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The Impact of Particular Provisions of the 2017 Tax Cuts and Jobs Act on the United States Economy Amidst the Covid-19 Pandemic

Hillary Obinna Maduka
Columbia Law School

THE IMPACT OF PARTICULAR PROVISIONS OF THE 2017 TAX CUTS AND JOBS ACT ON THE UNITED STATES ECONOMY AMIDST THE COVID-19 PANDEMIC.

BY

MADUKA, HILLARY OBINNA

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Abstract

The Tax Cuts and Jobs Act is the most significant overhaul of the U.S. federal tax system in the last two decades. This paper seeks to discuss some of its most significant provisions and examine their overall impact on the U.S. economy, especially throughout the ongoing coronavirus pandemic.

This paper begins by undertaking an overview of the legislative history of the Act and then proceeds to discuss three provisions of the Tax Cuts and Jobs Acts which have had a tremendous impact on the U.S. economy by altering some major provisions of the United States Internal Revenue Code of 1986. I conclude my review and discussion of each provision by providing a critique of the provision and proposing recommendations and amendments which should be made to the Act, if these provisions are to remain viable, in light of recent developments.

Key Words.

Tax. Internal Revenue Code. FDII – Foreign Derived Intangible Income. Accelerated Depreciation. Economy. Covid-19. Inflow. Congress. Investment. Policy.

Introduction.

Former U.S. President Donald Trump signed The Tax Cuts and Job Act, hereinafter referred to as the ("**Act**") into law on the 22nd day of December 2017. By this singular act, the Trump administration undertook some of the most extensive Code reforms of the last two decades.

President Trump touted the Act to be the "biggest tax cut in American history and one for which everyone is better for."[1] In April 2017, the Trump administration released a skeletal tax outline[2] which demonstrated the intent of the administration to reduce federal revenue by almost eight trillion USD. However, the legislation eventually passed by Congress is estimated to bring about a 1.65 trillion dollars reduction in federal revenue over the next 10 years.[3]

The Act was enacted pursuant to a budget reconciliation process and so took a much shorter timeframe than a typical legislative process, and quite a number of the substantial changes brought about by this Act are largely temporary such as some modifications to the tax rates and obligations of private individuals.

At the international front, by introducing a form of participation exemption the Act further moved the U.S. towards a territorial tax system.

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[1] *President Trump Remarks at Rally in Great Falls, Montana*, C.Span (July 5, 2018), https://www.c-span.org/video/?447876-1/president-trump-delivers-remarks-rally-great-falls-montana&start=3998

[2] The White House, *2017 Tax Reform for Economic Growth and American Jobs* (Apr. 26, 2017), https://www.journalofaccountancy.com/content/dam/jofa/news/2017-tax-reform-for-economic-growth.jpg

[3] Urban-Brookings Tax Policy Center, https://www.taxpolicycenter.org/briefing-book/how-did-tcja-affect-federal-budget-outlook#:~:text=Conventional%20estimates&text=This%20figure%20comes%20from%20the,trillion%20from%202018%20to%202027 (last updated May 2020)

<u>Legislative History.</u>

The legislative history of the Act can be traced to the 19th day of July 2017, when the House Budget Committee held a markup on reconciliation instructions and the 2018 FY concurrent resolution on the budget (H. Con. Res. 71).

H. Con. Res. 71 was accompanied by House Report 115-240. The resolution and the report directed the House Committee on Ways and Means, the lead committee on taxation matters, and other committees to establish the allocation of spending authority to House committees, identify accounts eligible for advance appropriations, and set forth the appropriate budgetary levels for fiscal years 2019 through 2027.[4]

Afterwards, the legislative process stalled and the resolution was not presented for a vote until October 5, 2017, when House members voted largely along party lines, to pass H. Con. Res. 71.

Pursuant to this directive and in line with the budget reconciliation process, two weeks after the passage of H. Con. Res. 71, amendment 1116 was made to H. Con. Res. 71 and passed by the Senate speedily. The House passed this amended version on October 26, 2017, by a simple majority vote, effectively paving the way for introduction of tax legislation into the House of Representatives.[5]

On November 2, 2017, the House bill H.R. 1 was officially termed the Tax Cuts and Jobs Act and was officially introduced into the United States House of Representatives by Congressman Kevin Brady[6].

On November 3, 2017, the Chairman of the House Ways and Means Committee publicized an amendment to H.R.1, afterward further committee markups were held between November 6th – 9th, 2017, resulting in the

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[4] *Legislative History of Tax Cuts and Jobs Act*, Drexel University Legal Research Center, https://drexellaw.libguides.com/c.php?g=732113&p=5230265 (last updated Jan. 6, 2021)

[5] *Id*

[6] Woodlands Online, *Kevin Brady Introduces Tax Cuts and Jobs Act, Receives Kudos from President Donald Trump*, U.S. Congressman Kevin Brady (Nov. 3, 2017), https://kevinbrady.house.gov/news/documentsingle.aspx?DocumentID=400863

House Report 115-409 (2017). On November 9 the House Ways and Means Committee passed the bill advancing it to the House floor.[7]

On Nov 16, 2017, by a vote of 227-205,[8] the bill was approved by the House and on the same day the Senate Committee on Finance submitted the bill to the Senate Committee on Budget.

On November 28, 2017, riding on a simple majority vote, the Senate Budget Committee reported a bill for reconciliation pursuant to title II of the concurrent resolution on the budget for the fiscal year 2018. This bill included legislative text from the Committee on Finance.[9]

A motion to proceed was approved by the entire Senate on November 1 by simple majority vote, and by December 2, an amended version of H.R.1 was approved.

