Taxation of Individual Income

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Preface

Federal tax law has changed in some important ways in recent months. Legislative developments include various provisions of the Further Consolidated Appropriations Act, 2020 (which incorporates the Setting Every Community up for Retirement Enhancement (SECURE) Act) and the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Administrative developments include Treasury’s promulgation of proposed and final regulations interpreting and applying certain provisions of the Tax Cuts and Jobs Act of 2017. Judicial developments are reflected in the decisions rendered by the Tax Court and other federal courts addressing the proper application of various Code sections. This Supplement highlights these legislative, administrative, and judicial developments as they relate to topics discussed in Taxation of Individual Income, Twelfth Edition.
Chapter 1

Introduction to Federal Income Taxation

Page 14: Add to Footnote 3 that for 2020 the basic standard deduction is $24,800 on a joint return and is $12,400 on the return of an unmarried individual (not a surviving spouse or head of household). Rev. Proc. 2019-44, I.R.B. 2019-47.

Page 17: At the end of the first full paragraph, add the following:

Note: For the year 2020 only, the CARES Act allows “qualified charitable contributions,” in an amount not to exceed $300, to be deductible above the line. § 62(a)(22). Among other requirements, qualified charitable contributions must be made in cash and must be made by “eligible individuals,” i.e., individuals who do not elect to itemize. Section 62(a)(22) allows a modest above-the-line deduction to taxpayers who could otherwise not deduct any portion of their charitable contributions if their standard deduction exceeds their itemized deductions, as is the case for most taxpayers. Because Caroline’s itemized deductions exceed her standard deduction, she will elect to itemize her deductions and, as illustrated in the analysis, will be allowed to deduct all her charitable contributions regardless of § 62(a)(22).

Page 19: Tax Rates. As noted, the tax rate tables under § 1 are adjusted annually for inflation. The tables for 2020 are contained in Rev. Proc. 2019-44, I.R.B. 2019-47.

Page 20: Credits. At the end of the first paragraph under Credits, add the following:

The CARES Act, as part of its efforts to assist individuals during the massive disruptions of the coronavirus epidemic, added an unusual credit to the Code, applicable to 2020 only. Section 6428, entitled “2020 Recovery Rebates for Individuals,” allows “as a credit against the tax imposed by subtitle A” an amount equal to $1,200 for each eligible individual plus $500 for each qualifying child. The credit phases out for individuals with more than $75,000 of adjusted gross income and for married taxpayers filing a joint return with an adjusted gross income exceeding $150,000. Each eligible individual is “treated as having made a payment against the tax imposed” in an amount equal to the “advance refund” authorized by the statute.
Chapter 3

The Effect of an Obligation to Repay

Page 57: Following the carryover paragraph at the top of the page, insert:

In Novoselsky v. Commissioner, T.C. Memo. 2020-68, the Tax Court restated its position on determining whether a transfer of funds is a loan or a taxable payment. The taxpayer, who “practiced law with a focus on class action litigation,” entered into “litigation support agreements” pursuant to which various persons made upfront payments to him to support the cost of litigation. Under the terms of these agreements, if the litigation was successful the taxpayer repaid the upfront payment plus a premium; if not, the taxpayer was under no obligation to make repayment. The taxpayer took the position the upfront payments were loans. The Tax Court held they were gross income.

Because a genuine loan is accompanied by an obligation to repay, loan proceeds do not constitute income to the taxpayer.... For this rule to apply, however, the obligation to repay ‘must be unconditional and not contingent upon some future event’.... Where an obligation to pay arises only upon the occurrence of a future event, we have consistently held that a valid debt does not exist for Federal tax purposes....

The Tax Court held this same analysis applied here, where repayment of the upfront payments was conditioned on the outcome of litigation. The court went on to state that it would reach the same conclusion — i.e., the upfront payments were income, not loans — under a so-called multifactor analysis, noting:

[Taxpayer] did not execute a formal promissory note; no fixed schedule for repayments was established; [taxpayer] provided no collateral or security; and no payments of principal were ever made.... [No] interest or other amount was ever paid.... Most importantly, the parties did not conduct themselves as if the transactions were bona fide loans.
Chapter 5
Gifts, Bequests and Inheritance

Page 112: Insert the following after the Goodwin case:

In Felton v. Commissioner, T.C. Memo. 2018-168, the Tax Court concluded that voluntary payments from members of a congregation to a pastor were income, not gifts. The court in Felton reviewed the caselaw on donations to clergy and found that four factors were important in distinguishing between income and gifts: (1) “whether the donations are objectively [emphasis added] provided in exchange for services;” (2) “whether the cleric (or other church authorities) requested the personal donations;” (3) “whether the donations were part of a routinized, highly structured program, and given by individual church members or the congregation as a whole;” and (4) “whether the cleric receives a separate salary from the church and the amount of that salary in comparison to the personal donations.” In its assessment of the facts, the court concluded that income characterization was appropriate, given that factors (1), (3), and (4) supported such characterization, and noting in particular, with regard to factor (4), that the purported gifts were “around double the total of his deemed salary and parsonage allowance for both of the years at issue.”

The same result obtained in another case, Brown v. Commissioner, T.C. Memo. 2019-69, involving purported gifts to a pastor from members of his congregation. The court in Brown applied the four-factor test noted above in Felton and found that all four factors supported income characterization. As it did in Felton, the court in Brown found that “when comparatively so much money flows to a person from people for whom he provides services (even intangible ones), and to whom he expects to provide services in the future, we find it to be income and not gifts.”
Chapter 7

Scholarships and Prizes

Page 137: Add to the last paragraph’s discussion of § 127:

Pursuant to the CARES Act, for the year 2020 only, “educational assistance” eligible for exclusion from an employee’s income under § 127 includes an employer’s payment of principal or interest on an employee’s qualified education loan. § 127(c)(1)(B), as amended.
Chapter 8
Life Insurance and Annuities

Page 158: In Problem 2 assume that the early distribution penalty of § 72(t) is inapplicable.

In Problem 3, assume the distribution is not a “coronavirus-related distribution” as that term is defined in Section 2204(a)(4)(A) of the CARES Act and is thus not exempted from the § 72(t) early withdrawal penalty. (As noted below, Section 2202(a)(1) of the CARES Act specifically provides that § 72(t) will not apply to any “coronavirus-related distributions.”) Additionally, assume no part of the distribution could qualify for the special rule of § 72(t)(2)(H) [added by the SECURE Act] which negates any early distribution penalty on distributions of up to $5,000 made “during the 1-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized.”

Page 160: The SECURE Act repealed § 219(d)(1) which had disallowed deductions for “qualified retirement contributions for the benefit of an individual who had attained the age of 70½ before the close of such individual’s taxable year for which the contribution was made.” As a result, contributions for the benefit of an individual can continue after the individual has attained the age of 70 ½. The repeal of § 219(d)(1) is effective for taxable years beginning after December 31, 2019.

Page 161: The Tax Court in Conard v. Commissioner, 154 T.C. No. 6 (March 2020), held that “applying the §72(t) additional tax to the qualified retirement plan distributions [received by a taxpayer] while she was not yet 59-1/2, was not disabled, and was otherwise not eligible for any of the other exceptions described in § 72(t)(2), does not violate the equal protection component of the Due Process Clause of the Fifth Amendment.”

Page 161 (A. Deductible IRAs — The Investment for Retirement Purpose): The Secure Act amended § 401(a)(9)(C)(i)(I) by striking 70 ½ and inserting “age 72.” Thus, distributions from an IRA must commence by April 1 of the year following the year the taxpayer reaches age 72. (See § 408(a)(6)). The CARES Act amended § 401(a)(9) by providing that the minimum distribution requirement would be temporarily waived for calendar year 2020. § 401(a)(9)(I). As a result, for an individual who attains the age of 72 in 2020 and, as a result, whose required beginning date for minimum distributions would be April 1, 2021, no distribution is required for 2020. Thus, that individual would not be required to make a distribution by April 1, 2020.

