# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

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State Bar of Texas Tax Section
First Wednesday Tax Update
February 3, 2021

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The Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, enacted on December 27, 2020, made permanent several Code provisions that previously had been temporarily extended for many years, temporarily extended several expiring provisions, and provided tax relief to those in areas affected by certain natural disasters.

# I. ACCOUNTING

# II. BUSINESS INCOME AND DEDUCTIONS

## A. Income

## B. Deductible Expenses versus Capitalization

## C. Reasonable Compensation

## D. Miscellaneous Deductions

**1. Go ahead and deduct 100 percent of the cost of that business meal, at least through 2022.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 210 of the 2021 Consolidated Appropriations Act, amends § 274(n)(2), which sets forth exceptions to the normal 50 percent limitation on deducting business meals, to add an additional exception. The exception is for the cost of food or beverages provided by a restaurant paid or incurred before January 1, 2023. This rule applies to amounts paid or incurred after December 31, 2020.

**2. A permanent incentive to make commercial buildings energy efficient.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 102 of the 2021 Consolidated Appropriations Act, made permanent the § 179D deduction for the cost of energy-efficient commercial building property. Generally, these are improvements designed to reduce energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of a commercial building by 50 percent or more in comparison to certain standards. The lifetime limit on deductions under § 179D is $1.80 per square foot. The legislation also provides that the maximum credit is adjusted for inflation for taxable years beginning after 2020. This provision had expired for property placed in service after December 31, 2017, and was retroactively extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 130 of the 2020 Further Consolidated Appropriations Act to property placed in service after 2017 and before 2021.

**3. Seinfeld warned us: no double-dipping (with your PPP money)! Or, on second thought, maybe you can!** Notice 2020-32, 2020-21 I.R.B. 1 (5/1/20). Section 1102 of the CARES Act, in tandem with § 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)), establishes the much-touted Paycheck Protection Program ("PPP"). The PPP was created to combat the devastating economic impact of the coronavirus pandemic. Generally speaking, the PPP facilitates bank-originated, federally-backed loans ("covered loans") to fund payroll and certain other trade or business expenses ("covered expenses") paid by taxpayers during an eight-week period following the loan's origination date. Moreover, § 1106(b) of the CARES Act allows taxpayers to apply for debt forgiveness with respect to all or a portion of a covered loan used to pay covered expenses. Section 1106(i) of the CARES Act further provides that any such forgiven debt meeting specified requirements may be excluded from gross income by taxpayer-borrowers.

*Background.* The CARES Act does not address whether covered expenses funded by a forgiven covered loan are deductible for federal income tax purposes. Normally, of course, covered expenses would be deductible by a taxpayer under either Code § 162, § 163, or similar provisions; however, a long-standing provision of the Code, § 265(a)(1), disallows deductions for expenses allocable to one or more classes of income "wholly exempt" from federal income tax. Put differently, § 265(a)(1) generally prohibits taxpayers from double-dipping: taking deductions for expenses attributable to tax-exempt income. Section 265 most often has been applied to disallow deductions for expenses paid to seek or obtain tax-exempt income. (For example, a taxpayer claiming nontaxable social security disability benefits pays legal fees to pursue the claim. The legal fees are not deductible under Code § 265(a)(1). *See* Rev. Rul. 87-102, 1987-2 C.B. 78.) Covered expenses, on the other hand, presumably would have been incurred by taxpayers (at least in part) regardless of the PPP. The question arises, therefore, whether covered expense deductions are disallowed by Code § 265 when all or a portion of a PPP covered loan *subsequently* is forgiven.

*Notice 2020-32*. The notice sets forth the IRS's position that covered expenses funded by the portion of a PPP covered loan subsequently forgiven are not deductible pursuant to § 265. The IRS reasons that regulations under § 265 define the term "class of exempt income" as any class of income (whether or not any amount of income of such class is received or accrued) that is either wholly excluded from gross income for federal income tax purposes or wholly exempt from federal income taxes. *See* Reg. § 1.265-1(b)(1). Thus, because the forgiven portion of a covered loan is nontaxable (i.e., "wholly exempt") and is tied to the taxpayer's expenditure of the loan proceeds for covered expenses, § 265 disallows a deduction for those expenses. The IRS also cites several cases in support of its position. *See Manocchio v. Commissioner*, 78 T.C. 989 (1982) (taxpayer-pilot's flight-training expenses funded with a nontaxable Veteran's Administration allowance not deductible pursuant to § 265(a)(1)), *aff'd on other grounds*, 710 F.2d 1400 (9th Cir. 1983); *Banks v. Commissioner*, 17 T.C. 1386 (1952) (deduction for business-related educational expenses disallowed under § 265(a)(1) when paid by the Veterans' Administration and not taxable to taxpayer); *Heffelfinger v. Commissioner*, 5 T.C. 985 (1945) (Canadian income taxes on income exempt from U.S. tax are not deductible in computing U.S. taxable income pursuant to § 265(a)(1)'s statutory predecessor). As if to convince itself, though, the IRS also cites as support—but without analysis—several arguably inapposite cases that do not rely upon § 265(a)(1). Instead, these cases hold that expenditures reimbursed from or directly tied to nontaxable funds are not deductible. *See, e.g., Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966) (living expenses advanced by personal injury attorney to clients pending outcome of lawsuit not deductible because the expenses will be reimbursed from the lawsuit proceeds); *Wolfers v. Commissioner*, 69 T.C. 975 (1978) (taxpayer cannot deduct relocation costs funded with nontaxable proceeds from Federal Reserve Bank); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977) (similar).

