June 2020 Update Memorandum for

Miller & Maine's

The Fundamentals of Federal Taxation: Problems and Materials

(5th ed. 2018)

By
John A. Miller and Jeffrey A. Maine

CAROLINA ACADEMIC PRESS
700 Kent Street
Durham, NC 27701
Phone: (919) 489-7486
Fax: (919) 493-5668
www.cap-press.com

Introductory Note

On March 27, 2020, Congress passed and the President signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The $2.2 trillion act, which is the most expensive legislation ever passed by Congress, was an effort to support and stabilize the economy during the COVID-19 pandemic. While much of the CARES Act does not have a tax impact, the Act did make numerous changes to the income tax in the form of tax relief and tax incentives for individuals and businesses impacted by the pandemic. This update memorandum provides a brief summary of those changes, as well as other recent tax developments, relevant to the contents of our casebook, THE FUNDAMENTALS OF FEDERAL TAXATION: PROBLEMS AND MATERIALS (5th ed. 2018).

Chapter 2: Gross Income

Page 22: *3. Long-Standing Administrative Practices*

The CARES Act provided cash payments to many Americans (i.e., up to $1,200 for an eligible individual plus $500 for a qualifying child) to provide much needed liquidity for a struggling economy. Many recipients questioned whether the cash payments would be taxable (i.e., included in gross income). The answer is "no" because these economic impact payments made in 2020 were really advanced refunds of a fully refundable tax credit (with eligibility and credit amounts based on tax information from 2018 or 2019). This tax credit—the Recovery Rebate Credit—is discussed more fully in the chapter dealing with credits.

Pages 26-27: D. Impact of Obligations to Repay

The CARES Act authorized the Treasury Department to make up to $500 billion in loans to provide liquidity to eligible businesses for losses incurred as a result of the COVID-19 (coronavirus) crisis. P.L. 116-136, § 4003(a). Eligible borrowers must agree to certain terms and conditions, such as retaining a certain percent of their workforce at full compensation for a certain period of time. These Treasury loans, which cannot be forgiven under any circumstances, are treated as debt for tax purposes and, thus, are not income to the borrower.

Page 43: In the last paragraph of "*1. General Framework,*" 39.6% should read as 37%:

As will be explained in Chapter 14, the Tax Cuts and Jobs Act of 2017 (TCJA) temporarily capped the top rate bracket at 37%. IRC § 1(j)(2). In the illustration, the annual depreciation deductions of approximately $36,000 would produce an annual tax savings of $13,320 assuming the taxpayer was in the 37% tax rate bracket.

Chapter 3: Gains and Losses from Dealings in Property

Page 53: Add to Related Matters:

- **Sports Teams' Player Contracts**. Professional sports teams often trade players. These "sales or other dispositions" of personnel contracts would seem to produce gain or loss based on the difference between the value of the contract received and the adjusted basis of the contract exchanged. In Rev. Proc. 2019-18, 2019-18 I.R.B. 1077 (Apr. 11, 2019), however, the IRS provided a safe harbor for a professional sports team to treat certain personnel contracts as having a *zero value* for purposes of determining gain or loss from such trades. Thus, unless cash is thrown in the deal, a team making a trade does not realize gain or loss from the trade. The IRS provided the safe harbor because valuation of professional sports personnel contracts fluctuates and is highly subjective and was the source of disputes between sports teams and the IRS.

Chapter 4: Gifts and Inheritances

Page 69: At end of Related Matters, add the following new bullet:

- **Income in Respect of Decedent (IRD) Exceptions to Sections 102 and 1014.** Sometimes, income is earned by a decedent prior to death, but not collected until after death. The earned but uncollected income would not be reported on the decedent's final income tax return. Instead the income is treated as "income in respect of a decedent" (IRD), which is taxed to the actual recipient (the decedent's beneficiaries) in the year of receipt. IRC § 691. A traditional retirement account, for example, is IRD. As a result, a designated beneficiary who inherits a retirement account will not receive a basis step up under section 1014. *See* § 1014(c). Instead the beneficiary will step into the employee/decedent's shoes for tax purposes, which means that any distributions will be taxable to the beneficiary. Retirement accounts are addressed in Chapter 36.

