2020 Update to Graetz, Schenk, and Alstott, Federal Income Taxation (8th ed.)

Note on tax provisions related to the COVID-19 pandemic:

In spring 2020, the federal government enacted several measures aimed at alleviating the impact of the COVID-19 pandemic. Some of these included tax measures, including the Families First Coronavirus Response Act (the “Families First” Act), Pub. L. No. 116-127, and the Coronavirus Aid, Relief, and Economic Security Act (the “CARES” Act), Pub. L. No. 116-136.

This supplement adds a discussion of these tax measures to the relevant sections of the casebook. For teachers and students interested in reading holistically about the tax changes made during the 2020 pandemic, we provide a summary here. As of this writing (June 10, 2020), the Congress has not passed additional relief legislation with significant tax provisions.

Magnitude of budget impact foretells tax changes to come. Before the virus hit, the federal debt was already at its highest level relative to the economy than at any time since the end of World War II. In no year of the 21st century have federal revenues fully paid for federal spending; deficits are commonplace. In the near term, the pandemic will have a major negative effect on the federal budget. The economic downturn that began in February 2020 will sharply reduce federal income tax and payroll tax collections, and the spending measures enacted in response to the 2020 pandemic will cost the government trillions of dollars. The CARES Act alone was estimated to increase federal spending by more than $2 trillion dollars.

In the short- and medium-run, these events will increase federal deficits. Even when the economy rebounds, so that temporary additional spending expires and revenues return to their normal level, the federal debt will be much larger than had been anticipated. More deficits are expected to continue into the future. Even before the pandemic, influential economists had estimated that, even with low interest rates, interest on the federal debt would be the fastest rising element of the federal budget.

Eventually the government must raise revenue or cut spending just to keep the public debt constant as a percentage of the economy. It doesn’t take a crystal ball to predict that at some point in the near future Congress will have to raise taxes to
keep the debt and deficits in check. Tax legislation to produce more robust revenues will then become a priority. By the time the 2017 tax cuts for individuals expire at the end of 2025, major changes seem inevitable.

Extended filing deadlines. The IRS extended the filing date for 2019 federal income tax returns to July 15, 2020 from the usual April 15 due date. Section 7508A grants the IRS the authority to extend filing and other deadlines during any federally-declared disaster. In March 2020, the President issued a formal emergency declaration for all 50 states, all tribes, all territories, and the District of Columbia. The emergency declaration also triggers taxpayer-favorable rules in § 7805A(d), which provides an automatic 60-day delay for actions including Tax Court filings. The disaster declaration may also permit taxpayers to make use of § 165(i), which permits taxpayers to carry back one year a loss otherwise allowable under § 165 and “occurring in a disaster area and attributable to a federally declared disaster.”

Tax provisions for individuals. The CARES Act’s major initiative to aid individuals took the form of a one-time payment of up to $2,400 for married couples ($1,200 for individuals) plus $500 per qualifying child. This “recovery rebate” is phased out gradually for married taxpayers with incomes over $150,000 (and single individuals with incomes over $75,000). See § 6428.

The CARES Act liberalized the deduction for charitable contributions. Section 62 now authorizes an above-the-line deduction for cash contributions made by non-itemizers in 2020, with a cap of $300. § 62(a)(22). The legislation also suspends the 60% of AGI limitation (found in § 170(b)) with respect to cash contributions made in 2020.

The CARES Act also includes several taxpayer-favorable rules for withdrawals from retirement accounts. First, the act waived the usual 10% penalty (imposed by § 72(t)) on up to $100,000 in early withdrawals from retirement plans, provided that the distribution of funds is made in 2020 and is related to the coronavirus. A distribution is treated as coronavirus-related if the taxpayer, her spouse, or dependent is diagnosed with COVID or if the taxpayer experiences “adverse financial consequences” due to quarantine, layoffs, or inability to work due to lack of child care. Second, pension distributions remain includible in gross income, but the CARES Act permits taxpayers to spread out the inclusion over three years. Third, the legislation permits taxpayers to borrow up to $100,000 (instead of the usual $50,000) from a qualified retirement plan. Finally, the CARES Act also
waived, for 2020, the minimum required distribution rules found in § 401(a)(9). See § 401(a)(9)(I).

Finally, the CARES Act amended § 127 to permit workers to exclude payments on student loans made by their employers in 2020. See § 127(c)(1)(B).

*Tax provisions for business: tax credits for sick leave and family leave.* The Families First Act requires some employers with fewer than 500 workers to provide ten days of paid sick leave and an additional ten weeks of paid family leave to some workers affected by the COVID emergency in 2020. To reduce the financial cost of paid leave to employers, the Act also provides a refundable payroll tax credit for 100% of wages paid to workers on leave. The Act extended the refundable sick leave and family leave credits to self-employed workers as well.

*Tax provisions for business: payroll-related measures.* The CARES Act included three tax-related measures to help businesses pay workers’ wages (and payroll taxes on those wages). The first, the “employee retention credit,” awarded some firms a refundable tax credit against their payroll tax liabilities. The credit included complex eligibility rules. For instance, firms claiming assistance under the Paycheck Protection Program (a loan program administered by the Small Business Administration) could not claim the payroll tax credit. The credit was calculated as 50% of “qualified wages” (basically, the first $10,000 of wages) paid to employees between March 2020 and the end of the year but could be claimed only by businesses that were shut down by governmental order due to COVID-19 or that suffered at least a 50% drop in gross receipts.

The second employer assistance measure, the Paycheck Protection Program (“PPP”), operated outside the tax system but raised major tax issues. The PPP provided loans to some businesses adversely affected by the pandemic. The loans were forgivable, provided that the recipients used the money for specified purposes, including the payment of wages, utilities, rents, and interest. Legislation passed in early June 2020 liberalized the terms of the program.

The CARES Act anticipated the first tax issue, providing that the forgiveness of PPP loans would not produce cancellation of indebtedness income to loan recipients. By excluding the COD from recipients’ income, the legislation ensured that 100% of the loan forgiveness would benefit firms. Had Congress not excluded the COD, the “forgiven” loan amounts would be taxed, reducing the net amount of assistance provided by the government, depending on the taxpayer’s marginal tax
rate. For example, a taxpayer who received a forgiven loan of $10,000 would (absent the special provision) be taxed on that amount, leaving just $6,300 for a taxpayer in the 37% bracket.

The exclusion of COD income, however, raised a second, unanticipated issue: could recipients also deduct the costs funded by PPP loans? Code § 162 normally authorizes businesses to deduct ordinary and necessary expenses including wages, utilities, and rents, and § 163 permits the deduction of interest. But, taken together, the exclusion of the COD and the allowance of the deduction would produce a double benefit. For example, a taxpayer with a forgiven loan of $10,000 would both exclude that amount from income and take a deduction of $10,000. In the 37% bracket, the net effect would be a transfer from the government of $13,700 (the $10,000 forgiven loan plus the $3,700 in tax savings attributable to the deduction). The additional benefit would be only $1,000 for a taxpayer in the 10% bracket.

