p. 50. Add new Note (E) as follows:

(E) Tax Credits and the Art of the Scam. Alternative energy sources are, well, hot these days, and a company called D.C. Solar seemed to be leading the way. The company touted its mobile solar generators, which would supply green energy to sporting events and other outdoor venues. Investors were attracted by D.C. Solar’s business model — and by the generous tax credits for alternative energy (found in §§ 25D and 48). D.C. Solar counted among its investors Progressive Corp., the insurance company, and Berkshire Hathaway, run by Warren Buffett, the famed “Sage of Omaha” whose investment acumen is legendary.

The problem was, the federal government alleges, that D.C. Solar was a Ponzi scheme. Unknown to investors, say federal authorities, the company spent investors’ money on a lavish lifestyle for the founders and built only a fraction of the solar generators it claimed to build. Investors must now repay the tax credits, since there was no real investment in solar energy. Katherine Chiglinsky and Brian Eckhouse, Berkshire Takes Tax Hit as Victim of ‘Ponzi-Type’ Solar Scheme, Bloomberg, May 8, 2019, https://www.bloomberg.com/news/articles/2019-05-08/berkshire-takes-tax-hit-as-victim-of-ponzi-type-solar-scheme.

Critics contend that tax credits like the alternative energy credits can be so attractive to investors that they dampen investors’ incentive to monitor the underlying business. Should the federal government try to monitor investments that include tax benefits? Could the IRS feasibly do so?

p. 75: Delete Note (B) and substitute the following:

(B) “Acquiescence” and “Non-Acquiescence.” After the IRS has lost a case, it may decide, for one reason or another, not to seek further review. The IRS may conclude that the adverse decision is correct. In that event, the IRS may decide to publish its “acquiescence” in the decision. This is done by including the case in a list of “acquiescences” in the Internal Revenue Bulletin. The IRS’s formal acquiescence amounts to instructions to all Treasury employees that the decision is to be followed. Thus, it has much the same effect as a revenue ruling.

However, the IRS, even though it does not appeal, may announce his “non-acquiescence” in an adverse court decision. This, too, is published in the Internal Revenue Bulletin. The procedure of “non-acquiescence” causes some misunderstanding. If the IRS does not agree with the decision, why does it not appeal? In the first place, the decision whether to appeal is made by the Solicitor General, who may refuse to follow the IRS recommendation. Or the IRS itself may have recommended against an appeal on the grounds that the case is unimportant or factually weak so that review of the issue by an appellate court should await some other
case where the facts are better for the government.

A non–acquiescence also has something of the status of a revenue ruling against the taxpayer and means that Treasury personnel will not apply the court’s decision. The taxpayer, however, can probably win if his case falls under the jurisdiction of the same court, unless it has factual differences or is affected by an intervening appeal of a similar case.

pp. 107-108: Revise Note (A) to read as follows:

(A) Employers’ Entertainment Deductions Disallowed. The result in Townsend Industries remains valid: workers may exclude (and firms need not withhold income or payroll taxes on) the value of the fishing trip. The 2017 tax legislation altered the tax picture for such trips, however, by eliminating the employer’s deduction for activities that constitute “entertainment, amusement, or recreation.” § 274(a). The new rule would not affect the workers’ exclusion. As Chapter 3 describes, Congress in 2017 repealed the deduction for employee business expenses, but the statute explicitly makes clear that this change does not affect the scope of the exclusion of working condition fringes under § 132. See p. 269, infra.

But the new law would require Townsend to allocate the costs of future fishing trips between (nondeductible) “recreation” and (deductible) meals, travel, and lodging. Indeed, the IRS has announced that taxpayers may now deduct otherwise-deductible meals provided during or at an “entertainment activity” only if 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 IRS adds a warning: “The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.” Notice 2018-76, I.R.B. 2018-42 (describing regulations to be issued under § 274).

p. 108: Add new Notes (B) and (C) and relabel following notes accordingly:

(B) Even Judges Have Trouble Applying the Code. Curiously, the Eighth Circuit in Townsend correctly quotes the Code but then proceeds to misapply it. The text of § 132(d), as the court correctly notes, permits an employee to exclude an employer-paid item as a working condition fringe benefit “to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.” But the court then proceeds to conflate the employee’s business purposes with those of her employer – and they aren’t necessarily the same.

A word of background will clarify the issue. As you will learn in Chapter 3, § 162 permits a taxpayer to deduct the “ordinary and necessary” expenses of her business. A firm like Townsend Industries is, obviously enough, engaged in a business and has a variety of deductible business expenses, including wages and fringe benefits paid to workers. Workers, too, are engaged in business for purposes of § 162. That may seem odd at first, but consider that workers make their living by selling their labor. And some
workers do incur expenses as part of their jobs (think of a professor who buys her own reference books, or a salesman who pays for his own travel).

The Townsend Court’s mistake lies in this passage from the opinion:

What [the] statutes and regulations boil down to is a requirement that Townsend prove that its fishing trips were reasonable and necessary business expenses that were directly related to, or associated with, the active conduct of Townsend’s business. Further, Townsend must demonstrate its business purpose by showing: that it had more than a general expectation of deriving some income or other trade or business benefit from the trip; that its employees actively engaged in business meetings, negotiations, discussions, or other bona fide business transactions; and that the principal character of the combined business and entertainment was the active conduct of Townsend’s trade or business. **

The problem with the court’s reasoning is that § 132(d), quoted above, requires an inquiry into the employee’s business purposes, and not the employer’s. So the correct inquiry would be whether the fishing trip served the worker’s business interests by (say) putting in “face time” with the bosses, showing commitment to the company, or making connections with co-workers and vendors. Townsend’s own business purposes (of the sort the court outlines) are, strictly speaking, relevant only to its own § 162 deduction. They are irrelevant to its workers’ § 132(d) exclusion.