*A possible legislative solution?* The authors doubt that Notice 2020-32 is the last word on the tax treatment of PPP covered loans and covered expenses. Apparently, many practitioners and at least a few members of Congress believe that the IRS's position in Notice 2020-32 contravenes congressional intent. *See* Chamseddine and Yauch, *Neal Plans PPP Fix to Provide Expenses Deduction*, 2020 TNTF 86-5 (5/4/20). Treasury Secretary Mnuchin, though, has defended the IRS's position. *See* Chamseddine, "Tax 101": Mnuchin Defends Nondeductibility of PPP Expenses, 2020 TNTF 87-2 (5/5/20). Furthermore, what happens to capitalized covered expenses? Are taxpayers forced to reduce basis when a portion of a covered loan is forgiven? What about outside basis adjustments for S corporations and partnerships that have paid covered expenses with the proceeds of a subsequently forgiven covered loan? Remember *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) (excludable cancellation of indebtedness increases S corporation shareholder's outside basis allowing use of previously suspended losses) followed by enactment of § 108(d)(7)(A) (legislatively overruling *Gitlitz*)?

*A broader perspective.* Perhaps the unstated but no less unsettling aspect of Notice 2020-32 is that the Notice fails to address adequately the inconsistent application of § 265 by the IRS and Treasury. It is well established that § 265(a)(1) disallows so-called "forward-looking" deductions allocable to "wholly exempt" income (i.e., expenses paid to earn or obtain exempt income). For instance, as mentioned above § 265(a)(1) disallows a deduction for legal fees paid to pursue a nontaxable social security disability award. *See* Rev. Rul. 87-102, 1987-2 C.B. 78. Less established, however, is whether § 265 disallows so-called "backward-looking" deductions (i.e., expenses funded with tax-exempt income but not paid to obtain such tax-exempt income). *Cf.* Rev. Rul. 75-232, 1975-1 C.B. 94 (taxpayer can exclude from income under § 104(a)(2) a settlement, including the portion allocated to future medical expenses, but cannot deduct that portion of the future medical expenses when incurred). For example, a taxpayer might receive an excludable bequest of artwork but nonetheless is allowed a charitable contribution deduction upon donating the artwork to a tax-exempt museum. For a thorough analysis, see Dodge, *Disallowing Deductions Paid with Excluded Income*, 32 Va. Tax Review 749 (2013).

**a. Don't think you can avoid having deductions disallowed just because your PPP loan has not yet been forgiven, says the IRS.** Rev. Rul. 2020-27, 2020-50 I.R.B. ___ (11/18/20). Following the IRS's issuance of Notice 2020-32, which provides that costs are not deductible to the extent they are paid with the proceeds of a PPP loan that is forgiven, many taxpayers questioned whether they could take deductions for costs paid in 2020 with the proceeds of a PPP loan if the loan is not forgiven in 2020. In this revenue ruling, the IRS has crushed the hopes of many taxpayers. According to the ruling:

> A taxpayer … [that paid expenses with the proceeds of a PPP loan] 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."

(Emphasis added.) The revenue ruling illustrates this rule in two situations. In the first, the taxpayer paid qualifying costs (payroll, mortgage interest, utilities, and rent) in 2020 with the proceeds of a PPP loan, satisfied all requirements for forgiveness of the loan, and applied for forgiveness of the loan, but the lender did not inform the taxpayer by the end of 2020 whether the loan would be forgiven. In the second situation, the facts were the same except that the taxpayer did not apply for forgiveness of the loan in 2020 and instead expected to apply for forgiveness of the loan in 2021. The ruling concludes that, in both situations, the taxpayers have a reasonable expectation that their loans will be forgiven and therefore cannot deduct the expenses they paid with the proceeds of their PPP loans. The ruling relies on two distinct lines of authority to support this conclusion. One line involves taxpayers whose deductions are disallowed because they have a reasonable expectation of reimbursement at the time they pay the costs in question. *See, e.g.*, *Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966) (attorney who advanced costs for client and was entitled to reimbursement if successful in the client's matter); *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971) (same). The IRS reasons in the ruling that the taxpayers in the two situations described have a reasonable expectation of reimbursement in the form of forgiveness of their PPP loans. The second line of authority is under § 265(a)(1), which disallows deductions for any amount otherwise deductible that is allocable to one or more classes of tax-exempt income regardless of whether the tax-exempt income is received or accrued. *See* Reg. § 1.265-1(a)(1), (b). Thus, according to the ruling, the fact that the loans in the two situations have not yet been forgiven does not preclude the costs paid by the taxpayers from being allocable to tax-exempt income.