Section 2202(a)(1) of the CARES Act specifically provides that § 72(t) (imposing a 10% additional tax on early distributions from qualified retirement plans) will not apply to any “coronavirus-related distributions.” Section 2202(a)(2)(A) of that Act limits the amount of distributions that can be treated as “coronavirus-related distributions” to $100,000. Unless a taxpayer elects otherwise, any amount of a coronavirus-related distribution required to be
included in gross income shall be included ratably over a 3-taxable year period beginning with the taxable year of the distribution. Section 2202(a)(5)(A). A “coronavirus-related distributions” is defined in Sec. 2202(a)(4) of the Act and must be made on or after January 1, 2020, and before December 31, 2020.

Page 161 (B. Nondeductible IRAs — Nondeductible Contribution Limits): As a result of the SECURE Act’s repeal of § 219(d)(1), contributions to nondeductible IRAs may be made even after the individual attains the age of 70 ½. See § 408(o)(2)(B)(i).

Page 161 (B. Nondeductible IRAs — The Investment-for-Retirement Purpose): As in the case of deductible IRAs, distributions from nondeductible IRA’s no longer must commence by April 1 of the year following the year the taxpayer reaches the age of 70 ½. See § 401(a)(9)(C)(i)(I) The special rule of Section 2202(a)(1) of the CARES Act regarding the § 72(t) additional tax or early distributions is also applicable to nondeductible IRAs.

Page 162 (Roth IRAs — Contribution Limits): Substitute for the last sentence of this paragraph the following sentence:

Contributions to Roth IRAs, unlike contributions to deductible and nondeductible IRAs, may be made for the benefit of an individual after the individual has reached the age of 72.

Page 162 (Roth IRAs — The Investment-for-Retirement purpose): Substitute the following sentence for the sentence in the casebook:

While Congress established the Roth IRA to encourage investment for retirement, that purpose is undercut somewhat by (1) a taxpayer’s ability to make contributions to the Roth IRA regardless of the taxpayer’s age; (2) the lack of a requirement for distribution when a taxpayer reaches age 72; and (3) the special ordering rule for distributions not qualifying for exclusion.
Chapter 9

Discharge of Indebtedness

Page 172: After the first full paragraph, insert the following:

In *Hamilton v. Commissioner*, T.C. Memo 2018-62, the Tax Court considered whether money transferred to the taxpayers’ son had to be considered in determining the taxpayers’ insolvency status under § 108(a)(1)(B). Mr. Hamilton, who became permanently disabled as a result of certain injuries, sought relief from education loans taken out for the taxpayers’ son education. The lender ultimately discharged education loans amounting to approximately $158,500. In the same year as the discharge of the education indebtedness, Mr. Hamilton received a $308,105 nontaxable cash distribution relating to his interest in a limited liability company. His spouse, apparently concerned about her husband’s erratic spending, transferred $323,000 to their son’s savings account. In turn, the son gave his mother his electronic banking username and password and gave her permission to transfer funds from his savings account. Mrs. Hamilton regularly transferred money from the son’s savings account to the taxpayers' joint account, from which she paid a majority of the household bills.

On their tax return for the year, the taxpayers, claiming to be insolvent, did not include any discharge of indebtedness income. Challenging the taxpayers’ position, the Service argued that the taxpayers’ son held his savings account as a nominee for the taxpayers, and, accordingly, his savings account should be taken into consideration in determining taxpayers' insolvency status.

In resolving the issue, the Tax Court looked first to applicable state law, noting that Utah courts use the following six factors to determine whether a nominee relationship exists:

(i) the taxpayer exercises dominion and control over the property while the property is in the nominee's name; (ii) the nominee paid little or no consideration for the property; (iii) the taxpayer placed the property in the nominee's name in anticipation of a liability or lawsuit; (iv) a close relationship exists between the taxpayer and the nominee; (v) the taxpayer continues to enjoy the benefits of the property while it is in the nominee's name; and (vi) the conveyance to the nominee is not recorded.

Applying these factors and concluding the taxpayers had failed to establish that their son was not a nominee, the Tax Court emphasized that (a) Mrs. Hamilton exercised dominion and control over her son’s bank account; (b) the taxpayers’ son provided no consideration for the funds transferred to his bank account; and (c) the taxpayers continued to enjoy the benefits of the transferred funds. Accordingly, the Tax Court held that the taxpayers were not insolvent and the discharged debt should be included in the taxpayers’ gross income.

On appeal, the Tenth Circuit Court of Appeals affirmed, holding that the Tax Court “appropriately applied the substance-over-form doctrine to characterize the disputed funds as the Hamiltons’ assets for purposes of the insolvency exception ... and properly concluded they
exercised effective ongoing control over these funds.” *Hamilton v. Commissioner*, No. 19-9000 (2020).

**Page 177**: Add to Footnote 14 that the exclusion in § 108(a)(1)(E) and (h) for the discharge of “qualified personal residence indebtedness” has been extended through 2020 by the Further Consolidated Appropriations Act, 2020 (P.L. 116-94).
Chapter 10

Compensation For Personal Injury and Sickness

Page 194: In PLR 201950004, the IRS ruled that physical, cognitive and behavioral injuries and disabilities suffered by an infant because of a clinic’s failure to test for genetic mutations before implanting a donor egg and embryo in the taxpayer/birth mother could be characterized as physical injuries or physical sickness within the meaning of § 104(a)(2). As a result, the IRS concluded that the settlement received for these injuries and disabilities and the emotional distress attributable to them was excluded from taxpayer’s income under § 104(a)(2) (other than those amounts reimbursing the taxpayer for medical expenses incurred and previously deducted).
Chapter 11

Fringe Benefits


Page 231 (Footnote 9): Add the following sentence to the end of Footnote 9:

The Tax Cuts and Jobs Act of 2017, however, disallowed employers a deduction for the expense of any qualified transportation fringe benefit. § 274(a)(4). Proposed Regulations (Reg - 119307-19) have been issued interpreting and applying the limitations of both § 274(a)(4) and § 274(l).
Chapter 12

Business and Profit-Seeking Expenses

Page 263: Footnote 3 notes the Tax Cuts and Jobs Act amendments to the § 162(m) limitation on remuneration paid by publicly held corporations to certain individuals. In December 2019, Treasury published proposed regulations (Reg-122180-18) interpreting and applying § 162(m) as amended.

Page 276: Footnote 16 should read: See Footnote 15.

Page 277: On February 28, 2019, the IRS posted on its website the following FAQ addressing the question raised in Footnote 20 on this page regarding whether § 162(q) precludes a victim of sexual harassment from deducting her attorney’s fees if a settlement to which she is a party is subject to a nondisclosure agreement:

Question:

Does section 162(q) preclude me from deducting my attorney’s fees related to the settlement of my sexual harassment claim if the settlement is subject to a nondisclosure agreement?

Answer:

No, recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by section 162(q) from deducting attorney’s fees related to the settlement or payment, if otherwise deductible...

Page 279: Footnote 21 notes § 280E disallowing deductions or credits incurred by businesses trafficking in controlled substances. In Northern California Small Business Assistants, Inc. v. Commissioner, 153 T.C. 65 (2019), the Tax Court rejected taxpayer’s arguments that: (1) § 280E doesn’t apply to a marijuana business operated legally under state law, (2) § 280E is a penalty violating the Eighth Amendment of the U.S. Constitution, and (3) § 280E doesn’t preclude taxpayer from claiming deductions under §§ 164 and 167. Previously, in Alterman v. Commissioner, T.C. Memo 2018-83, the Tax Court applied § 280E to disallow deductions for expenses a medical marijuana business incurred with respect to the sale of “non-marijuana merchandise” (e.g., pipes, papers, and other items used to consume marijuana). In Alterman, the Tax Court held that the selling of the non-marijuana merchandise was not an activity separate from the taxpayer’s business of selling marijuana merchandise but, instead, complemented that business. As a result, the court concluded the taxpayer was engaged in a single business, i.e., selling marijuana.
Page 280: In May 2020 Treasury issued proposed regulations incorporating the changes made by the Tax Cuts and Jobs Act to § 162(f). Prop. Reg. § 1.162-21 (denial of deduction for certain fines, penalties, and other amounts); and Prop. Reg. § 1.6050X-1 (information reporting for fines, penalties, and other amounts by governments, governmental entities, and nongovernmental entities treated as governmental entities).