This might seem to be nit-picking: surely, Townsend and its workers share a general purpose of furthering the company’s business? But the distinction has bite in the § 132 context, because Townsend unquestionably has a business purpose for providing the fishing trip, even if, as to the employees, the trip is nothing more than a free vacation. To see the point, imagine a company that gives every employee a free trip to Hawaii with the worker’s family. The free trip would be properly includable in the worker’s income, because there is no business purpose for the trip from the worker’s perspective. But the employer has a business purpose: to compensate employees for their work and, perhaps, to increase retention and loyalty by providing a special treat. Thus, the Townsend court’s error undermines the purpose of § 132(d), which is to distinguish between personal consumption and business expenditures. By failing to inquire into the business value of the fishing trip from the workers’ perspective, the court misapplied the statute and ran the risk of permitting an unwarranted exclusion.

(C) Interactions with other Code Provisions. Section 132(d), at issue in Townsend, explicitly relies on the law under § 162 and 167, which prescribe standards for business deductions. These provisions, in turn, are subject to additional restrictions in, inter alia, §§ 67(limiting or denying miscellaneous itemized deductions) and 274 (limiting or denying certain business expenses, particularly for entertainment, travel, and meals). This nested set of rules raises a hard question of statutory interpretation: does §132(d) apply if a taxpayer could deduct the item in question under § 162 but would face some additional restriction under §67 or §274. For instance, § 67(g) disallows all “miscellaneous itemized deductions,” including employee business expenses, in tax
years beginning in 2018 and ending in 2025. Thus, a worker who pays out-of-pocket for a business trip in these years may not deduct the cost: although the expense meets the longstanding criteria of § 162, it is subject to the disallowance imposed by § 67(g). The "Blue Book," a legislative history prepared by the Joint Committee on Taxation to describe the 2017 tax act, weighs in on the side of the taxpayer:

"Notwithstanding the temporary repeal of miscellaneous itemized deductions, working condition fringes continue to be excluded under section 132(d). Because section 132(d) provides that a working condition fringe is excluded from an employee’s gross income to the extent that had the employee paid for the benefit, such payment would be allowable as a deduction to the employee under section 162 or 167, the provision does not affect the exclusion. A deduction for these items would still be allowable under section 162, notwithstanding that the deduction may have been subsequently disallowed under section 67. A similar result is achieved under prior law, wherein a working condition fringe was excludable in its entirety, notwithstanding that a deduction under section 162 was limited by the prior law section 67 two-percent haircut on miscellaneous itemized deductions." Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, December 2018, p. 74, note 310.

The JCT's approach reflects the regulations under § 132, which provide that the (prior law) 2% floor of § 67 does not apply to § 132(d). Reg. § 1.132-5(a)(i)(vi).

p. 135: In the second paragraph, omit the parenthetical, "(Children under age 18 may be taxed at their parents’ tax rates. § 1(g).).

p. 184: Amend the second sentence of Note (B) to read: “The taxpayer/embezzler may be entitled to a deduction in the year in which he actually repays or forfeits the illegally obtained gains (but see Note (F), below).

p. 186: Before Section B. Discharge of Indebtedness, add new Note (F):

(F) Down the Rabbit Hole: Ambiguities in the Code. As Note (B) discusses, when an embezzler makes restitution to her victim, she may, in principle, deduct the payments under § 165(c)(2), which provides a deduction for losses incurred in transactions entered into for profit. (Yes, embezzlement, though illegal, is a transaction intended to profit the embezzler, and repayment marks a loss in connection with that scheme.) It turns out that restitution paid between 2018 and 2025 cannot be deducted, thanks to the § 67(a) and (g) limitations on miscellaneous itemized deductions? (These are discussed at p. 269 and 381.) Consider an embezzler with wages of $50,000 who wishes to repay an embezzled amount of $40,000. Without any deduction for the repayment, her after-tax income (taking into account income and payroll taxes) would be less than the $40,000 she’d like to repay. Is this good public policy? Will it discourage restitution payments or make them financially infeasible?
P 138: In the last paragraph before Section 4. Capital Appreciation and Recovery of Basis, delete the phrase, “educational expenses,” and substitute “interest on educational loans.”

p. 243. Add the following new paragraph to the end of Note (C):

In Lucas v. Commissioner, the Tax Court applied the origin of the claim test to deny a claimed deduction for $2.5 million in legal fees incurred in a divorce. The taxpayer, a hedge fund manager, claimed that the fees were deductible because the divorce proceedings required the taxpayer to defend his legal right to income-producing property against claims by his wife. The court applied a “but for” test and found that the marriage was the sole source of the wife’s claim to the taxpayer’s income, rendering the legal expenses personal and nondeductible under § 262. T.C. Memo. 2018-80 (June 11, 2018).

p. 269: In the fourth line from the top, replace “§ 67(f)” with “§ 67 (g).”

p. 269: At the end of the first (carryover) paragraph, add a new footnote:

The “Blue Book,” a legislative history prepared by the Joint Committee on Taxation to describe the 2017 tax act, takes the taxpayer-favorable position that workers may exclude items under § 132(d) despite the disallowance of the deduction for employee business expenses in § 67(g). Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, December 2018, p. 74, note 310. But the statute is not crystal clear. See supra at the addition to p. 108, new Note (C) following Townsend.

p. 269: In the second full paragraph, after the citation to Commissioner v. Banks, replace the following two sentences with:

Congress has permitted an above-the-line deduction for attorneys’ fees and court costs in a range of anti-discrimination suits, defined broadly in § 62(e), and whistleblower cases. But attorneys’ fees and costs for other employee recoveries, however, remain deductible (in principal) below the line and, thus, subject to the disallowance of miscellaneous itemized deductions in § 67(g).

p. 269: After the second full paragraph, add:

The § 67(g) temporary disallowance of miscellaneous itemized deductions has produced harsh consequences. In the case of losses, for instance, § 67(b)(3) excludes from the category of miscellaneous itemized deductions “the deduction under § 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c).” Read literally, that language now means that § 165 losses other than casualty and theft losses may not be deducted. (Note that § 165(c)(2) losses of individuals that arise from the sale or exchange of property are above-the-line deductions (see § 62(a)(3)) and so are not itemized deductions at all, whether miscellaneous or otherwise. Thus, losses on the sale of stock or real estate, for example, remain fully deductible.)
This is a puzzling provision. It isn’t obvious why theft and casualty losses should be privileged (by exclusion from the deduction limitation) over other types of losses in §165(c)(2) transactions entered into for profit. The temporary regulations, §1.67-1T(b)(7), do not clarify matters much. The regulations list as excluded from miscellaneous itemized deductions all §165(c)(3) losses, but do not mention §165(c)(2) at all. The results for taxpayers can be harsh. See the additions to p. 186 (discussing embezzlers who make restitution to their victims) and p. 391 (discussing hobby losses).

p. 270: Before Section 2. Distinction Between Deductible Business or Investment Expenses and Nondeductible Personal, Living or Family Expenses, add the following new section, titled Notes:

Notes

(A) Does Kevin Durant Know About § 67(g)? The temporary disallowance of the deduction for (unreimbursed) employee business expenses likely affects relatively few workers. Most workers only pay out of pocket for perhaps a few books or an occasional business lunch. But one class of prominent employees stands to lose big: pro athletes. Athletes typically are considered employees of their teams for tax purposes, and they often pay hefty sums for agents’ fees, trainers, and travel costs. Marketwatch interviewed one CPA, whose pro athlete client would pay an additional $80,000 thanks to § 67(g) and the temporary disallowance of the state and local tax deduction in excess of $10,000 in § 164. Steven Kutz, Why Pro Athletes May Lose a Fortune Because of the New Tax Law, Marketwatch, Dec. 9, 2018, https://www.marketwatch.com/story/why-pro-athletes-may-lose-a-fortune-because-of-the-new-tax-law-2018-12-06. Could athletes get around the limitation by renegotiating their contracts, accepting lower cash salaries in exchange for employer reimbursements of agents’ fees, training, and travel costs?

p. 283: At the end of the note on “Working and Driving,” change “educational tapes” to “educational podcasts.”

p. 299: At the end of Note (A), add: In 2026 and thereafter, however, § 274(o) disallows the employer’s deductions for meals excludable under either § 119 or § 132(e)(2).

p. 299: Replace Note (B) with the following:

(B) The Client’s Meal. How do you think the Tax Court would view a case where a law partner eats lunch with a client and pays for both meals? As a starting point, § 274(a) disallows any deduction “[w]ith respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation.” Does that broad language encompass meals? After all, only the strictest ascetics would deny that eating, and especially, eating out, can be entertaining. But the legislative history of the 2017 tax legislation indicates that Congress intended only to disallow “entertainment.”
Consistent with that intent, § 274 continues to contemplate that some meals will be deductible. Section 274(k) prohibits the deduction of “lavish or extravagant” meals, and § 274(n) limits meal deductions generally to 50% of the expenditure.

The IRS clarified the state of the law in Notice 2018-76, I.R.B. 2018-42, which describes regulations to be issued under § 274. The regulations will treat an expenditure as a business meal (and not entertainment) if:

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.

Would you expect these requirements to significantly limit the number of client meals that are deductible?

p. 302: Delete the first full paragraph (discussing a case involving the Boston Bruins) and the paragraph that follows.

p. 303: In Note (G), replace the third paragraph with the following:

Is it important that high income individuals generally are thought to capture most of the benefits of the meal deduction? Note that if a law firm partner takes a client/friend to an expensive dinner, the costs are deductible, but if a blue-collar laborer shares a hot dog after work with a co-worker, the cost is not deductible even if they talk about their jobs.

p. 320: In Notes (A) and (B), delete the references to Reg. § 1.263(a)-2T and substitute Reg. § 1.263(a)-2.

p. 322: In Note (E), delete the reference to Reg. § 1.263(a)-1T and substitute Reg. § 1.263(a)-1.

p. 358: In the second paragraph, delete the phrase, “Business interest is fully deductible, but” and begin the sentence with “If the taxpayer’s activities...”
Students should consider the impact of the home mortgage interest deduction in the context of broader U.S. housing policy. In the period 2016-2020, the federal government expects to spend $45 billion on tax credits for low-income housing, compared to more than $700 billion on tax expenditures for owner-occupied housing, including the home mortgage interest deduction. See p. 44, supra. Middle-income renters currently receive no tax benefit, even though housing affordability is a major issue, especially in high-cost cities like San Francisco, Los Angeles, New York, and Boston. Legislators including Senator Cory Booker have proposed a federal renters' tax credit, which could ensure that no taxpayer spends more than 30% of her income on rent. Estimates suggest that the proposal could assist nearly 60 million families. If you were in charge of federal housing policy, how would you deploy the billions now spent on housing tax expenditures?

Nonbusiness losses face a further disadvantage between 2018 and 2025, thanks to the disallowance of miscellaneous itemized deductions by § 67 (g), discussed at p. 269. Section 165(c)(2) losses of individuals that arise from the sale or exchange of property are above-the-line deductions (see § 62(a)(3)) and so are not itemized deductions at all, whether miscellaneous or otherwise. But any other § 165(c)(2) loss is an itemized deduction, and unless it is a casualty or theft loss, it is a miscellaneous itemized deduction disallowed for tax years including 2018 through 2025. See § 67(b)(3).

When businesses incur deductions that exceed income, they have a “net operating loss.” For instance, suppose that a one-person law firm earns $100,000 in fees but incurs total costs, including salaries, office rent, and depreciation on office property, of $120,000. The law firm thus has a net operating loss (sometimes abbreviated “NOL”) of $20,000.

