

2021 Cumulative Update

For Students and Teachers

Federal Income Tax:
Doctrine, Structure, and Policy
Fifth Edition

by

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The Fifth Edition was current when it went to press on July 24, 2019. This update includes important subsequent developments, the principal ones being Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE), Coronavirus Aid, Relief, Economic Security Act (CARES), Consolidated Appropriations Act, 2021 (2021 CAA), and American Rescue Plan Act of 2021 (ARPA).

This is a cumulative update. New material appears in bold type.

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PART ONE: THE FUNDAMENTAL STRUCTURE OF THE FEDERAL INCOME TAX

Chapter 2: The Fundamental Structure of the Federal Income Tax

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The 2021 inflation-adjusted basic standard deduction amounts are \$25.1K for joint-return filers, \$18.8K for head-of-household filers, and \$12.55K for all other individuals. See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

Pages 78-79

In response to a global pandemic and stay-at-home orders across America, including for many IRS employees, Congress (in the CARES Act) postponed the due date for filing returns and paying taxes that would otherwise have been due on April 15 until July 15. This extension not only included 2019 income tax returns and payments due on April 15, but also included the first two estimated income tax payments for 2020 otherwise due on April 15 and June 15. **In Notice 2021-21, 2021-15 I.R.B. 968, the IRS extended the due date for 2020 individual returns to May 17, 2021.** No interest or penalties were assessed on any tax payments that were paid in full by either postponed due date.

Chapter 4: Rates and Allowances for Basic Maintenance

Pages 101-02

Section 199A(e)(2) specifies only two phaseout threshold categories: joint return filers and all other returns. Thus, it is puzzling that the IRS has added a separate threshold for marrieds filing separately filers. The 2021 phase-out thresholds for § 199A, as indexed for inflation, are \$329.8K for joint-filers, (\$164.925K for marrieds filing separately), and \$164.9K for all other returns. Thus, taxpayers are fully phased-out at \$429.8K for joint-filers, \$214.925K for marrieds filing separately filers, and \$214.9K for all other returns, which means that taxpayers with taxable incomes above those amounts are fully subject to the alternative limit in § 199A(b)(2)(B) that is based on certain percentages of W-2 wages and unadjusted basis of qualified property in the qualified trade or business. See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

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The inflation-adjusted tax rate schedules for 2021 can be found in *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

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The 2021 inflation-adjusted basic standard deduction amounts are \$25.1K for joint-return filers, \$18.8K for head-of-household filers, and \$12.55K for all other individuals. See *Rev. Proc. 2020-45*, 2020-46 I.R.B. 1016. The additional standard deduction amount for taxpayers age 65 or older and/or blind is \$1.35K or, if the individual in this category is also unmarried and not a surviving spouse, \$1.7K. *Id.*; § 63(f).

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The 2021 standard deduction amounts for an individual claimed as a dependent did not change from the 2019 amounts. See *Rev. Proc. 2019-44*, 2019-47 I.R.B. 1093. The 2021 regular standard deduction for unmarried individuals and marrieds filing separately filers is \$12.55K. See *Rev. Proc. 2020-45*, 2020-46 I.R.B. 1016.

Pages 117-18

ARPA made the following changes for 2021 only:

Child tax credit: added 17-year-olds to qualifying children, increased the credit to \$3K per child (\$3.6K for children under six), made the increase subject to certain phaseout rules, made the credit fully refundable, and directed the IRS to make periodic advance payments of 50 percent of the estimated amount of the credit in the second half of 2021. In July 2021, the IRS began making these payments in monthly installments.

Earned income tax credit: increased the maximum credit for childless taxpayers from \$543 to \$1,502, and reduced the minimum age for childless claimants from 25 to 19 (24 for full-time students and 18 for qualified former foster and homeless individuals) and eliminated the maximum age of 64.

Child and dependent care credit: made the credit refundable, increased the amount of qualifying expenses from \$3K to \$8K in the case of one qualifying care recipient and from \$6K to \$16K if there are two or more qualifying care recipients.