Page 280 (Footnote 24): Replace the text of Footnote 24 with the following text:

§ 162(f)(3). Additional important exceptions include: § 162(f)(2) — the allowance of a deduction for certain amounts constituting restitution (including remediation of property) or paid to come into compliance with the law; and § 162(f)(4) — the disallowance rule of § 162(f)(1) inapplicable “to any amount paid or incurred as taxes due.”
Chapter 13

Deduction for Qualified Business Income: Section 199A

Page 290: Add the following assignment: (Note the following regulations were finalized early in 2019.)

Treasury Regulations: §§ 1.199A-1(b), (c)(1)-(3) Examples (1), (2) and (3), (d)(1),(2), (4) Examples (1) and (2), (5) and (6); 1.199A-2(a)(1)-(3), (b)(2), (c)(1)(i), (3)(i), (4) Example 1; 1.199A-5 (a), (b)(1), (b)(2)(xiv).

Page 292: In the fifth line of the paragraph headed Net business income, the citation should read § 199A(c)(1).

Page 293: Pursuant to Rev. Proc. 2019-44, the § 199A(e)(2) threshold amount for taxable years beginning in 2020 is $326,600 for married individuals filing joint returns, $163,300 for married individuals filing separate returns, and $163,300 for all other returns.

Page 294: In the sixteenth line of the first paragraph, the citation should read § 199A(d)(1).

Page 300: The parenthetical at the end of the Analysis of Example 6 should read as follows:

(the lesser of Brenda’s $32,500 combined qualified business income amount, or $36,500 [20 percent the $182,500 excess of Brenda’s taxable income of $182,500 over her net capital gain of $0]).
Chapter 15

Depreciation

Note: For taxable years beginning after 2018, the dollar limitations of § 179(a)(1), (2) and (5)(A) are adjusted for inflation. §179(b)(6). For the sake of simplicity, in answering the Problems in this Chapter, disregard the inflation adjustments. Thus, assume that the maximum deduction under § 179(a)(1) is $1,000,000.

Page 340: (Treasury Regulation Assignment) Add the following: Skim 1.168(k)-2(a)(1), (b)(1), (b)(3)(i)-(iii), (b)(4)(i), (e)(1)(i)(A), (e)(1)(ii), (e)(2)(i), (f)(1)(i), (g)(1)(i).

Page 346: The CARES Act amended § 168(e)(3)(E) to include “qualified improvement property” as “15-year property.” § 168(e)(3)(E)(vii). Qualified improvement property is “any improvement made by the taxpayer to an interior portion of a building that is nonresidential real property if such improvement is placed in service by the taxpayer after the date such building was first placed in service.” § 168(e)(6)(A). The amendment to §168(e)(3)(E) renders qualified improvement property eligible for the additional first-year depreciation deduction allowed by § 168(k) discussed on pages 351-354. For purposes of the alternative depreciation system provided in § 168(g)(2), the CARES Act amended the table in § 168(g)(3)(B) to provide that qualified improvement property will have a class life of 20 years. § 168(g)(3)(B)(E)(vii).

Page 354: The last sentence of the Analysis to Example 2 states that Rennard’s basis is reduced to $80,000. The sentence should state that Rennard’s basis is reduced to $240,000.

Page 355: For taxable years beginning in 2020, under § 179 (b)(1), the aggregate cost of any § 179 property a taxpayer elects to treat as an expense cannot exceed $1,040,000 and, under § 179 (b)(5)(A), the cost of any sport utility vehicle that may be taken into account under § 179 cannot exceed $25,900. As adjusted for inflation, the $2,590,000 limitation of § 179 (b)(2) is reduced (but not below zero) by the amount the cost of § 179 property placed in service during the 2020 taxable year exceeds $2,590,000. Rev. Proc. 2019-44, 2019-47 I.R.B. 1093.

Page 382: The Year 1 depreciation percentage in Table A-7a is incorrect for all months except Month 1. The correct amounts for all months are shown in the table below:
Table A-7a: Nonresidential Real Property
Mid-Month Convention
Straight Line — 39 Years

<table>
<thead>
<tr>
<th>Month Placed in Service</th>
<th>Year 1</th>
<th>Year 2–39</th>
<th>Year 40</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.461%</td>
<td>2.564%</td>
<td>0.107%</td>
</tr>
<tr>
<td>2</td>
<td>2.247%</td>
<td>2.564%</td>
<td>0.321%</td>
</tr>
<tr>
<td>3</td>
<td>2.033%</td>
<td>2.564%</td>
<td>0.535%</td>
</tr>
<tr>
<td>4</td>
<td>1.819%</td>
<td>2.564%</td>
<td>0.749%</td>
</tr>
<tr>
<td>5</td>
<td>1.605%</td>
<td>2.564%</td>
<td>0.963%</td>
</tr>
<tr>
<td>6</td>
<td>1.391%</td>
<td>2.564%</td>
<td>1.177%</td>
</tr>
<tr>
<td>7</td>
<td>1.177%</td>
<td>2.564%</td>
<td>1.391%</td>
</tr>
<tr>
<td>8</td>
<td>0.963%</td>
<td>2.564%</td>
<td>1.605%</td>
</tr>
<tr>
<td>9</td>
<td>0.749%</td>
<td>2.564%</td>
<td>1.819%</td>
</tr>
<tr>
<td>10</td>
<td>0.535%</td>
<td>2.564%</td>
<td>2.033%</td>
</tr>
<tr>
<td>11</td>
<td>0.321%</td>
<td>2.564%</td>
<td>2.247%</td>
</tr>
<tr>
<td>12</td>
<td>0.107%</td>
<td>2.564%</td>
<td>2.461%</td>
</tr>
</tbody>
</table>
Chapter 16

Losses and Bad Debts

Page 390: The references to “Reg. § 1.165-9(a)(2)” should be corrected to read “Reg. § 1.165-9(b)(2)”

Page 390: In Footnote 1, delete the extra zero so that depreciation deductions are $5,400.
Chapter 17

Travel Expenses and Business Meals

Page 414: Following the excerpt from Commissioner v. Flowers, insert the following:

The U.S. Court of Appeals for the D.C. Circuit has affirmed the Tax Court’s decision in Liljeberg v. Commissioner. 2018 U.S. App. LEXIS 31067. At issue in Liljeberg were deductions for living and travel expenses claimed by three foreign nationals who participated in the State Department's Summer Work Travel Program. (The Summer Work Program provides “foreign students who are enrolled full-time and pursuing studies at accredited post-secondary academic institutions . . . with the opportunity to work and travel in the United States’ for a period of up to four months, during their summer vacations.” 22 C.F.R. § 62.32(b), (c). Note the year at issue in the case preceded the enactment of § 67(g).) Income earned in the Summer Work Program is subject to federal income taxes. § 871(b)(1), (c). In affirming the Tax Court, the D.C. Circuit Court concluded the taxpayers had failed to establish that their living and travel expenses were “in pursuit of a trade or business,” i.e., they failed to establish the necessary relationship between their expenditures and the employer’s business. In other words, the taxpayers failed to satisfy the business exigency test enunciated as follows in Commissioner v. Flowers, 326 U.S. 465, 470, a 472:

Travel expenses in pursuit of business within the meaning of [now § 162(a)(2)] could arise only when the [employer's] business forced the taxpayer to travel and to live temporarily at some place other than [his usual residence], thereby advancing the interests of the [employer]. Business trips are to be identified in relation to business demands and the traveler's business headquarters. The exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors.