The Code permits taxpayers to carry forward NOLs indefinitely. In our example, the law firm owner can carry forward the $20,000 and report it as a deduction on her return the following year. Section 172(a)(2) does, however, limit NOL carryforwards to 80% of the taxpayer’s taxable income (computed before any NOL deduction). Thus, if our hypothetical law firm owner earns only $10,000 in the subsequent year, her NOL carryover is limited to 80% of that amount, or $8,000. The remaining $12,000 (the $20,000 initial NOL less the permitted $8,000 deduction) would roll over as a carryforward in the next year.
p. 391: Replace the last paragraph of Note (A) with the following:

If an activity is not engaged in for profit, the Code still authorizes certain deductions. First, a taxpayer may deduct those amounts that are deductible without regard to whether there was a profit motive, for example, taxes under § 164. Second, any amount that would have been deductible if there had been the requisite profit motive is deductible to the extent of gross income from the activity minus the first sort of deductions. § 183(b).

Despite these provisions, § 67(g) disallows miscellaneous itemized deductions taken in tax years from 2018 through 2025. See supra at the additions to pp. 269 and 380. Hobby deductions allowable by § 183(b)(2) (other than casualty and theft losses) are miscellaneous itemized deductions. See Purdey v. U.S., 39 Fed. Cl. 413 (1997). Thus, § 67(g) temporarily disallows the §183(b)(2) deduction in most cases, so that hobbyists will – for this period – be taxed on gross income from the hobby (minus any expenses that would be deductible in any event without regard to profit).

p. 392: Add before Note (C):

In Kurdziel v. Commissioner, T.C. Memo 2019-20 (2019), the taxpayer devoted eight years to restoring a World War II fighter plane, the Fairey Firefly, spending what Tax Court Judge Mark Holmes described with ironic precision as “bales of money.” In the years at issue in the case, Mr. Kurdziel reported income of $10,000 or less per year (apparently from exhibiting and flying the plane at airshows). But he deducted depreciation and other expenses on his tax return to the tune of about $125,000 per year. The result, he claimed, was a net “business” loss of $115,000 each year, which sheltered his other income. Judge Holmes applied a nine-factor test and concluded that Kurdziel did not engage in his Firefly activities for profit. Applying § 183, Holmes upheld the IRS determination that the taxpayer could not deduct losses in excess of income from the activity.

p. 433: In the first full paragraph, delete the second sentence and substitute:

The standard deduction is not available, for example, to married taxpayers filing separate returns where either spouse itemizes deductions, to nonresident aliens, and to estates, trusts, common trust funds, or partnerships.

p. 445: In the second paragraph of E. Education Credits, delete from the second sentence of the second paragraph the parenthetical, “(which is also called the Hope Scholarship Credit).”

p. 445-446: Delete the carryover paragraph (beginning “A taxpayer is ineligible...”) to reflect the expiration of § 222 at the end of 2017.
Notes

(A) The SALT Cap, the States, and the IRS. The 2017 legislation, which enacted the temporary cap on state and local tax deductions, motivated some high-tax states to attempt a workaround measure. To understand the workaround, imagine a hypothetical taxpayer who (before the workaround) itemizes deductions and has paid state income taxes of $15,000. Under the SALT cap of § 164(b)(6), the taxpayer may deduct only $10,000, leaving her with no tax benefit for the remaining $5,000.

The workaround attempts to convert nondeductible state income taxes into deductible charitable contributions. In a typical plan, taxpayers make a donation to a state-controlled entity (say, a school fund). State law provides that contributing taxpayers may then take a dollar-for-dollar credit against their state income tax. The idea is that the hypothetical taxpayer would “donate” $5,000 to the state-controlled fund and claim a federal charitable deduction under § 170. She would also claim a $5,000 state income tax credit, reducing her total state tax liability to $10,000, a sum that (not coincidentally) equals the federal SALT cap. When the dust clears, her federal return would report a $10,000 deductible state income tax payment and a $5,000 deductible charitable contribution.

Despite the longstanding existence of such state tax credits in many (often “red”) states, the IRS has attacked the charitable deduction claimed by taxpayers in such circumstances in a new application of the “quid pro quo” standard, initially stated in the Duberstein case at p. 125 and later applied to charitable contributions as discussed in Hernandez and Note (B) at p. 461. The IRS views the taxpayer as having received a dollar-for-dollar benefit (the state tax credit) in exchange for the charitable contribution. Accordingly, new regulations under § 170 provide that a taxpayer must reduce any federal charitable deduction by the amount of any state or local tax credit received in consideration for the donation. Reg. § 170A-1(h)(3). The regulations provide a safe harbor if the amount of the state or local tax credit is less than 15 percent of the taxpayer’s donation. Reg. § 170A-1(h)(3)(vi).

The legality of the charitable deduction claimed in state workarounds like these is likely to be resolved by litigation. Recall that (as Chapter 1 explains), Treasury regulations carry the force of law unless they exceed the statutory authority granted by Congress, so that affected taxpayers may well challenge the § 170 regulation itself as an invalid exercise of the Treasury’s regulatory authority.

(B) The Constitution and SALT. The attorneys general of New York, Connecticut, and New Jersey have sued the federal Treasury, asking the federal courts to invalidate the SALT cap as an unconstitutional infringement on state fiscal sovereignty. According to the complaint:
A SALT deduction has been a part of every federal income tax law since the first federal income tax was enacted in 1861. The deduction is necessary to ensure that the exercise of the federal government’s tax power does not unduly interfere with the sovereign authority of the States to determine their own taxation and fiscal policies by crowding the States out of traditional revenue sources, like income, property, and sales taxes. The SALT deduction further ensures that States have the prerogative to determine the appropriate mix and level of public investments to make on behalf of their residents, as well as the authority to choose how to raise revenue to pay for those investments. The new cap on the SALT deduction will raise the federal tax liability of millions of taxpayers within the Plaintiff States. And by increasing the burden of those who pay substantial state and local taxes, the new cap on the SALT deduction will make it more difficult for the Plaintiff States to maintain their taxation and fiscal policies, hobbling their sovereign authority to make policy decisions without federal interference.