Chapter 5: Discharge of Indebtedness

Pages 71 & 72: References to section 61(a)(12) should be to section 61(a)(11):

The Tax Cuts and Jobs Act of 2017 (TCJA) prospectively repealed section 61(a)(8), which included alimony in gross income, for divorces after 2018. As a result, section 61(a)(12) was redesignated section 61(a)(11) starting in 2019. Moving forward, income from discharge of indebtedness in included under section 61(a)(11).

Pages 75-76: Add the following at the end of the section D. Discharge of Recourse Debt in Property Transactions:

For a recent illustration of the difference between recourse debt and nonrecourse debt in the determination of "amount realized," see Breland v. Commissioner, T.C. Memo 2019-59 (holding that the amount realized in a foreclosure sale was the $7.2 million bid price, not the full $10.7 million outstanding loan balance).

Page 84: Add the following to the second bullet on Section 108(a)(1)(E):

Congress retroactively extended through 2020 the exclusion for discharge of qualified principal residence indebtedness. Taxpayer Certainty and Disaster Tax Relief Act of 2019 (amending IRC § 108(a)(1)(E)). The exclusion applies for years 2019, 2019, and 2020.

Page 84: Add to Related Matters:

- **Discharged SBA Loans.** The Small Business Administration (SBA) has a loan program for providing financial assistance to small businesses. The CARES Act expanded this SBA loan program to include forgivable loans made (from February 15 through June 30 of 2020) to help small businesses pay up to eight weeks of payroll costs, mortgage or rent obligations, and utilities. Under the CARES Act, the amount forgiven is excluded from gross income. P.L. 116-136, § 1106(i). (Note that the CARES Act simply excludes this special loan forgiveness from gross income; it does not create any special exclusion or exception in section 108.).

Chapter 7: Business Expenses

Pages 111-112: At the end of "G. Section 163(j)—Business Interest," add the following:

The CARES Act increased the business interest deduction limit under section 163(j) from 30 percent to 50 percent of the taxpayer's adjusted taxable income (ATI) for the 2019 and 2020 tax years. IRC § 163(j)(10)(A)(i), as added by CARES Act. [The deduction remains limited by the taxpayer's business interest income and floor plan financing interest discussed in the Overview.] As with so many other provisions in the CARES Act, this temporary change was designed to help businesses who need additional liquidity.

Page 112: H. Section 280E—The Curious Case of Legalized Marijuana

The Tax Court recently held that section 280E is not a penalty provision and therefore does not violate the Eighth Amendment's prohibition on excessive fines. Northern California Small Business Assistants, Inc. v. Commissioner, 253 T.C. No. 4 (Oct. 23, 2019). The court also rejected the taxpayer's arguments that section 280E (1) does not apply to items deductible under sections other than section 162, and (2) does not apply to marijuana business that operate legally under state law.

Page 125: Add to the last bullet on Confidential Sexual Harassment Settlements:

The IRS has stated on its website (without issuing an official ruling) that the provision does not apply to plaintiffs. *See* Section 162(q) FAQ, available at https://www.irs.gov/newsroom/section-162q-faq. *See also* Tax Notes, Mar. 11, 2019, at 1255.

Page 125: Add the following new bullet in Related Matters:

- **Double Dipping**. Many small businesses have received forgivable SBA loans under the CARES Act. A question that has arisen is whether business expenses remain deductible under section 162 to the extent they were funded by such forgivable loans. The IRS has taken the position that expenses funded by forgivable SBA loans are not deductible. *See* IRS Notice 2020-32. Bipartisan legislation, however, has been introduced to override the result in the IRS Notice. In your opinion, does it make sense to take away a deduction (e.g., for reasonable salaries) because it was funded by a tax exempt source (e.g., a forgivable SBA loan)? Consider a sole proprietor using municipal bond interest, which is excluded from gross income under section 103, to pay salary to a worker.

Chapter 9: Depreciation and Amortization

Page 148: Applicable Recovery Period

The Tax Cuts and Jobs Act of 2017 (TCJA) *intended* to assign a 15-year recovery period to "qualified improvement property." But under a technical error (failure to make a statutory change in section 168), qualified improvement property placed in service after 2017 did not get the short recovery period, but instead had to be depreciated as 39-year nonresidential real property. (Because the 15-year recovery period failed to take effect, qualified improvement property placed in service after 2017 also failed to qualify for certain bonus depreciation rules discussed later in this chapter.) Under the CARES Act, however, the technical glitch is fixed and 15-year recovery period is retroactively assigned to qualified improvement property. IRC § 168(e)(3)(E)(vii), as added by CARES Act. As a result, qualified improvement property placed in service after 2017 is depreciated over 15 years. (Alternatively, the property qualifies for 100 percent bonus depreciation if additional requirements are met.)

