2024 Supplement Federal Income Taxation

Eighth EDITION

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PREFACE

This 2024 Supplement to Federal Income Taxation provides materials reflecting legal developments arising since March 2020, which is when the content of 8th edition of the casebook was finalized.

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FEDERAL INCOME TAXATION

PART II

GROSS INCOME

CHAPTER 2

GENERAL PRINCIPLES OF GROSS INCOME

SECTION 2. THE REALIZATION REQUIREMENT

DETAILED ANALYSIS

Page 81

After the first full paragraph, add:

In June 2023, the Supreme Court granted certiorari on the question, "Whether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states." Moore v. United States) for the shareholders." The footnote continues by explaining the government's position that later cases, including *Bruun* and *Glenshaw Glass*¸ abrogated *Macomber*'s discussion of realization. The majority continued, "Because the MRT [new international tax] taxes realized income—namely, income realized by the corporation and attributed to shareholders—we do not address the Government's argument that a gain need not be realized to constitute income under the Constitution."

In a separate concurrence, Justice Jackson, noted "there is no constitutional requirement, from *Macomber* or otherwise, that a taxpayer 'be able to sever . . . the gain from his original capital' in order to be taxed on it." Justices Barrett and Alito concurred only in the judgment

and asserted that the Sixteenth Amendment imposes a realization requirement. In their dissent, Justices Thomas and Gorsuch reached the same conclusion with respect to the constitutional issue.

Thus, there are four votes on the current Court concluding that the Sixteenth Amendment requires realization, one vote that it does not, and four votes that are unknown. It is possible that the majority's decision to re-frame the issue means that at least one other Justice might have been inclined to hold that realization is required by the Sixteenth Amendment had the original cert. petition question been squarely addressed. Also, it is curious to note that the majority opinion flatly states that, "Because income taxes are indirect taxes, they are permitted under Article I, §8 without apportionment." (slp. op. p.7). If this is a correct analysis it implies that the income tax is not beholden to the Sixteenth Amendment and thus it follows that realization is not a constitutional principle required by the definition of income in the Sixteenth Amendment. But, this statement is arguably dicta as well because the majority opinion stated elsewhere that it would not reach the certified question of whether or not unrealized gains are assessable without apportionment among the states. Thus, whether the realization principle is a constitutional requirement is likely to remain unsettled until the Court addresses the question directly in a future case.

CHAPTER 3

COMPENSATION FOR SERVICES AND INDIRECT PAYMENTS

SECTION 3. EMPLOYEE FRINGE BENEFITS

A. STATUTORY EXCLUSIONS BASED ON TAX POLICY AND ADMINISTRATIVE CONVENIENCE

Page 113:

At the end of the second paragraph, add:

Although a retired airline employee is allowed to continue to exclude the value of standby tickets from their income, the value of standby tickets provided to adult children are ineligible for exclusion as § 132(h)(2) only excludes the value of standby tickets provided to dependent children. In Mihalik v. Commissioner, T.C. Memo 2022-36, the Tax Court held that the retired former employee, not the adult child who used the standby ticket, was ultimately the person responsible for reporting the taxable fringe benefit on a tax return.

Page 115:

After the last sentence of the first full paragraph, add:

Final Regulations provide an approach for calculating the deduction available to an employer for the portion of the qualified transportation fringe that is income to an employee. Treas.Reg. § 1.274-13(e)(2); T.D. 9939, 2021-3 I.R.B. 376; see I.R.C. § 274(e)(2).

CHAPTER 4

GIFTS, INHERITANCES, AND SIMILAR ITEMS

SECTION 2. LIFE INSURANCE AND DEATH BENEFITS

Page 147:

At the end of the carryover paragraph, add:

Treas. Reg. § 1.101-1(b) and (c) provides guidance on transfers that are described in § 101(a)(3) along with specific information reporting requirements for the sale of an interest in a life insurance contract.

CHAPTER 5

LOANS AND OTHER RECEIPTS BALANCED BY OFFSETTING OBLIGATIONS

SECTION 5. CONDUIT SITUATIONS

DETAILED ANALYSIS

Page 197:

After the first full paragraph, add:

In Hyatt Hotels Corp. v. Commissioner, T.C. Memo 2023-122, Hyatt operated a customer loyalty program that gave participating travelers hotels reward points that could be redeemed for a future free stay. Under the program, Hyatt required member hotel owners to pay 4% (4.5% for 2012 and onwards) of the revenue from a traveler's stay to an operating fund when a customer accrued reward points, and these funds were held by Hyatt as part of its Gold Passport Fund. When a traveler redeemed points for a stay at a Hyatt-branded hotel Hyatt would then compensate the member-hotel owner from the fund for the customer's use of its loyalty points at its hotel. On its tax return, Hyatt did not include any of the loyalty program revenue it received into its gross income and did not claim deductions for the payments from the loyalty fund to its member-hotel owners. The Tax Court determined that Hyatt should have reported the funds it received under its loyalty program as income at the time it received them and should have claimed deductions when payments were made to the member hotels. The Tax Court recognized that a line of authority had allowed for nontaxation of funds received under a restricted use or as a trust fund, but the Tax Court stated that this doctrine had undergone refinements since its original inception such that now the trust fund doctrine allows a taxpayer to exclude receipt of funds from gross income under that theory only if the funds were received in trust with a legally enforceable restriction that those funds be spent in their entirety for a specific purpose and only when the taxpayer does not profit, gain, or benefit from spending the funds for that restricted purpose. Only when both of these elements are present does the taxpayer have the authority to treat itself as mere "conduit or custodian of funds and not the beneficial owner for federal income tax purposes." The Tax Court then found that Hyatt had sufficient dominion and control over the funds to be required to include their receipt into income because Hyatt controlled the program, determined how the fund amounts would be invested, realized investment gains on the funds in its custody, and determined when and how advertising and administrative costs would be paid by the fund.

After the second full paragraph, add:

Congress eventually became concerned with the outcome of these restricted use cases because the funds might not be taxable to anyone for a significant period of time depending on the duration of the restricted purpose, and so Congress enacted § 468B(g) to provide that nothing in any provision of law is to be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. The statute then directs the Treasury Department to prescribe regulations providing for the manner of taxation of any such account or fund. Under its regulatory authority, the Treasury Department generally has treated the corpus of the restricted funds as not being subject to immediate taxation until distributed to the ultimate beneficiary. See Treas. Reg. §1.468B-2(b)(1); Treas. Reg. § 1.468B-9(c)(3). But the investment earnings on the corpus is subject to immediate taxation. See Treas. Reg. § 1.468B-2(b)(1); Treas. Reg. § 1.468B-9(c)(1). However, the holder of a qualified settlement fund may elect to treat the income of the qualified settlement fund as its own income in lieu of having the fund treated as a separate taxable entity if there is only one holder of the fund. See Treas. Reg. § 1.468B-1(k)(1).

CHAPTER 6

INCOME FROM THE DISPOSITION OF PROPERTY

SECTION 3. COMPLEX ASPECTS OF REALIZATION

B. REALIZATION AS MATERIAL CHANGE

DETAILED ANALYSIS

Page 241:

After *Detailed Analysis 3.3*, add a new section.

3.4 *Constitutionality of Mark-to-Market Rules*

As discussed in greater detail in Chapter 2 of this Update, the Supreme Court in Moore v. United States, 2024 WL 3056011 (June 20, 2024), declined to reach the question whether realization is constitutionally required. The dissent and concurrence in the judgement make clear that there are four votes for holding that the Sixteenth Amendment requires realization. Should the constitutionality of one of the Code's mark-to-market rules reach the Supreme Court, it is presently unclear whether a majority would require realization as a constitutional matter.

CHAPTER 8

TAXATION OF PERIODIC INCOME FROM CAPITAL

SECTION 2. TAX DEFERRED AND TAX-EXEMPT INVESTMENT ACCOUNTS

Page 290:

After the first sentence of the third full paragraph, insert:

In Conard v. Commissioner, 154 T.C. 96 (2020), the Tax Court, held that the age-related penalty imposed under § 72(t) does not violate the due process clause of the Fifth Amendment to the United States Constitution

CHAPTER 9

DAMAGE AWARDS AND SETTLEMENTS AND INSURANCE RECOVERIES

SECTION 1. DAMAGES RECEIVED ON ACCOUNT OF PROPERTY AND LOST PROFITS

Page 325:

At the end of the first full paragraph, add:

On the other hand, the capital recovery analogy of Clark was not followed in Holliday v. Commissioner, T.C. Memo. 2021-69 due to a failure of proof. In that case, the taxpayer received a settlement payment of $175,000 with respect to malpractice claims that she had brought against her divorce attorney. The taxpayer asserted that this payment merely compensated her for the loss of her marital property and that this was a return of capital. However, the settlement agreement allocated the settlement payment among the various claims that the taxpayer had brought against her former divorce attorney, and the Tax Court refused to look beyond the settlement agreement in determining the payor's intent. As a result, the Tax Court held that the taxpayer failed to meet her burden of proof that the settlement proceeds were meant to replace her marital property rather than generally to release the malpractice defendants from various claims and types of damages listed in the malpractice petition. Moreover, in the alternative, the Tax Court stated that the taxpayer failed to provide a basis for allocation among the various claims, so the Tax Court ruled that the full amount of her recovery was included in gross income.

Page 332:

After the carryover paragraph, add:

To be excludable, the person's award must bear a direct causal link with the recipient's actual physical personal injury. See Rivera v. Baker W., Inc., 430 F.3d 1253 (9th Cir. 2005). In Blum v. Commissioner, 2022 WL 1797334 (9th Cir. 2022), the taxpayer argued that a malpractice settlement should be excluded under § 104(a) because the malpractice claim arose out of litigation against a hospital for physical injuries the taxpayer sustained as a result of a broken wheelchair. The Ninth Circuit affirmed the Tax Court and rejected the taxpayer's assertion that the malpractice settlement payment was excludable because it stemmed from earlier litigation involving physical injury; the Ninth Circuit noted that the malpractice settlement agreement

expressly stated that the taxpayer had not suffered any physical injury as a result of the alleged negligence by her attorneys.

PART III

BUSINESS DEDUCTIONS AND CREDITS

CHAPTER 12

ORDINARY AND NECESSARY BUSINESS AND PROFIT-SEEKING EXPENSES

SECTION 3. THE LIMITATION OF "UNREASONABLE" COMPENSATION

Page 426:

After the carryover paragraph, add:

In Clary Hood, Inc. v. Commissioner, 69 F.4th 168 (4th Cir. 2023), the Fourth Circuit affirmed the Tax Court's utilization of a multifactor approach to determine the reasonableness of an executive's compensation. The Tax Court had found as a fact that a portion of the compensation was justified as a make-up payment for the executive officer having been under-compensated in prior years, but the Tax Court determined that a portion of the executive's officer's extra bonuses were nevertheless excessive compensation. In affirming the Tax

Court's decision, the Fourth Circuit endorsed a "reasonable compensation" test that utilized a multifactor approach, including the prior underpayment history of the employee.

SECTION 5. "PUBLIC POLICY" LIMITATIONS: TAX PENALTIES

A. BRIBES, FINES, AND PENALTIES

Page 437:

After the third paragraph but before 2. PAYMENTS TO PRIVATE PARTIES, add:

In 2017, Congress amended § 162(f)(1) to provide that no deduction shall be allowed for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation into a potential violation of law. Treas. Reg. § 1.162-21(a)(3) clarifies that the disallowance provision of § 162(f) applies to amounts paid in relation to a violation of any civil or criminal law but does not include payments made in connection with routine government investigations or audits that are not related to any evidence of wrongdoing or suspected wrongdoing.

Section 162(f)(2) provides an exception to the general disallowance rule of § 162(f)(1) for certain amounts paid or incurred for restitution, remediation, or to come into compliance with a law. Under § 162(f)(2)(A), an expenditure is not subject to disallowance by reason of § 162(f)(1) as long as (i) the taxpayer establishes the amount was paid or incurred as restitution (including remediation of property) or to come into compliance with a law (the so-called establishment requirement), and (ii) the amounts are identified in a court order or settlement agreement as restitution, remediation, or amounts paid or incurred to come into compliance with a law (the so-called identification requirement). Section 162(f)(2)(B) provides that amounts paid for restitution, remediation, and to come into compliance with a law do not include any amount paid or incurred to reimburse the government for the costs of any investigation or litigation. Treas. Reg. § 1.162-21(b)(1) makes it clear that an amount is eligible for the exception set forth in § 162(f)(2)(A) only if the taxpayer satisfies both the identification and establishment requirements. The identification requirement is satisfied if an order or agreement specifically identifies the amount of the payment that is restitution, remediation, and amounts paid to come into compliance with law. Treas. Reg. § 1.162-21(b)(2). If the order or agreement does not identify the nature of the payment, the identification requirement still may be met if the order or agreement describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer. Treas. Reg. § 1.162-21(b)(3) provides that the establishment requirement is met only through the proffer of documentary evidence that establishes the amount was paid and establishes that the nature and purpose of the payment represents restitution, remediation, or an expenditure to come into compliance with a law. A payment represents restitution or remediation if it is paid or incurred to restore, in whole or in part, the party of property harmed, injured, or damaged by the violation or potential violation of any law. Treas. Reg. § 1.162-21(e)(4). Treas. Reg. § 1.162-21(e)(4)(i)(A) clarifies that restitution or remediation of the environment, wildlife, or natural resources includes amounts paid or incurred for the purpose of conserving soil, air, or water resources, protecting or restoring the environment or an ecosystem, improving forests, or providing a habitat for fish, wildlife, or plants whether or not those amounts restore or could restore an irreparable harm. An expenditure to bring the taxpayer into compliance with law as

defined in the exception contained in § 162(f)(2) may include amounts expended to perform services, modify equipment, or to purchase or acquire property. Treas. Reg. § 1.162-21(e)(4)(ii).