**b. But taxpayers can deduct expenses paid with the proceeds of a PPP loan to the extent their applications for loan forgiveness are denied or to the extent they decide not to seek forgiveness of the loan.** Rev. Proc. 2020-51, 2020-50 I.R.B. ___ (11/18/20). This revenue procedure provides a safe harbor that allows taxpayers to claim deductions in a taxable 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 to the extent that, after 2020, the taxpayer's request for loan forgiveness is denied or the taxpayer decides not to request loan forgiveness. The deductions can be claimed on a timely filed (including extensions) original 2020 income tax return or information return, an amended 2020 return (or, in the case of a partnership, an administrative adjustment request for 2020), or timely filed original income tax return or information return for the subsequent year in which the request for loan forgiveness is denied or in which the taxpayer decides not to seek loan forgiveness. The deductions the taxpayer claims cannot exceed the principal amount of the PPP loan for which forgiveness was denied or will not be sought. To be eligible for the safe harbor, the taxpayer must attach a statement (titled "Revenue Procedure 2020-51 Statement") to the return on which the taxpayer claims the deductions. The statement must include information specified in the revenue procedure. The revenue procedure seems to acknowledge that, for taxpayers claiming the deductions in the subsequent taxable year in which loan forgiveness is denied, the safe harbor is unnecessary because such taxpayers would be able to deduct the expenses in the subsequent taxable year under general tax principles.

**c. Congress finally has stepped in and provided legislative relief.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 276 of the 2021 Consolidated Appropriations Act, provides that, for purposes of the Internal Revenue Code:

> no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income [of the forgiveness of a PPP loan]

The legislation also provides that, in the case of partnerships and subchapter S corporations, any amount forgiven is treated as tax-exempt income, which has the effect of providing a basis increase to the partners or shareholders. The provision applies retroactively as if it had been included in the CARES Act.

### E. Depreciation & Amortization

**1. We suppose it makes sense that racehorses have a swift recovery period.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 137 of the 2021 Consolidated Appropriations Act, extended the § 168(e)(3)(A)(i) classification of racehorses as 3-year MACRS property so that the classification applies to racehorses placed in service before January 1, 2022. A racehorse placed in service after December 31, 2021, qualifies for the 3-year recovery period only if it is more than two years old when placed in service. This provision allowing classification of all racehorses as 3-year property regardless of age had expired for racehorses placed in service after December 31, 2017, and was retroactively extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 114 of the 2020 Further Consolidated Appropriations Act.

**2. Good news for those who place motorsports entertainment complexes in service through 2025.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 115 of the 2021 Consolidated Appropriations Act, extended the § 168(e)(3)(C)(ii) classification of motorsports entertainment complexes as 7-year property to include property placed in service through December 31, 2025. *See* § 168(i)(15)(D). Such property is depreciable over a 7-year recovery period using the straight-line method. This provision had expired for property placed in service after December 31, 2017, and was retroactively extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 115 of the 2020 Further Consolidated Appropriations Act, to include property placed in service through December 31, 2020. As most recently amended, the provision now applies to property placed in service through December 31, 2025.

**3. For real property trades or businesses that elect out of the § 163(j) limitation on deducting business interest, the recovery period for residential rental properties under the alternative depreciation system is 30 years instead of 40 years for properties placed in service before 2018.** Section 163(j), enacted by the 2017 Tax Cuts and Jobs Act, § 13301, generally limits the deduction for business interest expense to the sum of: (1) business interest income, (2) 30 percent of "adjusted taxable income," and (3) floor plan financing interest. (Section 163(j)(10), enacted by the CARES Act, increases to 50 percent (instead of 30 percent) the "adjusted taxable income" component of the § 163(j) limitation for taxable years beginning in 2019 and 2020.) The § 163(j) limit applies to businesses with average annual gross receipts (computed over 3 years) of more than $25 million. Real property trades or businesses that are subject to § 163(j) can elect out of the limitation imposed by that provision. The cost of doing so, however, is that, pursuant to § 168(g)(1)(F) and (g)(8), a real property trade or business that elects out of the interest limitation of § 163(j) must use the alternative depreciation system (ADS) for nonresidential real property, residential rental property, and qualified improvement property. The 2017 Tax Cuts and Jobs Act, § 13204, modified the ADS to provide a recovery period of 30 years (rather than the former 40 years) for residential rental property subject to the ADS. This modification of the recovery period for residential rental property, however, applied only to property placed in service after December 31, 2017. This meant that, if a real property trade or business elected out of the interest limitation of § 163(j) in 2018 or future years, and if the business had placed residential rental property in service before January 1, 2018, it had to use the ADS for such property with a recovery period of 40 years. *See* Rev. Proc. 2019-8, § 4, 2019-3 I.R.B. 347. In the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 202 of the 2021 Consolidated Appropriations Act, Congress amended the 2017 Tax Cuts and Jobs Act, § 13204, to provide that the 30-year ADS recovery period applies to residential rental property that is held by an electing real property trade or business and that was placed in service before January 1, 2018. The effect of this amendment is that real property trades or businesses that elect out of the interest limitation of § 163(j) and therefore are subject to the ADS with respect to residential rental property can use a recovery period of 30 years for that property regardless of when the property was originally placed in service. This change applies retroactively to taxable years beginning after December 31, 2017.