Pages 151-153: B. Bonus Depreciation

As noted above, the CARES Act made a retroactive technical "fix" so that a 15-year recovery is assigned to "qualified improvement property." IRC § 168(e)(3)(E)(vii), as added by CARES Act. As a result, such property qualifies for 100 percent bonus depreciation if all bonus requirements are met. For the definition of qualified improvement property, see IRC § 168(e); Treas. Reg. § 1.168(b)-1(a)(5).

Chapter 10: Deductible Personal Expenses

Pages 170-172: F. Restrictions on the Deduction

The Taxpayer Certainty and Disaster Tax Relief Act of 2019 provided special rules for disaster losses in qualified disaster areas. Specifically, a "net disaster loss" is deductible to the extent it exceeds $500 (not $100) and is deductible without regard to the normal 10% of AGI threshold limitation.

Chapter 11: Other Deductible Personal Expenses

Page 188: E. Medical Expenses:

For tax years 2017 and 2018, the TCJA lowered the threshold for deducting medical expenses from 10% to 7.5% of the taxpayer's adjusted gross income. IRC § 213(a). After 2018, the 10% threshold would be applicable. The Taxpayer Certainty and Disaster Tax Relief Act of 2019, however, retroactively extended this reduced threshold to calendar years 2019 and 2020.

Chapter 12: The Deduction Hierarchy

Page 197: III. Overview

A general comment: The CARES Act created an above-the-line deduction for certain charitable contributions. More specifically, an individual who does not itemize deductions can deduct up to $300 in cash contributions made to public charities (e.g., churches, nonprofit schools, nonprofit medical institutions, etc.) as an above-the-line deduction in arriving at adjusted gross income (AGI). IRC § 62(a)(22), (f)(1), as added by the CARES Act. Thus, an individual can claim a limited charitable deduction even though she does not itemize.

Chapter 14: Ordinary Tax Rates and Taxpayer Classification

Page 237: Add the following to the bullet on The Kiddie Tax:

Congress has now repealed section 1(j)(4) (added by the TCJA), which temporarily modified the *Kiddie Tax* by apply applying the rates of tax applicable to trusts to the unearned income of children. This means that the law prior to the TCJA is now back in effect. *See* 2020 Further Consolidated Appropriations Act, § 501.

Chapter 15: Tax Credits

Pages 242-243: In "*3. The Hope Scholarship Credit and the Lifetime Learning Credit*," please note the following:

The Hope Scholarship Credit is now called the American Opportunity Tax Credit. The credit is partially refundable. IRC § 25A(i). In addition, the references to IRC § 25A(d), (i)(4) should be to IRC § 25A(d)(1)-(2), and the reference to IRC § 25A(h)(2) should just be to IRC § 25A(h).

Page 245: Add at the end of IV. Related Matters, the following new bullets:

- **Recovery Rebate Credits (Economic Impact Payments) for Individuals**. In response to the COVID-19 (coronavirus) crisis, Congress enacted the "Recovery Rebate Credit." IRC § 6428, as added by the CARES Act. The maximum credit is $1,200 for each eligible individual, plus $500 for each qualifying child. IRC § 6428(a), (d). Soon after enactment, in 2020, the IRS made advanced refunds of the credit via economic impact payments to eligible taxpayers, with eligibility and credit amounts based on tax information from 2018 or 2019. While the economic impact payments were based on earlier tax returns, the credit actually applies to the 2020 tax year, and the advance refund reduces the amount of the credit for the 2020 tax year. The Recovery Rebate Credit is a fully refundable personal credit. IRC § 6428(b). However, it is phased out if a taxpayer's adjusted gross income (AGI) exceeds a threshold amount. IRC § 6428(c). Note that the rebate/credit is not available to anyone who could be claimed by another taxpayer as a dependent.
- **Employer Tax Credits and Self-Employment Tax Credits for Paid Sick and Family Leave**. Under the Families First Coronavirus Response Act (different from the CARES Act), eligible employers may receive a refundable payroll credit for required paid sick leave or family leave paid to an employee who cannot work due to COVID-19. P.L. 116-127, §§ 7001, 7003. In addition, self-employed individuals can claim a refundable credit for a qualified sick leave or family leave equivalent amount if they cannot work due COVID-19. P.L. 116-127, §§ 7002, 7004. The credits are "equivalent" to those available to an eligible employer who pays required paid sick or family leave to an employee who cannot work due to COVID-19. These business credits, which have unique rules and limitations, are beyond the scope of this course. For information on a new refundable payroll tax credit for retaining employees during the COVID-19 crisis, see P.L. 116-136, § 2301, which too is beyond the scope of this course.