Invoking § 265(a)(1), which disallows deductions attributable to tax-exempt income, the IRS concluded that businesses cannot deduct amounts attributable to PPP loans. Notice 2020-32, IRB 2020-21, May 18, 2020. Some legislators have announced that they intend to reverse the IRS decision and permit the double benefit.

A third payroll-oriented tax measure offered firms the option of deferring payroll tax payments. Under the provision, businesses can elect to defer payment of employer payroll taxes and a portion of employee Social Security taxes attributable to (roughly) the last nine months of 2020. This measure applies to employer payroll taxes due after the employee retention credit (if any) is claimed. Taxes are deferred but not forgiven and are to be paid in two installments: half by the end of 2021 and half by the end of 2022. Payroll tax deferral is not available to businesses receiving a PPP loan.

Although tax deferral is often a welcome tax break for businesses, it does come at a cost: the money must ultimately be repaid. Some tax experts warned that the payroll-tax deferral could be a “ticking time bomb” for businesses that find themselves strapped for cash when the deferred payments come due in 2021 and 2022.

Tax provisions for business: Interest and net operating losses. The CARES Act also eased the rules on the deductibility of business interest. Before the CARES Act, § 163(j) limited interest deductions to 30% of business income (calculated
before taking into account the interest deduction). The Act increased the limit to 50% for 2019 and 2020. § 163(j)(10). One effect will be to increase interest deductions for 2019, the year before the pandemic hit. Further, the relief applies to all businesses, regardless of the pandemic’s impact on their income, leading some commentators to question whether the Act was well-targeted to the COVID crisis or was instead a giveaway to leveraged businesses.

The amendment of § 163(j) raised an interesting problem of pandemic tax policy. Business interest deductions are often fixed in amount; think of a firm that is paying off a loan used to finance a new plant and equipment. But the § 163(j) rule links interest deductibility to the taxpayer’s business income, and this amount likely fell sharply for many pandemic-affected businesses. To take an example, suppose that a corporation typically earns business income of $100 (before the interest deduction) and owes $50 in interest expense. The CARES Act increase in the limitation from 30% to 50% would help that business deduct an extra $20 – but only if business income remains at $100,000 or more. If, as is likely in many business sectors, the firm’s income plummets to near zero, then the limitation plummets too, since 50% of zero is zero. Anticipating this problem, the drafters of the CARES Act permit taxpayers to elect to calculate their 2020 limitation based on 2019 income. § 163(j)(10)(B).

Anticipating major business losses due to the pandemic, the CARES Act also temporarily eased the rules on the deduction of net operating losses (“NOLs”). Before the CARES Act, § 172 permitted businesses to carry forward (but not carry back) NOLs and limited NOL deductions in any year to 80% of income (calculated without regard to NOL deductions and the § 199A deduction). The CARES Act significantly liberalizes these rules, permitting taxpayers to carry back losses incurred in 2018, 2019, and 2020 for a period of five years and forward indefinitely. § 172(b)(1)(D). The law also suspends the 80% limitation for calculating tax due in 2018, 2019, and 2020. The 80% limitation will apply once again in 2021, but only with respect to losses incurred in 2021 or carried to 2021 from a post-2017 year. § 172(a)(2)(B).

A loss carryback permits a taxpayer to amend its federal income tax returns for a prior year and claim an immediate tax refund. For instance, suppose that X Corporation earned $100 in 2019 and paid taxes of $21. In 2020, X loses $40 (that is, X’s deductions exceed its income by $40). X can amend its 2019 tax return to show amended income of $60 ($100 – loss carryback of $40). Since the tax on $60 is just $12.60 at the 21% corporate rate, the corporation will receive an immediate tax refund of $8.40. The carryback, in effect, creates a legal fiction that the
corporation overpaid its taxes in a prior year; that overpayment then generates an immediate refund. This means that although corporate income in 2020 would be taxed at a 21% rate, losses that year may offset income from an earlier year that had been taxed at a 35% rate.

The CARES Act also permits an unlimited carryforward of NOLs arising in 2018, 2019, and 2020. A carryforward is what it sounds like; it permits firms to “carry” unused net operating losses forward to future tax returns and deduct them on those returns. A firm that cannot use the five-year carryback (because its losses exceed its past income) can carry forward the losses and deduct them against future income.

A separate provision of the CARES Act eases the deductibility of losses by pass-through entities, like partnerships, and sole proprietors. Enacted in 2017, § 461(l) originally provided that noncorporate taxpayers could use a maximum of $250,000 ($500,000 in case of a joint return) in business losses to offset nonbusiness income. The CARES Act delays the effective date of § 461(l) to 2021. The change benefits taxpayers with business losses and investment income, permitting them to offset unlimited amounts of investment income with losses generated by their business.

The CARES Act changes in loss deductibility will benefit businesses with pandemic-related losses. The five-year NOL carryback could provide immediate cash (in the form of tax refunds) to businesses. The delay in implementation of limitations on noncorporate taxpayers will also put immediate cash in taxpayers’ pockets, since they can file refund claims for 2018 and 2019 returns and claim loss deductions otherwise limited by § 461(l). The indefinite NOL carryforward will reduce firms’ future tax liability, providing a tax reduction that could continue through an economic recovery as firms return to profitability.

Still, commentators noted that the liberalization of loss deductions, like the easing of interest deductions, was broader than the pandemic crisis seemed to warrant. Firms and individuals with business losses incurred in 2018 and 2019 could not plausibly claim that the losses were COVID-related, because COVID affected the United States only in 2020. As to these prior years, the CARES Act was a tax giveaway to owners of money-losing businesses.

The liberalization of the loss deduction rules came under political fire after the CARES Act was enacted, when the Joint Committee on Taxation estimated that 80% of the benefits of the § 461(l) changes would benefit taxpayers with over $1
million in annual income. Some also pointed out that President Trump and his
son-in-law, Jared Kushner, could benefit from the liberalization of interest and loss
deductions. Real estate businesses, like those run by the Trump and Kushner
families, often generate large tax deductions for interest and depreciation and may
show net operating losses as a result, even when the businesses are economically
profitable.
In 2019 and 2020, Democratic presidential candidates and office holders advanced proposals for a federal wealth tax and a federal mark-to-market income tax for wealthy taxpayers. These proposals reignited the legal debate over the continuing validity of *Pollock*. Some scholars conclude that *Pollock* is an outlier, defying the judicial restraint shown before and afterward in adopting a narrow interpretation of the direct tax clause. See Bruce Ackerman, *Taxation and the Constitution*, 99 Colum. L. Rev. 1 (1999). Others, however, view *Pollock* as still a valid precedent. And readers of Supreme Court tea leaves note that Chief Justice Roberts, in dicta, cited *Pollock*. See National Federation of Independent Business v. Sibelius, 567 U.S. 519, 560 (2012) (upholding the Affordable Care Act individual mandate for health insurance as a tax that is not a direct tax; and citing *Eisner v. Macomber*, 252 U.S. 189 (1920) (set forth at page 157), for the proposition that the Court “continued to consider taxes on personal property to be direct taxes.”)