Page 438:

At the beginning of the first full paragraph, add the following two new sentences:

Section 162(f)(3) provides that the disallowance rule of § 162(f)(1) does not apply to any amount paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party. Treas. Reg. § 1.162-21(c)(1) provides that payments to private parties are not subject to the disallowance provision of § 162(f)(1). In addition, payments made to a governmental entity as a result of a contractual dispute where the government is enforcing its rights as a contracting party is not a fine or penalty that is subject to disallowance under § 162(f)(1). Treas. Reg. § 1.162-21(f) Ex. (7).

Page 439:

At the end of the page, add:

Section 162(f)(5) describes certain self-regulating nongovernmental entities that are treated as governmental entities for purposes of § 162(f). The regulations provide that a nongovernmental entity is treated as a governmental entity if it exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange or exercises other self-regulatory powers, including adopting, administering, or enforcing rules and imposing sanctions as part of performing an essential governmental function. Treas. Reg. § 1.162-21(e)(3).

Page 445:

Delete the last full paragraph. [Editor's Note: In 2017, Congress repealed the exception for lobbying for local governments that was mentioned in this paragraph of the casebook]

Page 449:

Replace the last full paragraph with the following:

In the late 1980s and early 1990s the amount of compensation received by executives of publicly held corporations was the subject of intense scrutiny and criticism. Congress concluded that many corporate executives were receiving excessive compensation that was nevertheless deductible under § 162(a)(1), and Congress responded with an additional limitation intended to induce corporations to reduce the amount of compensation paid to executives. Section 162(m) imposes a $1,000,000 ceiling on the deduction for annual compensation paid to a covered employee. Section 162(m)(3) defines a covered employee as (i) the principal executive officer or principal financial officer, (ii) all other employees whose compensation is required to be reported under the Securities Exchange Act of 1934 by reason of such employee being among the three highest compensated officers, or (iii) the person was a covered employee for any preceding taxable year after December 31, 2016. The regulations make it clear that a person's compensation need not be required to be disclosed in public

filings with the SEC and would nevertheless still be considered a covered employee if the officer's total compensation for the taxable year, determined in accordance with the SEC disclosure rules, places the officer among the three highest compensated officers for the taxable year. Treas. Reg. § 1.162-33(c)(2)(i). The regulations also provide detailed rules to determine whether a person was a covered employee of a predecessor company and thus set forth the type of corporate transactions that would cause an acquired entity to be viewed as a predecessor corporation. Treas. Reg. § 1.162-33(c)(2)(ii). A covered employee also, in certain circumstances, can include former employees.

Prior to 2017, the limitation set forth in § 162(m) generally applied only to fixed salaries. After 2017, the limitation is applied to a covered employee's "applicable employee remuneration" which is defined as the aggregate amount allowable as a deduction for the taxable year (determined without regard to § 162(m)) for remuneration for services performed by such employee (whether or not during the taxable year). I.R.C. § 162(m)(4)(A). Furthermore, the "applicable employee remuneration" of a covered employee also includes remuneration that is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee. I.R.C. § 162(m)(4)(F). The regulations also include an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the compensation paid by a partnership to a covered employee of the publicly held corporation for services performed by the covered employee. Treas. Reg. § 1.162-33(c)(3)(ii). However, compensation that is not treated as wages for purposes of the Federal Insurance Contributions Act or is excluded from an employee's gross income is not subject to § 162(m). Treas. Reg. § 1.162-33(c)(3)(iii).

Page 450:

At the end of the first full paragraph, add:

In Northern California Small Business Assistants Inc. v. Commissioner, 153 T.C. 65 (2019), the Tax Court stated that the disallowance of deductions did not constitute a "penalty" and as such did not violate the prohibition in the Eighth Amendment of the U.S. Constitution against excessive fines.

Page 450:

At the end of Problem Set 5, Problem 1, add the following new problems:

2. (a) Belching Smokestacks, Inc. enters into an agreement with a state's environmental enforcement agency related to its potential violation of state environmental laws. Pursuant to the agreement, Belching Smokestacks, Inc. pays $40X to the agency in civil penalties, $80X in restitution for the environmental harm that the taxpayer has caused, $50X for remediation of contaminated sites, and $60X to conduct comprehensive upgrades to Belching Smokestack, Inc.'s operations to come into compliance with the state environmental laws. What portion of these payments are subject to disallowance by reason of § 162(f)(1)?

(b) Belching Smokestacks, Inc. is under investigation by the state's environmental enforcement agency for a potential violation of state law governing emissions standards. Belching Smokestacks, Inc. enters into an agreement with the state agency under which it agrees to upgrade its equipment utilized in its operations to come into compliance with the

state's emission law. Although the agreement does not provide the specific amount that Belching Smokestack, Inc. will incur to upgrade its equipment to come into compliance with state law, the agency order directs Belching Smokestack, Inc. to upgrade its existing equipment with the goal of achieving a specific targeted reduction for emissions. Under the order, Belching Smokestack, Inc. also agrees to construct a nature center in a local park for the benefit of the community. Instead of paying $12X to come into compliance with state law, Belching Smokestack, Inc. pays $15X to upgrade its equipment to a standard higher than that which the law requires. Belching Smokestacks, Inc. presents evidence to establish that it would cost $12X to upgrade the engines to come into compliance with state law. Are any of these payments subject to disallowance by reason of § 162(f)(1)?

(c) Belching Smokestack, Inc. is subject to the supervision and annual examination by the state's environmental agency. In the ordinary course of its business, Belching Smokestack, Inc. is required to pay annual assessment fees to the state agency. The fees are used to fund the state agency's supervision and examination of industry participants. Following an annual examination conducted in the ordinary course of its business, the state environmental agency issues a letter to Belching Smokestack, Inc. identifying safety concerns with its operations. Belching Smokestacks, Inc. takes corrective action to address the agency's concerns by investing in additional safety training. The state agency does not conduct an investigation or inquiry into a potential violation of any law. Are any of the expenditures incurred by Belching Smokestack, Inc. subject to disallowance in this scenario?

3. ACME is a publicly held corporation. Employee K served as the sole principal executive officer of ACME, and Employees L and M both served as the principal financial officer of ACME at separate times during the year. Employees N, O, and P were, respectively, the first, second, and third highest compensated executive officers of ACME for the year other than the principal executive office and the principal financial officer, and all three retired before the end of the year. Employees Q, R, and S were, respectively, ACME's fourth, fifth, and sixth highest compensated executive officers other than the principal executive officer and the principal financial officer for the taxable year, and all three remained employed as of the end of the taxable year. On March 1 of the following year, ACME filed its Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 with the SEC. With respect to its SEC filing, ACME disclosed the compensation of Employee K for serving as the principal executive office, Employees L and M for serving as the principal financial officer, and Employees Q, R, and S pursuant to 17 CFR § 229.402(a)(3)(iii) (Item 402 of Regulation S-K). ACME also disclosed the compensation of Employees N and O pursuant to 17 CFR § 229.402(a)(3)(iv) (Item 402 of Regulation S-K). Which employee compensation is subject to potential disallowance for exceeding $1 million under § 162(m)?

Page 451:

After the fifth sentence of the second full paragraph, insert:

In Rev. Proc. 2019-11, 2019-9 I.R.B. 742, as modified by Rev. Proc. 2021-11, 2021-6 I.R.B. 833, the IRS provided guidance on three different methods that taxpayers could utilize for calculating "W-2 wages" for purposes of applying § 199A(b)(4).

CHAPTER 13

DEDUCTIBLE PROFIT-SEEKING EXPENSES VERSUS NONDEDUCTIBLE CAPITAL EXPENDITURES

SECTION 4. COST TO ACQUIRE OR CREATE INTANGIBLE ASSETS

DETAILED ANALYSIS

1.4 AMOUNTS PAID TO FACILITATE THE ACQUISITION OR CREATION OF INTANGIBLES

PAGE 479:

AFTER THE CARRYOVER PARAGRAPH, ADD:

Difficult line-drawing problems can arise, however. For example, in Mylan, Inc. v. Commissioner, 76 F.4th 230 (3d Cir. 2023), aff'g 156 T.C. 137 (2021), a pharmaceutical company incurred substantial legal expenses in connection with FDA applications that sought approval for its generic drugs. As part of that FDA application process, Mylan certified that existing relevant patents were either invalid or would not be infringed upon by the sale or use of Mylan's generic version of the drug. Mylan incurred substantial legal expenses to prepare the notice letters and to pursue the FDA application process to get approval for its generic drugs. Simultaneously, Mylan also incurred significant legal expenses to defend itself against patent infringement lawsuits brought by the name-brand drug manufacturers in response to their receipt of Mylan's notice letters about its generic drugs. The Third Circuit held that Mylan's legal costs incurred as part of its FDA application process were required to be capitalized as those legal expenses represented amounts paid to facilitate an acquisition or creation of an intangible as envisioned by Treas. Reg. § 1.263(a)-4(b)(1)(ii), (v). However, under an origin of the claim analysis, the Third Circuit held that the legal costs incurred by Mylan to defend itself again the patent infringement lawsuits were not incurred to facilitate the acquisition or creation of an intangible within the meaning of Treas. Reg. §§ 1.263(a)--4(b)(1)(v) and 1.263(a)-4(e)(1)(i). According to the Third Circuit, whether the FDA approves (or disapproves) an application for approval to market a generic drug does not depend on the outcome of the patent infringement litigation. Because the patent litigation costs were not incurred to facilitate the acquisition of its generic drug approval, the Third Circuit concluded

that the patent infringement litigation expenses incurred by Mylan were currently deductible as ordinary and necessary expenses because these legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed the decision of the U.S. Court of Appeals for the Third Circuit in Urquhart v. Commissioner, 215 F.2d 17 (3d Cir. 1954), which held that patent litigation arises out of the exploitation of the invention embodied in the patent and, therefore, costs incurred to defend a patent infringement suit are not capital expenditures because they are not costs incurred to defend or protect title but rather are expenses incurred to protect business profits. Because Mylan's legal expenses arose out of the patent infringement claims initiated by the patent holders, the Third Circuit held that these costs were currently deductible.

CHAPTER 14

COST RECOVERY MECHANISMS

SECTION 1. DEPRECIATION

A. ACCELERATED COST RECOVERY SYSTEM

Page 511:

After the second paragraph, add:

Consistent with the amendments made to § 168(k)(2)(A)(ii) and (k)(2)(E)(ii), the Treasury Department issued regulations providing that the acquisition of used property is eligible for the additional first year depreciation deduction if such acquisition meets the following three requirements: (1) the property was not used by the taxpayer or a predecessor at any time prior to the acquisition; (2) the acquisition of the property meets the related party and carryover basis requirements of § 179(d)(2)(A), (B), and (C) and Treas. Reg. § 1.179-4(c)(1)(ii), (iii), and (iv), or § 1.179-4(c)(2); and (3) the acquisition of the property meets the cost requirements of § 179(d)(3) and Treas. Reg. § 1.179-4(d). Treas. Reg. § 1.168(k)-2(b)(3)(iii)(A). To determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to its acquisition, the regulations also provide that only the five calendar years immediately prior to the taxpayer's current placed-in-service year are taken into account. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(1). If the taxpayer and a predecessor have not been in existence for this entire five-year period, the regulations provide that only the number of calendar years the taxpayer and the predecessor have been in existence are taken into account. The regulations also provide that if a taxpayer has a depreciable interest in a portion of the property and subsequently acquires an additional portion of the same property, then the additional depreciable interest is not treated as having been previously used by the taxpayer and thus is eligible for the additional bonus depreciation. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(B)(2). The regulations also provide special rules to ascertain whether taxpayers were related with respect to a series of transactions in order to determine if the property has been used by the taxpayer or a related person within the previous five years. Treas. Reg. § 1.168(k)-2(b)(3)(iii)(C).