A conference committee comprised of representatives of both the House and Senate unveiled a new version of the legislation on December 15, 2017, and the House approved this by a simple majority vote on December 19, 2017. The Senate subsequently passed the bill on December 20, 2017, after making technical corrections, and the House approved this amended version on the same day by a vote of 224 – 201.[10]

Former President Trump signed the tax bill into law on December 22, 2017.[11]

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[7] Jacob Pramuk, *House Republicans Advance Tax Bill, Aim to Bring It to a Vote Next Week*, CNBC (Nov. 9, 2017), https://www.cnbc.com/2017/11/09/gop-tax-reform-plan-advanced-by-house-ways-and-means-committee.html

[8] *Final Vote Results for Roll Call 637*, United States Senate (Nov. 16, 2017, 1:48 PM), https://clerk.house.gov/evs/2017/roll637.xml

[9] Molly F. Sherlock & Donald J. Marples, *The 2017 Tax Revision (P.L. 115-97): Comparison to 2017 Tax Law*, Congressional Research Service, https://fas.org/sgp/crs/misc/R45092.pdf (last visited Feb. 13, 2021)

[10] Thomas Kaplan, *House Gives Final Approval to Sweeping Tax Overhaul*, New York Times (Dec. 20, 2017), https://www.nytimes.com/2017/12/20/us/politics/tax-bill-republicans.html

[11] John Wagner, *Trump Signs Sweeping Tax Bill Into Law*, Washington Post (Dec. 22, 2017), https://www.washingtonpost.com/news/post-politics/wp/2017/12/22/trump-signs-sweeping-tax-bill-into-law/

Analysis of Some Key Provisions of the Tax Cuts and Jobs Act.

Accelerated Depreciation.

The current regime of tax laws in the United States provides for accelerated depreciation primarily under section 179 and section 168(k) of the Code, as modified by the Tax Cuts and Jobs Act.[12]

Both provisions have several differences such as the target business structure and the amount that businesses can save under each. However, they both share the same primary policy objective of stimulating the economy.

Accelerated Depreciation under Section 179 of the Code - Expensing of Equipment.

Expensing of equipment provides for a procedure by which business establishments upon incurring certain categories of current business expenditure[13] can claim a deduction up to the full cost of the current asset purchased.

This tax policy which is targeted at small to medium-size business structures, can be traced to April 1958 when amidst widespread demand for tax legislation that would stimulate small businesses, the House Ways and Means Committee introduced a small business tax revision bill.[14] This bill underwent several revisions and amendments, and in September 1958 the United States Congress enacted the bill into law. This new law contained several significant provisions, such as a first-year depreciation allowance.

Similar to the Small Business Tax Revision Act of September 1958, section 179 of the U.S. Code as amended by the TCJA aims to stimulate the growth of small businesses and by extension - the economy, considerably

[12] All references to "Code" are to the Internal Revenue Code of 1986

[13] 26 U.S.C. § 179 provides a general list of depreciable tangible property and equipment which may be expensed.

[14] Karl R. Price, *The Small Business Tax Revision of 1958*, JSTOR, https://www.jstor.org/stable/40683312?seq=1 (last visited Feb. 22, 2021)

reduce the tax obligations of businesses that seek to invest and expand, and simplify tax accounting for smaller firms.[15]

Prior to the enactment of the TCJA, expensing provisions under section 179 of the Code was capped at five hundred thousand dollars. This cap effectively limited the type of businesses that can take advantage of the incentive to relatively small businesses. The TCJA increased this cap to one million dollars, thereby broadening the spectrum of business sizes that can benefit under this provision.

Since 1958, successive U.S. governments have employed expensing of equipment as a tax policy incentive to benefit small businesses and stimulate the U.S. economy. The success of this policy thrust is a matter of great debate and I will examine this subsequently.

Accelerated Depreciation under Section 168(k) of the Code – Bonus Depreciation

Before the enactment of the TCJA, the Code permitted a first-year depreciation deduction up to a maximum of 50 percent of the adjusted cost of qualifying property, purchased and placed in service prior to January 2020 or 2021 as applicable under the Code[16].

The TCJA made several temporary[17] but critical amendments to section 168(k) of the Code. The most significant amongst these amendments which is most relevant to this paper is contained under section 13201 of the Act.

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[15]Gary Guenther, *The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects*, Congressional Research Service Reports (May 1, 2018), https://www.everycrsreport.com/reports/RL31852.html#_Toc524529324

[16] Report of the Committee on Ways and Means on H.R. 1, the ''Tax Cuts and Jobs Act,'' H. Rep. No. 115–409, November 13, 2017.

[17] The 100% expense deduction will cease to apply on Dec 31, 2022.

Section 13201 increases the amount which can be expensed under section 168(k) to the full cost of qualifying property either purchased before September 28, 2017, but placed in service after September 2017, or both purchased and placed in service after September 27, 2017, but before January 2023. I will discuss the significance of this amendment in subsequent paragraphs

Qualifying Property

The Joint Committee on Taxation describes a property that qualifies for expensing as depreciable tangible personal property purchased for use in the normal course of business activities[18].

The TCJA also broadened the scope of property that qualifies for expensing under section 179 of the Code beyond just new equipment, to include used tangible property. Purchase of property or equipment from non-related parties that have been previously used by an independent third party or another unrelated party now qualifies for expensing as long as they are to be utilized in the active conduct of the purchaser's trade or business.

The TCJA amended section 168(k) of the Code to broaden the definition of qualifying property to include eligible equipments acquired and placed in service after September 27, 2017, and in the case of items such as aircrafts, acquired and placed in service before January 1, 2023. Eligible automobiles and SUVs subject to the limitations of depreciating luxury vehicles[19] are also deemed qualifying property. The TCJA also amended section 168(k) to include the purchase of used equipment in an arm's length transaction, as eligible for expensing under section 168(k).

Film, television, and live theatrical productions which were commercially broadcasted or released after September 27, 2017, but before January 1, 2027, and which would have been deductible up to fifteen million

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[18] Joint Committee on Taxation, General Explanation of Public Law No. 115–97 (JCS–1–18), December 2018

[19] I.R.C. § 280(f)

USD as provided by the Code[20] is deemed qualifying property. Other real property which meets the exceptions outlined under the Act will also be deemed eligible for expensing.