Chapter 20: The Charitable Contribution Deduction

Page 295: 3. Sections 170(b)(1)(A) & (B). Add the following at the end of the section:

As noted in the text, the Tax Cuts and Jobs Act of 2017 (TCJA) increased the AGI limitation for charitable contributions of cash made by individuals to public charities to 60% (up from 50%). IRC § 170(b)(1)(G). The CARES Act, however, suspended the 60% limitation and raised it to 100% for qualified charitable contributions in 2020 in response to the COVID-19 (coronavirus) crisis. Specifically, an individual may deduct charitable contributions in cash to public charities as long as the contributions do not exceed the individual's contribution base (100%). Consistent with other carry forward rules in section 170, an individual may carry forward for five years any qualified cash contributions that exceeds her contribution base. P.L. 116-136, § 2205.

Page 312: At the end of Related Matters, add the following new bullet:

Deduction Hierarchy. Recall from Chapter 12 that the deduction under section 170 (relating to charitable contributions) is an itemized deduction. IRC § 67(b)(4). For tax years beginning in 2020 only, however, an eligible individual may claim an above-the-line deduction in computing AGI of up to $300 for any qualified charitable contribution. IRC § 62(a)(22), as added by CARES Act. For this purpose, an eligible individual is someone who does not claim any itemized deductions, and a qualified charitable contribution is a cash contribution to a public charity described in section 170(b)(1)(A) (i.e., church, nonprofit educational institution, nonprofit medical institution, etc.). IRC § 62(f).

Chapter 24: Like Kind Exchanges

Page 360: At the end of Related Matters, add the following new bullet:

- **Qualified Opportunity Zones.** The TCJA added Code sections 1400Z-1 and 1400Z-2. These provisions provide tax benefits to taxpayers who realize capital gains and invest them in certain funds ('qualified opportunity funds") that invest in businesses and real estate located in economically distressed communities. *See* IRS Notice 2019-42, 2019-29 I.R.B. 352 (June 25, 2019) (providing list of "qualified opportunity zones" by state). More specifically, a taxpayer can defer capital gains to the extent they ae invested in a qualified opportunity fund within 180 days. If that investment is held for at least five years, the taxpayer can exclude from gross income 10% of the *original deferred gain*. If held for at least seven years, the taxpayer can exclude an additional 5% (for a total of 15% of the *original deferred gain*). Any remaining deferred capital gain is taxed on the earlier of (1) the date the investment in the fund is sold or (2) December 31, 2026. For investments in a qualified opportunity fund held for at least 10 years, the taxpayer may elect to exclude from gross income any gain from *post-acquisition appreciation*. In 2020, the Treasury and IRS issued regulations.

Chapter 27: Limitations on Deductions

Pages 389-390: In "E. Limitation on Excess Business Losses," add the following at the end of the section:

It should be noted that the CARES Act defers the effective date of section 461(l) for three years (specifically, the limitation on excess business losses is postponed for tax years beginning in 2018, 2019, and 2020). The limitation, which is discussed in the main text, applies for tax years beginning after 2020. IRC § 461(l), as amended by CARES Act. The CARES Act also made some technical corrections that will become effective when the limitation on excess business losses once again becomes applicable. *See, e.g.*, IRC § 461(l)(3)(A)-(B), as either added or amended by CARES Act.