## F. Credits

**1. Congress gives a "thumbs up" to new energy efficient homes.** Section 45L provides a credit of $2,000 or $1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year. The provision had expired for homes acquired after December 31, 2017, and was retroactively extended by a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 129 of the 2020 Further Consolidated Appropriations Act. Most recently, Congress extended the credit through a provision in the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 115 of the 2021 Consolidated Appropriations Act. As extended, the credit is available for homes acquired before January 1, 2022.

**2. Congress has extended through 2025 the credit for employers that pay wages to certain employees during periods of family and medical leave.** The 2017 Tax Cuts and Jobs Act enacted Code § 45S, which provides that an "eligible employer" can include the "paid family and medical leave credit" among the credits that are components of the general business credit under § 38(b). The credit is equal to a percentage of the amount of wages paid to "qualifying employees" during periods in which the employees are on family and medical leave. The credit is available against both the regular tax and the alternative minimum tax. As enacted, the § 45S credit was available for wages paid in taxable years beginning after December 31, 2017, and before January 1, 2020. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 142 of the 2020 Further Consolidated Appropriations Act, extended the credit to wages paid in taxable years beginning before January 1, 2021. Most recently, a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 119 of the 2021 Consolidated Appropriations Act, extended the credit to wages paid in taxable years beginning before January 1, 2026.

*Amount of the credit.* To be eligible for the credit, the employer must pay during the period of leave at a rate that is at least 50 percent of the wages normally paid to the employee. The credit is 12.5 percent of the wages paid, increased by 0.25 percentage points for each percentage point by which the rate of payment exceeds 50 percent. The maximum credit is 25 percent of wages. Thus, if an employer pays an employee at a rate that is 60 percent of the employee's normal wages, the credit is 15 percent of wages paid (12.5 percent plus 2.5 percentage points). The credit reaches 25 percent when the employer pays at a rate that is 100 percent of employee's normal wages. The credit cannot exceed the amount derived from multiplying the employee's normal hourly rate by the number of hours for which the employee takes leave. The compensation of salaried employees is to be prorated to an hourly wage under regulations to be issued by the Treasury Department. The maximum amount of leave for any employee that can be taken into account for purposes of the credit is twelve weeks per taxable year.

*Eligible employer.* An eligible employer is defined as one who has in place a written policy that (1) allows all full-time "qualifying employees" not less than two weeks of annual paid family and medical leave, and that allows all part-time qualifying employees a commensurate amount of leave on a pro rata basis, and (2) requires that the rate of payment under the program is not less than 50 percent of the wages normally paid to the employee.

*Eligible employee.* An eligible employee is defined as any employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more and who, for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees. For 2019, the threshold for highly compensated employees (see § 414(q)(1)(B)) was $125,000. Thus, for purposes of determining the credit in 2020, an employee is an eligible employee only if his or her compensation for 2019 did not exceed $75,000 ($125,000 * 60 percent).

*Family and medical leave.* The term "family and medical leave" is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993. (Generally, these provisions describe leave provided because of the birth or adoption of a child, because of a serious health condition of the employee or certain family members, or because of the need to care for a service member with a serious injury or illness.) If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave is not considered to be family and medical leave.

*No double benefit.* Pursuant to Code § 280C(a), no deduction is allowed for the portion of wages paid to an employee for which this new credit is taken. Thus, if an employer pays $10,000 to an employee and takes a credit for 25 percent, or $2,500, the employer could deduct as a business expense only $7,500 of the wages.

*Effective date.* The credit is now available for wages paid in taxable years beginning after December 31, 2017, and before January 1, 2026.

**3. Congress has extended various business credits.** The Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, of the 2021 Consolidated Appropriations Act, extended several business credits, including: (1) the § 51 Work Opportunity Credit, extended for wages paid through December 31, 2025; (2) the § 45 credit for electricity produced from certain renewable resources, extended for facilities for which construction has commenced before January 1, 2022); (3) the § 45G railroad track maintenance credit, extended for 50 percent of qualified railroad track maintenance expenditures paid or incurred in taxable years beginning before January 1, 2023 (reduced to 40 percent after that date); (4) the § 45A Indian Employment Credit, extended for taxable years beginning before January 1, 2022, and the § 45 Indian Coal Production Credit, extended for coal produced before January 1, 2022; (5) the § 45D New Markets Credit, extended through 2025; (6) the § 45N mine rescue team training credit, extended for taxable years beginning before January 1, 2022; and (7) a number of others that we have missed or didn't care enough about to include.

### G. Natural Resources Deductions & Credits

### H. Loss Transactions, Bad Debts, and NOLs

### I. At-Risk and Passive Activity Losses

## III. INVESTMENT GAIN AND INCOME

## IV. COMPENSATION ISSUES

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

### B. Miscellaneous Income

**1. Congress has extended through 2025 the exclusion for discharge of qualified principal residence indebtedness.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 114 of the 2021 Consolidated Appropriations Act, extended through December 31, 2025, the § 108(a)(1)(E) exclusion for up to $2 million ($1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness. The provision had expired after 2017 and was retroactively extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 101 of the 2020 Further Consolidated Appropriations Act, to apply for calendar years 2018, 2019, and 2020. As most recently amended, the provision applies for calendar years 2021 through 2025.

