

2009 Cumulative Update

For Students

Federal Income Tax: Doctrine, Structure, and Policy

by

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Since the current edition was published in 2004, Congress has amended the Internal Revenue Code several times (as it tends to do rather routinely). Fortunately, the Code's basic structure is unchanged so that the textbook still "works." You should, however, be aware of certain changes. In this supplement, we highlight some of the more significant amendments (and some new cases and rulings) that are not mentioned in your textbook but may be explored in the basic tax class. Our purpose is to alert you to the amendments rather than to describe them in detail. Many of these changes are narrow in scope and several are temporary. Therefore, do not be surprised if your teacher is selective regarding which ones are explored in class.

Chapter 1

In *Swallows Holding v. Comm’r*, 515 F.3d 162 (3rd Cir. 2008), the Third Circuit confirmed that *Chevron* deference takes precedence over what is perhaps a reduced level of deference required by *National Muffler Dealers Ass’n v. U.S.*, 440 U.S. 472 (1979), which pre-dated *Chevron*. In *Swallows Holding*, the Tax Court had held that Treas. Reg. § 1.882-4(a)(3)(i), providing that a foreign corporation must file a tax return within 18 months of its due date to be eligible to take deductions with respect to a U.S. trade or business, was invalid under the *National Muffler Dealers* level of deference for administrative agency actions. The relevant Code section provided that a return had to be filed to obtain the benefit of the deductions but was silent regarding any timing requirement. Because the regulation at issue was an interpretive regulation issued under the authority of § 7805 (as opposed to a so-called substantive or legislative regulation), the Tax Court concluded that it did not merit *Chevron* deference under *U.S. v. Mead Corp.*, 533 U.S. 218 (2001). The Third Circuit conceded that, under *Mead*, *Chevron* does not apply unless Congress “would expect the agency to be able to speak with the *force of law*” (emphasis in original). However, the Third Circuit reversed the Tax Court and upheld the regulation, concluding that *Chevron* applied and that its two-prong test was satisfied with respect to the regulation at issue because the regulation had been issued after public notice and comment.

Chapter 2

Beginning in 2011, securities brokers will be required to provide sellers of securities and the IRS with a statement showing the seller’s adjusted basis and whether the gain or loss is long-term or short-term.

Chapter 3

See Chapter 10 of this Update regarding amendments made to § 121.

With respect to the favorable tax treatment of personal residences, see Chapter 20 of this Update regarding state and local real property taxes and the first-time homebuyer credit.

Chapter 4

Section 195 has been amended by replacing 60-month amortization for start-up costs with a Year-1 amortization deduction equal to the lesser of (1) the start-up costs, or (2) \$5,000 reduced (but not below zero) by start-up costs in excess of \$50,000. Therefore, no amount would be deductible under this formula if start-up costs exceed \$55,000. All is not lost, however, as start-up costs not deductible under the above formula are amortized over 180 months (15 years), beginning with the month in which the business begins.

Assume, for example, that start-up costs equal \$40,000, and the business begins on December 1, Year 1. For Year 1, the taxpayer could deduct \$5,000 *plus* \$194.44

(\$35,000/180). In Year 2, the taxpayer would deduct \$2,333.33 (\$194.44 x 12). And so on for the remainder of the 15-year amortization period.

Proposed regulations issued in 2006 pertaining to capitalization of costs related to tangible assets have been withdrawn, and new proposed regulations were issued in 2008. See 73 Fed. Reg. 12,838. To find them, go to Lexis, click on the “Get a Document” Tab, and type 73 Fed. Reg. 12,838. As printed on a computer, they are 63 pages in length and their ultimate fate is uncertain, so we do not describe them in depth here. Nevertheless, highlights noted below are worth mentioning.

- The new proposed regulations adhere more closely to the nomenclature in the current regulations. Thus, outlays must be capitalized if they result in the “betterment” or “restoration” of tangible property or adapt the property to a “new or different use.” A focus in the previous proposed regulations on whether the value of the property is increased has been abandoned. Rather, “betterment” or “restoration” looks to whether the work alleviates a material defect that existed prior to the acquisition or arose during the property’s production (whether or not the taxpayer knew of the defect at the time of acquisition or production), materially adds to the unit of property (such as physical expansion), materially increases the quality of the property or its output, returns property to its ordinarily efficient operating condition after a period of deterioration that rendered it non-functional, rebuilds a unit to like-new condition after its useful life ends, restores property after a casualty, or replaces a major component or substantial structural part of a unit of property.
- The “unit of property” rules were completely rewritten. Buildings and their structural components are considered a single unit of property. A leasehold improvement that is § 1250 property made by a lessee is also a separate unit of property. With respect to property other than buildings, a single unit of property includes all components that are “functionally interdependent.” Special rules are provided for certain types of property, such as machinery and equipment in a manufacturing plant.
- The proposed regulations provide that the cost of tangible property used or consumed in the taxpayer’s operations is generally deductible in accordance with the materials and supplies rules of Reg. § 1.162-3 if the tangible property (1) is neither a unit of property nor acquired as part of a single unit of property or (2) is a unit of property but has either an economic useful life not greater than 12 months or a cost of \$100 or less. This seems to mean that an item of tangible business property can be expensed without regard to its useful life if its cost does not exceed \$100.
- The proposed regulations create a general safe harbor under which the costs of routine or recurring maintenance generally can be expensed. They also abandon the “plan of rehabilitation” doctrine developed in prior case law and referred to at page 105 of the textbook, under which outlays that would have