As noted in the main text, the Tax Cuts and Jobs Act (TCJA) made significant changes to the net operating loss (NOL) rules of section 172. Specifically, under the TCJA, NOLs arising in 2018 and later are carried forward indefinitely; in addition NOLs may only reduce 80 percent of a taxpayer's taxable income in a carryforward year. The CARES Act changed these rules temporarily in response to the COVID-19 crisis. First, the CARES Act created a five-year carryback rule. In other words, any NOL arising in 2018, 2019, or 2020 may be carried back five years. IRC § 172(b)(1)(D), as added by CARES Act. The carryforward period for NOLs remains unlimited. Second, the CARES Act suspended the 80 percent taxable income limitation for NOLs for 2018, 2019, and 2020. IRC § 172(a)(1), as amended by CARES Act. Again, these changes are temporary. The normal NOL rules are reinstated in tax years beginning after 2020 (e.g., NOLs arising in 2021 may not be carried back).

Chapter 33: Education Benefits and Costs

Page 485: *2. Educational Assistance Programs*

General comment: The CARES Act expanded the type of educational assistance an employee can exclude from gross income under section 127. Specifically, payments by an employer to either an employee or a lender to be applied toward an employee's student loans can be excluded from gross income. IRC § 127(c)(1)(B), as added the CARES Act. The payments can be of principal or interest on any qualified education loan incurred by the employee for his or her education (not for education of a child), but payments must be paid by the employer before 2021. The $5,250 cap still applies, and it applies to both the new student loan repayment benefit, as well as other educational assistance (e.g., tuition, fees, books) provided. IRC § 127(a)(2).

Page 487: In "E. Special Credits and Deduction for Qualified Tuition and Related Expenses," please note the following corrections:

The references to IRC § 25(h)(2) and (i)(4) and (i)(5) are obsolete. They should just be IRC § 25A(h) and IRC § 25A(i).

Page 487: At the end of "E. Special Credits and Deductions for Qualified Tuition and Related Expenses," add the following:

The Taxpayer Certainty and Disaster Tax Relief Act of 2019 retroactively extended through December 31, 2020, the section 222 above-the-line deduction of qualified tuition and related expenses for higher education of the taxpayer (or taxpayer's spouse or dependents).

Page 488: 2. Section 529: Qualified Tuition Programs

Section 529 was recently amended to permit tax-free distributions from section 529 accounts to pay expenses of apprenticeship programs. IRC § 529(c)(8), as added by the SECURE Act. The provision was also amended to permit up to $10,000 of tax-free distributions to repay qualified education loans of the beneficiary or a sibling. IRC § 529(c)(9), as added by the SECURE Act.

Page 489-490: At the end of "H. Coordination Rules," add the following:

As noted above, certain employer student loan payments are excluded from income under the CARES Act. Note, however, that no deduction is allowed under section 221 for student loan interest payments paid by the employer that are excluded from the employee's income. IRC § 221(e)(1), as amended by CARES Act.

Chapter 34: Personal Injury Recoveries and Punitive Damages

Page 496: Add the following cite in the last paragraph:

See Doyle v. Commissioner, T.C. Memo 2019-8 (Feb. 6, 2019) (holding damages received by a taxpayer who was terminated from his job were for emotional distress and therefore included in gross income). The court rejected the taxpayer's argument that "one can't' really distinguish symptoms of emotional distress from symptoms of other physical injuries or sicknesses because '[p]hysical relates to both the body and mind which are inseparable in a person.'" The court concluded that the taxpayer "may well be right ontologically, but not legally."

Page 535: In Related Matters, add to the bullet on Confidential Sexual Harassment Settlements, the following:

The IRS has stated on its website (without issuing an official ruling) that the provision does not apply to plaintiffs. *See* Section 162(q) FAQ, available at https://www.irs.gov/newsroom/section-162q-faq. *See also* Tax Notes, Mar. 11, 2019, at 1255.

Chapter 36: Retirement Resources and Deferred Compensation

Page 551: At the end of Related Matters, add the following new bullet:

CARES Act Changes. The CARES Act made numerous changes affecting retirement plans:

- The 10% early-withdrawal penalty under section 72(t) is waived for any qualified coronavirus-related distribution from a retirement plan. P.L. 116-136, § 2202(a)(1). (Note that this type of relief is often granted by Congress in response to major disasters, such as hurricanes.) To qualify as a "coronavirus-related distribution," it must be made from an eligible retirement plan between March 27 – December 31, 2020, to an individual who has been diagnosed (or who has a spouse or dependent diagnosed) with coronavirus, or who experiences adverse financial consequences as a result of the coronavirus. *Id*. § 2202(a)(4). The portion of a distribution that is includible in income is reported over a three-year period (unless elected otherwise). *Id*. § 2202(a)(5). However, under a three-year rollover provision, a person who receives a coronavirus-related distribution may recontribute the amount to an eligible retirement plan within three years with the result that the original distribution is not subject to tax. *Id*. § 2202(a)(3).