p. 453: Add new Note (C):

(C) Collateral Damage and the Charitable Deduction. One stated goal of the 2017 tax legislation was to simplify the tax law. To that end, the law increased the standard deduction (discussed at pp. 432-434, supra) in order to reduce the number of taxpayers who itemize deductions. Charities expressed concern that the new law would also discourage charitable donations: the § 170 deduction is an itemized deduction for individuals, and so the new law could reduce (or eliminate) the tax value of a charitable contribution for many taxpayers. It is too early for IRS data on the 2018 filing season, but the nonprofit Giving USA reports that, adjusted for inflation, total charitable giving by individuals in 2018 dropped by more than 3%, adjusted for inflation. Giving by foundations and corporations (unaffected by the new tax limitations) increased in the same period, after inflation. Giving USA 2019: Americans Gave $427.71 to Charity in 2018 Amid Complex Year for Charitable Giving, June 18, 2019, https://givingusa.org/giving-usa-2019-americans-gave-427-71-billion-to-charity-in-2018-amid-complex-year-for-charitable-giving/

p. 462: Add before Note (D):

And the IRS has recently extended equal treatment to the Satanic Temple of Salem, Massachusetts. The Satanic Temple announced in 2019 that the IRS had granted it tax-exempt status as a religious organization. Depicted in the 2019 documentary, “Hail Satan?”, the group has a primarily political mission and often challenges protections for organized religion. For instance, it created after-school Satan Clubs, now operating in Los Angeles and Portland, among other
places, to compete with after-school Christian religious clubs. Parents, watch for the Satan Club; it may be coming to a school near you.

p. 489: Add as new Note (A) and relabel following notes accordingly:

(A) Constitutional Issues in Morrissey. Having rejected Mr. Morrissey's interpretation of the statutory language of § 213, the 11th Circuit also rejected his claim to the deduction under the Equal Protection Clause of the U.S. Constitution:

The pertinent question here...is not whether the Constitution protects a right to "procreation" generally—the Supreme Court has held that it does, at least in certain circumstances—but rather, more specifically, whether a man has a fundamental right to procreate via an IVF process that necessarily entails the participation of an unrelated third-party egg donor and a gestational surrogate....

To be sure, IVF and other assisted reproductive technologies represent revolutionary biomedical advances; they have enabled countless couples to conceive who otherwise couldn't have had children biologically. But these advances are not without their complexities. IVF-assisted reproduction involving (as it does here) third-party egg donors and gestational surrogates “raise moral and ethical issues” that can affect multiple, and often divergent, interests—among them, those of biological fathers, egg donors, surrogate mothers, and the resulting embryos....Not surprisingly, the States have tackled IVF- and surrogacy-related issues in very different ways. To take just one example, the States have adopted a range of positions with respect to surrogacy contracts....

Were we to confer “fundamental” status on Mr. Morrissey's asserted right to IVF- and-surrogacy-assisted reproduction, we would “to a great extent, place the matter outside the arena of public debate and legislative action.” ....Particularly in view of the ethical issues implicated by IVF, egg donation, and gestational surrogacy, as well as the ongoing political dialogue about those issues—and mindful that “guideposts for responsible decisionmaking” in the fundamental-rights area “are scarce and open-ended”—we decline to take that step....

The Court of Appeals also rejected the taxpayer’s claim that denying him the § 213 deduction amounted to unconstitutional discrimination based on sexual orientation:

As a threshold matter, Mr. Morrissey can't demonstrate that the IRS has treated him differently from similarly situated heterosexual taxpayers who claimed deductions of IVF-related expenses under Section 213. The agency's disallowance of Mr. Morrissey's claimed deduction is consistent with longstanding IRS guidance and analogous Tax Court precedent.

As a matter of both policy and practice, the IRS has consistently refused deductions sought by heterosexual taxpayers for IVF-related expenses similar to
Mr. Morrissey’s. An IRS guidance published in 2002 advised that “medical expenses paid for a surrogate mother and her unborn child would not qualify for deduction under § 213(a).”…

Even if Mr. Morrissey could show that he had been treated differently from similarly situated heterosexual taxpayers, he hasn’t shown that any difference was motivated by an intent to discriminate against him on the basis of his sexual orientation….

p. 501: Delete the first paragraph of Note (B) and replace with the following:

(B) Marriage Penalties and Bonuses. Under current law, married couples may experience a marriage penalty or bonus, depending on their total income and the division of income between the spouses. That is, the married couple can pay less tax or more tax than they would if they remained single. The marriage bonuses and penalties reflect the relationship between the tax rate schedules applicable to married couples and those applicable to single people and heads of households.

A marriage bonus occurs if the size of a tax rate bracket for married couples filing jointly is twice the size of the same rate bracket for single people and if the couple has relatively unequal earnings. In effect, the double-size rate bracket permits a portion of the higher-earning spouse’s income to be taxed at a lower rate than if she were single. A marriage penalty, conversely, arises if the size of a tax bracket for married couples is less than twice the size of the same rate bracket for single people and the couple has relatively equal earnings. This difference arises because the second earner’s salary is pushed into a higher marginal rate when a couple is married. These effects can also arise when one or both the taxpayer would have otherwise filed as “head of household,” a filing status with its own rate brackets.