The COVID-19 pandemic is likely to alter the course of tax policy. Before the virus hit, the federal debt was already at its highest level relative to the economy than at any time since the end of World War II. In no year of the 21st century have federal revenues fully paid for federal spending; deficits are commonplace. In the near term, the pandemic will have a major negative effect on the federal budget. The economic downturn that began in February 2020 will sharply reduce federal income tax and payroll tax collections, and the spending measures enacted in response to the 2020 pandemic will cost the government trillions of dollars. One measure, the CARES Act, was estimated to increase federal spending by more than $2 trillion dollars.

The CARES Act and other 2020 legislation enacted several initiatives. The major relief program for individuals took the form of a one-time payment of up to $2,400 for married couples ($1,200 for individuals) plus $500 per qualifying child. This “recovery rebate” is phased out gradually for married taxpayers with incomes over $150,000 (and single individuals with incomes over $75,000). See § 6428.
Legislation in 2020 also requires some employers with fewer than 500 workers to provide ten days of paid sick leave and an additional ten weeks of paid family leave to some workers affected by the COVID emergency in 2020. To reduce the financial cost of paid leave to employers, the Act also provides a refundable payroll tax credit for 100% of wages paid to workers on leave. The Act extended the refundable sick leave and family leave credits to self-employed workers as well.

Tax legislation in 2020 also included measures to help businesses pay workers’ wages (and payroll taxes on those wages). The “employee retention credit,” awarded some firms a refundable tax credit against their payroll tax liabilities. The credit included complex eligibility rules. For instance, firms claiming assistance under the Paycheck Protection Program (a loan program administered by the Small Business Administration) could not claim the payroll tax credit. The credit was calculated as 50% of “qualified wages” (basically, the first $10,000 of wages) paid to employees between March 2020 and the end of the year but could be claimed only by businesses that were shut down by governmental order due to COVID-19 or that suffered at least a 50% drop in gross receipts. For additional measures, see the additions made by this Supplement to casebook pages 199, 357, and 380.

In the short- and medium-run, the economic downturn and stimulus spending will increase federal deficits. Even when the economy rebounds, so that temporary additional spending expires and revenues return to their normal level, the federal debt will be much larger than had been anticipated. More deficits are expected to continue into the future. Even before the pandemic, influential economists had estimated that, even with low interest rates, interest on the federal debt would be the fastest rising element of the federal budget.

Eventually the government must raise revenue or cut spending just to keep the public debt constant as a percentage of the economy. It doesn’t take a crystal ball to predict that at some point in the near future Congress will have to raise taxes to keep the debt and deficits in check. Tax legislation to produce more robust revenues will then become a priority. By the time the 2017 tax cuts for individuals expire at the end of 2025, major changes seem inevitable.
Students are often surprised at the levels of income at various percentiles of the income distribution. In 2018, for example, according to the Census Bureau, median household income in the United States was $63,179. Nineteen percent of households had income of $25,000 or less; 16% had income of $150,000 or more, less than the income of a first-year associate at many large urban law firms. The top 20% of households had total income greater than the income of the remaining 80%. And the top 5% of households had 23% of total income. U.S. Bureau of the Census, Income and Poverty in the United States: 2018, Table A-2.

Income for tax purposes is calculated differently from the Census Bureau’s measure of household income, but tax data show a similar dispersion of income. The individual income tax is quite progressive, as the following data from tax returns for 2017, published in the IRS Statistics of Income Bulletin, demonstrates:

<table>
<thead>
<tr>
<th>AGI (in millions)</th>
<th>Total AGI (millions)</th>
<th>Total income tax* (millions)</th>
<th>Total income tax* as a percentage of AGI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $20,000</td>
<td>44,831,892</td>
<td>205,539</td>
<td>(44,778)**</td>
</tr>
<tr>
<td>$20,000-$50,000</td>
<td>45,932,985</td>
<td>1,529,637</td>
<td>32,909</td>
</tr>
<tr>
<td>$50,000-$100,000</td>
<td>34,466,799</td>
<td>2,457,203</td>
<td>216,575</td>
</tr>
<tr>
<td>$100,000-$200,000</td>
<td>19,951,000</td>
<td>2,707,841</td>
<td>340,993</td>
</tr>
<tr>
<td>$200,000-$500,000</td>
<td>6,215,046</td>
<td>1,770,816</td>
<td>339,963</td>
</tr>
<tr>
<td>$500,000-$1M</td>
<td>1,010,203</td>
<td>679,942</td>
<td>172,977</td>
</tr>
<tr>
<td>$1M-</td>
<td>474,634</td>
<td>1,026,762</td>
<td>290,443</td>
</tr>
<tr>
<td>$10M</td>
<td>Over 10M</td>
<td>$10M</td>
<td>20,223</td>
</tr>
<tr>
<td>--------</td>
<td>----------</td>
<td>------</td>
<td>--------</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>152,903,232</td>
</tr>
</tbody>
</table>

*Total income tax less refundable credits

**Negative totals reflect the payment of refundable credits


Although the federal income tax is progressive, it has done little to eliminate the “income gap.” As Table 1-5 illustrates, returns with AGI above $1 million accounted for about 0.3% of returns filed but 15% of total AGI. Reflecting the progressive nature of the federal income tax, that group paid 27% of the total income tax paid.

p. 30. After the first full paragraph, insert the following:

Economists also invoke the goal of stabilization in analyzing taxation and other forms of fiscal policy (including government spending). Policies tend to stabilize the economy when they ameliorate the ups and downs of the business cycle. The income tax, for instance, is thought to be an automatic stabilizer. Income tax collections increase in boom times, because revenues automatically rise as incomes rise, and revenue falls in recessions, as incomes fall.

Stabilization has played a larger role in tax policy discussions in recent years, thanks in part to the 2020 COVID pandemic and the 2008 Great Recession. In both cases, Congress adopted tax cuts and spending measures intended to stimulate the economy.