**2. Volunteer firefighters and emergency medical responders can exclude from gross income any reduction or rebate of state or local tax and up to $50 per month of any payments they receive for their service for 2020 and beyond.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 103 of the 2021 Consolidated Appropriations Act, made permanent Code § 139B. Section 139B allows volunteer firefighters and emergency medical responders to exclude from gross income any reduction or rebate of state or local tax they receive for their service as well as up to $50 per month of any payment they receive on account of their service. Congress enacted § 139B in 2007 but the provision had expired for taxable years beginning after 2010. Congress had reinstated § 139B for taxable years beginning after December 31, 2019, and before January 1, 2021, i.e., only for 2020, in the SECURE Act, Division O, Title 3, § 301 of the 2020 Further Consolidated Appropriations Act. As most recently amended, the provision is permanent for taxable years beginning after 2020.

### C. Hobby Losses and § 280A Home Office and Vacation Homes

### D. Deductions and Credits for Personal Expenses

**1. The reduction of the personal exemption deduction to zero does not affect an individual's ability to claim the § 36B premium tax credit.** Guidance Clarifying Premium Tax Credit Unaffected by Suspension of Personal Exemption Deduction, 85 F.R. 76976 (12/1/20). The Treasury Department and the IRS have finalized, without change, proposed regulations that clarify that an individual's ability to claim the premium tax credit of § 36B is not affected by Congress's reduction of the personal exemption deduction to zero. *See* Guidance Clarifying Premium Tax Credit Unaffected by Suspension of Personal Exemption Deduction, 85 F.R. 31710 (5/27/20). Section 151(a) authorizes a deduction for allowable exemptions, and § 151(b)-(c) provide exemptions of the "exemption amount" for the taxpayer and each individual who is a dependent of the taxpayer as defined in § 152. In the 2017 Tax Cuts and Jobs Act, Congress temporarily eliminated the deduction for exemptions for the taxpayer and the taxpayer's dependents by adding § 151(d)(5). Section 151(d)(5)(A) provides that, for the years 2018-2025, the exemption amount is zero. Nevertheless, § 151(d)(5)(B) provides that the reduction of the exemption amount to zero "shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section." In other words, for purposes of provisions of the Code that refer to a taxpayer being entitled to a deduction under § 151 for exemptions for the taxpayer or the taxpayer's dependents, the fact that the exemption amount has been reduced to zero (which results in no deduction) is not taken into account. Pursuant to this authority, these final regulations provide that the reduction of the exemption amount to zero does not affect an individual's ability to claim the premium tax credit authorized by § 36B. As noted in the preamble to these final regulations, "[s]everal rules relating to the premium tax credit apply based on whether a taxpayer property claims or claimed a personal exemption deduction under section 151 for the taxpayer, the taxpayer's spouse, and dependents." For example, various rules require determining the members of the taxpayer's "family," and Reg. § 1.36B-1(d)(1) provides that "[a] taxpayer's family means the individuals for whom a taxpayer properly claims a deduction for a personal exemption under section 151 for the taxable year." Among other amendments, the final regulations add Reg. § 1.36B-1(d)(2), which provides:

> For taxable years to which section 151(d)(5) applies, a taxpayer's family means the taxpayer, including both spouses in the case of a joint return, except for individuals who qualify as a dependent of another taxpayer under section 152, and any other individual for whom the taxpayer is allowed a personal exemption deduction and whom the taxpayer properly reports on the taxpayer's income tax return for the taxable year. For purposes of this paragraph (d)(2), an individual is reported on the taxpayer's income tax return if the individual's name and taxpayer identification number (TIN) are listed on the taxpayer's Form 1040 series return. See §601.602 of this chapter.

The final regulations generally apply to taxable years ending on or after December 31, 2020, but taxpayers can apply the final regulations to taxable years to which § 151(d) applies that end before that date.

**2. Permanent extension of the 7.5 percent threshold for deduction of medical expenses.** Prior to the 2017 Tax Cuts and Jobs Act, medical expenses generally were deductible only to the extent they exceeded 10 percent of a taxpayer's adjusted gross income. For taxable years beginning after 2012 and ending before 2017, this threshold was reduced to 7.5 percent if the taxpayer or the taxpayer's spouse had attained age 65 by the close of the year. The 2017 Tax Cuts and Jobs Act, § 11027, amended § 213(f) to provide that the 7.5 percent threshold applies to all taxpayers for taxable years beginning after 2016 and ending before 2019, i.e., to calendar years 2017 and 2018. Further, the legislation provided that this threshold applies for purposes of both the regular tax and the alternative minimum tax. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 103 of the 2020 Further Consolidated Appropriations Act, retroactively extended this reduced threshold to taxable years beginning before January 1, 2021, i.e., to calendar years 2019 and 2020. Most recently, a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 101 of the 2021 Consolidated Appropriations Act, made this reduced threshold permanent for taxable years beginning after December 31, 2020.

**3. Mortgage insurance premiums paid through 2021 remain deductible** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 133 of the 2021 Consolidated Appropriations Act, extends through December 31, 2021, the § 163(h)(3)(E) deduction (subject to the pre-existing limitations) for mortgage insurance premiums paid or accrued in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer. This provision had expired after 2017 and was retroactively extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 102 of the 2020 Further Consolidated Appropriations Act through December 31, 2020. The provision now applies through December 31, 2021.