- Generally, a loan from a qualified retirement plan to a participant is treated as a distribution and included in gross income unless the loan does not exceed $50,000 or 50 percent of the value of the participant's vested benefits under the plan (whichever is less). IRC § 72(p). The CARES Act increased the threshold limit on loans to $100,000 or 100% of the value of the participant's benefits. P.L. 116-136, § 2202(b)(1). The loan, however, must be made between March 27 – December 31, 2020, to an individual who is diagnosed with coronavirus (or whose spouse or dependent is diagnosed) or who experiences adverse financial consequences as a result of the coronavirus. P.L. 116-136, § 2202(a)(4).
- Retirement plans and IRAs must meet required minimum distribution (RMD) requirements to qualify for tax-favored status. IRC § 401(a)(9). For 2020 only, the required minimum distribution (RMD) requirements are suspended with respect to deferred contribution plans, including IRAs. IRC § 401(a)(9), as added by CARES Act. Note the Act waives all RMDs for 2020 regardless of whether the taxpayer has been impacted by the pandemic.

Chapter 37: Overview of Entity Taxation

Pages 563-565: D. The Deduction for Qualified Business Income—Section 199A

In 2019, the Treasury Department and the IRS finalized regulations under section 199A, which was enacted by the Tax Cuts and Jobs Act of 2017 (TCJA). These regulations provide various rules for determining the deduction, including extensive guidance on the meaning of the term "specified service trade or business." Also in 2019, the IRS issued Rev. Proc. 2019-38, which provides a safe harbor under which a rental real estate enterprise will be treated as a "trade or business" solely for purposes of section 199A and the new regulations thereunder. 2019-42 I.R.B. 942 (Sept. 24, 2019).

Page 621: Add the following bullet to V. Related Matters:

- **Use It or Lose It**. The TCJA only increased the basic exclusion amount to $10,000,000 temporarily. The increase is scheduled to sunset on January 1, 2026, and fall back to $5,000,000. IRC § 2010(c)(3)(C). This introduces an additional level of complexity into the planning process since the unified credit can be used during life as well as at death. Thus, the question naturally arises, what if the credit was used during life to shelter more gifts than the credit amount that is permitted by the law on the date of death. The regulations provide that there will be no clawback of the credit on the date of death. Treas. Reg. § 20.2010-1(c). Nor will there be any credit remaining to shelter any bequests from tax. *See* Treas. Reg. § 20.2010-1(c)(2)(i) ex.1. This is a use-it-or-lose it situation. This creates some incentive to make inter vivos gifts in advance of 2026 when the credit is slated to fall back. There is a downside. If those gifts are of appreciated property, the donee will take a carryover basis rather than a stepped up basis. The deceased spousal unused exclusion amount also provides an interesting wrinkle. If the taxpayer's spouse dies before 2026, the regulations provide that the DSUE amount will be fixed on that date and will not decline even if the taxpayer dies after 2026. *See* Treas. Reg. § 20.2010-1(c)(2)(iii) ex.3. The taxpayer's basic exclusion amount, on the other hand, will fall to the post 2026 level. *Id*.

Chapter 42: Tax Practice and Procedure

Page 624: A. Tax Returns

As a result of the ongoing COVID-19 (coronavirus) emergency, the Treasury Department and IRS extended the due date for filing individual federal income tax returns (and for making federal income tax payments otherwise due) from April 15, 2020 to July 15, 2020. Penalties, interest, or additions to take for failure to file the returns or pay the taxes will not accrue until July 16, 2020. A taxpayer does not have to be impacted by COVID-19 to qualify for the extension; any person with a return or payment due on April 15, 2020, is eligible for the automatic relief. The payment extension is unprecedented, and amounts to a 90-day interest-free loan from the government!