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. 64. Add new Note (G) as follows:

(G) IRS Disaster Authority to Extend Filing Deadlines. Responding to the 2020 coronavirus pandemic, the IRS extended the filing date for 2019 federal income tax returns to July 15, 2020 from the usual April 15 due date. Section 7508A grants the IRS the authority to extend filing and other deadlines during any federally-declared disaster. In March 2020, the President issued a formal emergency declaration for all 50 states, all tribes, all territories, and the District of Columbia. The emergency declaration also triggers taxpayer-favorable rules in § 7805A(d), which provides an automatic 60-day delay for actions including Tax Court filings. The disaster declaration may also permit taxpayers to make use of § 165(i), which permits taxpayers to carry back one year a loss otherwise allowable under § 165 and “occurring in a disaster area and attributable to a federally declared disaster.”

p. 69. In the third full paragraph from the bottom, delete “entertainment” and substitute “travel”

p. 72. Add Note (H) as follows:
(H) *Tax Protesters.* There is a cottage industry of purported tax advice offered by people known as tax protesters, who typically rely on patently invalid interpretations of the law. They and their followers are subject to civil and, sometimes, criminal penalties when detected. A 2019 case, Hendrickson v. Commissioner, T.C. Memo. 2019-10 (Feb. 11, 2019), recounts the tax history of Peter Hendrickson, the author of a self-published book urging readers to take tax protester positions. Hendrickson and his wife repeatedly filed tax returns reporting zero income, and their legal claims were repeatedly denied by the courts, which deemed them frivolous:

The Hendricksons’ tax-protester arguments have burdened the judicial system and the IRS for nearly three decades. Their use of substitute Forms W-2 and “corrected” Forms 1099-MISC, as discussed in *Cracking the Code* and used by [other] taxpayers… have been repeatedly rejected by the Court.


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 its “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.
CHAPTER 2

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, although tax experts disagree about how, precisely, the statute gets us there.*

The new law would require Townsend to allocate the costs of future fishing trips between (nondeductible) “recreation” and (deductible) meals, travel, and lodging. Proposed regulations now provide that taxpayers may deduct otherwise-deductible meals provided during or at an entertainment activity only if the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The proposed regulations caution against inflating the value of the food to increase the taxpayer’s deduction: “The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue’s usual selling cost for those items if they were to be purchased separately from the entertainment, or must approximate the reasonable value of those items.” Prop. Reg. § 1.274-11(b).

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 misapplies it. The text of § 132(d), as the court correctly notes, permits an employee to exclude an employer-paid item

* * One reading of the statute is that § 132(d) focuses narrowly on whether expenses would be deductible under § 162, even if disallowed by §274(a). On that reading, § 132(d) would exclude entertainment provided by the employer. This is the position taken by the Joint Committee Blue Book in an analogous situation under § 67(g), discussed at p. 269 infra. An alternative reading is that § 132(d) should be read to treat the § 274(a) disallowance as part of § 162, so that § 274(a) would affect the § 132(d) exclusion. Even on this view, however, § 274(e)(3), an exception to the § 274(a) disallowance, could be read to apply to workers whose employers provide entertainment, a reading that would bring employer-provided entertainment expenses once more within § 132(d).
as a working condition fringe “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 the 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)(1)(vi). Although we think that the Joint Committee’s reading seems reasonable, one might interpret the two statutes otherwise. Section 67(g) provides that “no miscellaneous itemized deduction shall be allowed” for taxable years from 2018 to 2025. Some tax experts read that language – contra the Blue Book – to limit the § 162 deduction and so negate a § 132(d) working condition fringe exclusion. Even so, the working condition fringe exclusion might still be saved by treated working condition fringes as the equivalent of reimbursed employee business expenses, which are deductible above the line, § 62(a)(2)(A) and thus not subject to § 67 at all.

p. 120. Replace the first paragraph of Note (C) with the following:

(C) Sections 107 and 134. Note § 107, which exempts from gross income the rental value of a parsonage or a rental allowance paid to a minister. In Gaylor v. Mnuchin, 278 F. Supp. 3d 1081 (W.D. Wis. 2017), the district court held that the exclusion from gross income of “a rental allowance” paid to “a minister of the gospel” violates the Establishment Clause of the First Amendment since the exclusion has no secular purpose. The Seventh Circuit reversed, 919 F. 3d 420 (7th Cir. 2019), holding that the § 107 exclusion has a secular legislative purpose, does not have a principal effect of endorsing or inhibiting religion, and does not cause excessive government entanglement.

p. 135. In the second paragraph under “Note on Prizes and Awards,” add the following at the end of the last sentence: “or if the recipient takes the standard deduction.”

p. 136. Replace the third paragraph of Note (C) with the following:

Section 74(d) also provides that the exclusion for Olympic prizes and prize money does not apply if the taxpayer’s adjusted gross income exceeds $1 million. This, of course, means that National Basketball Association players who garner Olympic gold must include the value of their medals and prize
money in income. So must other athletes who earn more than $1 million in
the year of the Olympics from product endorsements. The swimmer Michael
Phelps may be one; news reports estimate his endorsement income to be $12
million in 2016. Note that the $1 million figure is a “cliff,” unusual in the tax
law: If an Olympic prize winning athlete has only $1 million of adjusted
gross income, her prizes and prize money are tax-exempt; if the athlete’s
adjusted gross income is $1,000,001 or more, the entire winnings are taxed.

p. 138. In the last paragraph before Section 4. Capital Appreciation and Recovery
of Basis, delete the phrase, “education expenses,” and substitute “interest on
educational loans.”

p. 153. At the end of Note (B), replace the last three sentences with the following:

Suppose Irvin returns the money? It is, in principle, deductible when paid,
although § 67 eliminates the deduction between 2018 and 2025. This issue is
discussed infra at page 186, Note (F).

p. 163. Replace the last sentence in the carryover paragraph with the following:

Recently, proposals for wealth taxation and mark-to-market income taxation
have revitalized debate over the continuing vitality of Macomber and other
cases interpreting the direct tax clause. See p. 7 supra.

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. 199. Add new Note (O) as follows:

(O) COD and the COVID-19 Response. In 2020, the Congress enacted the Paycheck Protection Program (“PPP”), a program that operated outside the tax system but raised major tax issues. The PPP provided loans to some businesses adversely affected by the pandemic. The loans were forgivable, provided that the recipients used the money for specified purposes, including the payment of wages, utilities, rents, and interest.

The CARES Act anticipated the first tax issue, providing that the forgiveness of PPP loans would not produce cancellation of indebtedness income to loan recipients. By excluding the COD from recipients’ income, the legislation ensured that 100% of the loan forgiveness would benefit firms. Had Congress not excluded the COD, the “forgiven” loan amounts would be taxed, reducing the net amount of assistance provided by the government, depending on the taxpayer’s marginal tax rate. For example, a taxpayer who received a forgiven loan of $10,000 would (absent the special provision) be taxed on that amount, leaving just $6,300 for a taxpayer in the 37% bracket.