CHAPTER 16

INTEREST AS A PROFIT-SEEKING EXPENSE

SECTION 3: LIMITATIONS ON THE INTEREST DEDUCTION

A. LIMITATION ON BUSINESS INTEREST INCOME

Page 595:

Replace the first full paragraph with the following:

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Treas. Reg. § 1.163(j)–4(b)(1) provides that, for a C corporation, all interest paid or accrued by the corporation will be business interest, and all interest on indebtedness held by a C corporation that is includible in its gross income will constitute business interest income. Treas. Reg. § 1.163(j)-1(b)(22)(i) through (iii) provide a definition of interest that includes various categories of transactions that are generally treated as interest under the Code but then also identify certain payments that are not interest but would be treated as such for purposes of § 163(j). Moreover, the regulations provide for a broad anti-abuse rule that will treat any expense or loss that is economically equivalent to interest as though it were interest expense for purposes of § 163(j) if a principal purpose of structuring the transaction is to reduce an amount incurred by the taxpayer that otherwise would have been treated as interest expense. Treas. Reg. § 1.163(j)-1(b)(22)(iv)(A). An expense or loss is economically equivalent to interest if the item is (1) deductible by the taxpayer, (2) incurred by the taxpayer in a transaction(s) (or series of integrated or related transactions) in which the taxpayer secures the use of funds for a period, (3) substantially incurred in consideration of the time-value of money, and (4) not otherwise described in Treas. Reg. § 1.163(j)-1(b)(22). Treas. Reg. § 1.163-1(b)(22)(iv)(A)(1). Whether a taxpayer enters into a transaction with a principal purpose to reduce an amount that would otherwise be characterized as interest expense depends on all facts and circumstances. Treas. Reg. § 1.163(j)-1(b)(22)(iv)(C). The taxpayer's business purpose and pre-tax cost of funds, however, are ignored and deemed irrelevant in this inquiry. In certain circumstances, items of income arising from a transaction subject to the anti-avoidance rule will be characterized as interest income if the transaction was entered into with a principal purpose to artificially increase business interest income in the adjusted taxable income computation. Treas. Reg. § 1.163(j)-1(b)(22)(iv)(B). The anti-avoidance rules that prohibit taxpayers from artificially increasing interest income largely mirror those that address transactions that have a principal purpose of reducing the amount of interest expense.

Replace the second full paragraph with the following:

Adjusted taxable income is defined in § 163(j)(8) as the taxpayer's taxable income computed without regard to nonbusiness deductions, any business interest income, any net operating loss deduction, the deduction allowed under § 199A, and any deduction allowable for depreciation. Treas. Reg. § 1.163(j)-1(b)(1) provides specific rules with respect to the disposition of depreciable property. A taxpayer's "tentative taxable income" (which is computed without regard to § 163(j)) is the point for determining adjusted taxable income. Treas. Reg. § 1.163(j)-1(b)(43). The regulations confirm that § 163(j) applies after the application of other provisions that subject interest expense to disallowance, deferral, capitalization, or other limitation. Although § 163(j) generally applies before § 461(*l*), § 465, and § 469, the regulations consider these provisions in determining tentative taxable income and thus those provisions are considered for purposes of computing adjusted taxable income. Treas. Reg. § 1.163(j)-3(b)(4).

For tax years beginning on or after January 1, 2022, depreciation deductions may not be added back. This change will reduce adjusted taxable income for many taxpayers, thereby reducing the base against which the 30 percent ceiling is applied and increasing the effect of § 163(j). Prior to January 1, 2022, the regulations permitted depreciation, amortization or depletion that is capitalized into inventory under § 263A to be added back to tentative taxable income when calculating adjusted taxable income for that tax year. Treas. Reg. § 1.163(j)–1(b)(1).

CHAPTER 17

BUSINESS TAX CREDITS

SECTION 3: OTHER BUSINESS CREDITS

Page 625:

After the third full paragraph, add:

1.11 *Tax Credits for Green Energy Initiatives*

For purposes of the general business credit allowed under § 38, the amount of the investment credit for any taxable year is the sum of the credits listed in § 46. That list includes the recently expanded § 48C credit for qualified investments in qualifying advanced energy projects. Section 48C(a) provides for a credit in an amount equal to a certain percentage of the qualified investment (as defined in § 48C(b)) with respect to any qualifying advanced energy project (as defined in § 48C(c)(1)). The § 48C credit generally is allowed in the taxable year in which the eligible property (as defined in § 48C(c)(2)) is placed in service. For purposes of § 48C credit allocations, § 48C(e)(4)(A) provides a base credit rate of 6 percent of the qualified investment. In the case of any project that satisfies the requirements of § 48C(e)(5)(A) and (6) (prevailing wage and apprenticeship requirements), § 48C(e)(4)(B) provides an alternative rate of 30 percent of the qualified investment.

The statute directs Treasury to establish the § 48C(e) program and to award certifications for qualified investments eligible for § 48C credits to energy project sponsors. The total amount of § 48C credits that may be allocated under the § 48C(e) program may not exceed $10 billion. The application process begins with submitting a concept paper to the Department of Energy (DOE). After reviewing the concept paper, the DOE will send applicants a letter encouraging or discouraging them from moving onto the next stage, which consists of submitting a full application to the DOE. Taxpayers have up to two years after receiving the allocation letters to confirm they have met the certification requirements, after which the IRS will certify the project. If a taxpayer's project is certified as compliant by the IRS, then the taxpayer has 2 years from the date of acceptance to provide evidence that the requirements of the certification have been met. I.R.C. § 48C(e)(3). Taxpayers that place a qualifying project in service within two years of certification and notify the DOE may claim the § 48C credit on their income tax return for the tax year in which the project was placed in service (subject to certain exceptions for qualified progress expenditures). I.R.C. §48C(e)(3)(C). Taxpayers that do not place the project in service within two years or notify the DOE will forfeit their allocation. Forfeited allocations will likely be made available in future rounds of funding.

In Notice 2023-18, 2023-10 I.R.B.508, the IRS defines an advanced energy project eligible for an award as including a project that (i) re-equips, expands or establishes an industrial or manufacturing facility for producing or recycling specified advanced energy property, (ii) re-equips any industrial or manufacturing facility with equipment designed to reduce greenhouse gas emissions by at least 20% by installing (1) low- or zero-carbon process heat systems; (2) carbon capture, transport, utilization and storage systems; (3) equipment for energy efficiency and reducing waste from industrial processes; or (4) any other industrial technology designed to reduce greenhouse gas emissions, or (iii) re-equips, expands or establishes an industrial facility for processing, refining or recycling critical materials (as defined in § 7002(a) of the Energy Act of 2020). The property that must be manufactured in order to be eligible for the credit includes, for example, property for producing solar, water, wind or geothermal energy as well as property that captures, removes, uses or sequesters carbon oxide emissions. It lists several other items and leaves room for future designations of "other advanced energy property designed to reduce greenhouse gas emissions as determined by the Secretary."

Separately, § 48 provides credits for wind, solar, and energy storage projects. In 2022, Congress added § 48(e) that increases the amount of the § 48(a) energy investment credit if the facilities are located in low-income communities. Treasury provided interim guidance on this enhanced wind and solar credit in Notice 2023-17, 2023-10 I.R.B. 505. Other credits are also available under § 38 for a variety of other congressionally endorsed reasons, but the combination of the above actions represent a significant expansion of the Treasury's involvement in a transition away from fossil fuels.

CHAPTER 18

DETERMINING WHEN A TAXPAYER IS ENGAGING IN A BUSINESS FOR PROFIT-SEEKING ACTIVITY

SECTION 1: IS THERE A PROFIT-SEEKING MOTIVE?

Page 634:

After the second sentence of the first full paragraph, insert:

See Gregory v. Commissioner, 69 F.4th 762 (11th Cir. 2023), aff'g T.C. Memo. 2021-115 (holding that hobby expenses are miscellaneous itemized deductions).

PART IV

DUAL PURPOSE EXPENSES

CHAPTER 19

EXPENSES INVOLVING BOTH PERSONAL AND BUSINESS PURPOSES

SECTION 2. TRAVEL AND RELATED EXPENSES

Page 684:

After the carryover paragraph, add:

5. EMPLOYEE PARKING AND COMMUTING

In 2017, Congress modified the tax treatment afforded to employee parking fringe benefits and employee provided commuting and transportation fringe benefits. First, Congress enacted § 274(a)(4) to provide that an employer would not be allowed a deduction for the expense of a qualified transportation fringe benefit provided to an employee that is excluded from the employee's gross income under § 132(f). The disallowance provision of § 274(a)(4) applies to any amounts excludible as commuter transportation in a commuter highway vehicle, transit passes, or qualified parking. Because of § 274(a)(4)'s cross reference to § 132, qualified bicycle commuting reimbursements are excepted from the disallowance, but only prior to

January 1, 2026. I.R.C. § 132(f)(8). Section 274(*l*) disallows a deduction for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee, but this disallowance does not apply to any qualified bicycle commuting reimbursement that is paid or incurred before January 1, 2026.

Detailed regulations implement the disallowance provisions of § 274(a)(4) and § 274(*l*). Treas. Reg. § 1.274-13 implements the disallowance rules of § 274(a)(4), and generally allows taxpayers to calculate the §274(a)(4) disallowance amount based on a reasonable method. However, if taxpayers utilize this general rule, the regulations require taxpayers to utilize in its reasonable method the expense paid or incurred in providing a qualified transportation facility and must use a methodology that allocates parking expenses to reserved employee spaces and must also reasonably apply the exception for parking made available to the general public. Treas. Reg. § 1.274-13(d)(2)(i). The regulations then include three simplified methodologies as alternatives to the general rule. Treas. Reg. § 1.274-13(d)(2)(ii). Under the first simplified methodology, the "qualified parking limit methodology," taxpayers calculate the disallowance by multiplying the total number of parking spaces used by employees during the peak demand period, or, alternatively, the total number of the taxpayer's employees, by the § 132(f)(2) monthly per employee limitation on exclusion for qualified parking for each month in the taxable year. Treas. Reg. § 1.274-13(d)(2)(ii)(A). The second simplified methodology, the "primary use methodology," uses an allocation formula for allocating certain mixed parking expenses and aggregating parking spaces by geographic location. Treas. Reg. § 1.274-13(d)(2)(ii)(B). The third simplified methodology utilizes a "cost per space methodology," which allows taxpayers to calculate the disallowance by multiplying the cost per parking space by the number of available parking spaces used by employees during the peak demand period. Under this third methodology, the cost per space is calculated by dividing the employer's total parking expenses (including expenses for inventory/unusable spaces) by total parking spaces (including inventory/unusable spaces). Treas. Reg. § 1.274-13(d)(2)(ii)(C). The regulations also contain special rules for allocating certain mixed parking expenses and aggregating parking spaces by geographic location to be used with the cost per space methodology.

Regardless of methodology, Treas. Reg. § 1.274-13(e)(1) provides that the deduction disallowance under § 274(a)(4) does not apply to expenditures for a qualified transportation fringe benefit that meets the requirements of § 274(e)(2), (7), or (8). As a result, pursuant to § 274(e)(2), the regulations make clear that the disallowance under § 274(a) does not apply to expenditures for qualified transportation fringe benefits to the extent the taxpayer properly treats the expenses as compensation to the employee on the taxpayer's originally filed tax return and properly withholds at source on the wages. Treas. Reg. § 1.274-13(e)(2)(i). As a separate exception, pursuant to § 274(e)(7), any taxpayer expense for transportation in a commuter highway vehicle, a transit pass, or parking is not subject to the deduction disallowance under § 274(a) to the extent such transportation, transit pass, or parking is made available to the general public. Treas. Reg. § 1.274-13(e)(2)(ii). Finally, consistent with § 274(e)(8), the regulations provide that any taxpayer expense for transportation in a commuter vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe benefit under § 132(f)(1) that is sold to customers in a bona fide transaction for adequate consideration is not subject to the deduction disallowance under § 274(a). Treas. Reg. § 1.274-13(e)(2)(iii).

Treas. Reg. § 1.274-14 implements the disallowance rules of § 274(*l*). In this regard, Treas. Reg. § 1.274-14(a) provides that a taxpayer is not allowed a deduction for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment. The regulations make clear that any disallowance of a commuter payment under § 274(*l*) is not subjected to any of the exceptions provided in § 274(e). Thus, the disallowance afforded under § 274(*l*) applies regardless of whether the travel between the employee's residence and place of employment includes more than one mode of transportation, and this disallowance applies regardless of whether the taxpayer provides, or pays or reimburses the employee for, all modes of transportation used during the commuting trip. For example, the disallowance applies if an employee drives a personal vehicle to a location where a different mode of transportation is used to complete the trip to the employee's place of employment, even though the taxpayer may not incur any expense for the portion of travel in the employee's personal vehicle. However, the regulations make clear that the disallowance provisions of § 274(*l*) do not apply to business travel expenses that satisfy the away from home standards of § 162(a)(2). Consistent with § 274(*l*)(1)'s safety exception, the regulations provide an exception to the disallowance rule of § 274(*l*) if the employee's transportation or commuting expense is incurred in order to ensure the safety of the employee. Treas. Reg. § 1.274-14(b). For this purpose, the regulations refer to the standards for determining unsafe conditions under Treas. Reg. § 1.61-21(k)(5).

SECTION 3. BUSINESS MEALS AND ENTERTAINMENT

Page 685:

Before Churchill Downs, Inc. v. Commissioner, insert:

Some elements of business meals and entertainment expenditures represent personal consumption even in the context where the expenditures for meals and entertainment may relate to business activities. Since at least the 1970s, there has been a tension in the tax law as to whether and to what extent a deduction should be allowed for business meals and entertainment expenses. Immediately prior to the Tax Cuts and Jobs Act of 2017, Congress had generally allowed a deduction for only 50 percent of the cost for meals and entertainment expenses. The Tax Cuts and Jobs Act of 2017 eliminated the deduction for entertainment expenses entirely, but Congress did not amend the provisions relating to the deductibility of business meals at that time. Thus, business meals remained deductible, as a general rule, to the extent of 50 percent of the food and beverage expenses associated with operating their trade or business, including meals consumed by employees on work travel. I.R.C. § 274 (n). The exceptions to this general rule that would afford a full deduction for meals are set forth in § 274(n)(2). However, as was true for the law prior to 2017, no deduction—even at a 50 percent amount—is available for the expense of any food or beverages unless (a) the expense is not lavish or extravagant under the circumstances, and (b) the taxpayer (or an employee of the taxpayer) is present at the furnishing of the food or beverages. I.R.C. § 274(k). In addition, § 274(d) provides substantiation requirements for deductions under § 162 or § 212 for any traveling expense (including meals and lodging while away from home).