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In its response to the financial devastation of the COVID-19 crisis, Congress enacted the “2020 Recovery Rebates.” § 6428. They were new, one-time refundable tax credits up to \$1.2K for every individual who had a Social Security number that was valid for work, and who was not claimed as a dependent by another taxpayer or characterized as a nonresident alien for tax purposes. Joint-filing taxpayers qualified for \$2.4K (if one of the spouses was a member of the armed services, only one of the spouses had to have a Social Security number valid for work). Individuals with “qualifying children” under § 24(c) (who had a Social Security number that was valid for work) qualified for an additional \$500 per “qualifying child” under age 17.

The credit phased out by \$5 for every \$100 over certain adjusted gross income thresholds (\$150K for joint-filers, \$112.5K for head-of-household filers, and \$75K for all other taxpayers). Therefore, individuals without any “qualifying children” did not receive an advance payment if their 2019 (or 2018) adjusted gross income was \$198K, \$136.5K, and \$99K, respectively.

2021 CAA added § 6428A to the Code. This gave “eligible individuals” Additional Recovery Rebate Credits for 2020 of \$1.2K for joint filers, and \$600 for others, plus \$600 for each qualifying child. Consistent with the first Recovery Rebate Credit, the credit phased out by \$5 for every \$100 over certain adjusted gross income thresholds (\$150K for joint filers, \$112.5K for head-of-household filers, and \$75K for all other taxpayers). Therefore, individuals without any “qualifying children” were phased out of the Additional Recovery Rebate Credit if their adjusted gross income was equal to or greater than \$174K (joint filers), \$124.5K (heads-of-household), and \$87K (all others). In response to criticism regarding the first Recovery Rebate Credit, Congress clarified that to receive the credit an individual had to be alive on January 1, 2020, and expanded the coverage to include joint filers if at least one spouse has a valid-for-work Social Security number.

ARPA added § 6428B to the Code. This allows eligible individuals a 2021 Recovery Rebate Credit. The maximum credit is \$2.8K for joint filers and \$1.4K for most other individuals, plus an additional \$1.4K for each dependent. The credit is completely phased out at \$160K AGI for joint filers and surviving spouses, \$120K AGI for heads-of-household filers, and \$80K AGI for other individuals. In response to criticism regarding the first two Recovery Rebate Credits, Congress expanded the credit coverage to include all dependents under §152 instead of only qualifying children. For this purpose, dependents include dependents of filers who do not have valid-for-work Social Security numbers.

Chapter 5: Deductions for Off-The-Bottom Personal Expenses

Page 140

The SECURE Act retroactively extended the medical expense deduction floor percentage of 7.5% (versus 10%) to include tax years before 2021 under § 213(f). **The 2021 CAA made the 7.5% floor permanent.**

PART TWO: VIEWING THE INCOME TAX THROUGH A CONSUMPTION-TAX LENS

Chapter 6: Viewing the Income Tax Through a Consumption-Tax Lens

Page 171

The maximum amount that a taxpayer can expense under § 179 for taxable years beginning in 2021 is \$1.05M, reduced by eligible property placed in service during the year in excess of

\$2.62M. Thus, at \$3.67M of eligible property placed in service in 2021, taxpayers will not be eligible for any § 179 deduction. See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

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To mitigate financial consequences from the global pandemic, Congress (under the CARES Act) increased the § 163(j) business interest expense limitation from 30% to 50% of a business's "adjusted taxable income" for 2019 and 2020. Moreover, given the economic challenges in 2020 taxpayers can elect to use 2019 adjusted taxable income in lieu of 2020 adjusted taxable income pursuant to § 163(j)(10).

Nevertheless, § 163(j) does not apply to any business (other than a tax shelter) whose average annual gross receipts for the three years ending with the preceding tax year does not exceed \$26M. (Inflation indexing has not changed this amount for 2021). See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

Chapter 7: The Capitalization Principle in Practice

Page 189

For taxable years beginning in 2021, an entity (other than a tax shelter) meets the gross receipts test to use cash-method accounting under § 448(c) if its average annual gross receipts for the three-year period ending with the preceding tax year does not exceed \$26M. See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

PART THREE: DIFFERENTIATING AMONG THE BUSINESS, INVESTMENT, AND PERSONAL SPHERES

Chapter 8: The Basic Framework Governing Business and Investment Deductions

Pages 217-18

In *Rev. Proc. 2019-38, 2019-42 I.R.B. 942*, the IRS provided a detailed safe harbor for treatment of rental real estate enterprises as a trade or business for purposes of determining QBI and the 20% deduction under § 199A. The safe harbor applies to all years after 2017.