Modifications of Rules for Expensing Depreciable Business Assets

Upon purchase and utilization of qualifying equipment or machinery for business operations, a business owner who pays taxes may elect to expense the cost of the machinery in lieu of amortizing the cost or deducting depreciation expenses annually.

The TCJA doubles the previously applicable amount that business owners can expense upon the purchase of qualifying business equipment under section 179 of the Code from five hundred thousand USD ($500,000) to one million USD ($1,000,000). The Act also increases the amount at which a taxpayer is ineligible to benefit completely from this tax incentive to two million five hundred thousand USD ($2,500,000). Like most tax provisions, these amounts are to be adjusted for inflation.

The TCJA also broadens the category of improvements that are eligible to be expensed under section 179 of the Code to include those made to nonresidential real property, which meets certain conditions.[21]

The Effects of Accelerated Depreciation as a Tax Policy Incentive on The U.S. Economy.

Proponents of section 179 expensing and section 168(k) bonus depreciation tax allowance argue that this policy thrust extensively stimulates the U.S. economy and increases government revenue primarily by incentivizing businesses to undertake investments and expand their operations, even if this is capital-intensive, due to benefits such as immediately decreased tax obligations. Accelerated depreciation is

[20] I.R.C § 181

[21] I.R.C § 179(f)(2). Heating, ventilation, and air-conditioning property includes all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts. Treas. Reg. sec. 1.48–1(e)(2).

undoubtedly valuable to achieving lower cost of capital, simpler accounting methods and increasing the short-term liquidity of business owners. However, the long-term beneficial viability of this tax policy on the larger economy is highly contested amongst economists and tax professionals.

The first criticism of utilizing accelerated depreciation as a policy thrust under section 179 of the Code is this: Accelerated depreciation as a tax policy incentive to spur expansion and investment by business owners fails to consider the myriad of factors which businesses must consider to make their expansion and investment decisions. Some of these factors are:

Elasticity.

The price elasticity of demand and supply and the ability of fluctuations brought about by this metric to diminish or erode gains if increased demand makes prices soar up to or above the phase-out threshold amount.

Section 179 of the Code caps the amount that can be expensed to one million dollars. This provision aims to encourage businesses to undertake capital-intensive expansion, which could shore up demand across industries for such qualifying equipment and in equal proportion - the prices of such equipment beyond the limit of a million dollars.

This criticism may have been addressed by the TCJA's amendment of section 168(k) of the Code, which permits businesses to expense up to the full cost of eligible purchases – under its 100 percent bonus depreciation. However, not all businesses and corporations find section 168(k) bonus depreciation most beneficial due to benefits that may not be readily available under the 100 percent bonus depreciation provisions of section 168(k),[22] and for these set of businesses the possible effects of the price elasticity of demand and supply still exist.

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[22] Thomson Reuters Tax & Accounting, *Who Needs Sec. 179 Expensing When 100% Bonus Depreciation Is Available?* Thomson Reuters (Oct. 5, 2018), https://tax.thomsonreuters.com/news/who-needs-sec-179-expensing-when-100-bonus-depreciation-is-available/

<u>Cash Flow.</u>

Even though not explicitly stated, section 179 expensing provisions are structured by their very nature in such a manner as to particularly benefit small and medium-sized businesses. However, the wide-scale impact of this policy on small-scale businesses is arguable. The onslaught of the pandemic has dealt a blow to most industries and small businesses have been particularly impacted by the economic downturn. This state of affairs leaves small businesses who typically have restricted access to the debt and equity markets without the option of maximizing this tax policy incentive.

In the rather few cases where such businesses can raise loans to take advantage of incentives such as this, the intended benefits of the tax incentives are greatly diminished for two reasons:

1. The cost of internal funds for small businesses are typically considerably lower than the cost of external funds, due to the limited and much more expensive financing options available to smaller companies.
2. Businesses with net operating losses are unable to increase liquidity in the short term because they are unable to expense the full cost of qualified assets in the same tax year when the business entity begins to utilize them.[23]

A research study conducted by Cohen and Cummings[24] found that although approximately 50 percent of all C and S corporations took advantage of accelerated-depreciation related tax incentives, only 10 percent of those companies asserted that the tax breaks were a major consideration in determining the timing or amount of qualifying investments made.

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[23] Richard Phillips & Steve Wamhoff, *The Failure of Expensing and Other Depreciation Tax Breaks*, Institute on Taxation and Economic Policy (Nov. 19, 2018), https://itep.org/the-failure-of-expensing-and-other-depreciation-tax-breaks/

[24] Darrel Cohen & Jason Cummins, *A Retrospective Evaluation of the Effects of Temporary Partial Expensing*, Federal Reserve Board (Apr. 2006), https://www.federalreserve.gov/pubs/feds/2006/200619/200619pap.pdf

Their findings imply that 90 percent of the companies that claimed a tax break under the applicable tax laws would have undertaken those projects regardless of the tax break and so may have simply altered their timing to take advantage of the tax benefits. Based on these findings, some analysts argue that accelerated depreciation under both section 179 and section 168(k) of the Code is largely unnecessary, as astute business professionals would only undertake investments and business expansion which would eventually provide value that exceeds the costs incurred in undertaking such ventures.

Therefore, such investments will be made regardless of the provision of tax breaks as long as they are beneficial to the business. Accelerated depreciation will only serve to hasten such expansion which would have been conducted in the long term.

Philips and Wamhoff argue that accelerated depreciation engineers a shift in the U.S. tax system from taxing income to taxing consumption, thereby effectively exempting income derived from investments from taxation.[25] While some economists argue that this serves the economy better as businesses tend to invest more if such investment income is tax-exempt, this line of thought seems to have been effectively diminished by the argument that businesses would still invest in ventures that offer the promise of profitable returns.

