Recent Developments in Federal Income Taxation

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas

State Bar of Texas Tax Section
First Wednesday Tax Update
September 1, 2021

CLE Number for Today's Webcast:
174132413

Final Regulations: Simplifying Provisions Enacted by TCJA
T.D. 9942, 86 F.R. 254 (1/5/21)
Outline: item A.1, page 2

- TCJA: enacted several simplifying provisions that are available to a business if the business's average annual gross receipts, measured over the three prior years, do not exceed $25 million. These include:
  1. Ability of C corporations or partnerships with a C corporation as a partner to use the cash method of accounting (§ 448(b)(3))
  2. Ability to use a method of accounting for inventories that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories (§ 471(c)(1)),
  3. Ability to be excluded from applying the uniform capitalization rules of § 263A (§ 263A(i))
  4. The small construction contract exception that permits certain taxpayers not to use the percentage-of-completion method of accounting for certain construction contracts (§ 460(e)(1)(B)), and
  5. Ability to be excluded from the § 163(j) limit on deducting business interest (§ 163(j)(3))
- Final regulations issued January 2021 address 1-4 above.

3

Final Regulations: Simplifying Provisions Enacted by TCJA
T.D. 9942, 86 F.R. 254 (1/5/21)
Outline: item A.1, page 2

- Absent relief, many small businesses are ineligible for these simplifying provisions enacted as part of the 2017 TCJA because the businesses meet the definition of a "tax shelter" that is prohibited from using the cash method of accounting.
- Specifically, a business is a "syndicate" (§ 1256(e)(3)(B)) and therefore a tax shelter prohibited from using the cash method "if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs."
- The final regulations permit a taxpayer to make an <u>annual</u> election to use the allocated taxable income or loss of the *immediately preceding* taxable year (rather than the current year) to determine whether the taxpayer is a syndicate for the current taxable year.
- This helps a normally profitable business that experiences an unforeseen loss from being treated as a syndicate, but would not help a business with consistent losses.

4

Final Regulations: Year of Inclusion and Advance Payments
T.D. 9941, 86 F.R. 810 (1/6/21)
Outline: item D.1, page 3

- 2017 TCJA amended Code § 451 to enact rules on revenue recognition by accrual method taxpayers
  - No later than recognized in "applicable financial statement"
  - Codification of deferral method for advance payments
- Proposed regulations issued September 2019 (items D.1.b-c, pages 4-5).
- Final regulations issued January 2021 (item D.1.d, page 5).

5

Deduction of Costs Paid with PPP Loan Proceeds
Outline: item D.1, page 6

- Federally-backed loans made to businesses under the Paycheck Protection Program (PPP) must be used to fund payroll and certain other expenses.
- Businesses that use the loans in this manner can apply to have the loans forgiven.
- CARES Act § 1106(i) provides that any income arising from having PPP loans forgiven is excluded from gross income.
- Issue: can a business that has a PPP loan forgiven deduct expenses funded with the loan proceeds?
- Notice 2020-32 (5/1/20): No. Section 265 precludes a deduction.
  - Section 265(a)(1): disallows a deduction for "any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest wholly exempt from the taxes imposed by this subtitle."

6

Deduction of Costs Paid with PPP Loan Proceeds
Outline: item D.1.c, page 8

- Taxpayer Certainty and Disaster Tax Relief Act (12/27/20):
  - Legislatively changes the result in Notice 2020-32
    - "no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income [of the forgiveness of a PPP loan]"
  - In the case of partnerships and subchapter S corporations:
    - Any amount forgiven is treated as tax-exempt income
    - This has the effect of providing a basis increase to the partners or shareholders.
  - Applies retroactively as if included in the CARES Act.
- Weird aspect? See Rev. Proc. 2021-20 (4/22/21), item d, page 8 (can deduct 2020 expenses on 2021 return).

7

100% Deduction of Restaurant Business Meals
Outline: item D.2, page 9

- Taxpayer Certainty and Disaster Tax Relief Act of 2020.
  - Part of the 2021 Consolidated Appropriations Act, Pub. L. No. 116-260, enacted on December 27, 2020.
- Amends § 274(n)(2)
  - Provides exceptions to normal 50 percent limitation on deducting business meals
  - Legislation adds a new exception:
    - Can deduct 100% of the cost of food or beverages provided by a restaurant paid or incurred before January 1, 2023
    - Applies to amounts paid or incurred after December 31, 2020.
- Notice 2021-25, 2021-17 I.R.B. 1118 (4/8/21).
  - A restaurant is "a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises."
  - Your favorite food truck and street vendors are "restaurants," but Whole Foods is not. Caterers that don't operate restaurants? Who knows?