The following case addresses an interpretive issue for the exceptions available under § 274(n)(2) to the general 50 percent disallowance result afforded under § 274(n)(1). The case remains relevant for interpreting the exceptions addressed in that case.

Pages 692 through 694:

Replace the text of 2. ENTERTAINMENT with the following:

2. ENTERTAINMENT

Prior to 2017, § 274 allowed a deduction for 50 percent of the cost of entertainment that was "directly related" to the active conduct of a trade or business.[1] In *Churchill Downs* the Commissioner conceded that the expenses in question were directly related or associated with the taxpayer's business under the pre-2017 law. However, after the 2017 Act, an amount considered to be entertainment is not deductible unless the expenditure can meet the requirements of § 274(e). Thus, entertainment expenses are completely disallowed under § 274(a) whereas a business meal is afforded a full deduction or a 50 percent disallowance under § 274(n)(1) and (2), but only if the business meal is not itself entertainment. Thus, a distinction now is required to be made as to whether an expenditure is entertainment (and thus subject to full disallowance) or is instead a business meal (that is afforded a full deduction or a 50 percent disallowance depending on the application of § 274(n) and its exceptions).

Section 274(e)(1) through (9) provide exceptions to a disallowance for entertainment expenses for the following items: (i) expenses for food and beverages furnished on the business premises primarily for employees, (ii) expenses treated as compensation, (iii) expenditures under certain reimbursement arrangements, (iv) recreational expenses for employees, (v) expenditures for certain business meetings, (vi) expenditures for certain business league meetings, (vii) expenditures for amounts made available by the taxpayer to the general public, (viii) expenditures for entertainment sold to customers, and (ix) certain expenditures that are included into income of persons who are not employees.

Expenditures that otherwise constitute entertainment that do not satisfy one of the above § 274(e) exceptions are now subject to a complete disallowance, so a demarcation must be made as to whether and to what extent an expenditure for a business meal is entertainment subject to full disallowance or is instead a non-entertainment business meal that is then subject to a full deduction or only a partial disallowance under the strictures of § 274(n). Detailed regulations implement this distinction. The regulations provide that the term entertainment does not include food or beverages unless the food or beverages are provided at or during an entertainment activity and only then if the food or beverages are not purchased separately from the entertainment event, or the cost of the food or beverages is not stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. Treas. Reg. § 1.274-11(b)(1)(ii). 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. If the food or beverages are not purchased separately from the entertainment, or the cost of the food or beverages is not stated separately from the cost of the entertainment on one or

[1] Treas. Reg. §1.274-2(c) delineated the standards for determining if entertainment is "directly related" to the active conduct of the trade or business.

more bills, invoices, or receipts, the regulations state that the entire amount of the expenditure is treated as a nondeductible entertainment expenditure except to the extent that one of the exceptions afforded under § 274(e) is available.

Page 694:

Replace the last full paragraph with the following:

As amended by the 2017 Act, § 274(n)(1) applies the 50 percent limitation to all expenses incurred for food or beverage unless one of the exceptions in § 274(n)(2) applies. However, after 2025, § 274(o) will deny deductions for meals provided to employees that are fringe benefits under § 132(e) or provided for the convenience of the employer under § 119.

Section 274(n)(2)(A) incorporates by reference several exceptions provided in § 274(e) with the consequence that if those exceptions apply then the expenditure for food and beverages is not subject to the 50 percent disallowance requirement of § 274(n)(1). In this regard, § 274(k)(2)(A) and § 274(n)(2)(A) provide that the limitations on deductions in § 274(k)(1) and (n)(1), respectively, do not apply to any expense described in § 274(e)(2), (3), (4), (7), (8), and (9). Accordingly, Treas. Reg. § 1.274–12(c)(2) clarifies that the deduction limitations of § 274(n) and § 274(k) are not applicable to expenditures for business meals, travel meals, or other food or beverages that fall within one of these exceptions:

i. *Expenses Treated as Compensation under Section 274(e)(2) or (e)(9).* Pursuant to § 274(e)(2), the regulations provide that the limitations in § 274(k)(1) and § 274(n)(1) do not apply to expenditures for food or beverages provided to an employee to the extent the expenses are treated as compensation to the employee. In addition, the regulations provide that the limitations in § 274(k)(1) and § 274(n)(1) do not apply to expenses for food or beverages provided to a person who is not an employee of the taxpayer to the extent the expenses are includible in the gross income of the recipient of the food or beverages as compensation for services rendered or as a prize or award under § 74. Treas. Reg. § 1.274-12(c)(2)(i). The exceptions in § 274(e)(2) related to employees and in § 274(e)(9) related to non-employees allow a taxpayer to deduct the full amount of an expense if the expense has properly been included in the compensation and wages of the employee, or gross income of the recipient, even if the amount of the expense exceeds the amount included in compensation or income. Per § 274(e)(2)(B), to the extent an employee or non-employee is designated as a specified individual under § 274(e)(2)(B), the exception to the § 274(n) limitation is available only to the extent that the expenses do not exceed the amount of the expenses which are treated as compensation and wages to the employee or as income to a non-employee.

ii. *Food or Beverage Expenses Provided under Reimbursement Arrangements*. Pursuant to § 274(e)(3), whenever expenses for food or beverages paid or incurred by one person in connection with the performance of services for another person (whether or not the other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on deductions in § 274(k)(1) and § 274(n)(1) apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. Section 274(e)(3)(B) provides that if the services are performed for a person other than an employer, such as by an independent

contractor, the exception in § 274(e)(3) applies only if the taxpayer, in this case, the independent contractor, accounts, to the extent provided by § 274(d), to such person. Treas. Reg. § 1.274-12(c)(2)(ii) therefore provides that the deduction limitations in § 274(k)(1) and § 274(n)(1) apply to an independent contractor unless, under a reimbursement or other expense allowance arrangement, the contractor accounts to its client or customer with substantiation that satisfies the requirements of § 274(d).

iii. *Recreational Expenses for Employees*. Pursuant to § 274(e)(4), any food or beverage expense paid or incurred by a taxpayer for a recreational, social, or similar activity, primarily for the benefit of the taxpayer's employees, is not subject to the deduction limitations in § 274(k)(1) and 274(n)(1). However, activities that discriminate in favor of highly compensated employees, officers, or shareholders or others who own a 10-percent or greater interest in the business are not considered paid or incurred primarily for the benefit of employees. Treas. Reg. § 1.274-12(c)(2)(iii). The regulations clarify that this exception can apply to company holiday parties, annual picnics, and summer outings that do not discriminate in favor of highly compensated employees. Treas. Reg. § 1.274-12(c)(2)(iii)(B), Exs. (1) and (2). However, this exception does not apply to free food or beverages available to all employees in a pantry, break room, or copy room because the mere provision or availability of food or beverages is not a recreational, social, or similar activity, despite the fact that employees may incidentally socialize while they are in the break room. Treas. Reg. § 1.274-12(c)(2)(iii)(B), Ex. (3). In addition, the regulations provide that the exception in § 274(e)(4) does not apply to food or beverage expenses that are excludable from employees' income under § 119. Because these food or beverages excluded from an employee's income by reason of § 119 are, by definition, furnished for the employer's convenience, they cannot also be primarily for the benefit of the employees as required to meet § 274(e)(4)'s exception, even if some social activity occurs during the provision of the food or beverages.

iv. *Items Available to the Public.* Pursuant to § 274(e)(7), food or beverage expenses of a taxpayer are not subject to the deduction limitations in § 274(k)(1) and § 274(n)(1) to the extent the food or beverages are made available to the general public. The regulations provide that this exception applies to expenses for food or beverages provided to employees if similar food or beverages are provided by the employer to, and are primarily consumed by, the general public. For this purpose, "primarily consumed" means greater than 50 percent of actual or reasonably estimated consumption, and "general public" includes, but is not limited to, customers, clients, and visitors. Treas. Reg. § 1.274-11(c)(2)(iv)(B) Ex. (1) through Ex. (4).

v. *Goods or Services Sold to Customers.* Pursuant to § 274(e)(8), the regulations provide that any expense for food or beverages that are sold to customers in a bona fide transaction for adequate consideration is not subject to the deduction limitations in § 274(k)(1) and § 274(n)(1). The regulations provide an example to indicate that this exception applies to allow a restaurant or catering business to fully deduct its costs for food or beverage items purchased in connection with preparing and providing meals to its paying customers even when a portion of those items are consumed at the worksite by employees who work in the employer's restaurant or catering business. Treas. Reg. § 1.274-11(c)(2)(iv)(B). For purposes of this exception, the term "customer" includes anyone who is sold food or beverages in a bona fide transaction for an adequate and

full consideration in money or money's worth. For example, employees of the taxpayer are customers when they purchase food or beverages from the taxpayer in a bona fide transaction for arm's length, fair market value prices. Treas. Reg. § 1.274-11(c)(2)(v)(A).

Page 699:

PROBLEM SET 3

Add the following new problem:

7. (a) Michael invites Danielle, a potential business client, to a baseball game to discuss a proposed business deal. Michael purchases tickets for Michael and Danielle to attend the game. Michael also buys hot dogs and drinks for Michael and Danielle from a concession stand. How would § 274 apply on these facts?

(b) Would your answer be different if Danielle is a business associate and not a potential client and the tickets that Michael purchases are to a suite where they have access to food and beverages? How would § 274 apply on these facts?

(c) Would your answer be different in (b) above if the invoice for the suite separately states the cost of the food and beverages and the cost reflects the venue's usual selling price if the food and beverages were purchased separately? How would § 274 apply on these facts?

PART V

DEDUCTIONS AND CREDITS FOR PERSONAL LIVING EXPENSES

CHAPTER 21

ITEMIZED PERSONAL DEDUCTIONS

SECTION 2. MEDICAL EXPENSES

Page 733:

Third paragraph, line 7, replace 10 percent with 7.5 percent.

Page 734:

Fourth paragraph, line 3, replace 10 percent with 7.5 percent.

Page 735:

Fourth paragraph, line 4, replace 10 percent with 7.5 percent.

Page 743:

Third paragraph, line 1, replace 10 percent with 7.5 percent.

Page 746:

Delete 8. Impact of Patient Protection Act of 2010.

Page 760:

After the end of the second full paragraph, add:

Recent conservation easement cases, such as Coal Property Holdings, LLC v. Commissioner, 153 T.C. 126 (2019), have utilized Treas. Reg. § 1.170A-14(g)(6)(ii) as authority to deny a deduction to taxpayers for the donation of a conservation easement unless the donor had agreed that the donee would receive a portion of any proceeds from the subsequent extinguishment of the easement in an amount equal to at least the proportionate value of the perpetual conservation restriction.

Page 761:

Replace the second sentence of the first full paragraph with the following:

If the contribution is $250 or more, then § 170(f)(8) requires the taxpayer to obtain a contemporaneous written acknowledgment from the donee organization that must include (i) the amount of cash and a description (but not value) of any property other than cash contributed; (ii) whether the donee organization provided any goods or services in consideration, in whole or in part, for any such property; and (iii) a description and good faith estimate of the value of any such goods or services.

Replace the last sentence of the first full paragraph with the following:

In Albrecht v. Commissioner, T.C. Memo. 2022-53 (2022)), the taxpayer documented her "unconditional and irrevocable" donation of Native American jewelry and artifacts to an exempt museum, but the contemporaneous documentation executed by the taxpayer and the museum failed to include language stating that the taxpayer had not received "goods or services" in return for her gift. Even though there was no evidence that the taxpayer had in fact received any goods or services, the Tax Court disallowed the taxpayer's claimed charitable contribution deduction, citing § 170(f)(8) as authority for the need for the contemporaneous documentation to affirmatively state whether or not any goods or services were received by the taxpayer for the taxpayer's gift.

In addition to satisfying the contemporaneous written documentation requirements of § 170(f)(8), contributions to a "donor advised fund" (as defined in §4966(d)(2)) must comply with § 170(f)(18) which requires the contemporaneous written documentation issued by the donor advised fund in connection with a donation of $250 or more to state that the donor advised fund has "exclusive legal control over the assets contributed." In Keefer v. United States, 130 A.F.T.R.2d 2022-5002 (N.D. Texas 2022), the taxpayer assigned a 4 percent interest in a hotel partnership to a donor advised fund shortly before the hotel's sale, claiming a

charitable contribution deduction of approximately $1.25 million. The Tax Court agreed with the IRS's denial of the taxpayer's claimed charitable contribution deduction because the contemporaneous written documentation issued by the donor advised fund (along with other documents executed in connection with the donation) did not expressly state that the donor advised fund had "exclusive legal control" over the contributed partnership interest. In addition to the above requirements, § 170(f)(17) imposes stringent substantiation requirements for contributions of money.

Page 765:

After the first full paragraph, add:

4.3 In-Kind Donations of Nontaxed Amounts

Section 408(d)(8) permits individuals who have attained the age of 70½ to donate up to $100,000 of any individual retirement account per annum to a qualified charity as tax-free distributions. This amount is indexed for inflation starting after 2023. I.R.C. § 408(d)(8)(G). Amounts that are nontaxable as a qualified charitable distribution may not be deducted as charitable contributions to prevent a double benefit. I.R.C. § 408(d)(8)(E).