Therefore, it stands to reason that if accelerated depreciation does not incentivize businesses to undertake investments that they would not otherwise undertake, then tax policy breaks such as this only serve to deprive the government of the much-needed revenue it requires to perform crucial functions such as the provision of public goods and services and the maintenance of law and an orderly society.

Prior to the pandemic the Trump administration and those who supported accelerated depreciation under the TCJA touted improved wages, better job numbers and more foreign direct investment as accruing benefits of this policy.[26]

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[25] WAMHOFF & PHILIPS, *Supra* note 23

[26] White House, President Trump Proposed a Massive Tax Cut. Here's What You Need to Know, (April. 26, 2017) https://trumpwhitehouse.archives.gov/articles/president-trump-proposed-massive-tax-cut-heres-need-know/

Over three years into the enactment of this Act, the facts obtainable across the United States are in stark contrast to the assertions of the Trump administration.

Ben Page, an economist at the non-partisan Urban-Brookings Tax Policy Center described the prevalent state of affairs even prior to the pandemic in these words:

> "We saw a short-term boost to output and investment that really seems to have largely dissipated. GDP is growing more slowly and investment is actually shrinking over the past two quarters, there's almost no evidence for a big inflow of foreign capital[27]."

It is also important to note that accelerated depreciation as provided for under section 179 and section 168(K) of the Code will fail as a policy tool to attract foreign direct investment into large corporations in the U.S.

This is because even though most companies pay less than the statutory tax rate of 35 percent and others pay no taxes at all, accelerated depreciation is not reflected in the financial statements of companies nor does it impact the after-tax book earnings available to potential investors. As noted by Professor Batchelder, not even a savvy investor or analyst could utilize publicly available information to piece together the necessary information and use that to accurately determine a firm's after-tax economic income for the financial year in view. This is because financial statements treat accelerated cost recovery and expensing as lacking any economic benefit to firms.[28] To whatever limited extent that investors and analysts might be able to estimate a firm's marginal tax rate, not only would this require considerable time and resources but

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[27] Max de Haldevang, *Two Years Into Trump's Tax Cut, the Results Are Not Promising*, Quartz (Dec. 22, 2019), https://qz.com/1769421/trumps-tax-cuts-and-jobs-act-shows-poor-results-after-two-years/

[28] Lily L. Batchelder, *Accounting for Behavioral Considerations in Business Tax Reform: The Case of Expensing*, Ssrn (Jan. 25, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2904885

econometric findings based on the work of scholars such as Chen and Schoderbek (2000) find that investors and analysts tend to largely rely on statutory or book tax rates.[29]

The significant reliance of prospective investors on statutory and book-tax rates explains why firms have lobbied congress for years to reduce the statutory tax rate. An official reduction in the statutory tax rate has the most impact on a corporation's financial statements and has the potential to shore up share prices and attract both foreign and domestic investment.

Section 168(k) of the Code, which enables businesses to expense the full cost of purchases, costs the U.S. government much more and is most beneficial to large businesses, who rarely ever need these tax shelters to remain profitable and in business.

In 2020 the United States Government ran an estimated deficit of USD 3.1 trillion, more than triple the deficit in the fiscal year 2019 and the greatest deficit as a share of the economy since 1945.[30] While this was in no small measure increased by the ongoing pandemic, the tax breaks under the TCJA are a significant contributory factor.

Tax breaks under the TCJA, such as accelerated depreciation is estimated to add 1-2 trillion USD to the federal debt[31] and even though the effects of these mammoth deficits are yet to be felt across the U.S. economy, such deficits are not sustainable eternally and its adverse effects are inevitable if left unaddressed.

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[29] Anne C. Ehinger et al., *Let's Talk About Tax: The Determinants and Consequences of Income Tax Mentions During Conference Calls*, Wharton Accounting (Sept. 2017), https://accounting.wharton.upenn.edu/wp-content/uploads/2017/10/ELST_2017.pdf

[30] Bipartisan Policy Center, Deficit Tracker, *BPC's economic policy team analyzes the government's running budget deficit and updates the Deficit Tracker every month*, (April 12, 2021) https://bipartisanpolicy.org/report/deficit-tracker/

[31] *Federal Budget Outlook*, Tax Policy Center, https://www.taxpolicycenter.org/briefing-book/how-did-tcja-affect-federal-budget-outlook (last updated May 2020)

Wasteful tax shelters introduced and expanded under the TCJA drove up deficits thereby considerably impairing the ability of the United States government to effectively and promptly contain and address the COVID-19 pandemic from the outset[32] due to tight budgets.

A consequence of the deficits worsened by the tax breaks given under the TCJA is tighter budgets. As can be easily deduced with little effort from ongoing mass unemployment in the United States, tighter budgets result in reduced hiring or even furloughs in some cases and in worst-case scenarios, which is currently the case in the United States, mass unemployment and shrinking of the government workforce.

Economic rebound is inextricably linked to recovery from the corona-virus pandemic, which has devastated lives as much as it has small businesses. The fiscal squeeze facing federal and state governments, engineered by severe short-fall in revenue can undermine the ability of the government to undertake the necessary fund-intensive projects such as vaccinations that are indispensable to recovery from the health and economic crisis.

As noted in a report from the Congressional Research Service, bonus depreciation is a relatively ineffective means to stimulate the U.S. economy during periods of limited growth.[33] Decisive action should be taken to extensively limit tax policy breaks such as those under the Code as amended by the TCJA which add little to the economy.

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[32] William Wan, *America Is Running Short on Masks, Gowns and Gloves. Again.*, Washinton Post (July 8, 2020), https://www.washingtonpost.com/health/2020/07/08/ppe-shortage-masks-gloves-gowns/

[33] Gary Guenther, *The Section 179 and Section 168(k) Expensing Allowances: Current Law and Economic Effects*, Congressional Research Service, http://www.fas.org/sgp/crs/misc/RL31852.pdf (last visited Mar. 4, 2021)

Opportunity Zones.