8

Consolidated Appropriations Act 2021 (Dec. 2020) Depreciation Changes
Outline: items E.1, page 9

- Real property trades or businesses that elect out of the interest limitation of § 163(j) and must use ADS for nonresidential real property, residential rental property, and qualified improvement property use a 30-year recovery period (not 40 years)
  - Previously, this rule applied only to property placed in service after 2017.
  - The rule now applies to property placed in service before 2018 as well.
  - This is retroactive to tax years beginning after 12/31/17.
- Rev. Proc. 2021-28, 2021-27 I.R.B. 5 (6/17/21). Provides guidance to those affected by the retroactive change described above to the recovery period under the ADS for residential rental property placed in service before January 1, 2018.

9

Notice 2021-49, 2021-34 I.R.B. 316 (8/4/21) Employee Retention Credit
Outline: item F.1, page 10

- This notice provides guidance on the employee retention credit first enacted in the CARES Act (2020), modified by the Taxpayer Certainty and Disaster Tax Relief Act (2020), and extended by the American Rescue Plan (2021).
- The notice provides guidance on several important issues, including:
  - The definition of a "full-time employee" for purposes of the employee retention credit.
  - Whether cash tips can be treated as qualified wages.
  - Whether wages paid to an employee who owns more than 50 percent (majority owner) or to the spouse of a majority owner may be treated as qualified wages.

10

Hussey v. Commissioner, 156 T.C. No. 12 (6/24/21)
Outline: item H.1, page 11

- The taxpayer sold 15 investment properties in short sales in 2012.
  - The lending bank cancelled $754,054 of debt and issued 15 Forms 1099-C reflecting cancellation of debt income.
  - Taxpayer's amended 2012 return excluded $685,281 of COD from income.
  - Taxpayer and the government agreed the debt was qualified real property business indebtedness (QRPBI) and was excludable under § 108(a)(1)(D).
  - Section 108(c)(1) requires a reduction in basis of depreciable real property in the amount of the excluded QRPBI.
- Issue: did the taxpayer have to reduce the basis of the depreciable real property sold in 2012, or the basis of such property still held in 2013?
- Held: the basis of the property sold in 2012. Although § 1017(a) generally requires reduction in the basis of property held in the subsequent year, an exception in § 1017(b)(3)(F)(iii) requires reduction of the basis of property sold before the subsequent year if that property is taken into account in applying the § 108(c)(2)(B) limit on the exclusion of QRPBI.

11

Notice 2021-42, 2021-29 I.R.B. 19 (6/30/21)
Outline: item A.1.a, page 12

- Pursuant to Notice 2020-46, 2020-27 I.R.B. 7 (6/11/20), under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments the employer makes to charitable organizations.
- If an employer makes cash payments pursuant to such a program to charitable organizations for the relief of victims of the COVID-19 pandemic, the IRS will not assert that:
  1. The payments constitute gross income or wages of the employees;
  2. The employees, by making the election, have constructively received gross income or wages.
- The payments are deductible by the employer either as a charitable contribution (§ 170) or as a business deduction (§ 162).
- Employees who make the election cannot deduct the forgone leave as a charitable contribution.
- Originally, this applied to cash payments made before January 1, 2021, but is now extended to payments made before January 1, 2022.

12

American Rescue Plan 2021 (Mar. 2021)
Child Tax Credit of § 24
Outline: item D.1, page 13

- The 2021 American Rescue Plan:
  - For taxable years beginning in 2021:
    - Increases the child tax credit amount to $3,600 in the case of a qualifying child younger than 6 at the end of 2021, and to $3,000 in the case of other qualifying children.
    - Enlarges the definition of a qualifying child to include children who have not attained the age of 18 by the end of 2021 (rather than 17, as under the usual child tax credit rules).
    - Reduces the phase-out thresholds for the increased ($3,600/$3,000) CTC and preserves the existing $2,000 CTC for those with higher incomes.
    - Provides for advance, monthly payment of 50 percent of a taxpayer's expected 2021 CTC with reconciliation on 2021 returns.
- IR-2021-130 (6/22/21): update portal on IRS website.

13

Summa Holdings, Inc. v. Commissioner,
848 F.3d 779 (6th Cir. 2/16/17)
Outline: item H.1.a, page 15

- Members of the Benenson family owned C corporation stock.
  - Two family members established Roth IRAs, which (through a holding company) held the shares of a domestic international sales corporation (DISC).
  - The C corporation paid $5.2 million in deductible commissions to the DISC, which excluded them from income. The DISC paid dividends to the Roth IRAs, triggering UBIT.
  - IRS asserted that the structure impermissibly avoided the contribution limits for Roth IRAs, and that the substance-over-form doctrine required recharacterization of the corporation's commission payments as nondeductible dividends.
- <u>Held</u>: IRS cannot use the substance-over-form doctrine to recharacterize the C corporation's commission payments.