been expensed if incurred alone must be capitalized if undertaken as part of a larger plan of rehabilitation, though § 263A might nevertheless require capitalization if the costs “directly benefit” the improvement itself or are incurred by reason of the improvement of property.

- The proposed regulations indicate that industry-specific repair allowance methods will be allowed under future guidance published in the Internal Revenue Bulletin.
- The proposed regulations provide greater guidance with respect to when and whether investigatory costs and abandonment costs can be deducted.

The IRS Chief Counsel’s Office has begun issuing a new form of legal guidance—The Generic Legal Advice Memorandum or “GLAM.” It is generated at the request of IRS personnel rather than taxpayers and usually deals with an issue or issues of general application rather than a controversy with a specific taxpayer. For an example, see Chapter 21 of this Update.

For a comprehensive discussion of the various forms of legal guidance issued by Treasury and the IRS, see Mitchell Rogovin and Donald L. Korb, *The Four R’s Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323 (2008).

Chapter 6

Because of recent statutory changes, assume in Problem 3 on page 165 that Daughter is a 24-year-old graduate student. You may explore why this change in the facts is necessary in Chapter 18, where we discuss the § 1(g) kiddie tax.

With respect to the example on page 167 involving Mary’s sale of an insurance policy on her life to Investor, Rev. Rul. 2009-14, 2009-21 I.R.B. 1031, confirms that Investor’s \$4,000 gain is ordinary income, presumably because receipt of the death benefit under an insurance contract does not qualify as a sale or exchange.

A case that may (or may not) be interesting to mention is *Peebles v. Comm’r*, T.C. Summ. Op. 2006-61, No. 22386-04S, which you can find at 2006 TNT 76-5. The Tax Court held that a police officer could not exclude \$25,000 as a “gift” under § 102. The police officer’s wife was having an affair with her doctor, and the \$25,000 payment was made by the doctor to the officer upon termination of the affair. The Tax Court concluded that the doctor made the payment “to avoid a lawsuit, to avoid public and professional embarrassment, and to assuage his own feelings of guilt or moral obligation” rather than out of “detached and disinterested generosity.”

The Supreme Court has clarified the case law summarized in Question 1.d. on page 175. In *National Cable & Telecommunications Ass’n v. Brand X Internet Services*, 125 S.Ct. 2688; 162 L.Ed. 2d 820; 2005 U.S. LEXIS 5018, the Court ruled that because of the two-step analysis mandated by *Chevron* (see p. 32 of the textbook) a judicial

interpretation of a federal statute, including a Supreme Court decision, can always be reversed by a subsequent Regulation that satisfies *Chevron* unless “the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion.” Thus, if *Duberstein* regards the term “gift” in § 102(a) as ambiguous, Treasury can now alter the *Duberstein* definition of gift with a Regulation if the Regulation satisfies the *Chevron* reasonableness requirement. In the following portion of *Duberstein* that is omitted from the textbook, the Supreme Court may have indeed held that “gift” in § 102(a) is an ambiguous term that can be reinterpreted *ex post* by Treasury:

The meaning of the term “gift” as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious.

Regrettably, however, we conclude that this passage and the other parts of *Duberstein* are themselves ambiguous with regard to whether the Supreme Court regarded “gift” as an ambiguous term that could have reasonable meanings in addition to the construction adopted in the *Duberstein* opinion.