The concept of Opportunity Zones is fairly novel and was first popularized in 2015 by Jared Bernstein and Kevin A. Hasset in a joint research publication[34] They described Opportunity Zones as “regional incentives or a geography preference program to address the persistent poverty and uneven recovery that has left too many American communities behind”

The Economic Innovation Group, a DC-based bi-partisan public policy, research, and advocacy organization defines opportunity zones as “low-income census tracts nominated by governors and certified by the U.S. Department of Treasury into which investors can now put capital to work, financing new projects and enterprises in exchange for certain federal capital gains tax advantages”[35]

Section 13823 of the Tax Cuts and Jobs Act amended the Internal Revenue Code to authorize the designation of opportunity zones in low-income communities and to provide tax incentives for investments in the zones, including deferring the recognition of capital gains that are reinvested in the zones

This provision of the TCJA enables investors in qualifying zones to take advantage of three tax benefits as follows:

I. Tax on capital gains from existing assets that are transferred to an opportunity zone fund can be deferred and reduced until liquidated or 2026, whichever is earlier.

II. if an investment in an opportunity zone is held for a minimum of ten years, resulting capital gains will not be taxed.

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[34] Bernstein & Hasset, Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf (last accessed: Mar 5, 2021)

[35]Jared Bernstein & Kevin A. Hassett, *Unlocking Private Capital to Facilitate Economic Growth in Distressed Areas*, Economic Innovation Group (Apr. 2015), https://eig.org/wp-content/uploads/2015/04/Unlocking-Private-Capital-to-Facilitate-Growth.pdf

III. Appreciated assets in Opportunity Funds held for at least five years receive a readjusted basis for tax purposes up to 10 percent, and if the investment is held for at least seven years investors receive an additional basis step-up equal to 15 percent.

The Treasury Department proposed regulations[36] provides a number of guidelines to stem abuse of opportunity zones and ensure the purpose for which these zones were established is achieved. One of these is that a prospective investor cannot invest in opportunity zones directly, but must do so through opportunity funds.

A qualified opportunity fund is a conduit set up by a corporation or partnership primarily to facilitate investments in designated opportunity zone property. A key requirement is that 90 percent of the assets of an opportunity fund must be held in qualifying opportunity zone property; otherwise monetary penalties will be awarded against the fund.

The Joint Committee on Taxation describe qualified opportunity zone property to include qualified opportunity zone stock, opportunity zone partnership interest and opportunity zone business property. To properly analyze their effect, we must examine each of the above.

The shares of any U.S. corporation that qualifies as an opportunity zone business at the time of its first issuance, meets all eligibility requirements for investment by opportunity funds, as long as the following are complied with: payment is made in January 2018 or afterwards in cash only, and beginning from the time of purchase through the period the stock is held by the fund, the business from which the stocks were purchased remains an opportunity zone business.

Qualified Opportunity Zone partnership interests are investment interests in a U.S. registered partnership business that also meets the requisite requirements to be an opportunity zone business.

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[36] Internal Revenue Service, *Investing in Qualified Opportunity Funds*, Federal Register (Oct. 29, 2018), https://www.federalregister.gov/documents/2018/10/29/2018-23382/investing-in-qualified-opportunity-funds

The Joint Committee on Taxation outlined the requirements for an interest to be deemed a qualified opportunity-zone partnership interest as follows: purchase of partnership interest must have been made after December 2017, by cash only, at a period when the partnership maintained its status as a qualified opportunity zone business and the partnership must maintain this status throughout the period its interest is held.

Finally, the committee defines qualified opportunity-zone business property as chattels used in the trade or business of a qualified opportunity fund or business.

For tangibles to be deemed qualified opportunity-zone business property, the property must be purchased after December 2017 for initial use by a qualified fund or business.

Opportunity Zones and the U.S. economy.

The United States Department of Commerce Economic Development Association ("EDA") under the Trump administration praised the creation of Opportunity Zones as advancing economic development and increasing job opportunities across economically distressed communities in the United States.

The EDA also credited a mile-marker of over half a billion USD in almost 400 projects to the creation of opportunity zones. However, it is important to note that these numbers include projects outside communities certified as opportunity zones but in proximity to them.

A report released by the White House - Council of Economic Advisers ("CEA") in August 2020, titled: "The impact of opportunity zones: An initial assessment report" predicted that opportunity zones would create 500,000 jobs and lift a million people out of poverty.[37] The Trump administration further claimed in this

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[37] White House Council of Economic Advisors, *The Impact of Opportunity Zones: An Initial Assessment Report*, U.S. Economic Development Administration (Aug. 2020), https://www.whitehouse.gov/wp-content/uploads/2020/08/The-Impact-of-Opportunity-Zones-An-Initial-Assessment.pdf

document that by December 2019 over $78 billion worth of investments would have been made in underserved communities through the creation of opportunity zones in them.

These statistics imply that opportunity zones have been greatly successful and continue to spur economic growth across the U.S.

Pursuant to the objective of this paper, we seek to determine if the tax breaks associated with this policy have translated to actual meaningful change in the daily lives and living standards of lower-income Americans and 'distressed' populations such as minorities and indigenous peoples.

I will focus my review on the impact of opportunity zones on distressed populations such as minorities and low-income earners for two reasons:

i. Opportunity Zones were created primarily to impact low-income communities, the majority of which constitute 'distressed' populations, defined by the EDA to include "a higher share of African Americans, Hispanics, and high school dropouts"
ii. These segments of the U.S. population continue to be disproportionately affected by the Covid-19 pandemic, due to factors such as inadequate housing and sanitation infrastructure, both attributable to poverty.

The CEA in their report noted that a significant number of census tracts that house minorities and a sizable population of some of the poorest communities in the United States have been designated opportunity zones and so African-Americans and Hispanics are some of the notable beneficiaries of the numerous accompanying benefits attributable to opportunity zones.

These claims were backed up by former President Trump when he pointed to opportunity zones as proof he had done more for the Black community "than any President since Abraham Lincoln"[38] However, this does not appear to be the case.