The court noted that the taxpayers’ temporary employers did not require the taxpayers to move to the United States. Instead, the taxpayers chose to come to the United States to participate in the Summer Work Travel Program. Their living and travel expenses were thus the product of their own choice rather than the needs of their U.S. employers. The court rejected the taxpayers’ argument that the fact they were required to have a “J visa” (which is issued to "an alien having a residence in a foreign country which [the person] has no intention of abandoning," 8 U.S.C. § 1101(a)(15)(J)), established that they maintained a home for business purposes in their own countries, and were traveling away from that home for business purposes. The court concluded by noting:

Allowing foreign students who travel to the United States on a "J visa" for temporary employment to deduct their travel expenses when students who are U.S. citizens traveling within the United States to seek temporary employment cannot, see Weiberg v. Commissioner, 639 F.2d 434, 437 (8th Cir. 1981), would be a peculiar and irrational result.
Page 424: Following the carryover paragraph, insert the following:

As discussed in Chapter 12, the 2017 tax legislation eliminated the deduction for entertainment expenses. That legislation, however, did not address the circumstances in which the provision of food and beverages might constitute entertainment, but the legislative history of the Act clarified that taxpayers generally may continue to deduct 50 percent of the food and beverages associated with operating their trade or business. The initial guidance on this matter was provided by the Service in Notice 2018-76, 2018-42 I.R.B. 599, which provided that taxpayers may deduct 50 percent of an otherwise allowable business meal expense if the following five conditions are satisfied:

1. The expense is an ordinary and necessary expense under § 162(a) paid or incurred during the taxable year in carrying on any trade or business;

2. The expense is not lavish or extravagant under the circumstances;

3. The taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;

4. The food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and

5. In the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

Proposed regulations have now been issued dealing with the elimination of the entertainment deduction and the determination of which activities are of a type generally considered to be entertainment.1 The proposed regulations largely incorporate the guidance of Notice 2018-76 in this regard, but they also, among other matters, (1) apply that guidance to all food and beverages provided at or during entertainment activities, (2) provide important clarification on the requirement that the disallowance of the entertainment deduction may not be circumvented by overcharging for food and beverages, and (3) define the term “current or potential business contact” — that is, define the category of persons to whom the taxpayer may provide the deductible food and beverages. The proposed regulations also provide that taxpayers may continue to rely on Notice 2018-76 until the proposed regulations are finalized.

The proposed regulations provide the following helpful examples (which are similar to the examples in the Notice) illustrating the difference between nondeductible entertainment expenses and deductible business meals. In each example, neither the taxpayer nor the business associate is engaged in a trade or business that relates to the entertainment activity.

1REG-100814-19 (2020). The proposed regulations also address the section 274(n) and (k) limitations on deductibility.
Example 1. Taxpayer A invites B, a business associate, to a baseball game to discuss a proposed business deal. A purchases tickets for A and B to attend the game. The baseball game is entertainment as defined in [Prop. Reg. § 1.274-11(b)(1)] and thus, the cost of the game tickets is an entertainment expense and is not deductible by A.

Example 2. Assume the same facts as [Example 1] except that A also buys hot dogs and drinks for A and B from a concession stand. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expenditure and is not subject to the § 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game if they meet the requirements of § 162 and [Prop. Reg.] § 1.274-12 [which requires that the expenses are not lavish or extravagant under the circumstances; the taxpayer or taxpayer’s employee is present at the furnishing of the food and beverages; and the food and beverages are provided to a business associate].

Example 3. Taxpayer C invites D, a business associate, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food and beverages. The basketball game is entertainment as defined in [Prop. Reg. § 1.274-11(b)(1)] and, thus, the cost of the game tickets is an entertainment expense and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages also is an entertainment expense that is subject to the § 274(a)(1) disallowance. Therefore, C may not deduct the cost of the tickets or the food and beverages associated with the basketball game.

Example 4. Assume the same facts as [Example 3], except that the invoice for the basketball game tickets separately states the cost of the food and beverages and reflects the venue’s usual selling price if purchased separately. As in [Example 3], the basketball game is entertainment as defined in [Prop. Reg. § 1.274-11(b)(1)] and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expense and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expense and is not subject to the § 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game if they meet the requirements of section 162 and [Prop. Reg.] § 1.274-12.
Chapter 18

Education Expenses

Page 473: The Further Consolidated Appropriations Act, 2020 extended § 222 through 2020. It is likely that Congress will again extend this deduction provision.

Page 475: The Further Consolidated Appropriations Act, 2020 amended § 529(c) to add a new paragraph (9) which expands the definition of “qualified higher education expense” to include amounts (not to exceed $10,000) “paid as principal or interest on any qualified education loan (as defined in section 221(d)) of the designated beneficiary or a sibling of the designated beneficiary.”
Chapter 19

Dual Use Property: Home Offices, Vacation Homes, and Passenger Automobiles

Pages 491-92: Delete Example 3 and Example 4 and insert the following immediately before Example 3:

Special issues arise when the purchase price of the automobile exceeds the first-year dollar limitation of §§ 280F(a)(1)(A)(i) and 168(k)(2)(F)(i). In that case, when the 100-percent additional first year depreciation deduction allowable under § 168(k)(1) exceeds the first-year limitation amount, Rev. Proc 2019-13, I.R.B. takes the position that the excess amount is a “disallowed deduction” for purposes of § 280F(a)(1)(B). As such, the excess amount is not deductible until the first year after the end of the recovery period, and then only to the extent of the annual limitation under § 280F(a)(1)(B)(ii). Revenue Procedure 2019-13 illustrates this point, with respect to the year 2018 and a dollar limitation of $18,000, with an example where the cost of the automobile is $50,000. The $32,000 excess ($50,000 less $18,000) is a disallowed deduction. As such, it cannot be deducted to any extent until 2024 (the first year after the end of the 2018-2023 recovery period) and then only at the rate of $5,760 per year, the annual limitation under § 280F(a)(1)(B)(ii) for years after the recovery period.

In the words of the revenue procedure, “to mitigate [the] anomalous result” under which no deduction at all is allowable for Years 2 through 6 (2019 through 2023) of the recovery period, Rev. Proc. 2019-13 provides a safe harbor method of accounting that permits such deductions. The safe harbor is applicable only (1) where the automobile is qualified property for which the 100-percent additional first year depreciation deduction is allowable; (2) the cost of the automobile exceeds the first year limitation of § 280F(a)(1)(A); and (3) the taxpayer does not elect any deduction under § 179. If these requirements are met, then the remaining depreciable basis may be recovered by applying to that basis the applicable depreciation rates (found in the depreciation tables) for Years 2 through 6, subject to the annual limitation of § 280F(a)(1)(A). The safe harbor is illustrated in Example 3 below.

Example 3: Assume the facts of Example 1, except that the purchase price of the automobile is $40,000. As indicated in Example 1, the Year 1 depreciation limitation is $18,000. Marilyn may deduct no more than that under § 168(k)(1) or § 179, and she may take no additional deduction under § 168(a). If Marilyn deducts the $18,000 under § 168(k)(1), Rev. Proc. 2019-13 will allow her to deduct the remaining $22,000 of unrecovered basis in Years 2 through 6, and thereafter, subject to the year-by-year limitations of § 280F(a)(1)(A), under the safe harbor method. However, if Marilyn

Pursuant to the depreciation tables for 5-year property, applying the 200-percent declining balance method, the depreciation deductions after Year 1 are as follows: Year 2 — $7,040 (the remaining unrecovered basis of $22,000 times 32 percent); Year 3 — $4,224 ($22,000 times 19.2 percent); Year 4 — $2,534.40 ($22,000 times 11.52 percent); Year 5 — $2,534.40 ($22,000 times 11.52 percent); and Year 6 — $1,267.20 ($22,000 times 5.76 percent). Note that, in each of these years, the depreciation
elects out of § 168(k)(1) and deducts the $18,000 under § 179, the safe harbor method is not available, and the remaining $22,000 is treated as a disallowed deduction under § 280F(a)(1)(B); as a result, no further depreciation deductions are allowed for the remainder of the recovery period, and when further recovery is permitted in Year 7, it is limited to the annual maximum of $5,760 under § 280F(a)(1)(B)(ii). Finally, if Marilyn elects out of § 168(k)(1) and does not elect § 179, and instead takes her depreciation deductions under § 168(a)(1), her Year 1 deduction will be 20 percent of $40,000, or $8,000, an amount within the Year 1 limit of § 280F(a)(1)(A).  