Chapter 9: Defining the Personal Realm: Of Human Capital

Page 251

The SECURE Act retroactively extended the above-the-line deduction for "qualified tuition and related expenses" under § 222 through December 31, 2020. Section 222 had expired for tax years after 2017. **The 2021 CAA repealed § 222 for years after 2020.** Under the CARES Act, Congress

added employer payments on employees' "qualified education loans" to the exclusion from gross income under § 127 for "educational assistance" payments made after March 27, 2020 through December 31, 2020. **The 2021 CAA extended this through the end of 2025.** § 127(c)(1)(B). However, Congress did not increase the overall cap of \$5,250, which is not indexed for inflation. § 127(a)(2).

Chapter 10: Dual-Purpose Outlays

Page 269

In Chief Counsel Advice Memorandum 202111012, February 16, 2021, the IRS Chief Counsel concluded that the 2017 TCJA amendment to § 165(d) applies only to individual gamblers and not to entities, such as casinos, engaged in the business of gambling. Under *Mayo v. Comm'r*, 136 T.C. 81 (2011), those entities can deduct § 162 trade or business expenses that are not the direct cost of the wager itself. After 2025 (when the 2017 TCJA is scheduled to sunset), *Mayo* will also apply to individual gamblers.

Page 275

The 2021 CAA makes the 50% limitation under § 274(n)(1) inapplicable to expenses paid or incurred after 2020 and before 2023 for food or beverages provided by a restaurant. For this purpose, Notice 2021-25, 2021-17 I.R.B. 1, defines a restaurant as a business that "prepares and sells food or beverages to retail customers for immediate consumption" regardless of whether the consumption occurs on the businesses' premises. Beer, wine, or liquor stores; vending machines; newsstands; drugstores; kiosks; specialty food stores; grocery stores; convenience stores; and employer-provided dining facilities are excluded from the foregoing definition.

Chapter 11: Allocating Costs Between the Income Production and Personal Realms

Pages 294, 301

The 2021 CAA makes the 50% limitation under § 274(n)(1) inapplicable to expenses paid or incurred after 2020 and before 2023 for food or beverages provided by a restaurant. For this purpose, Notice 2021-25, 2021-17 I.R.B. 1, defines a restaurant as a business that "prepares and sells food or beverages to retail customers for immediate consumption" regardless of whether the consumption occurs on the businesses' premises. Beer, wine, or liquor stores; vending machines; newsstands; drugstores; kiosks; specialty food stores; grocery stores; convenience stores; and employer-provided dining facilities are excluded from the foregoing definition.

PART FOUR: GROSS INCOME FROM MARKET TRANSACTIONS

Chapter 12: Forms of Compensation Income

Page 319

For 2020, the CARES Act adds certain employer paid “qualified education loans” to the exclusion for employer-paid-for-education under § 127(c)(1)(B). **The 2021 CAA extended this through the end of 2025.**

PART FIVE: WEALTH TRANSFERS

Chapter 14: Recoveries for Personal Injury and Other Windfall Receipts

Page 356

In *Blum v. Comm’r*, T.C. Memo. 2021-18, the taxpayer indisputably suffered a personal physical injury but she lost the suit for damages that she brought against the alleged tortfeasor. She then sued her attorneys for malpractice and received a \$125K settlement which she excluded under § 104(a)(2) on the theory that the settlement was a substitute for the personal physical injury judgement she would have received if her attorneys hadn’t mishandled the case. The court held that the settlement award was not received on account of a personal physical injury because the pleadings in the taxpayer’s suit against the lawyers framed the action as a lawyer malpractice case as did the settlement agreement. Might the taxpayer have achieved a § 104(a)(2) exclusion if the pleadings and settlement agreement had used language consistent with the “substitute for personal injury judgement” theory? Alternatively, the taxpayer argued that she could exclude the malpractice recovery as a loss reimbursement under *Clark v. Comm’r*, infra page 704. The court held that *Clark* and similar reimbursement cases did not apply because the settlement payment compensated the taxpayer for her lawyer’s professional failure rather than for the loss of the speculative amount she might have received if she had won her personal injury suit. The court did not discuss whether the taxpayer had any basis to offset against the settlement amount. Did she?