The Urban Institute, a leading non-profit research organization released a research report[39] in June 2020, that interviewed 70 investors, fund managers and related business individuals that have ties to opportunity zones. The Institute's report found that contrary to claims made by the Trump administration, "Opportunity Zones have generally failed to live up to its economic and community development goals", especially for minorities.

Insights gained from the conduct of independent research and interview of key players in opportunity zones demonstrates that opportunity zones by their design incentivizes investors to pursue profit not impact. This is because opportunity zones offer the most benefits to projects with the highest returns, not projects that address the most significant needs of host communities. This explains why market-rate real-estate projects such as luxurious apartments and hotels get abundant access to opportunity zone funds while affordable housing deals or small minority businesses in need of an equity partner or funding get little to no funds.[40]

The job opportunities that investment in luxurious real estate across opportunity zone tracts provides are largely unskilled, low-wage and temporary, as construction workers and other manual laborers are contract workers and are discarded as soon as the construction is completed. This creates a façade of gainful employment which cannot be further from the truth.

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[38] *Trump: 'Ve Done More for Black People Than Anyone, Maybe Lincoln*, NBC News (July 22, 2020), https://www.nbcnews.com/now/video/trump-says-he-has-done-more-for-black-people-than-anyone-with-possible-exception-of-lincoln-88141381811

[39] Brett Theodos et al., *An Early Assessment of Opportunity Zones for Equitable Development Projects*, Urban Institute (June 17, 2020), https://www.urban.org/research/publication/early-assessment-opportunity-zones-equitable-development-projects/view/full_report

[40] EHINGER ET AL, *supra* note 29

In June 2020, Novogradac, a national professional services organization that provides certified public accounting, valuation, and consulting services reported that over 95 percent of the funds raised across opportunity zones in the U.S. at the time went to large commercial or residential real estate instead of the small businesses the tax policy is supposed to support[41].

This lends credence to the criticism that opportunity zones have done more to gentrify minority neighborhoods than to build them up.

"We continually see a lack of understanding, a lack of regard to the needs and challenges of Black and brown businesses" said Connie Evans, President and CEO of the Association for Enterprise Opportunity, a D.C.-based trade association that advocates for organizations that provide capital and support to underserved entrepreneurs.

Connie Evans criticized opportunity zones due to its universal structure which is not tailored to work with the peculiarities that define underserved and minority entrepreneurs and communities.

She likened opportunity zones to federal anti-poverty and economic relief programs such as the paycheck protection program that failed to reach many minorities and small-business owners who lack banking relationships, and in the case of opportunity zones - the technical expertise to comb through the hundreds of pages of IRS and treasury guidelines regulating opportunity zones and make the most of investment opportunities available therein.[42]

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[41] Michael J. Novogradac, *Novogradac Opportunity Funds List Surpasses $10 Billion in Investment*, Novogradac (Apr. 29, 2020), https://www.novoco.com/notes-from-novogradac/novogradac-opportunity-funds-list-surpasses-10-billion-investment

[42] Sophie Quinton, *Black Businesses Largely Miss Out on Opportunity Zone Money*, Pew Charitable Trusts (June 24, 2020), https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2020/06/24/black-businesses-largely-miss-out-on-opportunity-zone-money

Finally, like every facet of life in the U.S, Bloomberg unsurprisingly reports that minority leaders of opportunity zone projects continue to contend with racial discrimination from prospective investors.[43] A developer told the Urban Institute during the interview that a number of wealthy investors had shut out pitches from minority developers simply based on their skin color.

Recommendations

The creation of Opportunity Zones is a laudable initiative and portends numerous benefits not only for investors or recipient communities but for the United States economy as a whole. However, in its current state, opportunity zones leave much to be desired and grossly fall short of its objectives.

To maximize its potential and stem avenues for it to serve as a wasteful tax break, the Biden administration should begin by aggregating data from its implementation and operation across the U.S. for analysis and review of its impact. Recommendations made have been largely based off conjecture, speculation and privately-funded research constrained by time and resources. However, a robust government-sponsored initiative to collect and review data from opportunity zones will inform necessary law and tax policy amendments that will engineer monumental changes for all.

In other to ensure the efficacy of this tax break, the Treasury Department must come up with guidelines prohibiting and penalizing racist overtures by investors as these sideline a majority of the persons opportunity zones are meant to benefit.

In order to stem abuse of its processes, it is also recommended that qualified opportunity tax zone projects be limited to specific high-impact areas. This may vary across parts of the U.S. and should not be overbroad in its applicability as to serve as a tax shelter for wealthy individuals without any significant contribution to

[43] Alex Wittenberg, *The Biggest Problem with Opportunity Zones*, Bloomberg (June 25, 2020), https://www.bloomberg.com/news/articles/2020-06-25/opportunity-zones-don-t-work-can-they-be-fixed

critical sectors of the local, state or federal economy. In doing this the Biden administration should restructure opportunity zones to better incentivize investments in small businesses and projects that actually provide jobs and benefit struggling communities regardless of profitability, as real estate alone cannot do this. Large-scale investment in community development financial institutions is key to achieving this objective.[44]

[44] EHINGER ET AL, *supra* note 29

Foreign Derived Intangible Income.

Background

Before the enactment of the Tax Cuts and Jobs Act, the U.S. operated a residence-based, "worldwide" corporate tax system[45]. Under this system, U.S.-based companies generally had no immediately arising tax obligations to the U.S. government when they earned revenue in a foreign jurisdiction until the funds earned in the foreign jurisdiction were repatriated. This arrangement greatly incentivized U.S. companies to keep their profits outside the U.S. and in some cases go the extra length of also moving their legal headquarters to low-tax foreign jurisdictions, while they retained most of their U.S.-based workforce and culture through a process known as inversion[46].