Example 4: Assume the facts of Example 3, except that Marilyn’s business use of the automobile is 75 percent rather than 100 percent. Because her business use satisfies the more-than-50-percent standard, Marilyn is allowed to calculate the depreciation deduction under an accelerated method rather than under straight-line. Assuming she does so under § 168(k)(1), she may deduct 75 percent (her business use percentage) of $18,000 (the maximum Year 1 deduction), or $13,500. However, the adjusted basis of the automobile, as in Example 2, must be reduced by the full $18,000 of depreciation attributable to the aggregate of her nondeductible personal use and deductible business use. (She may presumably continue to take depreciation deductions in Years 2 through 6 of the recovery period, and thereafter, under the safe harbor method authorized by Rev. Proc. 2019-13, subject to the § 280F(a)(1)(A) limits. If she were to elect out of § 168(k)(1), however, and made a § 179 election, she would have the same Year 1 deduction of $13,500 as under § 168(k)(1) and the same reduction in basis of $18,000. However, as noted in Example 3, the remaining unrecovered basis would be treated as a disallowed deduction under § 280F(a)(1)(B)(i), and no further deductions would be permitted during Years 2 through 6 of the recovery period. If, alternatively, Marilyn chose to elect out of § 168(k)(1), and did not elect § 179, but instead chose to determine the depreciation deduction under § 168(a) only, the deduction would be 75 percent of $8,000 (20 percent of the $40,000 unadjusted basis) or $6,000. The unrecovered basis would be $32,000 ($40,000 less $8,000), deductible during Years 2 through 6 of the recovery period and thereafter subject to the § 280F(a)(1)(A) limits.

\[\text{Example 4: Assume the facts of Example 3, except that Marilyn’s business use of the automobile is 75 percent rather than 100 percent. Because her business use satisfies the more-than-50-percent standard, Marilyn is allowed to calculate the depreciation deduction under an accelerated method rather than under straight-line. Assuming she does so under § 168(k)(1), she may deduct 75 percent (her business use percentage) of $18,000 (the maximum Year 1 deduction), or $13,500. However, the adjusted basis of the automobile, as in Example 2, must be reduced by the full $18,000 of depreciation attributable to the aggregate of her nondeductible personal use and deductible business use. (She may presumably continue to take depreciation deductions in Years 2 through 6 of the recovery period, and thereafter, under the safe harbor method authorized by Rev. Proc. 2019-13, subject to the § 280F(a)(1)(A) limits. If she were to elect out of § 168(k)(1), however, and made a § 179 election, she would have the same Year 1 deduction of $13,500 as under § 168(k)(1) and the same reduction in basis of $18,000. However, as noted in Example 3, the remaining unrecovered basis would be treated as a disallowed deduction under § 280F(a)(1)(B)(i), and no further deductions would be permitted during Years 2 through 6 of the recovery period. If, alternatively, Marilyn chose to elect out of § 168(k)(1), and did not elect § 179, but instead chose to determine the depreciation deduction under § 168(a) only, the deduction would be 75 percent of $8,000 (20 percent of the $40,000 unadjusted basis) or $6,000. The unrecovered basis would be $32,000 ($40,000 less $8,000), deductible during Years 2 through 6 of the recovery period and thereafter subject to the § 280F(a)(1)(A) limits.}\]
Chapter 20

The Interest Deduction

Page 503: On March 2, 2020, the Internal Revenue Service issued statistics compiled with respect to 2018 individual income tax returns filed through mid-November 2019. Approximately 13 million 2018 returns claimed the home mortgage interest deduction. By contrast, 33 million 2017 returns claimed that deduction. Because the home mortgage interest deduction is an itemized deduction, i.e., a below-the-line deduction, the significant increase in the standard deduction provided by the Tax Cuts and Jobs Act of 2017 has resulted in fewer taxpayers itemizing and, in turn, few taxpayers claiming the home mortgage interest deduction.

Page 509: The CARES Act amended § 163(j) providing that, for taxable years beginning in 2019 and 2020, the deduction for business interest will be limited to the sum of (A) the business income of the taxpayer for the taxable year and (B) 50 percent of the adjusted taxable income of such taxpayer for the taxable year. § 163(j)(10)(A)(i). A taxpayer, however, may elect not to have this special rule apply. § 163(j)(10)(A)(iii). In addition, in the case of a taxable year beginning in 2020, the taxpayer, instead of using the adjusted taxable income of a taxable year beginning in 2020, may use the adjusted taxable income for the last taxable year in 2019. § 163(j)(10)(B)(i).
Chapter 21

The Deduction for Taxes

Page 524: After the first paragraph, insert the following:

In response to the $10,000 limitation, a number of states adopted or considered “workaround” strategies under which, by making contributions to designated state or local charities — contributions intended to be deductible under § 170 for federal income tax purposes and thus not subject to a $10,000 cap — a taxpayer would receive a state or local tax credit against state income taxes otherwise due. As a result, for federal tax purposes, nondeductible state taxes (nondeductible by reason of exceeding the $10,000 limit) could be converted to deductible charitable contributions while the taxpayer continued to receive a state or local income tax credit for the same payment.

Under proposed regulations issued in 2018 and finalized in 2019, this strategy is largely blocked. The general rule of the regulations is that taxpayers must reduce the amount of their charitable contribution by the amount of any state or local tax credit received in consideration for the taxpayer’s payment to the state or local charity. Reg. § 1.170A-1(b)(3)(i).

Example 1: Susan pays $1,000 to State Charity, an entity described in § 170(c), and thus for which a federal charitable contribution is allowable. In return for her payment, Susan receives a state tax credit equal to 60 percent of her payment, or $600. Susan’s charitable contribution, for federal tax purposes, is reduced by the $600 state credit she receives. The amount of her charitable contribution, for federal tax purposes, is $400 ($1,000 payment less $600 credit).

The regulations provide an exception under which no reduction in the charitable contribution is required if the state or local tax credit does not exceed 15 percent of the taxpayer’s payment. Reg. § 1.170A-1(h)(3)(vi).

Example 2: Assume the facts of Example 1, except that the state tax credit Susan receives is equal to 15 percent of her payment, or $150. Because the credit does not exceed 15 percent of her payment, Susan is not required to reduce her $1,000 charitable contribution for federal tax purposes.

The regulations provide another exception for so-called dollar for dollar state or local tax deductions. If, in return for the payment to a qualifying charitable organization, a taxpayer receives state or local tax deductions that do not exceed the amount of the taxpayer’s payment, no reduction is required in the amount of the taxpayer’s federal charitable contribution. Reg. § 1.170A-1(h)(3)(ii)(A).

Example 3: Assume the facts of Example 1, except that in return for her payment of $1,000, Susan receives a $1,000 deduction for state tax purposes. Because the state
deduction does not exceed the amount of the payment, Susan is not required to reduce her $1,000 charitable contribution for federal tax purposes.

Finally, the Service issued (contemporaneously with the final regulations) Notice 2019-12, I.R.B. 2019-27. The notice provided a safe harbor under which a taxpayer who itemizes deductions for federal tax purposes may deduct the disallowed portion of the charitable contribution as a payment of state or local tax for federal tax purposes.

Proposed regulations incorporating this safe harbor have now been issued. Prop. Reg. § 1.164-3(j). The safe harbor, however, cannot be used to avoid the limitation of § 164(b)(6) or to permit the same payment to be deducted under any other provision of the Code. Prop. Reg. § 1.164-3(j)(3), (5).

Example 4: Assume the facts of Example 1, pursuant to which Susan’s $1,000 payment to State Charity was reduced to $400 (for federal charitable contribution purposes) on account of the 60 percent state tax credit. Under the safe harbor rule of Prop. Reg. § 1.164-3(j), Susan may treat $600 (the disallowed portion of the charitable contribution) as a payment of her state or local tax liability for purposes of § 164. Susan’s deduction of that amount is subject to all provisions of § 164, including the § 164(b)(6) limitation. See Prop. Reg. § 1.164-3(j)(6), Ex. 3.
Chapter 22

Casualty Losses

Note: On March 2, 2020, the Internal Revenue Service issued statistics compiled with respect to 2018 individual income tax returns filed through mid-November 2019. Those statistics reflect that approximately 18,280 2018 returns claimed a deduction for casualty and theft. By contrast, approximately 96,400 2017 returns claimed that deduction. The reduction in the number of returns claiming the deduction is attributable in large part to the significant increase in the standard deduction provided by the Tax Cuts and Jobs Act of 2017 which resulted in fewer taxpayers itemizing deductions.

Page 531: Assume all losses identified in the various questions of Problem 1 are sustained by the taxpayer between 2018 and 2025.

Page 532: Assume all of the gains and losses identified in Problem 3 were computed by reference to the basis Rose had in the properties noted.