Page 357

The IRS ruled in December 2019, *PLR 201950004*, that a wrongful birth settlement to pay for the challenges of caring for a disabled child and to compensate the child’s mother for her emotional distress due to her child’s physical illness was excluded from gross income under § 104(a)(2) and Reg. § 1.104-1(c)(1).

Chapter 15: Gratuitous Transfers

Page 390

In IR-2021-70 (March 30, 2021), the IRS announced that “Emergency financial aid grants made by a federal agency, state, Indian tribe, higher education institution or scholarship-granting organization (including a tribal organization) to a student because of an event related to the COVID-19 pandemic are not included in the student’s gross income.”

Page 400

Under the CARES Act, Congress added employer payments on employees’ “qualified education loans” to the exclusion from gross income under § 127 for “educational assistance” payments made after enactment of the CARES Act (March 27, 2020) through December 31, 2020. § 127(c)(1)(B). **The 2021 CAA extended this through the end of 2025.**

Chapter 16: Charitable Contributions

Page 403

Congress added § 62(a)(22) in the CARES Act, providing an above-the-line charitable deduction of up to \$300 (\$150 if married filing separately) for cash donations to qualifying public charities for 2020. **The 2021 CAA extended this to 2021 but increased the limit for married filing jointly filers to \$600 (\$300 for unmarried and married filing separately filers).**

Page 407

The Further Consolidated Appropriations Act of 2019, PL 116-94, reduced the § 4090(a) tax on the net investment income of private foundations from 2% to 1.39%.

Page 412

The CARES Act allows individual taxpayers to elect out of any deduction ceilings on cash contributions made to qualifying public charities in 2020. Any qualified contributions above 2020 modified AGI can be carried forward for up to five years. CARES Act, Pub. L. No. 116-136, § 2005(a)(2)(A), 34 Stat. 281 (2020) (not codified in § 170).

Inflation-adjusted data in *Giving USA 2020: The Annual Report on Philanthropy for the Year 2019* indicates that despite the increased standard deduction under 2017 TCJA, 2019 charitable giving was up from 2018 by 2.4%. However, 2018 charitable giving was less than 2017 by 1.7% perhaps as a result of increased giving in 2017 in anticipation of 2017 TCJA. Charitable giving in 2017 was 3% higher than 2016, which was 2.7% higher than 2015 (all percentages are adjusted for inflation). Notably, the 2019 percentage of individual donors was under 70%, continuing a steady decrease since at least 1980. See also Scott A. Hodge, Tax Foundation, *Latest Data Shows That the Tax Cut and Jobs Act Did Not Dampen Charitable Giving* (June 2020).

Chapter 17: Income-Shifting Strategies

Page 430

In Notice 2020-46, 2020-27 I.R.B. 7, the holdings in Notice 2014-68 were applied to employee waivers of vacation, sick or personal leave in exchange for employer cash contributions made before January 1, 2021, to § 170(c) organizations for the relief of COVID-19 pandemic victims in specified geographical areas.

Page 432

The SECURE Act repealed the temporary tax rate change in the Kiddie Tax under § 1(j)(4) for tax years after 2019. However, for 2018 and 2019 taxpayers may elect to use the higher of the child's rate or the rate at which such income would be taxed if the income were attributed to the parent(s) in lieu of the 2017 TCJA imposed trust rates under § 1(e).

PART SIX: BORROWING, LENDING, AND INTEREST

Chapter 18: Borrowing, Lending, and Interest

Pages 468-69

To mitigate financial consequences from the global pandemic, Congress (in the CARES Act) increased the § 163(j) business interest expense limitation from 30% to 50% of a business's "adjusted taxable income" for 2019 and 2020. Moreover, taxpayers can elect to use 2019 adjusted taxable income in lieu of 2020 adjusted taxable income pursuant to § 163(j)(10). Given the economic downturn caused by COVID-19 in 2020, electing to use 2019 adjusted taxable income will likely provide a larger 2020 business interest deduction for many taxpayers.