The 2017 Tax Cuts and Jobs Act introduced provisions such as the Global Intangible Low Tax Income ("**GILTI**") and the Foreign Derived Intangible Income ("**FDII**") amongst others, to address the problems which the worldwide corporate tax system occasioned.

FDII.

Bloomberg Tax succinctly defines FDII as that "portion of a domestic corporation's intangible income that is derived from serving foreign markets, and determined on a formulaic basis"[47]

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[45] Kyle Pomerleau, *A Hybrid Approach: The Treatment of Foreign Profits Under the Tax Cuts and Jobs Act*, Tax Foundation (May 3, 2018), https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/

[46]Laura Davison, *Firms That Left U.S. to Cut Taxes Could Qualify for Fed Aid (1)* Bloomberg Tax (May 15, 2020) https://news.bloombergtax.com/daily-tax-report/firms-that-left-u-s-for-tax-reasons-could-qualify-for-feds-aid

[47] *Foreign-Derived Intangible Income (FDII)*, Bloomberg Tax & Accounting, https://pro.bloombergtax.com/foreign-derived-intangible-income/ (last updated Dec. 15, 2020)

The concept of the tax break framed as FDII under the TCJA, and the rationale behind it isn't new. Prior tax schemes such as IC-DISCs (interest-charge domestic international sales corporations) and ETI (extra-territorial income) are largely similar to the FDII provision under the TCJA. However, some important differences between FDII and these other tax incentives are as follows: FDII tax deductions unlike prior related tax schemes are primarily deductible on income derived from the sale of intangible property such as patents and copyrights, and the products that are made from these patents. In addition, all companies regardless of size are eligible to take advantage of this benefit, and there are no requirements which mandate that the goods or services sold be wholly or partly (up to a certain threshold) manufactured in the United States.

However, like prior U.S. international tax incentives the requirement that the subject of the sale be utilized outside the U.S, and revenue eligible for FDII tax deductions be generated wholly from outside the U.S. also applies to FDII. Any sales made from products that will eventually end up in the U.S. market do not qualify for FDII deductions.

The FDII provisions, although primarily targeted at intangible income, enable eligible U.S. companies to claim up to a 37.5 percent deduction from their taxable income on eligible sales made outside the United States on certain tangibles. The maximum deductible amount will be reduced to 21.875 percent by 2026.

The deductible amount is calculated by evaluating metrics such as a C-corporation's net foreign-derived income in comparison to its total net income and its deemed intangible income.

To comprehend the policy drivers behind the FDII and how this tax break is expected to work, it is important to explain the following:

Qualified Business Asset Investment ("QBAI"): These are assets whose depreciation can be computed under section 167 of the Code and which are employed in the active trade or business of a company.

Deemed Intangible Income: This is any income that is more than 10 percent of the Qualified Business Asset Investment.

Any deemed intangible income that is realized from a foreign country is deemed FDII and therefore tax deductible as such.

<u>FDII Tax Calculations:</u>

The procedure to determine FDII as follows:

- Calculate the Deduction Eligible Income (DEI).

  DEI = Gross Income from business activities generally – deductions allocable to the gross income.
- Determine QBAI = Assets whose depreciation can be computed under section 167 of the Code and which are employed in the active trade or business of a company.
- Calculate Deemed Intangible Income (DII) = Income that is more than ten percent of the Qualified Business Asset Investment.
- Determine the Foreign-derived Deduction Eligible Income (FD DEI). FD DEI is simply the foreign portion of the DEI, and includes any income from sales or dispositions to a foreign person for foreign use.
- Calculate Foreign Derived Intangible Income (FDII). This is Deemed Intangible Income multiplied by the ratio of the corporation's Foreign Derived Deduction Eligible Income to its Deduction Eligible Income.
- Multiply your FDII by 37.5 percent to determine FDII reduction

As may be deduced from the above and complementary to the GILTI tax provision, FDII was introduced by the Trump administration to incentivize U.S. based C-companies or U.S based subsidiaries of foreign companies who hold intangible assets such as patents outside the U.S. and generate revenue from these to rather earn this income in the United States, or if earned outside the U.S, to repatriate them back into the country.

By offering eligible C-corporations an effective tax rate of 13.125 percent on foreign-generated income, companies, particularly those who have smaller amounts of fixed assets will have little incentive to perpetually keep intangible assets and revenue generated therefrom in low-tax jurisdictions outside the U.S.
The success of this tax policy was envisaged by the Trump administration to shore up capital and domestic investment within the U.S. The effects of this will improve the balance of trade, lower deficits and create more jobs.

Criticisms.

One of the most pervasive criticisms of FDII is the complex and resource-intensive computations eligible companies must undertake to fully take advantage of this tax benefit. However, the validity of this criticism may be muted by the fact that a significant percentage of companies at whom this incentive is targeted typically possess the resources necessary to take advantage of it, and whatever expense that is incurred in taking advantage of the FDII tax break is insignificant in comparison to the amount saved. However, this may vitiate the broad applicability of FDII to smaller companies, on the basis that there will be little to no incentive for them to take advantage of this tax break if the overall cost of doing so is almost the same as the benefits or outweighs it. Current rules have relaxed documentation requirements; however, the costs remain significant.

Eric Solomon, a former assistant secretary focusing on Tax Policy at the U.S. Treasury Department noted in a presentation at the Georgetown Tax Law and Public Finance Workshop that the FDII provision may turn out to be counter-productive if other countries in retaliatory response to this tax policy go on to introduce even lower corporate tax rates or other incentives which simply will not be approved in the U.S. by Congress.[48] Such an occurrence will only serve to further incentivize companies to derive their earnings outside the United States and leave the U.S. in a worse-off position than it was prior to the enactment of the FDII provision.

Chris Sanchirico, a law professor at the University of Pennsylvania also noted a different means through which the FDII provision could be counter-productive.