From 2018 through 2025, the rate brackets for married couples filing jointly are set at twice the rates for single individuals until joint income exceeds $400,000 and the 35% rate bracket applies. Couples with incomes in or above the 35% bracket thus may experience marriage bonuses or penalties, depending on the level of their income and the split between their incomes. For example, suppose that A and B each earn $310,000 in 2018. If they are single, each falls in the 35% bracket under § 1(j)(2)(C). If they marry and file jointly, their total income of $620,000 places them into the 37% bracket, so that $20,000 of their income is taxed at the 37% marginal tax rate. See § 1(j)(2)(A) (setting the 37% bracket for married couples filing jointly at $600,000). Thus, A and B face a marriage penalty. By contrast, suppose that C earns $525,000 and D earns $0. If unmarried, C would have $25,000 of her income taxed in the 37% bracket. By marrying D, C receives a marriage bonus; now none of her income is taxed in the top bracket.

p. 501: Delete Note (C) and re-label the following notes accordingly.

p. 502: In (existing) Note (D), replace the last sentence of the first paragraph with the following:
As Note (B) discusses, the 2017 tax legislation eliminated marriage penalties (and increased marriage bonuses) for income taxpayers below the 35% bracket but did not eliminate marriage penalties in the EITC.

p. 505-506: Delete the last paragraph of p. 505 and the first two paragraphs of p. 506 and substitute the following:

The so-called “kiddie tax” of § 1(g), revised for the years 2018 through 2025 by § 1(j)(4), aims to restrict the intrafamily shifting of income and tax benefits. The section provides that “net unearned income” of children under the age of 19 as well as children over age 18 but under age 24 who are full-time students (as of the end of the taxable year) is taxed at the ordinary and capital gains rates applicable to trusts and estates, regardless of the source of the unearned income. Net unearned income for this purpose is unearned income in excess of the child’s standard deduction plus either (i) an additional standard deduction or (ii) the amount of allowable deductions that are directly connected with the production of the unearned income. The standard deduction for this purpose, found in § 63(c)(5)(A), is adjusted for inflation and stands at $1,100 for 2019. For those who are 18 or older, the kiddie tax applies only to those whose earned income does not exceed one-half of the amount of their support. Investment income on a gift from dad is treated identically to interest income on a savings account funded with the earnings from babysitting or mowing lawns.

In combination, these rules mean that the first $1,100 of a child’s unearned income is taxed at the child’s marginal tax rate. Any greater amount of unearned income, however, is taxed at the rate applicable to trusts and estates. This rate schedule is highly unfavorable to taxpayers, because the rate brackets are set lower than those for individuals. Thus, the kiddie tax effectively penalizes (and, thus, discourages) income-shifting to children covered by the kiddie tax.

Under limited circumstances, the Code permits parents to report the gross income of a child in excess of $1,100 on their own return. § 1(g)(7). Under this election, the first $1,100 of unearned income is still not taxed; the next $1,100 is taxed at 10 percent, and any excess is taxed at the parents’ marginal rate. § 1(g)(7)(B). Such an election generally excuses the child from filing her own return. The election is permitted where the child has income between $1,050 and $10,500, and her income consists only of interest and dividends. These numbers are all indexed for inflation. (A good exercise in reading the Code is to determine where the $10,500 amount comes from.)

This parental election seems to be at odds with the intention of the 2017 tax legislation to impose the kiddie tax at the rates applicable to trusts and estates.

* After 2025, the applicable rates are scheduled to revert to the parents’ top marginal rate, which was the rule under § 1(g) before the 2017 legislation.
In 2019, the House Ways & Means Committee considered technical corrections legislation that would, inter alia, remove the § 1(g)(7) election. But for the moment, the literal language of the Code retains the parental election.

p. 507: Add new Note (H) as follows:

(H) The Kiddie Tax and Gold Star Families. As discussed in Note (F), supra, legislation in 2017 altered the kiddie tax so that the unearned income of children under age 19 (and, for full-time students, age 24) is taxed according to the rate schedule that applies to estates and trusts. Under prior law, such income was taxed at the parent’s rate. For high-income families, where parents are already in the top rate bracket, the change made little difference. But the change has been disastrous for some middle- and lower-earning families, including military survivors like Gold Star Families.

The problem is that the marginal tax rate schedule for estates and trusts is steeper than for other taxpayers, so that high marginal rates apply to relatively modest amounts of income. In 2018, for instance, the trust schedule applies the top rate of 37% to taxable income over $12,500, compared to $500,000 for a head of household (i.e., a single-parent) family.

The Wall Street Journal reported the case of the Headings family. After Senior Chief Petty Office Gary Headings died, the military paid his six-year-old son an annual benefit of about $30,000, a welcome addition to widow Rebecca Headings’ household finances. But the kiddie tax has taken a huge bite out of the Gold Star survivor benefit. Under prior law, the benefit would have been taxed at Ms. Headings’ marginal tax rate of 12%. But under current law, the majority of the benefit is taxed at the 37% top rate applicable to trusts. See § 1(g).

Gold Star families aren’t alone in feeling the bite of the new kiddie tax. Some college students receive taxable scholarship income; under § 117, financial aid that covers room and board is taxable. And, under § 1(g), when the student is under age 24, the kiddie tax applies. The result can be high tax bills for students from moderate- and low-income families. Congress seems certain to fix this problem for Gold Star families, but others may have to wait.

p. 511: At the beginning of Section 2 (Property Settlements), delete “under prior law” and substitute “Before 1984.”

p. 536: After the second full paragraph, add the following new paragraph:

According to projections by the Joint Committee on Taxation, the government expects 27 million tax returns, or 10% of all returns, to claim the § 199A deduction. A whopping 35% of taxpayers with incomes over $1 million are expected to claim the § 199A deduction and to save an average of $55,000 on their tax bill compared to pre-2017 law.
(A) Trade or Business of Performing Services as an Employee. Consider T, a law firm partner earning $175,000 per year. One of T’s law school classmates, G, is employed as the general counsel of one of the clients of T’s law firm. G earns a salary of $175,000 per year and files a joint tax return with her stay-at-home husband on which they report the same $175,000 of taxable income as T and her spouse Z report. Under § 199A(d)(1)(B), the trade or business of performing services as an employee is not a qualified trade or business. As a result, G is not entitled to any deduction under § 199A. But T is eligible for the 20 percent QBI deduction. Does it make sense for T and her spouse to enjoy the 20 percent deduction not available to G and her spouse? Why should Congress favor individual business owners over similarly situated individual employees?

