

Recent Developments in Federal Income Taxation

Bruce A. McGovern

Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas

State Bar of Texas Tax Section
First Wednesday Tax Update
December 2, 2020

To obtain today's outline and slides:

<https://tinyurl.com/outline12-2020>

<https://tinyurl.com/slides12-2020>

CLE Number for Today's Webcast:

174104407

Notice 2020-32, 2020-21 I.R.B. 837 (5/1/20)

Outline: item D.1, page 2

- Federally-backed loans made to businesses under the Paycheck Protection Program (PPP) must be used to fund payroll and certain other expenses.
- Businesses that use the loans in this manner can apply to have the loans forgiven.
- CARES Act § 1106(i) provides that any income arising from having PPP loans forgiven is excluded from gross income.
- Issue: can a business that has a PPP loan forgiven deduct expenses funded with the loan proceeds?
- Notice 2020-32: No. Section 265 precludes a deduction.
 - Section 265(a)(1): disallows a deduction for “any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest wholly exempt from the taxes imposed by this subtitle.”

3

Rev. Rul. 2020-27, 2020-50 I.R.B. 1552 (11/18/20)

Outline: item D.1.a, page 4

- “A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period.”
- This is true even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year.

4

Rev. Proc. 2020-51, 2020-50 I.R.B. 1599 (11/18/20)

Outline: item D.1.b, page 4

- Provides a safe harbor:
 - Allows taxpayers to claim deductions in a tax year beginning or ending in 2020 for otherwise deductible expenses paid with proceeds of a PPP loan that the taxpayer expects to be forgiven after 2020.
 - Deductions can be claimed in 2020 to the extent that, after 2020, the taxpayer's request for loan forgiveness is denied or the taxpayer decides not to request loan forgiveness.
 - Example: calendar-year taxpayer submits request for loan forgiveness in November 2020 that is denied in February 2021. Taxpayer can file 2020 tax return in March 2021 claiming deductions.
- Requirements:
 - Claim deductions on timely-filed (including extensions) original return or amended return for 2020, or timely-filed original return for later year in which loan forgiveness is denied or taxpayer decides not to seek forgiveness.
 - Attach statement (titled "Revenue Procedure 2020-51 Statement") with prescribed information to the return on which deductions are claimed.

5

Miscellaneous Itemized Deductions

2017 TCJA § 11045

Outline: item C.1, page 5

- For taxable years beginning after 2017 and before 2026, miscellaneous itemized deductions are not deductible.
- Includes:
 - Investment-related expenses
 - Unreimbursed employee business expenses
 - Tax preparation fees
- Notice 2018-61 (7/13/18): proposed regs. will clarify that estates and non-grantor trusts are not affected.

6

Miscellaneous Itemized Deductions

2017 TCJA § 11045

Outline: item C.1.b, page 6

- Proposed regulations issued May 2020
 - REG-113295-18, Effect of Section 67(g) on Trusts and Estates, 85 F.R. 27693 (5/11/20)
- Final regulations issued October 2020
 - T.D. 9918, Effect of Section 67(g) on Trusts and Estates, 85 F.R. 66219 (10/19/20)
- Amendments to Reg. § 1.67-4:
 - Clarify that § 67(g) does not deny deductions described under § 67(e)(1) and (2) for estates and nongrantor trusts.
 - Do not address whether such deductions will continue to be deductible for purposes of the AMT.
 - Provide guidance on the treatment of excess deductions on termination of the trust or estate by the beneficiary.

7

Miscellaneous Itemized Deductions

2017 TCJA § 11045

Outline: item C.1.b, page 6

- Amendments to Reg. § 1.642(h)-2 (final regulations issued October 2020):
 - Provide guidance under § 642(h) regarding net operating loss and capital loss carryovers under § 642(h)(1) and the excess deduction under § 642(h)(2).
 - Implement a more specific method which preserves the tax character of three categories of expenses in the hands of the beneficiary.
 1. Deductions allowed in arriving at adjusted gross income,
 2. Non-miscellaneous itemized deductions, and
 3. Miscellaneous itemized deductions.
 - Adopt principles used under Reg. § 1.652(b)-3 in allocating items of deduction among classes of income in the final year of a trust or estate for purposes of § 642(h)(2).