According to him, in a bid for companies to pay as little tax as possible, evade any punitive measures by the GILTI provision but also take advantage of the tax incentives under the FDII provision where possible, more U.S. companies may undertake more capital investments abroad such as building more offshore facilities like factories since this will increase their tangible assets outside the US and thereby shelter more of their profits from tax. FDII means having more tangible assets in the U.S. will result in smaller tax breaks; this flaw will undoubtedly result in the loss of capital and jobs to foreign jurisdictions[49]

As rightly noted by several commentators, the FDII and GILTI provision is a carrot and stick approach to get companies to earn income in the United States rather than overseas, and to enable the federal government to tax this income. However, the success of the FDII provision is greatly limited by the following realities:

A significant number of the countries that serve as tax havens to major U.S. companies, such as Ireland, afford such companies the luxury of single-digit to no tax rates at all, which is simply unrealistic in the United

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[48] Robert Verzi, *Lower FDII Tax Rate Lures Foreign IP and Services Back to U.S.*, Atlanta Business Chronicle (July 20, 2018), https://www.bizjournals.com/atlanta/news/2018/07/20/lower-fdii-tax-rate-lures-foreign-ip-and-services.html

[49] *Tax Havens Retain Allure for US Tech*, Financial Times, https://www.ft.com/content/bcf50bfc-ffd4-11e7-9650-9c0ad2d7c5b5

States. A single-digit tax rate will not be approved by the U.S. Congress, regardless of which political party is in control of Congress due to the United States government's considerable reliance on taxes. Tax incentives such as FDII simply cannot effectively compete with the tax rates offered by tax havens. In March 2021, Kimberly Clausing testified[50] before the Senate Committee on Finance. Her report indicated that the amount of total foreign income housed by U.S. multinational corporations in seven prominent tax havens remained largely unchanged for the two years (FY 2018 & 2019) immediately following the enactment of the TCJA. Her testimony indicated that despite the FDII provisions, tax havens remain attractive destinations for U.S. corporations to avoid taxes.

The success of policies such as FDII and GILTI is largely dependent on the discretionary response of companies, and when compared vis-à-vis the benefits of stashing income in tax havens, it is highly unlikely that these companies at whom the FDII is targeted will exercise their discretion in favor of the U.S. government. More so, since these companies continue to enjoy the international and domestic advantages of being a U.S. incorporated business entity even when they actively undertake activities geared solely at tax avoidance, they have no real incentive to consider the interests of the government that creates and maintains an enabling environment for them to grow and thrive. It might be imperative for the government to enact broad rules which compel U.S. incorporated companies to pay the full tax rates, as soon as they are earned anywhere in the world, or lose access to the U.S. market and all other accruing benefits such as relative government protection which U.S. companies and their principal officers enjoy.

The tax policy center reports that other critics such as finance ministers in the European Union ("EU") are concerned that FDII is an illegal backdoor export subsidy, which violates World Trade Organization trade

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[50] *Testimony of Kimberly A. Clausing, Deputy Assistant Secretary, Tax Analysis, Before the Senate Committee on Finance*, U.S. Department of Treasury (Mar. 25, 2021), https://home.treasury.gov/news/press-releases/jy0079

rules because it only applies to profits on foreign sales and is therefore a "prohibitive subsidy contingent on export."[51] The validity of this argument has not been tested as no country has challenged this tax incentive before the World Trade Organization. However, the EU has published criticisms of this provision[52] and requested that the Organization for Economic Cooperation and Development conduct a review to determine whether FDII qualifies as a harmful tax practice.[53]

The effective 37.5 percent FDII tax deduction afforded to companies by FDII is temporary and so will be reduced to 21.875 percent by December 2025. This change which will be effective in four years, may discourage corporations from taking advantage of FDII because most companies plan long-term, and so may be unlikely to take advantage of this incentive due to its short duration and uncertain future, as proposed tax reforms by the Biden administration remain a credible threat to its continuity.

President Biden has presented an infrastructure spending plan and tax reform plan that will effectively raise corporate income taxes. The Biden administration proposes to do this in part by repealing the FDII provision under the TCJA and setting the corporate income tax rate at 28 percent, which is a 7percent increase from the currently existing tax rate.[54]

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[51] Jill Boland, *US Exporters: The FDII Deduction Is Tax Reform's Gift to You*, Cla (July 6, 2018), https://www.claconnect.com/resources/articles/2018/us-exporters-the-fdii-deduction-is-tax-reforms-gift-to-you

[52] Jessica Silbering-Meyer , *EU Intensifies Criticism of U.S. Section 250 Deduction for FDII*, Thomson Reuters (May 15, 2019), https://tax.thomsonreuters.com/blog/eu-intensifies-criticism-of-u-s-section-250-deduction-for-fdii/

[53] Eric Toder, *Explaining the TCJA's International Reforms*, Tax Policy Center (Feb. 2, 2018), https://www.taxpolicycenter.org/taxvox/explaining-tcjas-international-reforms

[54] *FACT SHEET: The American Jobs Plan*, The White House (Mar. 21, 2021), https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/

Conclusion.

The Covid-19 pandemic has considerably increased the number of cross-border sales transactions that take place over the internet. This has improved the prospects for U.S. businesses to generate more intangible income abroad. The worldwide corporate tax system was flawed and simply not designed to take maximum advantage of the opportunities which currently exist. FDII places the U.S. at a much better vantage point. However, it is still yet to be seen if the end will justify the means.

The Joint Committee on Taxation estimates that FDII will cost the U.S. government over $US 63 billion dollars in revenue[55] over the next 10 years, for a provision whose efficacy is dependent on external factors such as the response of other countries and which likely violates the WTO rules this is a considerable tradeoff. The success of the FDII provision depends considerably on the response of companies and a poor response rate may mean that FDII will end up being a wasteful tax shelter for export-oriented domestic companies.

[55] *Estimated Budget Effects of the Conference Agreement for H.R.1, the "Tax Cuts and Jobs Act*, The Joint Committee on Taxation (Dec. 18, 2018), https://www.jct.gov/publications/2017/jcx-67-17/

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