**4. For 2020, all individuals can use prior-year earned income to determine their earned income tax credit and child tax credit.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 211 of the 2021 Consolidated Appropriations Act, provides that individuals can elect to use prior-year earned income for purposes of determining the individual's earned income tax credit under § 32 and child tax credit under § 24. The election is available for individuals whose earned income for the taxpayer's first taxable year beginning in 2020 is lower than their earned income for the preceding tax year. For married couples filing a joint return, the earned income for the preceding year is the sum of the earned income in the preceding year of both spouses.

- Congress previously has allowed individuals affected by certain natural disasters to use prior-year earned income in this manner. In extending this privilege to all individuals, Congress presumably recognized the widespread effect on earned income of the COVID-19 pandemic.

## E. Divorce Tax Issues

## F. Education

**1. An increase in the income threshold above which the Lifetime Learning Credit begins to phase out.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 104(a) of the 2021 Consolidated Appropriations Act, increased the income threshold above which the Lifetime Learning Credit provided by § 25A begins to phase out. The Lifetime Learning Credit is allowed for qualified tuition and related expenses for higher education of the taxpayer, the taxpayer's spouse, or dependents. The credit is available for qualifying expenses paid to acquire or improve job skills of an individual and thus is available for education throughout one's lifetime. In contrast, the American Opportunity Credit, also provided by § 25A, is available for qualified tuition and related expenses only for the first four years of post-secondary education. Before this legislation, the American Opportunity Credit and the Lifetime Learning Credit were subject to separate income-based phase-outs. The income threshold for the American Opportunity Credit was higher than that for the Lifetime learning Credit. As amended, § 25A(d) now provides a single income-based phase-out that applies for purposes of both credits. The effect of this change is to make the Lifetime learning Credit available to more taxpayers. The change applies to taxable years beginning after 2020.

- Under the unified income-based phase-out that applies to the American Opportunity Credit and Lifetime Learning Credit, each credit is phased out to the extent that the taxpayer's modified adjusted gross income (as defined) exceeds $80,000 ($160,000 for a married couple filing jointly). Each credit is eliminated when the taxpayer's modified adjusted gross income reaches $90,000 ($180,000 for a married couple filing jointly). These amounts are not adjusted for inflation.

- Simultaneously with the increased income threshold above which the Lifetime Learning Credit begins to phase out, Congress repealed the § 222 above-the-line deduction for qualified tuition and related expenses for tax years beginning after 2020.

**2. Repeal of the deduction for paying your child's college tuition.** A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 104(b) of the 2021 Consolidated Appropriations Act, repealed the § 222 above-the-line deduction for individuals of a limited amount ($0, $2,000, or $4,000, depending on the taxpayer's adjusted gross income) of qualified tuition and related expenses for higher education of the taxpayer, the taxpayer's spouse, or dependents. The repeal is effective for tax years beginning after 2020. Simultaneously with the repeal, Congress amended § 25A to increase the income threshold above which the § 25A Lifetime Learning Credit begins to phase out. The Lifetime Learning Credit, like the § 222 deduction, is allowed for qualified tuition and related expenses and will now be available to more taxpayers.

- Previously, a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title I, § 104 of the 2020 Further Consolidated Appropriations Act, had retroactively extended the § 222 deduction through December 31, 2020. With this retroactive extension, the deduction is available for calendar years 2018, 2019, and 2020.

**3. Want to get rid of that student loan? Get the boss to pay it tax-free!** Generally, Code § 127(a) excludes from the gross income of an employee up to $5,250 of employer-provided "educational assistance" as defined in § 127(c). The CARES Act, § 2206, amended Code § 127(c)(1) by redesignating subparagraph (B) as subparagraph (C) and adding a new subparagraph (B) that temporarily expands the definition of "educational assistance." Section § 127(c)(1)(B) provides that the term "educational assistance" within the meaning of § 127(c)(1) includes repayments of "qualified education loans" by an employer whether paid to the employee or to the lender. As added by the CARES Act, § 127(c)(1)(B) applied to payments made after March 27, 2020 (the date of enactment of the CARES Act) and before January 1, 2021. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 120(b) of the 2021 Consolidated Appropriations Act, extends the provision to payments made before January 1, 2026.

### G. <u>Alternative Minimum Tax</u>

## VI. CORPORATIONS

## VII. PARTNERSHIPS

## VIII. TAX SHELTERS

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

### B. Charitable Giving

#### 1. Provisions of the CARES Act that affect charitable contributions.

**a. "CARE" for a charitable panacea (at least in part) for a pandemic? A limited above-the-line deduction in 2020 and a deduction for non-itemizers in 2021 for contributions to public charities.** It took a pandemic, but Congress has reversed itself, at least partially, with respect to non-itemizers and charitable contributions. To wit, the CARES Act, § 2204, added new Code § 62(a)(22), which allows individual taxpayers who claim the standard deduction (i.e., non-itemizers) to deduct up to $300 in above-the-line "qualified charitable contributions." The legislation also adds new Code § 62(f), which defines "qualified charitable contributions" as donations of cash to organizations described in Code § 170(b)(1)(A)—primarily, so-called "public charities" such as churches, schools, hospitals, and publicly-supported nonprofits, but not non-operating private foundations, donor-advised funds, and Type III supporting organizations. New Code §§ 62(a)(22) and 62(f) are effective for taxable years beginning after 2019. This above-the-line deduction for qualified charitable contributions applies to "taxable years beginning in 2020" and thus is in effect for 2020.