14

Benenson v. Commissioner,
887 F.3d 511 (1st Cir. 4/6/18)
910 F.3d 690 (2d Cir. 12/14/18)
Outline: item H.1.b-c, pages 16-17

- Shareholders in the *Summa Holdings* case appealed the Tax Court's decision to the First and Second Circuits.
  - The Sixth Circuit ruled on the tax consequences <u>to the C corporation</u> that operated the family business.
  - These shareholders resided in the First and Second Circuits.
- The First and Second Circuits followed the Sixth Circuit in rejecting application of the substance over form doctrine.
- <u>Held</u>: the shareholders are <u>not</u> treated as receiving a deemed distribution and as making an excess Roth IRA contribution.

15

Mazzei v. Commissioner,
998 F.3d 1041 (9th Cir. 6/2/21)
Outline: item H.1.d, page 17

- Members of the Mazzei family owned S corporation stock.
  - Two family members established Roth IRAs, which bought shares in a newly-formed foreign sales corporation (FSC) for $500. [FSCs since repealed.]
  - The S corporation paid over $500k in deductible commissions to the FSC during years 1998 to 2002. Roth IRAs grew and paid no tax on dividends from FSC.
  - IRS asserted that the structure impermissibly avoided the contribution limits for Roth IRAs.
- <u>Held</u>: Tax Court erred in concluding Roth IRAs were not the true owners of FSC stock. Tax Court's decision reversed; IRS position rejected.

16

CARES Act Changes to Excess Business Losses and NOLs
Outline: item A.1, page 19

- 2017 TCJA changes to rules for net operating losses:
  - "Excess business losses" of noncorporate taxpayers disallowed
    - "Excess business loss" is amount by which taxpayer's aggregate trade or business deductions exceed aggregate gross income from those trades or businesses, plus $250,000 ($500,000 for joint filers), adjusted for inflation after 2018.
  - NOLS not carried back (only forward); capped at 80% of taxable income.
  - NOLs do not expire

17

CARES Act Changes to Excess Business Losses and NOLs
Outline: item A.1, page 19

- The CARES Act:
  - Suspends the disallowance of "excess business losses" for TY beginning before 2021
  - NOLS arising in 2018, 2019, and 2020:
    - May be carried <u>back</u> to each of the five preceding taxable years, then forward indefinitely.
  - For TY beginning before January 1, 2021 (generally, 2019 and 2020), the 80 percent taxable income limitation on NOL carryforwards does not apply.
  - IRS guidance on NOLS and filing for quick carryback on Forms 1045 and 1139:
    - Rev. Proc. 2020-24, 2020-18 I.R.B. 750 (4/10/20).
    - Notice 2020-26, 2020-18 I.R.B. 744 (4/10/2020)
    - FAQ on IRS website

18

CARES Act Changes to Excess Business Losses and NOLs
Outline: item A.1.a, page 19

- Notice 2021-8, 2021-6 I.R.B. 826 (1/19/21):
  - IRS has waived penalties for underpayment of estimated taxes for 2019 attributable solely to the CARES Act change that suspended the disallowance of excess business losses.
    - Rationale: taxpayers with an excess business loss in 2018 may have anticipated having an NOL carryforward to 2019 and therefore reduced estimated tax payments for 2019.
    - Taxpayers who did not deduct a 2018 EBL must amend their 2018 returns to take the loss into account.
  - IRS has not waived penalties for underpayment of estimated taxes for 2019 attributable to the CARES Act change that permits NOLs to be carried back to prior years.
    - Rationale: taxpayers with a 2018 NOL can waive the carryback and instead carry the NOL forward to 2019.

19

Garcia v. Commissioner, 157 T.C. No. 1 (7/19/21)
Outline: item H.1, page 20

- The taxpayers, a married couple, filed a joint federal income tax return for 2012.
- Pursuant to § 7345, the IRS issued a notice of certification of a “seriously delinquent tax debt” to the wife showing an unpaid tax liability of $583,803 and notified the Secretary of State that her passport should be revoked.
- The IRS subsequently issued a substantially identical notice to the husband showing the same delinquent tax debt.
  - The IRS subsequently reversed the certifications because the taxpayers had filed an offer-in-compromise.
- The taxpayers jointly petitioned the Tax Court and sought review of the certifications.
- Issue: could the taxpayers file a joint petition seeking review of the IRS’s certification of a seriously delinquent tax debt?
- Held: Yes. Although neither § 7345 nor the Tax Court’s Rules provide guidance, “equity and common sense” support this result.

20