In *Jue-Ya Yang v. Comm’r*, T.C. Summary Op. 2008-156 (Dec. 15, 2008) (an unreported decision that cannot be cited as precedent under § 7463(b)), the taxpayer met Howard Shih, an artist and calligrapher, through a mutual friend, and they began dating. After their relationship became intimate, Ms. Yang “moved into [Mr. Shih’s] home, and they cohabited.” The court notes that Ms. Yang did some light housekeeping and cooking “but she did not work for Mr. Shih under any form of written or oral contract for services... and did not have any skill or experience in connection with Mr. Shih’s artistic endeavors.” During 2005, Mr. Shih gave Ms. Yang checks totaling \$10,500 “to use for herself.” At the end of the year, Mr. Shih issued a Form 1099 to Ms. Yang, listing the \$10,500 as wage income, which he deducted on his own tax return.

Ms. Yang did not include the \$10,500 in gross income, claiming that the amount was transferred as a “gift.” After discussing the *Duberstein* standard, the court noted:

Mr. Shih was romantically involved with Ms. Yang, and she moved into his home. There were discussions of a formal engagement, and their relationship was intimate. Mr. Shih testified at trial and his testimony concerning his romantic relationship with Ms. Yan was evasive. Mr. Shih was called by [the government] and testified on direct examination that Ms. Yang had performed services in his business in exchange for the payments made to her during 2005. On cross-examination, however, after admitting that his relationship with Ms. Yang was more than a professional one, Mr. Shih could not recall taking her out on dates or any intimacy in their relationship, even though their relationship existed only a few years ago.

It is obvious that Mr. Shih and Ms. Yang have conflicting interests in the outcome of this controversy and that their positions are diametrically opposed....

Ms. Yang, however, was forthright in her testimony and answered all questions whether or not they favored her position. On the other hand Mr. Shih professed to remember only those things that supported his position that the payments were income to Ms. Yang. We find his testimony to be evasive and untrue.

The facts show that Mr. Shih made payments totaling \$10,500 to Ms. Yang with “detached and disinterested generosity” out of his affection for her at the time of payment. We accordingly hold that the \$10,500 in payments made during 2005 were a gift and not reportable as income.

This case is a nice example of how an information return does not necessarily control the nature of a payment. On the other hand, it also demonstrates that we must understand the *Duberstein* language that the “donor’s intent” controls the inquiry with the gloss that such intent is to be measured by objective circumstances and that a donee who produces persuasive evidence can overcome the implication resulting from the donor’s having claimed a business expense deduction or having filed an information return declaring the “gift” amount to be wages to the recipient.

Chapter 7

Section 85(c) now excludes up to \$2,400 per year of unemployment compensation benefits received during a tax year that begins in 2009.

Chapter 8

Congress has amended § 132(f) to add “qualified bicycle commuting reimbursement” to the qualified transportation fringe benefit.

New § 36A, generally known as the “making work pay” credit, provides that, for tax years beginning in 2009 and 2010, taxpayers can credit the lesser of 6.2% of earned income or \$400 (\$800 for married couples filing jointly). The credit phases out between \$75,000 and \$95,000 of “modified AGI” for single individuals (between \$150,000 and \$190,000 for married couples filing jointly). The credit is refundable, and it effectively eliminates the 6.2% employee share of social security tax applicable to approximately the first \$6,450 of a single worker’s wages.

Chapter 10

Section 121 now clarifies that, if business or investment property is obtained in a § 1031 like-kind exchange (explored in Chapter 16, *infra*) and then converted to use as a

principal residence, § 121 cannot apply if the home is transferred within five years of the like-kind exchange. This rule must be satisfied in addition to the two-of-five-years requirement in § 121(a).

Section 121 applies to property that is converted from rental use to use as the taxpayer's principal residence, but § 121(d)(6) has long provided that any gain attributable to depreciation taken with respect to a personal residence (attributable to a home office or a period of time when the home was not used as the taxpayer's residence but rather was rented to tenants) is not eligible for exclusion. Nevertheless, a taxpayer who previously rented a residence to tenants could move into the home, use it as the taxpayer's principal residence for two years prior to sale, and exclude the gain (in excess of depreciation) up to the \$250,000 and \$500,000 amounts. Section 121 also effectively allowed taxpayers to convert a second "vacation home" into a "principal residence" by moving into it full time for two years prior to sale.

Congress has now shut down these maneuvers by amending § 121 to require inclusion of gain attributable to periods of "nonqualified use," excluding periods of nonqualified use prior to January 1, 2009. In general, "nonqualified use" is any use of the home other than as the principal residence of the taxpayer or the taxpayer's spouse or former spouse but does not include periods after vacating the home as a principal residence. The amount that fails to qualify for exclusion is the same proportion of the total gain as the period of nonqualified use bears to the total ownership period. The legislative history includes the following two examples:

Example 1: Assume that an individual buys a property on January 1, 2009, for \$400,000 and uses it as rental property for two years, claiming \$20,000 of depreciation deductions. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer moves out, and the taxpayer sells the property for \$700,000 on January 1, 2014. As under present law, \$20,000 of gain attributable to the depreciation deductions is included in income. Of the remaining \$300,000 gain, 40% of the gain (2 years divided by 5 years), or \$120,000, is allocated to nonqualified use and is not eligible for exclusion. Since the remaining gain of \$180,000 is less than the maximum gain of \$250,000 that may be excluded, gain of \$180,000 is excluded from gross income.