Section 163(j) does not apply to any business (other than a tax shelter) whose average annual gross receipts for the three years ending with the preceding tax year does not exceed \$26M (as indexed for inflation for 2021). See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

Page 472

The SECURE Act retroactively extended the deduction for "qualified mortgage insurance" premiums for "Acquisition Indebtedness" as "Qualified Residence Interest" under § 163(h)(3)(E) through December 31, 2020. Section 163(h)(3)(E) had expired for tax years after 2017. **The 2021 CAA extended this treatment of qualified mortgage insurance premiums through 2021.**

Chapter 19: Cancellation-of-Debt Income

Page 497

In *Rev. Proc. 2020-11*, 2020-6 I.R.B. 406, the IRS extended safe-harbor relief from recognizing COD income where student loans are discharged either because schools closed or as a result of fraud. *Rev. Proc. 2018-39*, 2018-34 I.R.B. 319, provides similar relief for students whose higher education loans were discharged under a settlement resolving certain types of claims of unlawful business practices, including unfair, deceptive, and abusive acts and practices. Previously, the IRS provided exclusions from gross income for students who attended Corinthian College or American Career Institutes Inc., whose loans were discharged by the U.S. Department of Education. *Rev. Proc. 2015-57*, 2015-51 I.R.B. 863; *Rev. Proc. 2017-24*, 2017-7 I.R.B. 916.

Page 504

The SECURE Act retroactively extended the § 108(a)(1)(E) exclusion of COD income from the cancellation of “qualified principal residence indebtedness” through December 31, 2020. Section 108(a)(1)(E) had expired for tax years after 2017. **The 2021 CAA extended § 108(a)(1)(E) to cover cancellations before 2026.**

PART SEVEN: REALIZATION AND RECOGNITION

Chapter 23: Tax Accounting Methods

Page 593

Taxpayers (other than a tax shelter) whose average annual gross receipts for the three years ending with the preceding tax year does not exceed \$26M (as indexed for inflation for 2021) may use the cash method of accounting and are excused from inventory accounting. See *Rev. Proc. 2020-45*, 2020-46 I.R.B. 1016.

PART EIGHT: CAPITAL RECOVERY

Chapter 26: Recoveries of Expense Items: The Effect of Annual Accounting on Basis and Basis Recovery

Page 690

The inflation-adjusted amounts for 2021 for the 15% capital-gains rate ranges are as follows: taxable income more than \$80.8K, but not more than \$501.6K, for joint-filers; more than \$54.1K, but not more than \$473.75K, for head-of-household filers; more than \$40.4K, but not more than \$250.8K, for marrieds filing separately filers; and more than \$40.4K, but not more than \$445.85K for single filers. The capital-gains rate of taxpayers with taxable incomes below those ranges for 2021 is 0% and the capital-gains rate of taxpayers with taxable incomes above those ranges for 2021 is generally 20%. See *Rev. Proc. 2020-45*, 2020-46 I.R.B. 1016.

Pages 698-99

Under the CARES Act, Congress delayed the imposition of the 80% taxable income limitation on NOL deduction carryforwards until after 2020. In addition, any NOLs generated in 2018, 2019, or 2020 can be carried back five years and forward indefinitely. **In ARPA, Congress extended the “excess business loss” limitation for non-corporate taxpayers under § 461(l) through 2026.**

For 2021, the gross receipts ceiling for using the completed-contract method is \$26M. See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*