The exclusion of COD income, however, raised a second, unanticipated issue: could recipients also deduct the costs funded by PPP loans? Code § 162 normally authorizes businesses to deduct ordinary and necessary expenses including wages, utilities, and rents, and § 163 permits the deduction of interest. But, taken together, the exclusion of the COD and the allowance of the deduction would produce a double benefit. For example, a taxpayer with a forgiven loan of $10,000 would both exclude that amount from income and take a deduction of $10,000. In the 37% bracket, the net effect would be a transfer from the government of $13,700 (the $10,000 forgiven loan plus the $3,700 in tax savings attributable to the deduction). The additional benefit would be only $1,000 for a taxpayer in the 10% bracket.

Invoking § 265(a)(1), which disallows deductions attributable to tax-exempt income, the IRS concluded that businesses cannot deduct amounts
attributable to PPP loans. Notice 2020-32, IRB 2020-21, May 18, 2020. Some legislators have announced that they intend to reverse the IRS decision and permit the double benefit.
CHAPTER 3

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. 258. Add the following at the end of the first full paragraph:

In 2019, the IRS indicated in informal guidance that it will permit plaintiffs to deduct attorneys’ fees in such cases.

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 the following sentence:

(Experts disagree, however, on which portion of statute accomplishes this result. See supra Note (C) for p. 108 (in this Supplement).)

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. Attorneys’ fees and costs for other employee recoveries, however, remain deductible (in principle) 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 in taxes 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. 274. Add the following sentence to the beginning of the first full paragraph:

“Although the law tends to adopt a binary approach, either permitting deductions in full or denying them in full, the theory reviewed above suggests that one of two alternative approaches would be preferable.”

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

p. 295. In the last sentence of the carryover paragraph, replace the word “entertainment” with “expenses.”

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 the first paragraph of 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? 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 Prop. Regs. § 1.274-12. An expenditure for food or beverages will qualify if:

(i) The expense is not lavish or extravagant under the circumstances;
(ii) The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and

(iii) The food or beverages are provided to a business associate.

The proposed regulations also require that the cost of the food or beverages be separately stated from any entertainment. Prop. Regs. § 1.274-11.

p. 301. Replace the first full paragraph with the following:

In general, the expenses of attending a convention in the United States (even if at a ski resort or ocean-side paradise) are deductible. Under the 2017 tax act, any entertainment is nondeductible, however. Proposed regulations permit taxpayers to deduct food and beverage costs only if separately stated from entertainment items. Prop. Regs. § 1.274-11. The proposed regulations define “entertainment” as “any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer’s family.” Still, interesting questions of interpretation may arise: is, say, a paid speech to convention-goers by a former President “entertainment” or part of the business program? Does it depend on whether the former Commander-in-Chief includes jokes in his speech?

p. 301. In Note (F), delete the words “and entertainment” in the first sentence.

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

p. 303. In the carryover paragraph, delete the words “and entertainment” in the second line.

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. 309. In Note (G), delete the words “and computers” in the second sentence.

p. 309. Add new Note (H) as follows:

(H) *Shelter-in-place orders and the home office deduction.* During the 2020 coronavirus pandemic, many state and local officials ordered firms to close their offices and permit workers to work at home. The result is that many more workers than usual would meet the § 280A requirement that their home office be their sole place of business during the shutdown period. Complicating matters, however, is § 67(g), which prohibits the deduction of itemized employee business expenses incurred before 2026. The deduction would, however, be available to employees with reimbursed home office expenses and to self-employed individuals who would ordinarily work at an office outside their home. (Both of these would claim an above-the-line deduction under § 62, which is unaffected by § 67(g)).

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. 342. At the end of Note (G), add:

In 2020, responding to the coronavirus pandemic, the Congress amended § 127 to permit workers to exclude payments on student loans made by their employers in 2020. See § 127(c)(1)(B).

p. 348. Replace the third full paragraph with the following:

The first is so-called “bonus depreciation,” originally enacted as an economic stimulus in response to 9/11. The rules now permit taxpayers to deduct in the first year 100% of the cost of certain property (generally, property with a life of less than 20 years) if placed in service between September 2017 and January 1, 2023. The first-year “bonus” deduction is scheduled to phase down to 80% in 2023, 60% in 2024, 40% in 2025, and 20% in 2026, before disappearing entirely in 2027. § 168(k).

p. 355. In the first paragraph in the Note Providing an Overview of the Interest Deduction, delete the phrase “as an itemized deduction” in the second line.
Responding to the COVID-19 pandemic, tax legislation in 2020 eased the rules on the deductibility of business interest. Before the CARES Act, § 163(j) limited interest deductions to 30% of business income (calculated before taking into account the interest deduction). The Act increased the limit to 50% for 2019 and 2020. § 163(j)(10). One effect will be to increase interest deductions for 2019, the year before the pandemic hit. Further, the relief applies to all businesses, regardless of the pandemic’s impact on their income, leading some commentators to question whether the Act was well-targeted to the COVID crisis or was instead a giveaway to leveraged businesses.

The amendment of § 163(j) raised an interesting problem of pandemic tax policy. Business interest deductions are often fixed in amount; think of a firm that is paying off a loan used to finance a new plant and equipment. But the § 163(j) rule links interest deductibility to the taxpayer’s business income, and this amount likely fell sharply for many pandemic-affected businesses. To take an example, suppose that a corporation typically earns business income of $100 (before the interest deduction) and owes $50 in interest expense. The CARES Act increase in the limitation from 30% to 50% would help that business deduct an extra $20 – but only if business income remains at $100,000 or more. If, as is likely in many business sectors, the firm’s income plummets to near zero, then the limitation plummets too, since 50% of zero is zero. Anticipating this problem, the drafters of the CARES Act permit taxpayers to elect to calculate their 2020 limitation based on 2019 income. § 163(j)(10)(B).

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?

p. 380-381. After the carryover paragraph, add:

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).

p. 380. After the paragraph numbered 2., insert the following, and then renumber paragraph 3 as paragraph 4:

3. Net Operating Losses

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.

Anticipating major business losses due to the 2020 COVID-19 pandemic, the Congress temporarily eased the rules on the deduction of net operating losses (“NOLs”). Before the CARES Act, § 172 permitted businesses to carry forward (but not carry back) NOLs and limited NOL deductions in any year to 80% of income (calculated without regard to NOL deductions and the § 199A deduction). The CARES Act significantly liberalizes these rules, permitting taxpayers to carry back losses incurred in 2018, 2019, and 2020 for a period of five years and forward indefinitely. § 172(b)(1)(D). The law also suspends the 80% limitation for
calculating tax due in 2018, 2019, and 2020. The 80% limitation will apply once again in 2021, but only with respect to losses incurred in 2021 or carried to 2021 from a post-2017 year. § 172(a)(2)(B).