Page 538: In Mancini v. Commissioner, T.C. Memo 2019-16, taxpayer claimed a deduction under § 165(c)(3) for large gambling losses resulting from his compulsive gambling which he attributed to a medication he was taking for Parkinson’s disease. According to the taxpayer, the medication caused an impulse control disorder (ICD) which, in turn, resulted in his compulsive gambling. The taxpayer argued that the ICD fits the definition of “other casualty” under § 165(c)(3) — the ICD “was sudden because it manifested abruptly once his dosage [of the medication] reached a certain level, it was unexpected because neither he nor [his doctor] anticipated it, and it was unusual, even for [other takers of the medication].” Although the court agreed the medication could cause compulsive gambling and likely did so in the taxpayer’s case, the court nonetheless concluded the taxpayer’s gambling losses were not deductible as casualty losses under § 165(c)(3) because the taxpayer could not establish any physical damage and the losses were not “sudden.”

In rejecting the taxpayer’s argument that physical damage was not required, the court reviewed the long history of case law requiring a showing of physical damage: “We do find that Mancini’s brain was damaged by the [medication], but physical damage to property remains one of the prerequisites of a casualty-loss deduction. Mancini's depleted bank accounts ... didn't suffer any physical damage. So, even if the onset of his ICD was sudden, unexpected, and unusual, Mancini isn't entitled to a section 165(c)(3) deduction for his gambling losses.”

In addition to the failure to establish any physical damage, the court held a deduction under § 165(c)(3) was also unavailable as the taxpayer’s losses were not “sudden” and therefore did not qualify as a casualty losses within the meaning of § 165(c)(3):

Mancini claims he suffered gambling losses over the course of three years. These losses were necessarily the result of dozens or hundreds of individual gambling sessions and probably thousands of separate wagers.... [A] three-year-long casualty is not "sudden".
revenue ruling summarizing caselaw tells us that "sudden" means "swift and precipitous and not gradual and progressive." Rev. Rul. 72-592, 1972-2 C.B. at 101. Even if the onset of the ICD was "sudden," and even if Mancini didn't realize what was happening to his savings until three years later, the gambling losses grew gradually over time — Mancini himself is trying to deduct compulsive-gambling losses for three separate tax years. That makes the losses he sustained just like damage from slow-moving termites or dry rot, which can start without the taxpayer's knowledge and take years to discover, but isn't a casualty because the damage is not sudden.

Mancini's losses are simply not what the Code considers a "casualty". They progressed over the course of three years, and there was no physical damage to any of his property. Section 165(c)(3) allows the deduction of only specific types of losses — it's not a stand-in for all the types of damages that would be recoverable in a civil action.
Chapter 23

Medical Expenses

Statutory Update: The Further Consolidated Appropriations Act, 2020, amends § 213(f) to provide that, in the case of taxable years beginning before January 1, 2021, the deduction for medical care expenses allowed by § 213(a) will be that amount of the medical expenses exceeding 7.5% of a taxpayer’s adjusted gross income.

For purposes of the Problem, assume the tax year is 2020 and thus the taxpayers’ medical care expenses are deductible to the extent they exceed 7.5% of the taxpayers’ adjusted gross income.

Page 555 and Footnote 2: The first full paragraph and Footnote 2 note that for purposes of the § 213 deduction, qualifying medicine and drugs are limited to those that legally require a prescription. § 213(b). Footnote 2, however, points out that, for purposes of § 105(b) (employer reimbursements of employee medical care expenses), there was no prescription requirement for medicine and drugs, at least at the time of the cited 2003 revenue ruling. Beyond the individual deduction of § 213, the Code in fact provides several other tax-favored medical care arrangements, each with its own requirements. Thus, employer reimbursements of employee medical care expenses may be excluded from gross income under flexible spending accounts or health reimbursement accounts. §§ 105(b), 125. Health savings accounts, authorized by § 223, allow for savings and payments for medical expenses on a tax-favored basis, as do Archer Medical Savings Accounts authorized by § 220. Between 2010, with the enactment of the Patient Protection and Affordable Care Act, and 2020, qualifying medicines and drugs were limited, as under § 213(b), to those requiring a prescription. See §§ 106(f), 220(d)(2)(A), 223(d)(2), as before amendment by the 2020 CARES Act. The CARES Act amends these three cited statutes to eliminate the prescription requirement for medicine and drugs provided thereunder, thus restoring the pre-2010 law on medicine and drugs described in Rev. Rul. 2003-102 in Footnote 2. The CARES Act also extends the definition of qualified medical expenses applicable to these three cited statutes — but not to § 213 — to include menstrual care products.
Chapter 24

Charitable Deductions

Page 563 -564: In Problems 2 and 3, assume the contributions were made in 2021 unless your instructor directs otherwise.

Page 566 Footnotes 1 and 2: Both of these footnotes emphasize that the charitable deduction is not available to taxpayers who claim the standard deduction, i.e., the charitable deduction is a below-the-line deduction available only to those who itemize. The CARES Act provides, however, that, for taxable years beginning in 2020, an above-the-line deduction not to exceed $300 is available to “eligible individuals” making “qualified charitable contributions.” § 62(a)(22). An “eligible individual” is defined as “any individual who does not elect to itemize deductions.” § 62(f)(1). To be a “qualified charitable contribution” the contribution must be made in cash and is subject to other limitations. § 62(f)(2). This above-the-line deduction is not available to contributions made in a taxable year beginning after 2020.

Footnote 2 raises a question regarding the impact of the increased standard deduction on charitable giving. Not surprisingly, statistics released by Treasury in March 2020 indicate a dramatic reduction in the number of returns claiming a deduction for charitable contributions. Nonetheless, it appears the overall amount of charitable giving has not been significantly affected.

Page 568: As noted in Chapter 21, § 164(b)(6) [added by the Tax Cuts and Jobs Act of 2017] imposes a $10,000 limit ($5,000 in the case of a married individual filing a separate return) on an individual's deduction for the aggregate amount of state and local taxes paid during the taxable year. Section 164(b)(6) provides that this limitation is not applicable to taxes incurred in carrying on a trade or business or a § 212 activity. As discussed in Chapter 21 of this Supplement, states and local governments have for a number of years offered tax credit programs providing taxpayers tax credits for making contributions to or for the use of certain entities described in § 170(c). Given the lack of any dollar limitation on the amount of state and local taxes deductible under §164, these programs were of little significance for federal tax purposes. With the enactment of the limitations under § 164(b)(6) and the significant increase in efforts by state and local governments to devise alternate means for taxpayers to deduct the disallowed portion of their state and local taxes, Treasury, as a matter of tax policy, concluded action needed to be taken “to prevent revenue loss from the erosion of the limitation under § 164(b)(6).” TD 9864, 84 FR 27513. To that end, Treasury in June 2019 issued final regulations – Reg. § 1.170A-1(h)(3) – providing “that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in section 170(c), and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or quid pro quo, to the taxpayer and reduces the taxpayer's charitable contribution deduction.” Id. See Reg. § 1.170A-1(h)(3)(i). An exception is made for state and local tax credits received in exchange for a contribution where the credits don’t exceed 15 percent of the amount contributed. Reg. § 1.170A-1(h)(3)(vi). In addition, a taxpayer is generally not required to reduce its charitable
deduction as a result of the receipt of a state or local tax *deduction*. Reg. § 1.170A-1(h)(3)(ii)(A). See the examples provided in Chapter 21 of this supplement.

The final regulations noted above did not address certain ancillary issues including the application of the *quid pro quo principle* of § 170 to benefits received or expected to be received by the donor from a party other than the donee. The Treasury has proposed an amendment to the regulations under §170 to provide that the *quid pro quo* principle also applies in this context. Prop. Reg. § 1.170A-1(h)(4).

**Page 571:** Pursuant to the CARES Act, the percentage limitations of § 170(b) are, at the taxpayer’s election, suspended with respect to “qualified contributions,” i.e., contributions paid in cash during the calendar year 2020 to an organization described in § 170(b)(1)(A) (subject to certain limitations). § 2205(a)(1) and (3)(A) and (B) of the CARES Act. With respect to individuals, “qualified contributions” are allowed as a deduction only to the extent they do not exceed the excess of the individual’s contribution base (§ 170(b)(1)(H)) over all other charitable deductions allowed under § 170(b)(1). § 2205(a)(2)(A)(i) of the CARES Act. “Qualified contributions” exceeding this limitation may be carried over. § 2205(a)(2)(A)(ii) of the CARES Act.