8

Notice 2020-79
2020-46 I.R.B. 1014 (10/26/20)
Outline: item B.1, page 7

- Sets forth inflation-adjusted figures for benefits and contributions under qualified retirement plans for 2021.
- Among other figures:
 - Elective deferrals to 401(k) plans: \$19,500 (with catch-up provision for employees age 50 and older of \$6,500). [unchanged]
 - IRA contributions: \$6,000 [unchanged]

9

Deduction of State and Local Taxes
Outline: item D.1, page 8

- TCJA: An individual's itemized deductions on Schedule A for state taxes cannot exceed \$10,000.
 - Applies to aggregate of property taxes, and sales or income taxes.
 - Limit applies both to single individuals and married individuals filing jointly
 - Applies 2018 through 2025
- Some states have adopted workarounds, e.g., New Jersey gives a credit against property taxes for contributions to certain charitable funds designated by the state.

10

Notice 2020-75
2020-49 I.R.B. 1453 (11/9/20)
Outline: item D.1.g, page 14

- States that proposed regulations will be issued.
- Proposed regulations will clarify that state and local income taxes imposed on and paid by a partnership or S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non-separately stated taxable income or loss for the taxable year of payment.
- Therefore, such taxes are not subject to the \$10,000 state and local tax deduction limitation for partners and shareholders who itemize deductions.
- Application:
 - Proposed regulations will apply to payments of taxes made on or after November 9, 2020.
 - Taxpayers also can apply these rules to specified income tax payments made in a taxable year of a partnership or an S corporation ending after Dec. 31, 2017, and before November 9, 2020.

11

Final Regulations Defining Dependent
85 F.R. 64383 (10/13/20)
Outline: item D.2, page 14

- The 2017 Tax Cuts and Jobs Act added § 151(d)(5), which reduces the exemption amount to zero for TY beginning after 2017 and before 2026.
 - Eliminates the deduction for personal exemptions authorized by § 151(a).
- However, it is still necessary to determine for various purposes whether an individual is a “dependent” within the meaning of § 152.
 - Qualifying child
 - Qualifying relative:
 - To be a qualifying relative, § 152(d)(1)(B) requires the individual’s gross income for the calendar year be less than the exemption amount as defined in § 151(d).
 - Notice 2018-70: “because it would be highly unusual for an individual to have gross income less than zero, virtually no individuals would be eligible as qualifying relatives.”
- Final Regulations:
 - In determining eligibility for head-of-household filing status and for the new \$500 credit (§ 24(h)(4)) for dependents other than a qualifying child, an individual must have gross income not exceeding \$4,150, to be adjusted for inflation after 2018 (\$4,300 in 2020).

12

Rev. Proc. 2020-45
2020-46 I.R.B. 1016 (10/26/20)
Outline: item D.3, page 14

- Sets forth inflation-adjusted figures for 2021
- Among other figures:
 - Standard deduction for 2021 is \$25,100/\$18,800/\$12,550

13

Final Regs. On Eligible Terminated S Corporations
85 F.R. 66471 (10/20/20)
Outline: item D.1.b, page 16

- S corporations that existed before the date of enactment of the 2017 TCJA (12/22/2017) that converted to C corporations before 12/22/2019 and met certain requirements regarding shareholders are “eligible terminated S corporations” (ETSCs)
- Pursuant to changes made in the 2017 TCJA, ETSCs:
 - Can take into account any required § 481 adjustment (such as from converting from cash to accrual method) over 6 years (§ 481(d)), and
 - Can treat at least some distributions after the normal one-year post-termination transition period (PTTP) as allocable to the accumulated adjustments account (AAA) and therefore as nontaxable distributions (§ 1371(f)).
- Final regulations provide guidance on:
 - Definition of an ETSC
 - Distributions of money by an ETSC after the PTTP
 - Allocations of current E&P to distributions to shareholders

14

Commissioner v. Brokertec Holdings, Inc.

967 F.3d 317 (3d Cir. 7/28/20)

Outline: item H.1.a, page 17

- The State of New Jersey's economic development plan made cash grants totaling approximately \$56 million to two corporations.
 - The grants were incentives for the corporations to relocate from New York to New Jersey.
- Issue: are the cash grants nontaxable, nonshareholder contributions to capital?
- Held: No. The grants must be included in the corporations' incomes.
 - To be a contribution to capital, a payment must become a permanent part of the recipient's working capital structure.
 - This was not satisfied here because the grants were not restricted to use as capital.
 - The corporations could have used the grants to pay operating expenses or dividends.