A loss carryback permits a taxpayer to amend its federal income tax returns for a prior year and claim an immediate tax refund. For instance, suppose that X Corporation earned $100 in 2019 and paid taxes of $21. In 2020, X loses $40 (that is, X’s deductions exceed its income by $40). X can amend its 2019 tax return to show amended income of $60 ($100 – loss carryback of $40). Since the tax on $60 is just $12.60 at the 21% corporate rate, the corporation will receive an immediate tax refund of $8.40. The carryback, in effect, creates a legal fiction that the corporation overpaid its taxes in a prior year; that overpayment then generates an immediate refund. This means that although corporate income in 2020 would be taxed at a 21% rate, losses that year may offset income from an earlier year that had been taxed at a 35% rate.

The CARES Act also permits an unlimited carryforward of NOLs arising in 2018, 2019, and 2020. A carryforward is what it sounds like; it permits firms to “carry” unused net operating losses forward to future tax returns and deduct them on those returns. A firm that cannot use the five-year carryback (because its losses exceed its past income) can carry forward the losses and deduct them against future income.

A separate provision of the CARES Act eases the deductibility of losses by pass-through entities, like partnerships, and sole proprietors. Enacted in 2017, § 461(l) originally provided that noncorporate taxpayers could use a maximum of $250,000 ($500,000 in case of a joint return) in business losses to offset nonbusiness income. The CARES Act delays the effective date of § 461(l) to 2021. The change benefits taxpayers with business losses and investment income, permitting them to offset unlimited amounts of investment income with losses generated by their business.

The CARES Act changes in loss deductibility will benefit businesses with pandemic-related losses. The five-year NOL carryback could provide immediate cash (in the form of tax refunds) to businesses. The delay in implementation of limitations on noncorporate taxpayers will also put immediate cash in taxpayers’ pockets, since they can file refund claims for 2018 and 2019 returns and claim loss deductions otherwise limited by § 461(l). The indefinite NOL carryforward will reduce firms’ future tax liability, providing a tax reduction that could continue through an economic recovery as firms return to profitability.
Still, commentators noted that the liberalization of loss deductions, like the easing of interest deductions, was broader than the pandemic crisis seemed to warrant. Firms and individuals with business losses incurred in 2018 and 2019 could not plausibly claim that the losses were COVID-related, because COVID affected the United States only in 2020. As to these prior years, the CARES Act was a tax giveaway to owners of money-losing businesses.

The liberalization of the loss deduction rules came under political fire after the CARES Act was enacted, when the Joint Committee on Taxation estimated that 80% of the benefits of the § 461(l) changes would benefit taxpayers with over $1 million in annual income. Some also pointed out that President Trump and his son-in-law, Jared Kushner, could benefit from the liberalization of interest and loss deductions. Real estate businesses, like those run by the Trump and Kushner families, often generate large tax deductions for interest and depreciation and may show net operating losses as a result, even when the businesses are economically profitable.

p. 384. Replace the last two sentences of the first full paragraph and replace with the following:

The case was expressly overruled for entertainment expenses by § 274(d) of the Code, which (under prior law) required adequate records to support all entertainment expenses. Under present law, no deduction for entertainment expenses is allowed (§ 274(a)), and § 274(d) requires substantiation for travel expenses, gifts, and certain other items. Still, the Cohan rule lives on in other contexts.

p. 384. Replace the last full paragraph with the following:

Professional gamblers that meet the Groetzinger test may deduct their expenses of gambling in addition to gambling losses, but their total deductions attributable to gambling are limited to their gambling winnings by § 165(d) until 2025. In 2026, § 165(d) will (as under pre-2018 law) permit professional (but not amateur) gamblers a more generous deduction for gambling expenses (other than wagering losses), giving the Groetzinger test renewed importance.
p. 378. In the last full paragraph, fifth sentence, add “(or subject to disallowance under § 67(g) as miscellaneous itemized deductions) after the words “capital losses.”

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.

p. 448. Replace the last sentence of the carryover paragraph with the following:

The deduction for income and property taxes is not subject to the limitations on miscellaneous itemized deductions in § 67. § 67(b)(2)."

p. 451. Add the following section, titled “Notes,” before B. Charitable Contributions:

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% 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 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.


The District Court ruled against the states and for the federal government in 2019. The states have filed an appeal to the Second Circuit. And some states, such as Connecticut, have renewed their interest in substituting deductible payroll taxes for a portion of state income taxes subject to the limitation.

p. 452. Replace the last sentence of the carryover paragraph with the following:

The charitable deduction is not subject to the limitations on miscellaneous itemized deductions in § 67. It is, however, subject to the rules in § 68 (suspended through 2025 but scheduled to return to force in 2026) that reduce itemized deductions for higher-income taxpayers.

p. 452. Before the Notes, add:

The 2020 CARES Act, responding to the COVID-19 pandemic, liberalized the deduction for charitable contributions. Section 62 now authorizes an above-the-line deduction for cash contributions made by non-itemizers in 2020, with a cap of $300. § 62(a)(22). The legislation also suspends the 60% of AGI limitation (found in § 170(b)) with respect to cash contributions made in 2020.

p. 452. In the penultimate sentence of the last full paragraph, delete the parenthetical and substitute the following:

(such as patrons of the Metropolitan Opera and many church members)

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%. 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 Billion 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. After the carryover paragraph, insert the following new paragraph:

Is the IRS’s failure to value naming rights defensible when the value is established to be quite high? A change in naming rights in the performing arts world in 2015 opened a window into the high value of some names. Lincoln Center in New York City is the home to, among other venerable performing arts groups, the New York Philharmonic. The orchestra’s hall, traditionally known as Avery Fisher Hall, had become outdated, and in 2015, Lincoln Center announced a $100 million gift by David Geffen, the Forbes 400 entertainment mogul. As part of the deal, the hall was renamed David Geffen Hall. And what of Avery Fisher? The Fisher family agreed to surrender naming rights for a payment of $15 million. Doesn’t the payment to the Fisher family suggest that the benefits Geffen received from naming were at least $15 million?

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.
To be deductible under §170, contributions of services must be made “to or for the use of” a charity, meaning that the activities must be subject to coordination, supervision, or oversight by the organization. One taxpayer who failed this test was Robert Oliveri, a former Air Force officer, who devoted himself to Catholic evangelism after his retirement. According to the Tax Court opinion in Oliveri v. Commissioner, T.C. Memo 2019-57 (May 28, 2019), Oliveri did not coordinate his activities with the Catholic Church. Instead, he sought “to spread the teachings of the Catholic Church through random interactions with members of the general public. He considers all of his contact with members of the public to be opportunities for evangelism. … [He] evangelizes people he happens to see when he engages in otherwise personal activities, such as when he eats in restaurants, travels, and pilots private planes.” Oliveri deducted the costs of his flying lessons, all of his restaurant meals in 2012, travel to visit family members, and home internet and telephone service. The Tax Court held that these expenditures were not contributions and were primarily personal in nature and thus not deductible under §170.