- Congress has extended this deduction, in modified form, to 2021. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 212(a) of the 2021 Consolidated Appropriations Act, amends Code § 170 by enacting new § 170(p). Section 170(p) provides that, if an individual does not elect to itemize deductions, then the deduction authorized by § 170 is equal to the deduction that would be determined, not in excess of $300 ($600 for joint filers), for cash contributions to public charities. The legislation simultaneously repeals § 62(a)(22) and § 62(f), both enacted by the CARES Act, and amends the definition of taxable income in § 63(b) to make clear that the limited deduction authorized by § 170(p) is subtracted from adjusted gross income to arrive at taxable income. Thus, the $300 deduction for cash contributions to public charities will no longer be an above-the-line deduction but nevertheless will be available to non-itemizers. This change applies to taxable years beginning after December 31, 2020.

- These changes for non-itemizers partially reverse a significant effect of the 2017 Tax Cuts and Jobs Act. Specifically, the 2017 Tax Cuts and Jobs Act substantially increased the standard deduction such that many taxpayers no longer needed to itemize deductions starting in 2018. In 2020, for instance, the standard deduction is $24,800 for joint returns and surviving spouses, $12,400 for unmarried individuals and married individuals filing separately, and $18,650 for heads of households. *See* Rev. Proc. 2019-44, 2019-47 I.R.B. 1093 (11/6/19). Many charities predicted that the increased standard deduction would lead to decreased charitable giving, and a study by Giving USA found this to be true for 2018. *See* Eisenberg, *Charitable Giving Took a Hit Due to Tax Reform*, Forbes (6/18/19) (*available online here*).

**b. Also new for 2020 and 2021: You can elect to "CARE" less about charitable contribution limits on donations of cash to public charities.** The CARES Act, § 2205, an uncodified provision, temporarily suspends for 2020 the charitable contribution limits of Code § 170(b) for electing individual and corporate taxpayers. The legislation provides that "qualified contributions" by an individual are not subject to the normal limits, and instead are allowed, if the individual so elects, up to the amount by which the taxpayer's contribution base (generally, adjusted gross income) exceeds the other charitable contributions the taxpayer makes, i.e., those subject to the normal limits. In effect, this permits individual taxpayers to elect to deduct qualified contributions up to 100 percent of the taxpayer's contribution base (AGI) after taking into account other charitable contributions. A corporation may elect to deduct qualified contributions up to the amount by which 25 percent of its taxable income exceeds the corporation's other charitable contributions, i.e., the corporation can deduct qualified contributions up to 25 percent of taxable income after taking into account other charitable contributions. Qualified contributions by an individual or a corporation that exceed the relevant limit can be carried forward five years. A *qualified contribution* is defined as a contribution paid in cash during 2020 to an organization described in § 170(b)(1)(A) with respect to which the taxpayer elects to have the increased limits apply. As noted above, Code § 170(b)(1)(A) organizations primarily consist of so-called "public charities" such as churches, schools, hospitals, and publicly-supported nonprofits, but not non-operating private foundations, donor-advised funds, and Type III supporting organizations. Section 2205 of the CARES Act does not specify precisely how individuals and corporations elect into the temporary charitable contribution limits for donations of cash made in 2020. The legislation also temporarily increases from 15 percent to 25 percent the § 170(e)(3)(C) limit on contributions of food inventory made in 2020.

- *These same rules apply for 2021.* Congress has extended these increased limits on cash contributions to public charities to 2021. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 213 of the 2021 Consolidated Appropriations Act, amends § 2205 of the CARES Act to provide that the increased limits also apply in 2021.

- *The individual limit already had been increased slightly.* Prior to the CARES Act, Congress, in the 2017 Tax Cuts and Jobs Act, had increased the limit on deducting charitable contributions for individual donations from its historical norm without requiring an election into the new rules. Under Code §§ 170(b)(1)(G) and (H), as amended by § 11023 of the 2017 Tax Cuts and Jobs Act, individuals can take a charitable contribution deduction of up to 60 percent of their contribution base for cash donations made to Code § 170(b)(1)(A) organizations in taxable years beginning after 2017 but before 2026. Beginning in 2026 and thereafter, the charitable contribution limit for individuals reverts to its historical norm of 50 percent of an individual's contribution base.

- *This is not a revolutionary idea.* Increasing charitable contribution deduction limits on an elective basis during times of crisis is not a new idea. For instance, Section 504(a) of the 2017 Disaster Relief Act increased the charitable contribution limits for donations that benefitted those affected by Hurricanes Harvey, Irma, or Maria for eligible and electing taxpayers. Similarly, the Bipartisan Budget Act of 2018, § 20104(a) of Division B, increased the limit on deductions for charitable contributions towards relief efforts in areas affected by the California wildfires for eligible and electing taxpayers. Most recently, a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, Division Q, Title II, § 204(a) of the 2020 Further Consolidated Appropriations Act, provided special rules for charitable contributions for relief efforts in qualified disaster areas.