In the aftermath of the September 11, 2001, terrorist attacks, a number of employers adopted leave-based donation programs under which employees could elect to forgo vacation, sick, or personal leave in exchange for employer contributions of amounts to organizations described in § 170(c). The IRS indicated that any employees who participated in such a program would not have constructive receipt of the foregone vacation pay but would not be entitled to a charitable contribution deduction for the donation of these untaxed benefits. See Notice 2001-69, 2001-2 C.B. 491. At that time, the IRS indicated that this guidance would not be extended past 2002. See Notice 2003-1, 2003-1 C.B. 257. In 2022, the IRS returned to this idea in the context of leave-based donations made to the victims of Russia's invasion of Ukraine. In Notice 2022-28, 2022-23 I.R.B. 1182, the IRS indicated that any leave-based benefits donated to the victims of Ukraine prior to 2023 would not create constructive receipt to the employee for such amounts, but in turn the employee would not be allowed a charitable contribution deduction for these nontaxed donations in order to prevent a double benefit. When these rulings do not apply, however, the employer's payment of amounts on behalf of an employee generally should create income to the employee and a corresponding charitable contribution deduction under principles espoused in Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

CHAPTER 22

STANDARD DEDUCTION, PERSONAL AND DEPENDENCY EXEMPTIONS, AND PERSONAL CREDITS

SECTION 2. PERSONAL CREDITS

Page 817:

After the carryover paragraph, insert:

Baker v. Commissioner
T.C. Memo. 2006-60

CHIECHI, J.

Petitioner and Deanna Wus (Ms. Wus) have a daughter A and a son C (collectively, the children). At a time not disclosed by the record, Ms. Wus purchased a double-wide trailer (trailer) located at 153 Carnation Drive, Magnolia, Delaware. Ms. Wus, petitioner, and the children lived in the trailer for an undisclosed period of time prior to 2003. Sometime in 2002, Ms. Wus stopped residing in the trailer, but petitioner continued to live there until around mid-February 2003. Petitioner was unable to afford the payments for the mortgage loan, ground rent, and utilities with respect to the trailer after Ms. Wus stopped residing there.

Around mid-February 2003, petitioner moved to a duplex located at 299 Barney Jenkins Road, Felton, Delaware (Barney Jenkins Road property), that a friend of his owned. While residing at the Barney Jenkins Road property, petitioner paid his friend $300 a month and shared an undisclosed amount of utility expenses.

Sometime between the end of September or October 2003 and mid-November 2003, petitioner moved to a house located on 268 Fox Road, Dover, Delaware (Fox Road property), that his mother owned. While residing at the Fox Road property in 2003, petitioner paid his mother, who was living in Florida, $125 a week.

During 2003, petitioner, who worked as a plumber, and Ms. Wus were not married, lived in separate residences, and had no custody agreement concerning their daughter A who was four years old.

During 2003, Ms. Wus received public assistance for A's benefit from the State of Delaware, which listed Ms. Wus as the custodial parent of A. During that year, Medicaid, and not petitioner, provided healthcare benefits to A. During 2003, petitioner did not apply for

food stamps or any other type of public assistance for his daughter A.

During 2003, petitioner and Ms. Wus each asked Rosemary Srase (Ms. Srase) to babysit the children at Ms. Srase's home. Ms. Srase was a longtime friend of petitioner and his mother who used to babysit petitioner when he was a child. Approximately two to three times a week during 2003, Ms. Srase usually babysat the children at her home for a few hours during the evenings. Occasionally during 2003, she babysat them during the daytime and overnight on weekends. During 2003, petitioner did not pay cash to Ms. Srase for babysitting the children for him. Instead, he did work for her at her home. Most of the time during 2003 that Ms. Srase babysat the children, she provided them with some food at her own expense. At no time during 2003 before petitioner moved to the Fox Road property did Ms. Srase babysit the children at petitioner's residence or personally observe them at petitioner's residence. When petitioner moved into the Fox Road property, Ms. Srase observed the children at that property.

On at least certain days during the period January 2 through March 31, 2003, the Dover Educational & Community Daycare Center (Daycare Center) provided daycare for the children. On most, but not all, of such days, Ms. Wus brought the children to, and petitioner picked them up from, the Daycare Center. On certain other days during the period January 2 through March 31, 2003, Ms. Wus brought the children to, and also picked them up from, the Daycare Center. On certain other days during that period, petitioner brought the children to, and also picked them up from, the Daycare Center. During the period January 2 through March 31, 2003, the times at which the children were brought to the Daycare Center ranged from as early as 6:45 a.m. to as late as 4:20 p.m., and the times at which the children were picked up from that center ranged from 11:00 a.m. to 5:45 p.m. In most instances, however, the children were brought to the Daycare Center before 9:00 a.m. and picked up from the Center between 4:30 p.m. and 5:30 p.m. During the period January 2 through March 31, 2003, both petitioner and Ms. Wus made payments of undisclosed amounts toward the cost of the children's daycare at the Daycare Center.

*** In petitioner's 2003 return, petitioner claimed (1) a dependency exemption deduction for his daughter A, (2) head of household filing status, (3) the earned income tax credit, (4) the child tax credit, and (5) the additional child tax credit. In Ms. Wus's tax return for her taxable year 2003, Ms. Wus also claimed a dependency exemption deduction for her daughter A. ****

Section 151(a) permits a taxpayer to deduct an exemption amount for each dependent as defined in section 152. As pertinent here, section 152(a) defines the term "dependent" to include an individual who receives from the taxpayer over half of such individual's support for the calendar year in which the taxable year of the taxpayer begins and who is the taxpayer's daughter. Sec. 152(a)(1). As also pertinent here, if the taxpayer's daughter receives over half of her support during the calendar year from her parents who live apart at all times during the last six months of such year and if such daughter is in the custody of one or both of her parents for more than one-half of such year, the daughter will be treated for purposes of section 152(a) as having received over half of her support during the calendar year from the parent (custodial parent) having custody for the greater portion of the calendar year. Sec. 152(e)(1). Section 152(a) also defines the term "dependent" to include an individual who, for the taxable year of the taxpayer, has as such individual's principal place of abode the home of the taxpayer and is a member of the taxpayer's household and who received (or is treated as having received under, inter alia, section 152(e)) from the taxpayer over half of such individual's support for the calendar year in which the taxable year of the taxpayer begins. Sec. 152(a)(9).

In support of his position that he is entitled for his taxable year 2003 to a dependency exemption deduction for his daughter A, petitioner contends:

> Petitioner and two other witnesses testified that * * * [A] lived with her father, the petitioner from January 2003 until November 2003, when she went to live with her mother. They also testified that the mother took * * * [A] inconsistently on week-ends for those ten months. Further testimony provided that the petitioner maintained over half of the child's support for that period. * * * [Reproduced literally.]

With respect to whether petitioner is to be treated as the custodial parent under section 152(e)(1), the record establishes that petitioner and Ms. Wus had no custody agreement with respect to either of the children for 2003. However, the State of Delaware reported to respondent that Ms. Wus, and not petitioner, was the claimed child's custodial parent. Moreover, the record is devoid of evidence that we find to be reliable establishing that A lived with her father from January until November 2003 or that he otherwise had physical custody of A for a portion of 2003 that is greater than the portion of such year during which Ms. Wus had physical custody of A.

With respect to whether petitioner provided over one-half of A's support during 2003, petitioner must show the amount of total support incurred during that year on behalf of A from all sources, and he must establish that he provided over half of that amount. **** The term "support" includes food, shelter, clothing, medical and dental care, education, and the like. Sec. 1.152–1(a)(2)(i), Income Tax Regs. The total amount of support for each claimed dependent provided by all sources during the year in question must be shown by competent evidence. Blanco v. Commissioner, supra at 514. Where the amount of total support incurred on behalf of a child during such year is not shown, and may not reasonably be inferred from competent evidence, it is not possible to find that the taxpayer contributed more than one-half of such child's total support.

Petitioner failed to maintain any records establishing (1) the amount of total support incurred on behalf of A during 2003 and (2) the amount of such support that he provided to A during that year. During 2003, petitioner, who was a plumber, had total income and adjusted gross income of $15,349. Ms. Wus received public assistance from the State of Delaware for the benefit of A. Moreover, A received healthcare benefits under Medicaid, and not from petitioner. Although for the period January 2 through March 31, 2003, both petitioner and Ms. Wus made payments toward the cost of providing A's daycare, the record is devoid of evidence establishing the total amount of such payments or the amount of such payments that petitioner made. In addition, Ms. Srase, who usually babysat A approximately two to three times a week during 2003, often provided food to A at Ms. Srase's own expense. Finally, as discussed above, although petitioner claims that A lived with him during all of 2003 except November and December of that year, his claim is not supported by evidence that we consider to be reliable.

On the record before us, we find that petitioner has failed to carry his burden of establishing that he is entitled for his taxable year 2003 to a dependency exemption deduction for his daughter A. ****

Claimed Earned Income Tax Credit

Section 32(a)(1) permits an eligible individual an earned income credit against such

individual's tax liability. The earned income tax credit is calculated as a percentage of the individual's earned income. Sec. 32(a)(1). Section 32(a)(2) limits the credit allowed. Section 32(b) prescribes different percentages and amounts that are to be used to calculate the credit depending on whether the eligible individual has no qualifying children, one qualifying child, or two or more qualifying children.

As pertinent here, section 32(c)(1)(A)(i) defines the term "eligible individual" to mean "any individual who has a qualifying child for the taxable year". The term "qualifying child" with respect to any taxpayer for any taxable year includes a daughter of the taxpayer who has the "same principal place of abode as the taxpayer for more than one-half of such taxable year." Sec. 32(c)(3)(A)(i) and (ii) and (B)(i)(I).

It is petitioner's position that his daughter A is a qualifying child for purposes of the earned income tax credit because she had the same principal place of abode as petitioner for more than one-half of his taxable year 2003. We found above that petitioner failed to show that for his taxable year 2003 he maintained as his home a household that constituted the principal place of abode, as a member of such household, of his daughter A for more than one-half of that year. On the record before us, we find that petitioner has failed to carry his burden of showing that for his taxable year 2003 A is a qualifying child for purposes of the earned income tax credit.

On the record before us, we find that petitioner has failed to carry his burden of establishing that he is entitled for his taxable year 2003 to the earned income tax credit.

Claimed Child Tax Credit

Section 24(a) allows a tax credit of a specified amount with respect to each qualifying child of a taxpayer. The amount of the credit allowable under section 24(a) is limited by the taxpayer's adjusted gross income and may not exceed a taxpayer's regular tax liability. Sec. 24(b). As pertinent here, for purposes of section 24, the term "qualifying child" means a taxpayer's daughter for whom the taxpayer is entitled under section 151 to a dependency exemption deduction and who has not attained the age of 17 as of the close of the taxable year. Sec. 24(c)(1).

We found above that petitioner failed to show that he is entitled for his taxable year 2003 to a dependency exemption deduction for his daughter A. On the record before us, we find that petitioner has failed to carry his burden of showing that for his taxable year 2003 A is a qualifying child for purposes of the child tax credit.

On the record before us, we find that petitioner has failed to carry his burden of establishing that he is entitled for his taxable year 2003 to the child tax credit.

Page 825:

Replace the last three sentences in the first full paragraph with the following:

The credit declines from 30 percent for property placed in service after 2021 through 2032, to 26 percent for property placed in service in 2033, and 22 percent for property placed in service in 2034. I.R.C. § 25D(g). The credit terminates for property placed in service after December 31, 2034.

PART VI

CHARACTERIZATION OF GAINS AND LOSSES

CHAPTER 25

SALE OF ASSETS HELD FOR USE IN A TRADE OR BUSINESS

SECTION 1. SECTION 1231 PROPERTY

Page 963:

After the first sentence in the fourth paragraph, insert:

The Tax Court reached a contrary result in Keefe v. Commissioner, T.C. Memo. 2018-28, aff'd, 966 F.3d 107 (2nd Cir. 2020), where a taxpayer had attempted to renovate an historic mansion to use as a luxury rental property. After making substantial renovations, the taxpayer sold the property at a loss without ever renting it out. The Tax Court held that the asset was never used in a trade or business and thus the loss was a capital loss, not a loss from the disposition of a § 1231 asset, and the Seventh Circuit affirmed.

PART VII

DEFERRED RECOGNITION OF GAIN FROM PROPERTY

CHAPTER 26

LIKE-KIND EXCHANGES OF REAL PROPERTY

SECTION 1. LIKE-KIND EXCHANGES IN GENERAL

Page 987:

Immediately after *1. Generally*, insert:

Section 1031 does not define real property, but the regulations provide significant clarity to the definition. To begin with, the regulations state that real property means land and improvements to land, unsevered natural products of land, and water and air space superjacent to land. Treas. Reg. § 1.1031(a)-3(a)(1). The regulations also provide that property is real property for purposes of § 1031 if the property satisfies any of the following criteria: (i) the property is classified as real property under state or local law subject to certain exceptions, (ii) the property is specifically listed as real property in the regulations, or (iii) the property is determined to be real property based on all the facts and circumstances under the various factors provided in the regulations. Thus, a determination that property is personal property under state or local law does not preclude the conclusion that the property nevertheless is considered real property as specifically listed in Treas. Reg. § 1.1031(a)-3(a)(2)(ii) or Treas.