(D) *Golf course easements*. Golf courses are, by definition, large tracts of land planted with grass. Some environmentalists object to golf courses, because the grass consumes water and typically is sprayed with fungicides and pesticides. Nevertheless, more and more golf course owners have claimed a charitable deduction – without altering their operations – by donating a conservation easement. An easement is an interest in property, and in these settings, the owners typically donate an easement to a conservation group, agreeing to maintain the space occupied by the golf course as open land. The fair market value of the easement, the owners contend, is deductible under § 170(h), which permits a deduction for a restriction granted in perpetuity to a charity or to the federal or a state government for conservation purposes.

The IRS has challenged such easements as not serving a conservation purpose. For instance, in Champions Retreat Golf Founders v. Commissioner (slip op. 11th Cir. May 13, 2020), the taxpayer operated a private golf course near Savannah, Georgia. Struggling financially in the
2009 recession, the taxpayer learned that other golf course owners had deducted donations of conservation easements. The taxpayer then donated a conservation easement to the North American Land Trust on 348 acres of land that included both the golf course and undeveloped land.

The Tax Court disallowed the charitable deduction, finding that the land included in the easement did not meet the standards for conservation set out in § 170(h). The court pointed out that a habitat for endangered plant species occupied only 17% of the easement property; that the manicured and sprayed golf course was not a natural habitat; and that the use of chemicals on the golf course could harm the aquatic environments. The court also pointed out that the private golf course was not visible to or accessible to the public, and so the easement could not be justified as for the scenic enjoyment of the general public.

The Eleventh Circuit reversed. The court read the Code and the evidence in question as meeting conservation standards, despite the presence of the golf course. Donations of conservation easements for his golf courses is reportedly one way that Donald Trump substantially reduced his income tax liabilities.

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….
 CHAPTER 4

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 of the taxpayers 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. Replace the third sentence of the second full paragraph with the following:

A child claimed as a dependent on her parents’ return is entitled to a standard deduction of either $1,100 or, if greater, the sum of $350 and the child’s earned income. § 63(c)(5)). These amounts, adjusted for inflation, apply to 2020. See Rev. Proc. 2019-44, 2019-47 IRB 1093.

p. 505. Replace the carryover paragraph, and on page 506, replace the carryover paragraph and the first two paragraphs, with the following:

The so-called “kiddie tax” of § 1(g) takes a major step in the direction of taxation based on family income by providing restrictions on the intrafamily shifting of income and tax benefits and a rate structure under which the same rate is likely to apply to the income of all family members. 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) is taxed at the greater of the child’s own marginal tax rate or the parent’s marginal tax rate if at least one parent is alive and if the child does not file a joint return.

Net unearned income for this purpose is unearned income in excess of the standard deduction for dependents (found in § 63(c)(5)(A)), plus either an additional standard deduction or, if greater, the amount of allowable deductions that are directly connected with the production of the unearned income. The standard deduction is updated for inflation. For those who are 18 or older, the kiddie tax applies only to children whose earned income does not exceed one-half of their support. The result is that investment income on a gift from dad is treated identically to interest income on a savings account funded with the earnings of a paper route.

In combination, these rules mean that in 2020, $2,200 of investment income is taxed at the child’s marginal tax rate. Any greater amount of unearned income, however, is taxed at the parents’ rate, thus eliminating the income-shifting incentive.
In limited circumstances, parents may elect to report the gross income of a child 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%, 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 $1,100 and $11,000 and only from interest and dividends. These numbers are all indexed for inflation.

p. 507. In the first paragraph in Section B., change the phrase, “there will be a marriage penalty” to “there may be a marriage penalty.”

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.

pp. 539-542. The Notes should be revised to read as follows:

Notes

(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% QBI deduction. Does it make sense for T and her spouse to enjoy the 20% 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)(3)(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 any qualified trade or business of the taxpayer 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.

(F) 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 14th largest privately owned American company in 2019 (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?

(G) 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)(1).

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).

(H) 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).
CHAPTER 5

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 new 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% of the top rate on ordinary income and has historically been about 50% to 60% 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. 590. Revise the second full paragraph to read as follows:

Section 1231 requires a two-stage netting process. The first stage is colloquially called the “firepot” because it deals with gains and losses from fire and other casualties. In this step, the taxpayer nets her gains from casualty and theft losses (from insurance proceeds, for example) against her losses from such involuntary conversions. If losses exceed gains, § 1231 does not apply to either the losses or the gains. There is no “sale or exchange,” so the gains are taxable as ordinary income and the losses are deductible from ordinary income. If gains exceed losses, both gains and losses are carried over into the second stage of the netting process.
In the absence of § 1231, the treatment of involuntary conversions of capital assets would turn on whether the event constitutes a “sale or exchange.” Foreclosures and condemnations have been held to constitute a sale or exchange, and so gains and losses would be capital when the underlying asset is capital. *Hawaiian Gas Prods., Ltd. v. Commissioner*, 126 F.2d 4 (9th Cir. 1942). But other involuntary conversions, particularly losses due to the destruction of property, are not sales or exchanges, and these gains and losses would be ordinary but for § 1231. See *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247 (1941).

The Joint Committee on Taxation suggests, in a footnote in its “Blue Book” legislative history of the 2017 act, a way to reconcile the two provisions:

However, consistent with prior law, the transfer (other than by gift, inheritance, or devise) of a patent by an individual that created the patent, or any other individual who acquired an interest in the patent in an exchange for consideration in money (i.e., an exchange that did not result in a substituted or transferred basis in the patent) prior to the actual reduction to practice of the invention covered by the patent (where such other individual is not the employer of the creator or related to the creator), is treated as a sale or exchange of a capital asset held for more than one year. See section 1235.

See Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, December 2018, p. 207, n. 1027. Still, the plain text of the statute creates an apparent conflict, unless and until Congress acts to rationalize the two provisions.
p. 603. In the Note, the date of *Corn Products Refining Co. v. Commissioner* should be 1955 (not 1950).

p. 604. In the Note on Hedging Transactions, add “and § 1092” to the end of the first paragraph.

p. 605. Revise Note (A) to read as follows:

(A) *Timing and Character.* The character of a business hedge also may affect its timing. Section 1256 requires the holder of certain financial contracts and options to mark them to market at year end, requiring gain or loss to be recognized at that time. A business hedge that would produce ordinary gain or loss if sold generally is not subject to these mark-to-market rules. § 1256(e). Business hedges that would produce capital gains and losses (because they fall outside the scope of the hedging definition in § 1221(b)(2)) are subject either to the mark-to-market rules of § 1256 or, if applicable, to the straddle rules (§ 1092). If subject to § 1256, gain or loss is reported annually as 40% short-term gain or loss and 60% long-term gain or loss.

p. 613. Insert the following new paragraph at the end of the page:

In his detailed analysis, Judge Friendly drew on the distinction between equitable and legal remedies in civil procedure to distinguish between contracts that constituted “property” (and therefore are capital assets for tax purposes) and those that are merely a right to income (and so are ordinary assets). Friendly’s opinion found that Ferrer had an equitable interest in his right to produce the play and to prevent the sale of film and television permissions. That is, had those rights been breached, Ferrer could have sued for an injunction and not merely money damages. Accordingly, Friendly reasoned, those contract rights were sufficiently robust to constitute the kind of “property” that qualifies, for tax purposes, as a capital asset. However, Ferrer’s right to share in the proceeds of television and film permissions, once sold, did not have the same equitable remedies available, Friendly found, and so produced ordinary gain rather than capital.

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."
CHAPTER 6

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 first four full paragraphs and substitute the following:

Under current law, the maximum amount that can be contributed annually to a traditional IRA and deducted is $6,000 (in 2020; this amount is found in § 219(b)(5)(A) and is indexed for inflation). At age 50, people are allowed to contribute an extra $1,000. If, however, the individual is an active participant in a qualified plan (that is, an employer plan), the IRA deduction is phased out for single taxpayers with income between $65,000 and $75,000 (between $104,000 and 124,000 for married taxpayers filing jointly).

The Roth IRA reverses the usual deduction/inclusion picture. A nondeductible contribution of up to $5,000 (indexed for inflation; in 2020, the amount is $6,000) annually may be made to a Roth IRA, and distributions for certain purposes are excludible. § 408A. Qualified distributions are those made at least five years after the first contribution and that are either made after the taxpayer reaches age 59½, made to a beneficiary after the death of the contributor, or made because the contributor is disabled or to a first-time homebuyer. The use of a Roth IRA is phased out for single taxpayers with income between $124,000-139,000 and for married couples with income between $196,000 and $206,000 (these figures, adjusted for inflation, apply in 2020).

A taxpayer can contribute to both a regular and a Roth IRA, but total contributions cannot exceed $6,000 annually (in 2020). Generally, taxpayers who withdraw savings from either type of IRA before age 59½ are subject to a 10% withdrawal penalty. This penalty does not apply to withdrawals to pay medical expenses, health insurance premiums, or education expenses.
The early withdrawal penalty also does not apply to a distribution to a first-time homebuyer, capped at $10,000. See § 72(t)(2)(F).

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. 659. Add new Note (G) as follows:

(G) Coronavirus Relief Measures in 2020. The CARES Act also includes several taxpayer-favorable rules for withdrawals from retirement accounts. First, the act waived the usual 10% penalty (imposed by § 72(t)) on up to $100,000 in early withdrawals from retirement plans, provided that the distribution of funds is made in 2020 and is related to the coronavirus. A distribution is treated as coronavirus-related if the taxpayer, her spouse, or dependent is diagnosed with COVID or if the taxpayer experiences “adverse financial consequences” due to quarantine, layoffs, or inability to work due to lack of child care. Second, pension distributions remain includible in gross income, but the CARES Act permits taxpayers to spread out the inclusion over three years. Third, the legislation permits taxpayers to borrow up to $100,000 (instead of the usual $50,000) from a qualified retirement plan. Finally, the CARES Act also waived, for 2020, the
minimum required distribution rules found in § 401(a)(9). See § 401(a)(9)(I).

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”).

CHAPTER 7

On page 701, after the carryover paragraph, add new Note (E) as follows:

(E) More Mischief Thanks to Section 67(g). In 2017, the Congress acted to deny all “miscellaneous itemized deductions” to individuals for tax years 2018 through 2025. § 67(g). One (certainly) unintended consequence is that an employee may not deduct the return of an item originally reported under the claim of right doctrine. The chain of logic is lengthy but worth pursuing, as shown in Douglas A. Kahn, Return of an Employee’s Claim of Right Income, Tax Notes, June 17, 2019.

A returned amount is ordinarily deductible under §162 as a business expense. However, for employees, the repayment would be an unreimbursed employee business expense, which is now disallowed by § 67(g). A casual reader of § 1341 might believe that it authorizes deduction of returned amounts if they exceed $3,000. But § 1341 applies only if “a deduction is allowable for the taxable year.” § 1341(a)(2). (Indeed, the effect of § 1341 when it does apply is to permit the taxpayer to choose between having the deduction taken at the current year’s marginal tax rate or at the marginal tax rate in the prior year in which the income was included.)

A sharp-eyed reader of the Code might object that § 67(b)(9) explicitly excludes from “miscellaneous itemized deductions” the deduction under section 1341. But there is a conundrum here: if § 67(g) disallows the employee’s deduction, then it cannot qualify under section 1341 and so is not excluded by § 67(b)(9). Professor Kahn concludes that applying § 67(g) in this way would contravene the intention underlying § 67(b)(9) and so should not apply. Nevertheless, the plain-text argument is sitting in plain sight.

On page 701, delete the fourth full paragraph (which is a duplicate) and insert the following:

Under the cash method, items ordinarily are included in income in the year in which they are received, and items are taken as deductions in the year in which they are paid. Most individuals and small businesses use the cash method. Because this method affords opportunities to obtain tax deferral when payment is not received in the year services are performed,
many service companies such as accounting and law firms use the cash method.
Circular 230, which sets forth rules that govern tax practice by lawyers, accountants, and tax preparers before the IRS, also contains ethical standards for tax returns and other filings. How do these standards compare to the ABA pronouncements? A practitioner who violates Circular 230 may be barred from practice before the IRS and may be assessed a fine not exceeding the gross income derived from the conduct giving rise to the penalty. Is the prospect of such sanctions likely to deter violators?

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) *Tax returns.*

(1) A practitioner may not willfully, recklessly, or through gross incompetence…

(ii) Advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position, that —

(A) Lacks a reasonable basis;

(B) Is an unreasonable position as described in section 6694(a)(2) of the Code (including the related regulations and other published guidance); or

(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(2) A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence.
(b) **Documents, affidavits and other papers —**

(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service —

- (i) The purpose of which is to delay or impede the administration of the Federal tax laws;

- (ii) That is frivolous; or

- (iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation….

(d) *Relying on information furnished by clients.* A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.