem far away.

Last year we reported that some countries, most notably France, have begun to exercise self-help by enacting unilateral "digital services taxes," which essentially work like a sales tax based on revenue derived from the taxing jurisdiction. In 2020, France began attempting to collect its digital services tax from companies such as Amazon and Facebook, which prompted U.S. lawmakers to decry France's tax as "predatory." The Trump administration threatened to respond to France's digital services tax by increasing tariffs on the import of French goods, but in early January 2021, the U.S. Trade Representative suspended any action on French import tariffs.

## U.S. Tax Development Outlook for 2021

The COVID-19 pandemic has been a public finance disaster. The federal government and state governments have had to meet the crisis with unprecedented relief efforts costing trillions of dollars. At the same time, sources of government revenue are drying up: rising unemployment and a decline in spending have translated into a decrease in revenue from income, payroll and sales taxes. The resulting crunch will make governments scramble for tax revenue.

The most immediate way to increase tax revenue is by improving enforcement of existing laws. We expect federal and state audit activity to be fierce in 2021. The systematic underfunding of the IRS has made federal audits notoriously spotty and ineffective, especially with respect to middle- and upper-income taxpayers. We may see some effort to expand the prosecution of IRS audits in all segments of the tax base and to improve realization rates from those audits.

The federal government may consider creating new taxes to help pay the bill for COVID-19 relief. One option may be to adopt a federal consumption tax such as a VAT. Although VATs have proven to be politically unpopular, they have the advantage that any taxpayer who does not want to pay a VAT or other consumption tax can simply save a greater portion of his or her income. This would make American households more resilient and better able to weather a crisis like the COVID-19 pandemic.

States, on the other hand, have already begun to enact new laws to increase tax revenue as a result of the pandemic. Even before the pandemic, states were expanding their jurisdiction to tax out-of-state taxpayers in the wake of the *Wayfair* case. Now that the states are experiencing a financial crisis, the expansion of state sales and income tax jurisdiction is certain to accelerate. This will in turn put pressure on the federal legislative and judicial limits on state taxing authority.

In-state taxpayers are also targets for new tax legislation. As noted above, New Jersey has already established a new millionaire's tax. High-income taxpayers are likely to be viewed as low-hanging fruit in these efforts.

On the federal level, 2021 will be a sink-or-swim exercise for the incoming Biden administration. President Biden's most immediate challenge on taking office will be to continue supporting the country's recovery from the COVID-19 pandemic. In addition, one of President Biden's major policy goals is to invest in infrastructure, particularly in the area of renewable energy. President Biden will have a money-hungry agenda precisely at a moment when money will be harder than usual to come by.

One solution may be found in the Democrats' general opposition to the tax rate reductions and other tax cuts in the TCJA. The outgoing administration's tax policies have been subject to near-universal criticism from the Left, especially as the pandemic has affected upper-income beneficiaries of the Trump tax cuts less severely than the rest of the nation. If President Biden is successful at rolling back these tax cuts, he could free up more revenue for pandemic relief and infrastructure investment.

President Biden's ability to achieve any of his goals in the coming years will depend on whether he has the support of the U.S. Senate. As this Outlook was being drafted, Jon Ossoff and Reverend Raphael Warnock narrowly won runoff elections for Georgia's Senate seats. These victories give the Democrats razor-thin control of the Senate, with each party holding 50 seats and Vice-President Kamala Harris casting the tie-breaking vote. Since the Democrats retained control of the House of Representatives, they will control a majority of the votes in both houses of Congress in 2021.

Despite the victories in Georgia, however, significant obstacles to the Democrats' agenda remain. Although a majority vote is sufficient for legislation to pass in the Senate, the minority party can prevent a vote on legislation with a filibuster unless 60 or more senators force the vote. The Democrats could end the filibuster with a majority vote, but this move is controversial and some Democratic senators have already declared that they would not support it.

Even if the filibuster is retained, existing procedures would allow the Democratic senators to take some unilateral actions. For example, the approval of federal judges (including Supreme Court justices) requires a majority of senators and is not subject to filibuster.

In addition, a special budget reconciliation process allows the Senate to pass legislation relating to revenue and tax, spending and the federal debt limit without a filibuster. Only one reconciliation bill in each of these three areas is permitted each year, however, and reconciliation legislation is subject to a limitation preventing a deficit increase beyond a 10-year window (which is why some budget reconciliation tax cuts expire or are subject to sunset in 10 years).

Specific tax policy proposals that may be advanced by the Biden administration in 2021 include the following:

- **Tax Rates.** Increase of federal corporate income tax rates to 28% and increase of the maximum income tax rate for individuals to 39.6%.
- **SALT Deduction.** Elimination of the $10,000 cap on the deduction for state and local taxes.
- **Real Estate.** Roll-back of benefits for real estate investors, such as like-kind exchanges.
- **Estate and Gift Tax.** Elimination of stepped-up basis of assets at death, reduction of lifetime gift and estate tax exemption to $3,500,000 per individual, and increase in the top tax rate to 45%.[3]
- **Corporate Expatriation.** Implementation of stronger anti-inversion regulations subjecting corporations that expatriate or send jobs abroad to tighter penalties.
- **Corporate AMT.** Revival of corporate alternative minimum tax for corporations with at least $100 million of book income.
- **Capital Gains/Carried Interests.** Taxation of long-term capital gains and qualified dividend income above a certain threshold at ordinary income tax rates of 39.6%, thereby eliminating much of the benefit of capital gain treatment for carried interests in investment funds.
- **GILTI.** Expansion of scope of GILTI by increasing rate of tax and requiring country-by-country calculation.

The Democrats are expected to have more power in the Senate than they had in 2020, but that power will stop short of being free rein because (i) it is unlikely that the filibuster will be eliminated; (ii) without getting rid of the filibuster, the Democrats will need 60 votes to pass most legislation in the Senate; and (iii) without 60 votes, the Democrats will have to rely on the reconciliation process, which can be invoked only three times a year (and only once for tax legislation). With such a close balance of power in the Senate, we expect a year of dramatic negotiations between President Biden and the Democrats on the one hand and the Republicans on the other.

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (Code).

[2] The PPP loan provisions in the CARES Act were later supplemented by the Paycheck Protection Program and *Health Care Enhancement Act*, enacted in April, and the *Paycheck Protection Program Flexibility Act*, enacted in June.

[3] Estate planning practitioners do not anticipate that the estate and gift tax exemption (which is currently $11.58 million per individual), which was increased under the TCJA, will be reduced in the coming year, or that any reduction would be made retroactive to January 1, 2021. With an additional year of the increased exemption and historically low interest rates, 2021 looks to be an opportune time to engage in estate planning.

Key Contact: Peter Glicklich