Reg. § 1.1031(a)-3(a)(2)(iii)(B) or the property is considered real property under the facts and circumstances test provided in Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(C) or Treas. Reg. § 1.1031-3(a)(2)(iii)(B).

Under Treas. Reg. §1.1031(a)-3(a)(1), real property includes both inherently permanent structures and the structural components of inherently permanent structures. Inherently permanent structures are buildings or other structures that are permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(A). A list of structures that qualify as buildings or as other inherently permanent structures is provided in Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(B) and (C). A structural component is any distinct asset that is a constituent part of, and integrated into, an inherently permanent structure. Treas. Reg. § 1.1031(a)-3(a)(2)(iii)(A). Treas. Reg. § 1.1031(a)-3(a)(2)(iii)(B) provides examples of items that are structural components under § 1031. With regard to tangible property, if such property is permanently affixed to real property and will ordinarily remain affixed for an indefinite period of time, the regulations treat this tangible property as an inherently permanent structure and thus real property for § 1031 purposes, irrespective of the purpose or use of the property or whether it contributes to the production of income. A structural component likewise is characterized as real property under the regulations if it is integrated into an inherently permanent structure, regardless of whether the structural component contributes to the production of income. Accordingly, under the regulations, items of machinery and equipment are characterized as real property if they comprise an inherently permanent structure, a structural component, or are real property under the state or local law test. The regulations state that the treatment of distinct assets that otherwise would be considered to be tangible personal property as real property is done solely for purposes of apply § 1031 and is not intended to create an inference of a similar treatment for purposes of the federal income tax laws outside of § 1031. Treas. Reg. § 1031(a)-3(a)(7).

Real property is also defined in the regulations to include intangible assets that represent an interest in real property, such as fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, stock in a cooperative housing corporation, and shares in a mutual ditch, reservoir, or irrigation company described in § 501(c)(12)(A). Treas. Reg. § 1.1031(a)-3(a)(5).

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PART VIII

TIMING OF INCOME AND DEDUCTIONS

CHAPTER 28

TAX ACCOUNTING METHODS

SECTION 1. GENERAL PRINCIPLES

Page 1059:

Internal Revenue Code: Add reference to § 451(b).

Page 1061:

After the carryover quoted paragraph, add:

Section 451(b)(1)(A) provides that, for a taxpayer using an accrual method of accounting (accrual method taxpayer), the all events test is met no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable statement. Section 451(b)(1)(B) provides that this financial statement income inclusion rule does not apply to taxpayers that do not have an applicable financial statement for a taxable year and does not apply to any item of gross income from a mortgage servicing contract. Section 451(b)(2) provides that the applicable financial statement income inclusion rule does not apply for any item of gross income that is eligible to be reported under a special method of

accounting. The regulations provide a listing of accounting methods that satisfy this exception. Treas. Reg. § 1.451-3(a)(13).

Page 1066:

After the carryover paragraph, insert:

6. TAX IMPACT OF FINANCIAL STATEMENT INCOME INCLUSION

As noted above, § 451(b)(1)(A) provides that an accrual method taxpayer, who has an "applicable financial statement" satisfies the all events test no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable statement.

Section 451(b)(3) defines an applicable financial statement by providing a hierarchical list of financial statements that satisfy this definition. Section 451(b)(4) provides in the case of a contract with multiple performance obligations that the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of determining the revenue allocation in the taxpayer's applicable financial statement. Section 451(b)(5) provides that, if the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, the group's financial statement shall be treated as the applicable financial statement of the taxpayer. Treas. Reg. § 1.451-3(b)(2)(i)(B) provides that the amount taken into account as applicable financial statement revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year. Treas. Reg. § 1.451-3(b)(2)(ii) allows taxpayers to elect to not reduce the applicable financial statement revenue by amounts that the taxpayer lacks an enforceable right. Also, the requirement to include in income at least the amount of the revenue included on the applicable financial statements is not required if the transaction has a different characterization for financial statement purposes than for tax purposes or if the transaction is eligible for a nonrecognition treatment under the federal income tax laws. Treas. Reg. § 1.451-3(f) and (g).

Under the regulations, two additional adjustments to the applicable financial statement revenue are made. First, if the transaction price, as defined in Treas. Reg. §1.451-3(a)(14), was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its applicable financial statement, then any applicable financial statement revenue attributable to such increase is disregarded. Treas. Reg. § 1.451-3(b)(2)(i)(C). Second, the revenue in the applicable financial statements is increased to the extent that the applicable financial statement revenue reflects a reduction for (1) amounts that are cost of goods sold or liabilities that are required to be accounted for under other provisions of the Code, such as § 461, including liabilities for allowances, rebates, chargebacks, rewards issued in credit card and other transactions and other reward programs, and refunds (for example, estimated returns based on historic practice), regardless of when any such amount is incurred (Liability Amounts); or (2) amounts anticipated to be in dispute or anticipated to be uncollectable. Treas. Reg. § 1.451-3(b)(2)(i)(A).

Treas. Reg. § 1.451-3(c) allows taxpayers to elect to utilize a limited cost offset method of accounting for inventory. A taxpayer that uses the applicable financial statement cost offset method determines the amount of gross income includible for a year prior to the year in which

ownership of inventory transfers to the customer by reducing the amount of revenue it would otherwise be required to include under the applicable financial statement revenue method by the cost of goods related to the item of inventory for the taxable year, the "cost of goods in progress offset." The net result of these adjustments is then required to be included in gross income for the year under the applicable financial statement revenue inclusion rule. The deferred revenue, that is, the revenue that was reduced by the cost of goods in progress offset for a taxable year prior to the taxable year that ownership of the item of inventory is transferred to the customer, is generally taken into account in the taxable year in which ownership of the item of inventory is transferred to the customer.

Page 1072:

After the third full paragraph, add:

Another interesting means of avoiding the receipt of an advanced payment that implicates the holding of Schlude was posited in Continuing Life Communities Thousand Oaks LLC et al. v. Commissioner, T.C. Memo 2022-31. In this case, the taxpayer operated a continuing care facility that provided housing and health-care services to seniors in need of assistance. Per the agreement between the taxpayer and its residents, Continuing Life received two main fees: (1) large deposits from residents (the "contribution amount") into a third-party managed master trust, which covered lifetime care for the residents; and (2) monthly service fees covering various costs, such as utilities. Because of the unique nature of the industry (i.e., providing lifetime care for residents), California law required that continuing care facilities hold the contribution amounts in third-party master trust accounts to ensure that continuing care facilities stay solvent. When a resident voluntarily left the facility or passed away, Continuing Life then became entitled to be paid by the third-party trust a portion of the remaining balance of the resident's contribution amount, with the amount tied to the resident's length of stay at the facility. Under its method of accounting, Continuing Life recognized revenue from the contributed amounts only at the time that it provided the associated long-term care to the resident that entitled it to payment from the trust. On these facts, the Tax Court held that Continuing Life did not recognize income at the time that the contributed amounts were placed into the third-party trust account as Continuing Life had no actual nor constructive receipt of those funds. The Tax Court then held that Continuing Life had a fixed and determinable right to income from the deposited amounts only as and when its long-term services were performed because the provision of lifelong care to the residents was a condition precedent to the taxpayer's right to receive any portion of the amounts that the resident placed into the third-party trust.

Page 1073:

Replace 3. LIMITED DEFERRAL FOR CERTAIN ADVANCE PAYMENTS with the following:

3. LIMITED DEFERRAL FOR CERTAIN ADVANCE PAYMENTS

After many years of litigation to establish the principle that prepaid income must be included in gross income in the year of receipt, the IRS carved out a significant exception to the general rule for certain advance receipts. In this regard, Rev. Proc. 2004–34, 2004–1 C.B. 991, allowed taxpayers in certain specified circumstances to elect to defer the inclusion of

some or all of an advance receipt until the taxable year following the year of receipt. In 2017, Congress amended § 451(c) to provide explicit statutory rules for the treatment of the receipt of advance payments by accrual method taxpayers. Section 451(c)(1)(A) provides, as a general rule, that an accrual method taxpayer must include an advance payment in gross income in the taxable year of receipt. However, § 451(c)(1)(B) permits a taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent the income is not included in revenue in the taxpayer's applicable financial statements in the year of receipt. Thus, § 451(c)(1)(B) generally codified Rev. Proc. 2004-34, 2004-1 C.B. 991, which had provided for a similar deferral period. If a taxpayer makes this election, then § 451(c)(2) provides that the election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives the consent of the IRS to revoke the election.

For purposes of § 451(c), an advance payment means any payment that meets the following three requirements: (1) the full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an applicable financial statement for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. I.R.C. § 451(c)(4)(A). Section 451(c)(4)(B) lists certain payments that are excluded from the definition of an advance payment and gives the IRS the authority to identify other payments to be excluded from the definition. The regulations provide a listing of items that are considered advance payments and items that are excluded from that designation. See Treas. Reg. § 1.451-8(a)(1). Section 451(c)(4)(C) provides a special definition of the term "receipt" for purposes of the definition of an advance payment, and § 451(c)(4)(D) states that rules similar to those for allocating the transaction price among performance obligations in § 451(b)(4) also apply for purposes of § 451(c).

Treas. Reg. § 1.451-8(a)(1)(ii)(H) provides that an advance payment does not include a payment received in a taxable year earlier than the taxable year preceding the taxable year of the contractual delivery date for a specified good unless the taxpayer elects to treat this payment as subject to the specified good deferral method. Thus, unless the deferral method is elected, the general rule would therefore be that the advance payment is immediately included in income. Treas. Reg. § 1.451-8(f) allows taxpayers the opportunity to elect the specified deferral method for specified goods. Thus, taxpayers have the option of including the advance payment in gross income under the full inclusion method or the deferral method, described more fully in the next paragraph. The regulations define the contractual delivery date as the month and year of delivery as specified in a written contract.

Under the specified deferral method, the regulations allow a limited cost offset for costs already incurred with respect to inventory that is the subject of the advance payment. Treas. Reg. § 1.451-8(e). When an advance payment is received with respect to a specified good that is inventory property of the recipient, Treas. Reg. § 1.451-8(e) provides the taxpayer with an ability to claim an offset for cost of goods in progress (cost offset) to reduce the amount of the advance payment that is included in income with the consequence that this cost offset allows taxpayers to reduce the amount of an advance payment that is required to be included in gross income in a year prior to the year in which ownership of the inventory is transferred to the customer. The amount of such reduction, or cost offset, is equal to the inventoriable costs incurred as of the end of the taxable year in which the advance payment is required to be included in gross income under the taxpayer's method of accounting for advance payments.

However, the cost of goods in progress offset cannot reduce the amount of the advance payment income inclusion below zero in any particular year. Any incurred costs subject to this limitation may be carried forward to determine the cost of goods in progress in subsequent taxable years.

When a taxpayer does not have an applicable financial statement, the taxpayer is allowed to defer recognition of an advance payment that has not been earned for one year. Treas. Reg. § 1.451-8(d)(3). The regulations provide that a payment is earned when the all events test is met, without regard to when the amount is received, and they provide further safe harbor calculations when a taxpayer is unable to determine the extent to which a payment is earned in the taxable year of receipt.

Page 1076:

PROBLEM SET 2

Replace Problem 5 and add the following additional problems 6 through 8:

5. (a) Tabitha has a dance studio and provides dance lessons. In Year 1, Tabitha receives an advance payment of $480 for a 1-year dance lesson contract commencing on that date and providing for up to 48 individual, 1-hour lessons. Tabitha provides eight lessons in Year 1 and another 35 lessons in Year 2. Tabitha takes into account 1/6 (or $80) of the payment as applicable financial statement revenue for Year 1, and 5/6 (or $400) of the payment as applicable financial statement revenue for Year 2.

(b) The same facts as in 5(a) except that Tabitha receives an advance payment of $960 for a 3-year contract under which Tabitha agrees to provide up to 96 lessons. Tabitha provides eight lessons in Year 1, 48 lessons in Year 2, and 40 lessons in Year 3. Tabitha takes into account 1/12 (or $80) of the payment as applicable financial statement revenue for Year 1, 1/2 (or $480) of the payment as applicable financial statement revenue for Year 2, and 5/12 (or $400) of the payment as applicable financial statement revenue for Year 3.

6. (a) In Year 1, ACME enters into a contract with a customer to manufacture and deliver equipment in Year 4, with a total contract price of $100x. ACME is required to capitalize the cost to produce the equipment under § 471 and § 263A as the equipment represents inventory property of ACME. On the same day, ACME receives a payment of $40x from the customer. For its applicable financial statements, ACME reports the revenue from this equipment only in the year of delivery, which is also the year in which ownership of the equipment will transfer from ACME to the customer. As of the end of Year 1, ACME has not incurred any cost to manufacture the equipment. During Year 2, ACME does not receive any additional payments on the contract and incurs $10x of costs to manufacture the goods. ACME properly capitalizes and allocates such costs to the manufactured good under § 471 and § 263A. How much must ACME accrue in income in which year?

(b) The same facts as in 6(a) except that, in addition in Year 3, ACME incurs costs of $35x to manufacture the goods but does not receive any additional payments from the customer. How much must ACME accrue in income in Year 3?

(c) The same facts as 6(b) except that for tax Year 3 ACME receives an additional advance payment of $60x. In Year 4, A incurs the remaining $10x to manufacture the goods and deliver the good to the customer. How much must ACME accrue in income in Year 3?