With respect to corporations, “qualified contributions” cannot be deducted to the extent they exceed the excess of 25 percent of the corporation’s taxable income over the amount of other charitable contributions allowed under § 170(b)(2). § 2205(a)(2)(B)(i) of the CARES Act. “Qualified contributions exceeding this limitation may be carried over. § 2205(a)(2)(B)(ii) of the CARES Act.
Chapter 25

Limitations on Deductions

Part B: Section 265 — Expenses Related to Tax-Exempt Income

Page 616: At the end of the first full paragraph, add the following:

In Notice 2020-32, the Service restated the position it took in Rev. Rul. 83-3, 1983-1 C.B. 72, that “where tax-exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, § 265(a) applies because such deductions are allocable to the tax-exempt income.” Accordingly, those otherwise allowable deductions are disallowed. Notice 2020-32 applied this position with respect to the Payroll Protection Program established by the 2020 CARES Act. Under this Program loans made to employers in 2020 by the federal Small Business Administration would be forgiven, and the forgiveness of the loan would be excluded from the employer’s gross income to the extent, among other requirements, the loan proceeds were spent largely on such otherwise-deductible expenses as payroll, rent, utilities, mortgage interest, and similar items. Notice 2020-32 holds that such expenses are allocable to exempt income — the forgiven loan excluded from gross income — and thus disallowed.
Chapter 27

Accrual Method Accounting


Page 677: After the second full paragraph, add the following:

Proposed regulations under § 451(b) and (c) were issued in September 2019, and they reflect the recognition that the underlying statutes themselves are in substance a codification of Rev. Proc. 2004-34. The § 451(b) proposed regulations make clear that the so-called “AFS inclusion rule” — that is, the statutory requirement that a taxpayer with an applicable financial statement (AFS) include an amount in income no later than its inclusion in the taxpayer’s AFS — operates only to accelerate income inclusion, never to postpone income beyond the point the all events test is satisfied. Similarly, the § 451(c) proposed regulations make clear that advance payments may be deferred not only by taxpayers with an AFS, but also by taxpayers without an AFS, in which case the taxpayer electing deferral includes the advance payment as earned in the year of receipt. As always, any part of an advance payment not included in income in the year of receipt must be included in income in the following year.

Page 678, first full paragraph: Following the 2017 enactments of new § 451(b) and (c), making advance payment treatment applicable to the sale of goods, Treas. Reg. § 1.451-5 was deleted by regulations issued in October, 2019. Accordingly, the reference to that provision in the first full paragraph on this page should be deleted.

Page 678: Following the last full paragraph, insert the following:

In RJ Channels, Inc. v. Commissioner, T.C. Memo 2018-27, the Tax Court addressed the timing of fees received by an accrual method taxpayer for tax services provided. The taxpayer was under an obligation to return the fees to the clients if the taxpayer did not achieve a favorable result for them. The taxpayer deposited the fees in its bank account, was unrestricted in the use of the fees, periodically made withdrawals from its bank account for its own purposes, and never ultimately returned the fees to the clients. The Tax Court held that the fees were includable in the taxpayer’s gross income in the year of receipt rather than deferred until some later year as taxpayer contended. The court noted that "[i]n applying the all events test, this and other courts have distinguished between conditions precedent, which must occur before the right to income arises, and conditions subsequent, the occurrence of which will terminate an existing right to income, but the presence of which does not preclude accrual of income." The court found that the obligation to return the fees was a condition subsequent and, consistent with accrual principles as well as the claim of right doctrine (discussed in Chapter 3), the taxpayer was required to include the fees in gross income upon receipt.
Chapter 28

Annual Accounting

Page 715: As discussed previously, miscellaneous itemized deductions as defined in § 67(b) are subject to limitations, including disallowance under § 67(g) for the taxable years beginning after December 31, 2017 and before January 1, 2026. Section 67(b)(9), however, excludes from the § 67(b) definition of “miscellaneous itemized deductions” the deduction under § 1341. A taxpayer repaying income received under a claim of right will be allowed a deduction under § 1341 only if the taxpayer can establish that she would be entitled to a deduction for the repayment under another provision of the Code. § 1341(a)(2) and (3). For example, an employee required to return income (compensation for services) previously included by the employee in income under a claim of right would rely on § 162 as authority for a deduction. Because the repayment was incurred in the trade or business of being an employee, the § 162 deduction would be a below-the-line deduction. See § 62(a)(1). Disregarding § 67(b)(9), that deduction would be a miscellaneous itemized deduction as defined by § 67(b). Query: Does § 67(g) negate the application of § 67(b)(9) in the employee’s circumstances thus depriving the employee of the benefit of § 1341? Your authors believe the answer is “No.” Just as § 67(b)(9) was intended to free the taxpayer of the 2% “haircut” of § 67(a), we believe that, to be consistent with Congress’ purpose in enacting § 1341, § 67(b)(9) must be interpreted as likewise freeing the taxpayer of the disallowance rule of § 67(g).

Pages 718-719: The CARES Act suspended the application of the 80 percent limitation of § 172(a)(2) for taxable years beginning after December 31, 2017 and before January 1, 2021. § 172(a)(1). Thus, for those taxable years, the net operating loss deduction will be the aggregate of the net operating carryovers and net loss carrybacks to those years.

For a taxable year beginning after December 31, 2020, § 172(a)(2) provides the net operating loss deduction will equal the sum of:

(A) the aggregate amount of net operating loss carryovers to that year from net operating losses arising in taxable years beginning before January 1, 2018 plus

(B) the lesser of —

(i) the aggregate amount of net operating loss carryovers to that year from net operating losses arising in taxable years beginning after December 31, 2017, or

(ii) 80 percent of the excess (if any) of —

(I) the taxable income for the year computed without regard to deductions under §§ 172, 199A and 250 over

(II) the amount determined under (A) above.
The CARES Act also amends § 172(b)(1) to allow a five-year carryback for net operating losses arising in a taxable year beginning after December 31, 2017, and before January 1, 2021. § 172(b)(1)(D).

Example: Assume the facts of the Example on page 719 and assume also that Year 1 is 2018 and is the first year of Corporation X’s existence. (Note: If we assume the corporation had been in existence for at least five years prior to 2018, the $100,000 net operating loss could be carried back for five years thus potentially enabling Corporation X to recover taxes previously paid.) Corporation X could deduct in Year 2 (2019) $30,000 (i.e., an amount equal to the taxable income in Year 2) of the $100,000 net operating loss. The remaining $70,000 of the net operating loss would be carried over to Year 3 (2020) and would be deductible in the amount of $40,000 (the taxable income for Year 3). The remaining $30,000 of the net operating loss would then be carried over to Year 4 (2021). Pursuant to § 172(a)(2) noted above, Corporation X could deduct in Year 4 the entire $30,000 net operating loss carryover as it is less than 80 percent of Corporation X’s $50,000 taxable income for Year 4.
Chapter 29

Capital Gains and Losses

Page 738: Assume in answering the Part B Problems that the rates and brackets applicable to Henry and Nancy as a married couple filing a joint return are as follows (these are the 2018 rates and brackets):

<table>
<thead>
<tr>
<th>If taxable income is:</th>
<th>The tax is:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $19,050</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>Over $19,050 but not over $77,400</td>
<td>$1,905 plus 12% of the excess over $19,050</td>
</tr>
<tr>
<td>Over $77,400 but not over $165,000</td>
<td>$8,907 plus 22% of the excess over $77,400</td>
</tr>
<tr>
<td>Over $165,000 but not over $315,000</td>
<td>$28,179 plus 24% of the excess over $165,000</td>
</tr>
<tr>
<td>Over $315,000 but not over $400,000</td>
<td>$64,179 plus 32% of the excess over $315,000</td>
</tr>
<tr>
<td>Over $400,000 but not over $600,000</td>
<td>$91,379 plus 35% of the excess over $400,000</td>
</tr>
<tr>
<td>Over $600,000</td>
<td>$161,379 plus 37% of the excess over $600,000</td>
</tr>
</tbody>
</table>

Further assume (also based on 2018 amounts) Henry and Nancy’s Maximum Zero Rate Amount is $77,200 and their Maximum 15-Percent Rate Amount is $479,000.