(B) W-2 Wages. The Code limits the § 199A deduction by reference to wages paid in the case of qualified trades or businesses owned by taxpayers with taxable income above the applicable thresholds (in 2018, the thresholds are $315,000 for joint returns or $157,500 for singles). “Wages” for this purpose are W-2 wages paid to employees. See § 199A(b)(4), § 6051(a). The wage limit does not include amounts paid to independent contractors. Should businesses seek to convert from using independent contractors to hiring employees to increase the § 199A deduction? Consider the potential effect of such a reclassification of employment status or compensation on each independent contractor’s own § 199A and § 162 business expense deduction. Similarly, in a business where tips are important, such as a restaurant, could the owner add a service charge to all of the customer’s bills in lieu of tips and pay such amounts as wages to increase the QBI deduction limitation?

(C) Unadjusted Basis of Qualified Property. For purposes of § 199A, qualified property includes tangible real or personal property of a character subject to depreciation. If a business owner has acquired property in which the business is operated as an inheritance, the unadjusted basis under § 1014 would be the fair market value of the property at the date of the decedent’s death. Does it make sense to provide for an increase in the § 199A deduction with respect to the untaxed appreciation reflected in a stepped-up basis under § 1014?

(D) “Good” and “Bad” Service Businesses. Section 199A excludes income from specified service businesses for taxpayers with incomes above the income threshold found in § 199A(b)(3). The distinction thus poses high stakes for many taxpayers, and the statutory definition, which cross-references § 1202(e)(3)(A), is both unclear and potentially quite broad. For instance, the statute includes any trade or business whose “principal asset…is the reputation or skill of 1 or more of its employees.” Early commentators pointed out that many businesses seemingly qualify by that criterion. Many barber shops, auto repair shops, and dog groomers, just to take a few examples,
rely on repeat customers who patronize the business because of the owner’s particular skills.

The regulations under § 199A adopt a narrow construction of the “reputation or skill” provision, so that it affects only businesses that receive fees for endorsements, for the use of an individual’s image, or for appearing at an event or on television. Reg. § 1.199A-5(b)(2)(xiv). Thus, for instance, if a well-known actor agrees to appear in ads for a shoe company, the fees he receives are considered to be from a specified service business. Reg. § 1.199A-5(b)(xvi), Example 16.

Why should Congress draw such distinctions? For instance, assume that B operates a hair salon, which is a qualified trade or business for purposes of § 199A and is thus eligible for the special deduction under § 199A. If B had instead been a dentist, or engaged in any other specified service trade or business, such as being a doctor or investment banker, he would not have been entitled to any deduction under § 199A. § 199A(d). Are hair stylists more beneficial to society than doctors or dentists? Are hair stylists who own their businesses more beneficial to society than those who work as employees?

While § 199A clearly applies to hair salons, the regulations under § 199A draw fine distinctions within other industries. For instance, doctors and dentists are disfavored, because they are considered engaged in the “field of health,” which is a specified service business. Pharmacists and psychologists are, likewise, out of luck as health care providers. By contrast, the regulations favor (by excluding from the “field of health”) health clubs, health spas, and “the research, testing, and manufacture and/or sales of pharmaceuticals or medical devices.” Reg. § 1.199A-5(b)(2)(ii). Why would Congress intend to favor health spas and gyms over doctors and dentists? And why the favorable tax treatment of the pharmaceutical industry?

(E) Reasonable Compensation. Section 199A(c)(4) provides that QBI does not include “reasonable compensation paid to the taxpayer by a qualified trade or business for services rendered with respect to the trade or business.” The regulations under § 199A provide that compensation paid to an S corporation shareholder and guaranteed payments by a partnership to a partner will reduce QBI for the payor (the business) and will not qualify as QBI for the recipient.

So a tax-savvy business owner might decide not to pay himself any formal compensation, because such compensation would reduce the amount of his QBI and be taxed at his full ordinary income tax rate. Should the IRS be able to impute an amount of reasonable compensation to the owner to achieve the same result? Compare the reverse situation described in Exacto Spring, supra at page 243, where the IRS attempted to disallow a deduction under § 162 for any “unreasonable compensation” paid by a corporation to a shareholder in order to reduce the amount of corporate tax. § 1.199A-2(b)(2)(ii).

(F) Financial Services or Banking? The categories of “specified service trade or
business,” disqualified for higher-income taxpayers, includes “financial services,” but not “banking.” The Independent Community Banking Association claims to have been “in ongoing contact with lawmakers and staff during the crafting of the law and was repeatedly assured that shareholders in S-corp community banks would be eligible for the passthrough deduction.” See http://www.icba.org/news/news-details/2018/01/17/scorp-shareholders-eligible-for-new-20-percent-deduction. Are such assurances relevant for statutory analysis? Isn’t “banking” merely an example of “financial services”?

(G) Does Enormous Size Matter? Although § 199A is sometimes portrayed in the media and in politics as a “small business” tax break, many large business enterprises clearly qualify. For example, it has been reported that Bechtel, an enormous construction and civil engineering company, is organized as an S corporation. (See https://thinkprogress.org/are-the-small-businesses-republicans-claim-to-be-protecting-from-a-tax-increase-really-small-cf21b0be339e/.) If Bechtel is indeed an S corporation, its owners would be entitled to the § 199A deduction, even though it was reportedly the 8th largest privately owned American company in 2017 (https://www.forbes.com/companies/bechtel/). Does it make sense to allow very large businesses to choose whether to be taxed as a pass-through entity or a taxable corporation?

(H) Aggregating and Separating Businesses. Many taxpayers operate more than one business. A restaurateur, for instance, may own several restaurants. Early commentators predicted that such taxpayers could advantageously bundle or unbundle their businesses to maximize the § 199A deduction by increasing total property basis and W-2 wages. For instance, a taxpayer might increase her § 199A deduction for a business that owns little property and pays low total wages if she can combine it (for § 199A purposes) with a business that owns large amounts of property or pays high total wages.