7. QuickServ enters into a 2-year service contract with a customer to install the customer's manufacturing equipment for $100,000. Throughout the term of the contract, the customer retains control of the equipment. QuickServ begins providing the installation services in the current year and completes the installation services in the following year. Under the contract, QuickServ bills the customer $55,000 in the current year when installation begins but does not have a fixed right to receive the remaining $45,000 until installation is complete and approved by the customer. However, if the customer were to terminate the contract prior to completion, QuickServ would have an enforceable right to payment for all services performed prior to the termination date. In its applicable financial statement, QuickServ reports $60,000 of applicable financial statement revenue for the current year and $40,000 of applicable financial statement revenue for its next year, in accordance with the services performed in each respective year. QuickServ is an accrual method taxpayer. How much must QuickServ accrue in income in the current year?

8. (a) QuickServ enters into a contract with a customer to provide 50 customized computers for $80,000. Under the contract, QuickServ can bill $80,000 after the customer accepts delivery of the computers. However, the contract provides that QuickServ has an enforceable right to be paid for work performed to date if the customer were to terminate the contract prior to delivery. QuickServ produces and ships all of the computers in Year 1. In Year 2, the customer accepts delivery of the computers and QuickServ bills the customer. In its applicable financial statements, QuickServ reports $80,000 of applicable financial statement revenue for Year 1. How much must QuickServ accrue in income in Year 1?

(b) Now assume that QuickServ's contract with its customer is a 4-year contract to provide services for a total of $100x. Under the contract, QuickServ bills and receives $25x for each year of the contract. Instead of the facts in 8(a) above, assume that if the customer were to terminate the contract prior to completion that QuickServ has an enforceable right to only the billed amounts. In its applicable financial statements, QuickServ reports $60x, $0, $20x, and $20x of applicable financial statement revenue from the contract for years 1 through 4, respectively. How should QuickServ accrue these amounts into income and in which year?

SECTION 3. ACCRUAL METHOD TAXPAYERS

page 1093

Problem Set 3, Line 7 of Problem 3:

Replace $800 **with** $300.

SECTION 5. CHANGES IN METHOD OF ACCOUNTING OR METHOD OF REPORTING

Page 1121:

Replace the Existing Detailed Analysis with this new DETAILED ANALYSIS

1. WHAT IS A "CHANGE IN ACCOUNTING METHOD?"

The adjustments required by § 446(e) and § 481(a) have important implications for the statute of limitations. Adjustments can be required to be taken into account in the year of change (or the applicable "spread period") even though those adjustments in effect relate to years that are otherwise barred by the statute of limitations. These adjustments occur only if the change constitutes a change in accounting method. If it is simply a change in the treatment of a particular item, or otherwise falls outside the definition of a method change, no adjustments are permissible in years that are barred by the statute of limitations. See, e.g., Witte v. Commissioner, 513 F.2d 391 (D.C. Cir.1975). In practice, the change in accounting method concept is often an elusive concept. As Judge Tannenwald observed in Underhill v. Commissioner, 45 T.C. 489, 496 (1966), the concept of an accounting method change as "certain chameleon qualities."

Treas. Reg. § 1.446–1(e)(2)(ii)(a) provides the general rule that a change in the method of accounting includes "a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan." A "material item" is defined as "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction." Thus, in the case of the treatment of material items, it is the timing of the inclusion or the deduction that is determinative, not the amount. A change involving the method of valuing inventories has been held to be a change in accounting method. See Fruehauf Corp. v. Commissioner, 356 F.2d 975 (6th Cir.1966) (change in valuation of assets from historical value to lower of cost or market). However, the courts have been divided on the question of whether an ad hoc methodology may have sufficient consistency to represent a method of accounting. In this regard, in Potter v. Commissioner, 44 T.C. 159 (1965) , the court held that the taxpayer's ad hoc practice of excluding items from income lacked sufficient "consistency" and "regularity" to constitute an accounting method. But, in Primo Pants Co. v. Commissioner, 78 T.C. 705 (1982), the Tax Court held that arbitrary write-down of the value of ending inventory represented an accounting method, albeit the method was an impermissible method. Treas. Reg. § 1.446-1(e)(2)(iii) Ex. 7 posits a situation where an impermissible 20% write-down of ending inventory was an accounting method.

Treas. Reg. § 1.446–1(e)(2)(ii)(b) clarifies several definitional limits or exceptions to what constitutes a change in method of accounting under the above general rule. A change in method does not include the correction of mathematical errors or errors in the computation of tax liability. See Capital One Financial Corp. & Subsidiaries v. Commissioner, 130 T.C. 147, 166 (2008), aff'd 659 F.3d 316 (4th Cir. 2011). Nor does it include posting errors. See North Carolina Granite Corp. v. Commissioner, 43 T.C. 149 (1964) (the corporate tax department's misunderstanding of financial accounting data that led to the erroneous transposition of the data in the corporate tax return was a posting error); Wayne Bolt & Nut Co. v. Commissioner, 93 T.C. 500 (1989) (defining a "posting error" as an error in "the act of transferring an original entry to a ledger"). Errors in the computation of a tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit) are

also excluded from the definition. See e.g., North Carolina Granite Corp v. Commissioner, 43 T.C. 149 (1964) (correction in method of computing percentage depletion is not a change in accounting method).

Courts have found a correction of an error rather than a method change even when the correction impacted the timing of income and deductions. See Underhill v. Commissioner, 45 T.C. 489 (1966); Gimbel Brothers, Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1967); Standard Oil v. Commissioner, 77 T.C. 349 (1981). In close cases, distinguishing corrections of errors from changes in methods appears to be guided by policy and pragmatism. In this regard, when the avoidance of finding a method change would allow the taxpayer a windfall and preclude the IRS from making compensating corrections to closed tax periods under § 481, courts have been more likely to find that a prior practice represented an accounting method and not simply an error. See Huffman v. Commissioner, 126 T.C. 322, 342 (2006), aff'd 518 F.3d 357 (6th Cir. 2008) ("If the adjustments result from the correction of mathematical errors, then the unrealized gains eliminated by the decreases in reserves simply escape taxation. On the other hand, if those decreases in LIFO reserves result from changes in the members' methods of accounting, then respondent's section 481 adjustments will capture the unrealized gain eliminated by the decreases in reserves."). Courts have also considered whether the taxpayer had made a calculated, tax planning decision when reporting the items the taxpayer seeks to correct, or whether the position had been taken inadvertently. See Korn Indus., Inc. v. United States, 532 F.2d 1352, 1356 (Ct. Cl. 1976) ("omission of the 3 items was inadvertent. . . It was most assuredly an error analogous to a mathematical or posting error.").

Discontinuing an accounting method that results in recurring improper deductions may be a change of accounting method. Copy Data, Inc. v. Commissioner, 91 T.C. 26 (1988) (discontinuance of improper "reserve" for future warranty expenses was a change of accounting resulting in a § 481 adjustment); see also Rev. Rul. 90–38, 1990–1 C.B. 57 (erroneous treatment of a material item on two or more consecutively filed tax returns is a "method of accounting").

The change from immediate expensing of an item to capitalization plus depreciation is treated as a change in the method of accounting. Treas. Regs. §§ 1.167(e)–1(a) and Treas. Reg. § 1.446–1(e)(2)(ii)(a) & (d) provide that any change in depreciation (other than a change in the useful life of an asset depreciated solely under § 167, without reference to § 168) is generally treated as a change of an accounting method. A change from an impermissible method of accounting to a permissible method of accounting requires the consent of the IRS. In Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3d Cir.1961), an accrual method taxpayer could not change its method of accounting for insurance dividends without the Commissioner's consent, even though the taxpayer was accruing dividends for the wrong years and its new method of accounting would have treated the dividends properly. See also Rev. Rul. 75–56, 1975–1 C.B. 98 (taxpayer improperly capitalized taxes and carrying charges without making an election under § 266; held, taxpayer could not file amended returns for open years taking deductions for the expenditures as that constituted a change in accounting method for those years for which no consent had been received). In Cargill Inc. v. United States, 91 F. Supp. 2d 1293 (D. Minn. 2000), the improper treatment of a taxpayer's relationship to property as a lessee and not as the true owner of the property was an improper accounting method because the timing of deductions was involved even though the method of accounting resulted in a loss of a non-timing item (the loss of investment tax credits).

Even when a change in a method of accounting is found to exist, the change in method must impact timing before a § 481 adjustment can be made. To determine whether the

taxpayer's treatment impacts timing, courts have applied the lifetime income test, under which they examine whether the taxpayer's treatment would have allowed the taxpayer to permanently avoid reporting the income over the taxpayer's lifetime. If the taxpayer's treatment only postpones the reporting of the income, the court then considers whether a change to the taxpayer's treatment would result in no more or less income to the taxpayer over the course of its lifetime. If the taxpayer's lifetime income is not affected by the impermissible method, then a § 481 adjustment is not required or permitted. This line of reasoning was illustrated in Hyatt v. Commissioner, T.C. Memo 2023-122. In that case, Hyatt had excluded receipts it received under its customer loyalty program and did not deduct payments it made to member hotels when customers redeemed their loyalty points. The Tax Court held that this treatment was improper, finding that Hyatt should have instead reported the funds it received from member hotels for its loyalty program as income and should have claimed deductions when the customers redeemed their loyalty points and Hyatt paid out funds to its member hotels for those customer loyalty stays. The program had existed since 1987, so the question then became whether and to what extent a § 481 adjustment should be imposed given the longstanding mistaken accounting practice employed by Hyatt. Hyatt argued that it excluded both the income and the deductions and so "timing issues were not implicated" over its lifetime by its improper approach. The Tax Court agreed with Hyatt and found that Hyatt's consistent treatment of incorrectly excluding loyalty program income from its revenue and not claiming deductions from its customer's loyalty program redemptions was not a method of accounting that impacted timing; as a result, the IRS's imposition of a § 481 adjustment was not allowed.

Section 446(d) makes clear that a taxpayer that is engaged in more than one trade or business can utilize different methods of accounting for each trade or business. The regulations confirm that the taxpayer can elect different permissible methods of accounting for each trade or business, but the taxpayer must then apply its chosen method for each trade or business consistently thereafter. See Treas. Reg. § 1.446-1(d)(1). However, Treas. Reg. § 1.446-1(d)(2) provides that a taxpayer cannot claim that it has a separate trade or business unless the taxpayer maintains a complete set of books and records for each trade or business, and this requirement was upheld in Herbert C. Haynes, Inc. v. Commissioner, 88 T.C. Memo. 2004-185. Difficult factual questions exist in terms of distinguishing between an expansion of a trade or business and the commencement of a new trade or business.

2. TREATMENT OF YEAR OF CHANGE ADJUSTMENTS

Section 446(e) provides the IRS with significant discretion in deciding whether to grant requests to change accounting methods. The IRS has prescribed administrative procedures under which taxpayers will be permitted to change their method of accounting along with the terms and conditions necessary to obtain the Commissioner's consent. The terms and conditions that may be prescribed by the Commissioner include the need to make any adjustment as required under § 481(a) as a precondition for the Commissioner's consent to prevent amounts from being duplicated or omitted as a result of the transition to a new method of accounting. In this regard, § 481(a) requires that the taxpayer's taxable income for any year of change in an accounting method must take into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. Thus, if the change from one method to a different method would cause a duplication of income or deductions, § 481(a) requires that appropriate adjustments must be made to true-up the transition. The motivation behind the enactment of § 481 was to allow a change in the taxpayer's accounting method so as to clearly reflect the

annual income for post-change years but to effect the change only in a manner that would not permit the taxpayer to enjoy double deductions or suffer double inclusions in income.

The statute speaks in terms of requiring the § 481(a) adjustment to be made in the year of change, and this is the result when the adjustment is made as an IRS-initiated adjustment. However, under § 481(c), the taxpayer and the IRS can agree to attribute the adjustment to other taxable years. See Rev. Proc. 2002–18, 2002–1 C.B. 678. In addition, § 481(b) provides special rules that allow for a limited allocation of the adjustment to other years where it is in excess of $3,000. Under this authority, the IRS has provided mechanisms for a more favorable spreading of the adjustment over several years when the adjustment is made as a result of a taxpayer-initiated change. In this regard, Rev. Proc. 2015–13, 2015–5 I.R.B. 419, deals with situations in which the taxpayer has requested a change of accounting method. In general, a positive adjustment (increasing taxable income) will be taken into account over four years, and a negative adjustment (decreasing taxable income) will be taken into account in the year of the change. Moreover, an IRS appellate officer is authorized to agree to a longer period of time in which to include the § 481 adjustment. See Rev. Proc. 2002-18, Sec. 6, 2002-1 C.B. 678. The opportunity to spread the tax impact of a § 481 adjustment that results in an increase in taxable income over several years is designed to motivate taxpayers to affirmatively initiate requests to correct improper accounting methods instead of waiting for an IRS assessment.