Page 703

In *Anikeev v. Comm’r*, T.C. Memo. 2021-23, the joint filer taxpayers used two American Express cards to make purchases exceeding \$6M over a two-year period. These resulted in card rewards of more than \$300,000. Most of these card rewards were used to make American Express card purchases of (1) Visa gift cards that were promptly used to buy money orders that were then deposited in the taxpayers’ bank accounts, (2) money orders that were deposited into taxpayers’ bank accounts, and (3) cash infusions to reloadable debit cards. The IRS contended that the entire amount of card rewards was includable in gross income when issued by American Express because the rewards were rebates used to acquire cash equivalents and the purchase price adjustment approach illustrated in Rev. Rul. 76-96 is inapplicable to such purchases. Rev. Rul. 76-96 requires a basis reduction and the IRS asserts that cash equivalents must always have a basis equal to face amount. The taxpayers argued that the Rev. Rul. 76-96 and similar authorities made the card rewards totally excludable regardless of how they were used. The Tax Court held: (1) Visa gift cards are a product so that the principle in Rev. Rul. 76-96 made card rewards used to make American Express card purchases of Visa gift cards excludable, although basis in the gift cards had to be reduced to reflect the exclusion so that the taxpayers would have includable gains to the extent that the prices of future purchases with the gift cards exceeded the taxpayers’ basis therein and (2) Rev. Rul. 76-96 was inapplicable to card rewards used to make direct American Express card purchases of money orders or cash infusions into reloadable debit cards. Those card rewards were includable in income when credited to the taxpayers’ American Express card accounts.

Students might be interested in the underlying economics of the taxpayers’ American Express card transactions. Virtually all of the more than \$6M of card purchases were ultimately for purchases of money orders that were promptly deposited in the taxpayers’ bank accounts from which the card charges were subsequently paid. Thus, the credit card purchases and the payments of card balances were essentially a circular flow of money that had no net cost to the taxpayers, except for small credit card fees and transaction expenses, but that produced a “return” of more than \$300K of card rewards. The IRS asserted that this return was fully taxable when the card rewards were credited to the taxpayers’ card

accounts. The taxpayers argued that the rewards were tax-free rebates. The Tax Court made the bifurcated ruling explained above.

Pages 719-20

In *Mihelick v. United States*, 927 F. 3d 1138 (11th Cir. 2019), the 11th Circuit Court of Appeals held that § 1341 applied in the case of a divorcee repaying ½ of her former spouse' excessive compensation determined through litigation initiated by her sister-in-law. After Ms. Mihelick paid her ex-spouse her 50% share of the \$600K overpayment she filed a refund claim under §§ 165 and 1341. Although the IRS refunded her ex-husband's repayment of \$300K, the District Court denied Ms. Mihelick's refund claim as a matter of law through a summary judgment motion. Ms. Mihelick, represented by counsel, appealed the District Court's decision and prevailed. Indeed, the 11th Circuit opinion authored by Judge Rosenbaum begins as follows: "Inscribed above the main entrance of the Internal Revenue Service office in Washington, D.C., is a quotation from Supreme Court Justice Oliver Wendell Holmes Jr.: 'Taxes are what we pay for a civilized society.' An admirable outlook, yet even Justice Holmes would likely agree that it is uncivilized to impose taxes on citizens for income they did not ultimately receive. But that is precisely the result the government asks us to uphold today." *Id.* at 1138.

For a detailed discussion regarding issues related to the characterization of § 1341 deductions as "not MIDs" under § 67(b)(9) and the disallowance of MIDs for 2018-2025 in the 2017 TCJA, see Douglas A. Kahn, *Return of an Employee's Claim of Right Income*, 163 TAX NOTES 1819 (2019).

Page 722

In response to a global pandemic and stay-at-home orders across America, which apply to many IRS employees, Congress (in the CARES Act) automatically postponed the due date for filing 2019 returns and paying taxes (that otherwise would have been due on April 15) until July 15. This extension not only included 2019 income tax returns and payments due on April 15, but also included the first two estimated income tax payments for 2020 otherwise due on April 15 and June 15. **In Notice 2021-21, 2021-15 I.R.B. 986, the IRS extended the due date for 2020 individual returns to May 17, 2021.** No interest or penalties were assessed on any tax payments that were paid in full by the postponed due dates.

Chapter 28: Depreciation

Page 778

The maximum amount of § 179 deduction allowable for a sport utility vehicle in 2021, as indexed for inflation, is \$26.2K. See *Rev. Proc. 2020-45, 2020-46 I.R.B. 1016.*