## X. TAX PROCEDURE

### A. Interest, Penalties, and Prosecutions

**1. The sole shareholder of a captive insurance company organized as an S corporation escaped penalties because the IRS failed to comply with the supervisory approval requirement of § 6751(b).** Oropeza v. Commissioner, 155 T.C. No. 9 (10/13/20). The issue in this case was whether the IRS was precluded from asserting penalties because it had failed to comply with the requirement of § 6751(b)(1) that the initial determination of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The taxpayer was the sole shareholder of a micro-captive insurance company organized as a subchapter S corporation. The limitations period for assessment of tax for 2011 was nearing expiration and the taxpayer would not agree to extend it. Accordingly, on January 14, 2015, the IRS revenue agent auditing the taxpayer's 2011 return sent petitioner a Letter 5153 along with the revenue agent's report on Form 4549-A, Income Tax Discrepancy Adjustments. The revenue agent's report proposed to increase the taxpayer's distributive share of income from the S corporation by $1.25 million and his reported capital gain by $650,000. The report also asserted a 20 percent accuracy-related penalty under 6662(a). The report did not state the specific basis for the penalty but instead stated that it was based on a substantial underpayment of tax "attributable to one or more of" four possible grounds: (1) negligence, (2) substantial understatement of income tax, (3) substantial valuation misstatement (overstatement), or (4) transaction lacking economic substance. On January 29, 2015, the revenue agent's supervisor signed a Civil Penalty Approval Form that authorized the assertion of a 20 percent penalty for substantial understatement of income tax. In a subsequent memorandum prepared for an IRS Chief Counsel attorney and dated May 1, 2015, the revenue agent recommended a 40 percent penalty pursuant to § 6662(i) for a nondisclosed economic substance transaction based on the taxpayer's failure to disclose the captive insurance arrangement on either the subchapter S corporation's return or his personal return. The revenue agent's supervisor signed the memorandum on an unspecified date. The IRS issued a notice of deficiency on May 6, 2015, in response to which the taxpayer filed a petition in the Tax Court. The notice of deficiency asserted a 40 percent penalty under § 6662(i) for a nondisclosed economic substance transaction or, in the alternative, a 20 percent penalty based on either negligence or substantial understatement of income tax. In the Tax Court, the IRS conceded that it had not obtained supervisory approval of the negligence penalty. The Tax Court (Judge Lauber) held that the IRS was precluded from asserting both the 20 percent penalty based on substantial understatement of income tax or the 40 percent penalty for a nondisclosed economic substance transaction. With respect to the 20 percent penalty, the court relied on its prior decision in *Belair Woods, LLC v. Commissioner*, 154 T.C. No. 1 (1/6/20), in which the court had held that initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. In this case, the court held, the initial determination of the penalty was the Letter 5153 that was mailed to the taxpayer on January 14, 2015. Because the required supervisory approval of that penalty did not occur until January 29, 2015, the approval was untimely. With respect to the 40 percent penalty, the parties agreed that the first notification to the taxpayer was the notice of deficiency that was issued on May 6, 2015. The IRS argued that this penalty received the required supervisory approval when the revenue agent's supervisor signed the revenue agent's memorandum dated May 1, 2015, to the IRS Chief Counsel attorney. The court first concluded that § 6662(i) does not impose a distinct penalty, but instead "increases the rate of the penalty imposed by section 6662(a) and (b)(6) for engaging in a transaction lacking economic substance." The relevant questions therefore became whether the revenue agent's report had asserted a penalty under §§ 6662(a) and (b)(6) that received the required supervisory approval, and if not, whether the IRS can satisfy the § 6751(b) supervisory approval requirement by later determining that § 6662(i) applies because the transaction was not disclosed on the return. The court held that the "boilerplate text" of the Letter 5153 sent to the taxpayer on January 14, 2015, did assert a penalty under §§ 6662(a) and (b)(6) for engaging in a transaction lacking economic substance, and that the revenue agent's supervisor had not timely approved this penalty because the supervisor did not sign the Civil Penalty Approval Form until January 29, 2015. The court then turned to the question, which it regarded as one of first impression, of whether the IRS can satisfy the § 6751(b) supervisory approval requirement by later determining that § 6662(i) applies because a transaction was not disclosed on the return. The court reviewed the text and legislative history of § 6662 and concluded that the 40-percent penalty of § 6662(i) is an enhancement of the 20 percent penalty imposed by §§ 6662(a) and (b)(6) in situations in which the taxpayer has failed to disclose on the return a transaction lacking economic substance. The court viewed the enhancement as analogous to an "aggravating factor" in the area of criminal law that justifies a harsher penalty for a basic offense. Because the § 6662(i) penalty is an enhancement of the basic penalty imposed by §§ 6662(a) and (b)(6), and because the IRS had failed to obtain supervisory approval of the basic penalty, the court held, it was precluded from asserting the 40 percent enhancement of the penalty.

### B. **Discovery: Summonses and FOIA**

### C. **Litigation Costs**

### D. **Statutory Notice of Deficiency**

### E. **Statute of Limitations**

### F. **Liens and Collections**

### G. **Innocent Spouse**

### H. **Miscellaneous**

## XI. WITHHOLDING AND EXCISE TAXES

## XII. TAX LEGISLATION