15

2017 Tax Cuts and Jobs Act § 13312

Outline: item H.1.a, page 17

- Section 13312 of the 2017 TCJA amended Code § 118.
- New § 118(b)(2) provides:
 - Non-shareholder contributions to the capital of a corporation made after 12/22/17 by any *governmental entity or civic group* are *not* excluded from the corporation's gross income.

16

Tax Capital Accounts of Partners

Outline: item G.1, pages 18-24

- The 2018 Instructions for Form 1065 and accompanying Schedule K-1 required a partnership that does not report tax basis capital accounts to its partners to report, on line 20 of Schedule K-1 (Form 1065) using code AH, the amount of a partner's *tax basis capital* both at the beginning of the year and at the end of the year if either amount is negative.
- Notice 2019-20 2019-14 I.R.B. 927 (3/7/19), and FAQ on IRS website provide guidance on tax capital accounts.
- Draft 2019 Form 1065 and Schedule K-1 *required* partnerships to report *tax capital accounts* on Schedule K-1 (item b, page 20)
 - Several other significant changes
- Notice 2019-66, 2019-52 I.R.B. 1509 (12/9/19): defers requirement of tax basis capital accounts to partnership tax years beginning after 2019 (item c, page 21)

17

Tax Capital Accounts of Partners

Outline: item G.1, pages 18-24

- Notice 2020-43, 2020-27 I.R.B. 1 (6/5/20) (item d, page 22)
 - Proposes a requirement that partnerships use only one of two exclusive methods for reporting a partner's tax capital account that would apply to partnership taxable years that end on or after December 31, 2020.
 - Comments were due August 4, 2020
 - Rejects a "transactional approach" to determining tax capital accounts
 - Two proposed methods for determining tax capital accounts:
 - Modified Outside Basis Method
 - Outside basis less partner's share of liabilities.
 - Modified Previously Taxed Capital Method (hypothetical liquidation)
 - Based on method in Reg. § 1.743-1(d) for determining partner's share of previously taxed capital when a partner purchases a partnership interest and basis of partnership assets is adjusted under § 743(b) because partnership has a § 754 election in effect.

18

Draft Instructions - 2020 Form 1065 & Schedule K-1

Outline: item G.1.e, page 24

- Require partnerships to report each partner's capital account on a tax basis regardless of whether the account is negative.
- Each partner's tax capital account must be determined using a transactional approach.
- Beginning tax capital accounts for 2020:
 - If partnership reported tax capital accounts in prior year, or maintained books and records for tax capital accounts:
 - Beginning tax capital account for 2020 will be prior-year ending tax capital account.
 - If partnership did not report tax capital accounts in prior year and did not maintain books and records for tax capital accounts:
 - Beginning tax capital account can be determined for 2020 only using a transactional approach or one of three alternative methods:
 - Modified outside basis method
 - Modified previously taxed capital method
 - Section 704(b) method

19

Organic Cannabis Foundation, LLC v. Comm'r

962 F.3d 1082 (9th Cir. 6/18/20)

Outline: item E.1, page 25

- An LLC and a corporation operated medical marijuana dispensaries.
- The IRS issued notices of deficiency disallowing their deductions pursuant to § 280E.
- The last day to file a petition in the Tax Court was April 22, 2015.
 - The law firm representing the taxpayers sent the petitions on April 21 by Federal Express "First Overnight" service.
 - Federal Express attempted delivery on April 22, but the petitions did not arrive at the Tax Court until April 23.
- Issue: were the petitions timely filed?
- Held: No-(1) the Tax Court clerk's office was not inaccessible on April 22, and (2) FedEx First Overnight was not, at the time, a designated private delivery service eligible for the timely-mailed-is timely filed rule of § 7502(a). Cases dismissed.

20

Boechler, P.C. v. Commissioner
963 F.3d 760 (8th Cir. 7/24/20)

Outline: item F.1, page 26

- Following a collection due process (CDP) hearing, the IRS issued a notice of determination upholding proposed collection action.
- Under § 6330(d)(1), the taxpayer had 30 days to contest the determination by filing a petition with the U.S. Tax Court.
- The 30-day period expired on August 28, 2017.
- Taxpayer:
 - Mailed his petition to the Tax Court on August 29, 2017 (one-day late).
 - Argued that the 30-day period should be equitably tolled.
- Issue: is the 30-day period for filing a Tax Court petition to contest an IRS notice of determination jurisdictional and therefore not subject to equitable tolling?
- Held: Yes. Follows *Duggan v. Commissioner*, 879 F.3d 1029 (9th Cir. 2018), which reached the same conclusion.

21