The regulations under § 199A permit, but do not require, the aggregation of businesses under common ownership (defined as 50% or greater common ownership). Specified service businesses (discussed in Note (D), supra) may not be aggregated with other businesses. And businesses qualify for aggregation only if they meet two of the following three factors:

(A) The trades or businesses provide products, property, or services that are the same or customarily offered together.

(B) The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.

(C) The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

Reg. § 1.199A-4(b)(2).
The regulations provide the example of Taxpayer A, who owns and operates a catering business and a restaurant. The catering business and the restaurant engage in joint purchasing to obtain volume discounts and share a central accounting office. A’s advertising materials and website mention both the catering business and the restaurant, and A prepares food for the catering business in the restaurant kitchen. A may (but is not required to) aggregate the assets and wages of the two businesses, because they both provide prepared food to customers and because they share centralized purchasing and accounting functions. Reg. § 1.199A-4(d), Example (1).

(I) Cracking Down on “Cracking.” Early commentators on § 199A predicted that taxpayers might avoid the § 199A limitation on specified service businesses by “cracking” them open to create separate qualifying and nonqualifying businesses. For instance, a law firm is a specified service business under the literal language of the statute. However, a large law firm might be considered to engage in several different businesses. To be sure, the lawyers provide legal services, but the firm also provides secretarial and IT support to the attorneys. And if the firm owns an office building, it is, in effect, renting office space to itself.

Clever commentators mused that a law firm might “crack” itself into two businesses under common ownership. The law business would be pared down to employ only lawyers, would rent (not own) its office space, and would pay fees for support services provided by a sister company. The sister company would provide all support services, and would charge fees for office space, secretarial, and IT support. You can easily see the tax gambit: the new sister company avoids the “specified service business” designation, thus entitling its owners, the law firm partners, to a § 199A deduction.

But the regulations quash the “cracking” strategy with a special rule that treats related services companies as themselves specified services businesses. Reg. § 199A-5(c)(2).

pp. 560-561: In the carryover paragraph, in the subparagraphs headed “0%”, “15%”, and “20%”, delete the phrase “adjusted gross income” and substitute “taxable income.”

p. 561: Before the first full paragraph (beginning “Capital gains are not distributed evenly”), insert the following full paragraph:

Even this summary, as complicated as it may seem, does not capture the complexity of the capital gains calculation, which also depends on how much capital gains income the taxpayer has in relation to her total ordinary income. For instance, consider a single taxpayer (not a head of household) with taxable income of $48,100. She falls in the 22% bracket. But suppose that only $38,100 of her income is ordinary, while $10,000 is long-term capital gain. In that case, $500 of her capital gain would be taxed at a zero rate, thanks to the 0% capital gains threshold of $38,600 in § 1(j)(5)(B).

p. 572: In the last paragraph, delete the second sentence and substitute:
In addition, capital losses in excess of capital gains are deductible dollar for dollar against $3,000 of ordinary income whereas the top capital gains rate now is generally 55 percent of the top rate on ordinary income and has historically been about 50 to 60 percent of the ordinary rate.

p. 580: Insert [sic] after the word “principle” in the ninth line of the first full paragraph of the Bramblett opinion to reflect the court’s misspelling of “principal.”

p. 595: Add new Note (C):

(C): The Code vs. The Code. The drafters of the 2017 tax legislation apparently intended to repeal the long-term capital gains rate preference for patent creators, but the text of the Code now sends, well, a mixed message. Section 1221(a)(3) provides that patents are not capital assets in the hands of the inventor. But §1235 provides that the sale of a patent by any person (including its inventor) produces long-term capital gain.

The Joint Committee on Taxation suggests, in its “Blue Book” legislative history of the 2017 act, that § 1235 now applies only to holders other than the inventor. But the plain text of the statute reads otherwise, unless and until Congress acts to rationalize the two provisions. See Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, December 2018, p. 207, n. 1027.

p. 644: In the penultimate line of the example, delete the phrase “Plus: Amount of gain realized upon the exchange” and substitute “Plus: Amount of gain recognized upon the exchange.”

p. 644: In the last line, the reference to Note (I) should be to Note (H).

p. 645: In the third paragraph of Note (A), second line delete the word, “sale,” and substitute the word, “exchange.”

p. 656: In the third paragraph, add the following new footnote to the penultimate sentence: As noted in Note (E) on page 659, the contribution limits are the same for regular and Roth IRAs; that is, the Roth contribution in real life (unlike in the text example) need not be reduced by the tax payable on the contribution.

p. 656: Delete the last paragraph.

p. 657: Delete the third and fourth paragraphs and substitute the following:

Taxpayers may convert a traditional IRA to a Roth IRA by treating the value of their IRA as income in the current period. In order to benefit from the conversion, the entire conversion amount must be moved from the traditional to the Roth IRA, and the taxpayer must pay the tax due on the conversion out of non-IRA funds.
There is no income limitation on conversion of a regular IRA to a Roth IRA.

Conversion potentially has two benefits. First, paying the tax now to avoid paying tax in the future is a real advantage if you think tax rates will be higher when payouts begin from a regular IRA. If you think, for instance, that the future holds income tax increases to deal with the federal debt and deficits, then converting to a Roth IRA now makes sense. Second, as Note (B) below implies, one benefit of the conversion is an increase in the total investment that becomes eligible for the nontaxation of investment earnings.

What impact do conversions have on current government revenues? (Recall that government revenues are treated as cash receipts for budgetary purposes.) What impact do conversions today have on government revenues in the future? Given that Congress uses cash-flow budgeting rules focused on the short term, what incentives do the current members of Congress have to accelerate or deter conversions?

p. 667: In Case 2, the items for Year 1 and Year 2 should be shown in the “Employer” Column (including and ending with “Paid to Employee”).