The IRS may compel a retroactive change from an improper method to a proper method for years not barred by the statute of limitations. Ralston Development Corp. v. United States, 937 F.2d 510 (10th Cir. 1991). In contrast, § 481 does not authorize taxpayers to make retroactive changes in accounting methods, regardless of whether or not the change is from a permissible to impermissible method. See, for example, O. Liquidating v. Commissioner, 292 F.2d 225, 230-31 (3rd Cir. 1961). Treas. Reg. § 1.446-1(e)(2)(i) asserts that any taxpayer-initiated retroactive change in method of accounting requires the Commissioner's consent. Conversely, the Commissioner's authority to initiate a change in a taxpayer's accounting method is constrained, for example, when the taxpayer's method clearly reflects income. See Treas. Reg. §1.446-1(c)(2)(ii). Thus, if a taxpayer demonstrates that its method of accounting does clearly reflect income, the Commissioner cannot require the taxpayer to change its method even if the Commissioner's method more clearly reflects income. See Honeywell, Inc. v. Commissioner, T.C. Memo. 1992-453; Molsen v. Commissioner, 85 T.C. 485, 498 (1985); Joyner Family Ltd. Partnership v. Commissioner, T.C. Memo. 2019-159.

3. NEED FOR COMMISSIONER'S CONSENT

Significant controversy exists on whether the IRS may withhold its consent to allow a taxpayer to change from an impermissible method to a correct method. From a policy perspective, one would expect that the government should not object to a taxpayer request to change from an impermissible method to a permissible method as long as the taxpayer would take into account the required § 481 adjustment. However, as *Diebold* has held, the taxpayer must obtain the Commissioner's consent to make an accounting method change, and the courts have not been entirely consistent on whether the Commissioner's failure to consent would represent an abuse of discretion, as the *Diebold* case so illustrates. Other cases are to a similar effect. In Cargill, Inc. v. United States, 91 F. Supp. 2d 1293 (D. Minn. 2000), a taxpayer incorrectly treated a transaction as a lease instead of a purchase of property. All years were open for potential amendment, and the taxpayer was willing to make all corrections to all relevant years to properly treat the property as having been purchased and not leased. If the taxpayer had been able to treat the property as owned by the taxpayer from inception, the taxpayer would have been entitled to claim additional investment tax credits under the law that existed at the time of the property's original purchase. The National Office had issued a

technical advice memorandum indicating that the taxpayer's original treatment of the transaction as a lease was incorrect as a matter of law. However, even so, the government refused to give its consent to allow the taxpayer to make a retroactive change in the taxpayer's earlier treatment of the transaction, and the district court held that the taxpayer's failure to obtain the Commissioner's consent prevented the taxpayer from changing its earlier accounting method on a retroactive basis. The case law has been more supportive of the idea that the Commissioner has abused its discretion where the Commissioner has refused to allow a taxpayer to prospectively change from an impermissible method to a permissible method when the taxpayer has agreed to make all required § 481(a) adjustments.

Page 1122:

At the end of the page, add the following new Problem Set.

PROBLEM SET 5

1. Sally has operated a carpet cleaning business as a sole proprietorship since 2000. Sally reports her income from the carpet cleaning business using the cash method. In 2021, Sally opened a clothing store. Sally reported her 2021 income from the clothing store using the accrual method. Has Sally changed her method of accounting within the meaning of I.R.C. § 446(e)? See I.R.C. § 446(d).

2. Utility Co. (an accrual method taxpayer) includes customer deposits in income when received. This has been Utility Co.'s practice since inception. Utility Co.'s customers are not required to purchase electricity. The deposits will either be applied to the customer's bill or refunded at some point in the future. Utility Co. hires a new tax director who has greater knowledge of the law. With this greater understanding of the actual law, Utility Co. understands that its prior reporting position is inconsistent (and less favorable) than the Supreme Court's decision in *Indianapolis Power*, which is discussed in Chapter 5, Section 4 of this casebook. Utility Co. wants to change its practice to conform to that Supreme Court decision. Will this change represent a change in a method of accounting? See Treas. Reg. § 1.446-1(e)(2)(ii)(a).

3. Curly Howard has received interest income of $1,000 each year for the past five years. Curly erroneously believed that this interest was received with respect to a municipal bond and that it was tax-exempt, and so he failed to report it. Curly Howard used a tax advisor to help him with his tax filing obligations, and this tax advisor had greater knowledge of the law. With this greater understanding, Curly included the interest as taxable income in the current year. Does this change from prior practice represent a change in accounting method with respect to an item?

4. ACME (an accrual method taxpayer) instituted a vacation plan for employees in Year 1. Since then, ACME has consistently deducted the vacation pay in the year paid because its employees did not have a vested right to the vacation pay. In Year 20, ACME switches to a vested vacation pay plan and begins deducting the vacation pay in the year in which the expense accrues. Is this a change in an accounting method? See Treas. Reg. § 1.446-1(e)(2)(iii), Ex. 3.

5. (a) ACME purchased a factory and its component parts for $5 million. ACME classified the factory as non-residential real property and depreciated it under the straight-line method using a mid-month convention and 39-year recovery period. Three years later, ACME was approached by a tax accounting firm that wanted to conduct a cost segregation study. After further analysis, it was determined that $800,000 of the acquisition cost should have been allocated to items of § 1245 property with the consequence that the correct treatment of the $800,000 amount should have resulted in faster depreciation and potentially immediate expensing by reason of I.R.C. § 168(k). Will this change represent a change in a method of accounting?

   (b) Instead of the facts in 5(a), now assume that ACME purchased equipment for use in its trade or business and improperly treated the equipment as inventory, thus failing to take depreciation deductions on the equipment at any point in the last four years. After replacing its inexperienced staff with more knowledgeable personnel, ACME was advised that it should have claimed depreciation in prior periods. Does ACME's effort to correct its prior period reporting represent a change in accounting method that requires the Commissioner's consent? See Treas. Reg. § 1.446-1(e)(2)(ii)(d)(2).

   (c) Instead of the facts in 5(b) above, assume that ACME properly placed some of its equipment into service that had been held in inventory for sale to customers in a prior year. However, in the current year, ACME takes the property that was formerly held as inventory and commences to use that property as depreciable property used in the conduct of its own trade or business. ACME would like to start depreciation on the equipment in the year it is taken out of inventory and placed in service. Is this a change in accounting method that requires the Commissioner's consent?

6. ACME is an accrual method taxpayer. Its personnel had engaged in a practice of deferring recognition of randomly selected customer accounts receivable notwithstanding that the all events test had been met. Upon discovery of this practice, the responsible person was fired, and ACME would like to commence reporting all of its accounts receivable in a manner consistent with the all events test. Is this a change in accounting method that requires the Commissioner's consent?

7. Taxpayer uses the cash method of accounting but marks the box on the tax return that indicates that the Taxpayer has elected the accrual method of accounting. Is the actual use of the cash method of accounting when the tax return indicates that the accrual method has been elected a change in accounting method that requires Commissioner consent?

8. Taxpayer utilizes a permissible method for inventory in Year 1 pursuant to which the taxpayer capitalizes inventory. In Year 2, the company assigns a new person to handle the inventory function and that person immediately expenses purchased inventory instead of capitalizing it. This is an incorrect practice, but it is continued through Year 5 at which point that person is fired. The taxpayer wants to return to using its original permissible method in Year 6 and to stop using the impermissible method that was utilized in Year 2 through Year 5. Is the change back to the original method a change in accounting method?

9. Taxpayer desires to change from the cash method to the accrual method of accounting. As of the end of the prior year, the Taxpayer has $80,000 of accounts receivable that have not

been reported as income and $30,000 of accounts payable that have not been deducted. What is the taxpayer's required §481 adjustment?

10. Curly Howard has been deducting business expenses prior to the time provided in I.R.C. § 461(h). As of the end of the prior year, Curly Howard has $12,000 that has been deducted in advance of economic performance and thus in advance of the period in which I.R.C. § 461(h) would have allowed for such a deduction. Commencing with the current period, the taxpayer would like to commence an accounting method that will comply with I.R.C. § 461(h). What is the taxpayer's I.R.C. § 481 adjustment that will be required as a precondition for the Commissioner's consent to authorize the taxpayer to commence utilizing a permissible method?

CHAPTER 31

DEFERRED PAYMENT SALES

SECTION 1. NONSTATUTORY DEFERED REPORTING OF GAINS

Page 1207: Replace the bracketed introductory paragraph to Burnett v. Logan with the following slightly revised bracketed introductory paragraph:

[The taxpayer had owned stock in an iron company that held a supply contract entitling it to an annual share of iron ore from a certain mine. In 1916, Mrs. Logan and the other stockholders sold their stock to Youngstown Sheet & Tube Company. For the shares so acquired, the Youngstown Company paid the holders $2,200,000 in money, and agreed to pay annually thereafter for distribution among them 60 cents for each ton of ore obtained by the Youngstown Company from the mine under the supply contract. Mrs. Logan owned 250 shares out of the total 4,000 shares that were sold, so Mrs. Logan was to receive her proportionate share of $2.2 million of cash paid at closing, which equaled $137,500 (i.e., 250/4000 x $2,200,000). Mrs. Logan then became entitled to the same fraction of any annual payment thereafter made under the contingent payment obligation. The IRS had determined that the fair market value of this contingent payment right for all shareholders was equal to $1,942,111.46 in total, and under the IRS methodology Mrs. Logan's contingent payment right represented a present value of $121,389.97. Under the tax law at the time, the basis of the stock sold by the taxpayer for purposes of computing any gain on the sale was the stock's March 1, 1913, value. The Board of Tax Appeals accepted that Mrs. Logan's basis in her stock was $179,089.80 at the time of her sale in 1916. As of the end of 1920, Mrs. Logan had received $35,589.50 of contingent payments with respect to her interest and thus had received a total of $173,089.50 as of the time of the litigation ($137,500 of cash at the time of the 1916 closing plus $35,589.50 of the contingent payments in subsequent years). The taxpayer's mother had similarly sold her stock in 1916 and, on her death in 1917, left Mrs. Logan with a portion of her interest in the annual payments to be made by Youngstown Company. This bequest had been valued at $277,164.50 for estate tax purposes in 1917, and this amount became the tax basis for Mrs. Logan for her inherited interest. Mrs. Logan had received $31,767.50 of payments through the end of 1920 with respect to this inherited interest.]

PART IX

TAX MOTIVATED TRANSACTIONS

CHAPTER 34

THE ROLE OF DEBT IN PROPERTY TRANSACTIONS

SECTION 1. ACQUISITIONN AND DISPOSITION OF PROPERTY SUBJECT TO DEBT

A. NONRECOURSE DEBT

Page 1286:

After the last paragraph, add:

3. RECOUSE VERSUS NONRECOURSE DEBT CHARATERIZATION

Even if a debt instrument purports to be recourse, the effect of state law must be scrutinized to determine whether or not the debt is in fact nonrecourse debt. In Duffy v. Commissioner, T.C. Memo. 2020-108, the Tax Court found that Oregon's anti-deficiency statute foreclosed the right of a holder of a a debt instrument on residential property from claiming a remedy other than through an administrative foreclosure, and based upon those state law restrictions the Tax Court held that the debt was nonrecourse debt as holder could

only seek relief from the underlying collateral. A similar result was reached in Simonsen v. Commissioner, 150 T.C. 201 (2018), which involved a debt instrument secured by residential real property that implicated California's anti-deficiency statute. The Tax Court in *Simonsen* found the debt to be nonrecourse debt given that the state law restrictions on enforcement effectively prevented the holder from seeking relief except from the underlying collateral. Where the creditor was not prevented from seeking a remedy for any unsettled deficiency after the sale of the real property, then the debt is considered to be recourse debt. See Breland v. Commissioner, T.C. Memo. 2019-59.

CHAPTER 35

STATUTORY LIMITATIONS ON LEVERAGED TAX SHELTERS

Page 1344:

At the end of the chapter, add:

SECTION 3. EXCESS BUSINESS LOSSES

Dissatisfied with the protections afforded by §§ 465 and 469, Congress enacted § 461(*l*) as a temporary provision that would apply for tax years beginning after December 31, 2020, and ending before January 1, 2029. Section 461(*l*) provides that in the case of a noncorporate taxpayer any "excess business loss" for the taxable year is not allowed to be claimed by the taxpayer in that particular year. An "excess business loss" is defined as the amount by which a noncorporate taxpayer's aggregate trade or business deductions exceed the aggregate gross income from such trades or businesses, plus $250,000 ($500,000 for joint filers). The effect of § 461(*l*) appears to be to expand the passive activity loss restriction to active businesses that would not have been subject to the restrictions of § 469. However, any disallowed excess business loss is then allowed to be carried forward and claimed as a net operating loss *for the next taxable year* for purposes of calculating the net operating loss carryover under § 172(b) for subsequent taxable years. I.R.C. § 461(*l*)(2). Thus, the effect of § 461(*l*) appears to be that any excess business loss is simply deferred and allowed to be utilized in the following year, resulting in only a one-year deferral. Furthermore, § 461(*l*) only applies after the application of the passive loss rules of § 469. I.R.C. § 461(*l*)(6).

PART X

THE TAXABLE UNIT

CHAPTER 38

TAXATION OF FAMILIES

SECTION 4. GRANTOR TRUST RULES

Page 1441:

At the end of the carryover paragraph, replace the last sentence with the following:

Under § 685, the income of the trust is taxed to the trust at the rates prescribed in § 1(e). Under § 67(e), the adjusted gross income of an estate or trust generally is computed in the same manner as an individual. However, the regulations clarify that the disallowance provisions of § 67(g) do not apply to trusts, with the result that the deductibility of investment-related and tax-related expenses do not prevent the allowance of those deductions for purposes of computing the trust's taxable income. Treas. Reg. § 1.67-4(a)(1)(ii). Once the trust bears tax on the remaining amount, no income is recognized by the beneficiary as a result of a distribution.