Page 748: After the last sentence of the second paragraph, add the following sentence: “The 20 percent rate on adjusted net capital gain will also apply to a taxpayer in the 35 percent marginal income tax bracket if the taxpayer’s taxable income is above the ‘20 percent breakpoint’ – that is, the specific dollar amount in the 35 percent tax bracket (a dollar amount adjusted for inflation) at which the 15 percent rate on adjusted net capital gain becomes a 20 percent rate.”

Page 750: After the second sentence in the first full paragraph, delete the third sentence and insert in its place the following sentence: “For taxpayers in the 35 percent bracket, there is a breakpoint – the “20 percent breakpoint” – above which adjusted net capital gain is taxed at 20 percent and below which it is taxed at 15 percent; for taxpayers in the 32 percent, 24 percent, or
22 percent ordinary income tax brackets, the maximum rate on adjusted net capital gain is 15 percent."

Example 1 should state that the taxpayers are in the 35 percent tax bracket, below the 20 percent breakpoint.

Page 751: The Example should state that the taxpayer is in the 35 percent bracket, below the 20 percent breakpoint.

Delete the text of Footnote 8, and insert the following sentences in its place: “If the taxpayer’s marginal tax rate is 37 percent, or is 35 percent and above the 20 percent breakpoint, but the amount of the taxable income in those brackets is less than the taxpayer’s net capital gain, the adjusted net capital gain taxed at 20 percent will be the amount otherwise taxed at 37 percent plus the amount taxed at 35 percent that is above the 20 percent breakpoint. By way of example, assume the 37 percent rate applies to taxable income over $600,000 and the 35 percent breakpoint applies to taxable income over $500,000; further assume the taxpayer has taxable income of $525,000, of which $40,000 is adjusted net capital gain. In these circumstances, $25,000 of the adjusted net capital gain will be taxed at a 20 percent rate. ($525,000 minus $500,000 equals $25,000.) The remaining $15,000 of adjusted net capital gain will be taxed at 15 percent.”

Page 754: Example 1 should state that the taxpayer is in the 35 percent bracket, below the 20 percent breakpoint.

Page 762: Change the heading of part 3 to include patents so as to read “3. Section 1221(a)(3): Patents, Copyrights, Literary, Musical, or Artistic Compositions, Etc.”
Chapter 33

The Kiddie Tax

Page 835: The Problems state to assume the § 63(c)(5)(A) limitation on the basic standard deduction is $1,050. For 2020, the inflation-adjusted amount is actually $1,100. Rev. Proc. 2019-44, I.R.B. 2019-47, p. 1093. Nonetheless, continue to use the amount of $1,050 is answering the Problems.

Page 836 Statutory Update: The textbook notes on this page that the “initial approach taken by Congress in § 1(g) in 1986 was to tax the ‘net unearned income’ of a covered child at the top marginal rate of his or her parents ... [but] it took a different approach in the Tax Cuts and Jobs Act of 2017. For taxable years beginning after December 31, 2017, and before January 1, 2026, the child’s net unearned income was to be taxed, not at the parental rate, but under the rates applicable to estates and trusts.” The text goes on to note how highly compressed these rates are. However, within three years, in the Further Consolidated Appropriations Act, 2020, Congress returned to the initial approach — that is, to taxing the child at the top parental marginal rate — by repealing § 1(j)(4) (the provision making the estates and trusts rates applicable). Congress also made the repeal retroactive, at the taxpayer’s election. Because of the repeal, the first full paragraph on page 838 may be deleted. Note the answers to the problem set, which do not require computation of tax liability, are not changed by the repeal of § 1(j)(4).

Page 838: As noted in the Statutory Update above, delete the first full paragraph.
Chapter 36

Transfers Between Spouses and Incident to Divorce

Page 888: In Problem (e), add to the first sentence that Maureen’s continued use of the family home as her principal residence was pursuant to the terms of the property settlement agreement and the divorce decree.
Chapter 37

Like-Kind Exchanges of Real Property

Page 909: At the end of the carryover paragraph, add the following:

Prompted by the 2017 limitation of § 1031 to exchanges of real property only, proposed regulations were issued in June, 2020, defining the term “real property” (for purposes of § 1031) for the first time in either the Code or the regulations. Under the proposed regulations, real property “means land and land improvements, unsevered natural products of land, and water and airspace superjacent to land.” Prop. Reg. § 1.1031(a)-3(a)(1). An interest in such real property, “including fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, or a similar interest” is also real property for § 1031 purposes. Prop. Reg. § 1.1031(a)-3(a)(1).

Page 922: At the end of the first full paragraph, add the following:

Pursuant to proposed regulations issued in June, 2020, the receipt in a deferred exchange of personal property that is “incidental” (as defined in the proposed regulations) to the replacement real property has been added to the list of items that may be disregarded in determining whether the qualified intermediary safe harbor and certain other safe harbors have been satisfied. Prop. Reg. § 1.1031(k)-1(g)(7)(iii).
Chapter 41

Original Issue Discount


Page 1046: Add to Footnote 20 that for 2020 the inflation-adjusted limit for qualified debt instruments eligible for the interest rate limitation of § 1274A(b) is $6,039,100. Rev. Proc. 2019-44.
Chapter 42

Limitations on Tax Shelters — Sections 465, 469, and 461(l)

Part A: Section 465 — The At Risk Rules

Page 1055: Delete Footnote 5. (Alexander v. Commissioner, referenced in the footnote, applied § 465(c)(3)(D), which limits the scope of § 465(b)(3)(A), because regulations had not then been issued under § 465(c)(3)(D). Regulations have since been issued, extending the application of § 465(b)(3)(A) to include activities described in § 465(c)(1) or (c)(3)(A). See Reg. § 1.465-8(a).)

Part C: Section 461(l) — Excess Business Loss Disallowance

Statutory Update: The CARES Act amended the § 461(l) excess business loss limitation for taxpayers other than corporations to provide that it does not apply for taxable years beginning in 2018, 2019, or 2020. As originally enacted in 2017, the excess business loss limitation applied for taxable years beginning after December 31, 2017, and before January 1, 2026.

Page 1071 Problem: In answering parts (a) through (e) of the Problem, assume Years 1, 2 and 3 are 2021, 2022, and 2023, respectively, years to which the § 461(l) disallowance rule continues to apply following the 2020 CARES Act. (As the Problem already states, ignore the inflation adjustments under what is now § 461(l)(3)(C) as amended by the CARES Act.)

Page 1071 Assignment to Internal Revenue Code: § 461(l)(1)-(3), (6), as amended by the 2020 CARES Act. Review § 172(a), (b)(1)(A), (2), (c), (d)(1) as amended by the 2020 CARES Act.

Page 1072: Amend the first sentence of the second paragraph of the Overview to read as follows: As originally enacted in 2017, § 461(l) prohibited the deduction of “excess business losses” for taxpayers other than corporations for taxable years beginning after December 31, 2017, and before January 1, 2026; the 2020 CARES Act postponed the application of § 461(l) to years beginning after December 31, 2020, rendering the provision inapplicable to tax years beginning in 2018, 2019, or 2020.

At the end of the second paragraph of the Overview, add that the § 461(l)(3)(A) inflation-adjusted dollar amounts of $250,000 and $500,000 are increased for 2020 (a year to which § 461(l) now does not apply) to $259,000 and $518,000, respectively. Rev. Proc. 2019-44, I.R.B. 2019-47, p. 1093. The statutory provision for the inflation adjustment is now § 461(l)(3)(C). Note that capital losses are not taken into account in the § 461(l) calculation and that the capital gains taken into account are subject to limitation. § 461(l)(3)(B), as amended. Also note that the calculation is made without regard to any deduction allowable under § 172 or § 199A, and also without regard to deductions, gross income, or gains attributable to the business of performing services as an employee. § 461(l)(3)(A) as amended.
Pages 1072-73: Assume the references to Years 1 and 2 in Example 1 and Example 2 and in the Analyses, are references to the years 2021 and 2022, years to which § 461(l), as amended, is applicable.

Page 1073 Footnote 28: As discussed in Chapter 28 of this Supplement, the net operating loss provisions of § 172 were amended by the CARES Act to (among other changes) postpone the “80-percent-of-taxable-income” limitation to 2021. Since the years under discussion in the Footnote 28 — namely, Years 1 and 2 — are assumed to be, per the previous paragraph of this Supplement immediately above, the years 2021 and 2022, the calculation in Footnote 28 remains accurate.