Example 2: Assume that an individual buys a principal residence on January 1, 2009, for \$400,000, moves out on January 1, 2019, and on December 1, 2021, sells the property for \$600,000. The entire \$200,000 gain is excluded from gross income, as under present law, because periods after the last qualified use do not constitute nonqualified use.

Problem: Assume that a married couple living in Manhattan, who have owned a principal residence there for many years, buys a second home in the Hamptons on January 1, 2009, for use on weekends and vacations. Assume further that the taxpayers retire, sell their Manhattan home on January 1, 2015, and move into their home in the

Hamptons, using it thereafter as their principal residence. On January 1, 2017, they sell their home in the Hamptons and move to a new residence in Florida. What tax result under prior law? Under current law?

Chapters 10 and 21

Both Chapters 10 (at page 277) and 21 (at page 575) discuss the treatment of attorney fees incurred by certain plaintiffs to obtain includible damages. Assuming that the portion of the damage award received by the plaintiff's attorneys is includible in the plaintiff's gross income and that the plaintiff's outlay is properly categorized as an "expense" that is deductible only under § 212 (or, if deductible under § 162, is nevertheless not otherwise listed in § 62(a)(1) as an above-the-line deduction), then both § 67 and the Alternative Minimum Tax effectively reduce or eliminate the plaintiff's deduction. *See* § 56(b)(1)(A)(i). The textbook describes why this outcome is not consistent with income tax theory.

This issue has been partially addressed by both a recent statutory change and a Supreme Court decision. New § 62(a)(20), (e) now provides that an "expense" deduction (whether under § 212 or 162) for attorney fees incurred by plaintiffs in connection with certain listed discrimination actions (such as suits under the Civil Rights Act, the Age Discrimination in Employment Act, and the Americans with Disabilities Act), certain claims against the government, and certain actions brought under the Medicare Secondary Payer statute can now be taken "above the line." There will, however, be instances in which includible personal injury damages, such as common-law defamation damages or punitive damages, do not arise under one of the listed federal statutes. This means that not all plaintiffs will obtain relief under new § 62(a)(20).

Before the statutory amendment, the Supreme Court had accepted *certiorari* in *Commissioner v. Banks*, 543 U.S. 426 (2005), which gave the Court the opportunity to relieve taxpayers from the bind described in Chapters 10 and 21 by holding that a successful plaintiff's gross income does not include the portion of a damage award received by the plaintiff's attorneys. One argument advanced by the taxpayers in support of this approach was that state attorney lien statutes created a property interest in a portion of the claim that was successfully assigned to the lawyer under the contingent fee contract. The Court, however, rejected the argument. Another taxpayer argument was that a contingent fee contract creates a partnership between the plaintiff and the attorney and that the fee is the attorney's partnership "share" of the damage recovery. The Supreme Court rejected this assertion, as well, holding that an attorney is inherently an agent of the client and, therefore, cannot be regarded as a partner in prosecuting the client's claim for damages.

The argument made in the textbook (that the attorney fee should properly be viewed as a capitalized offset against amount realized, like a transaction cost) was advanced in an *amicus* brief. The Supreme Court did not reject this argument but rather decided not to reach the merits of it because the argument was "presented for the first time to this Court." The Court continued: "We are especially reluctant to entertain novel propositions

of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline to comment on these supplemental theories.” Can this capitalized-transaction-cost argument be developed in the lower courts in future cases? Would this argument be foreclosed by the enactment of the new above-the-line deduction on the grounds that the enactment is based on Congress’s assumption that the attorney’s fee is an “expense” and not a “capital expenditure” or “transaction cost”? Can Congress foreclose judicial development in this fashion? How do these developments affect the analysis of Paul’s suit in problem 2 on page 281?

In *Marrita Murphy v. IRS*, No. 05-513 (Aug. 26, 2006), the D.C. Circuit Court of Appeals held that it would be unconstitutional to tax damages received by a plaintiff solely for “emotional distress and mental anguish” and “injury to professional reputation.” The two grounds cited by the court for this conclusion were as follows:

First, as compensation for the loss of a personal attribute, such as well-being or a good reputation, the damages are not received in lieu of income. Second, the framers of the Sixteenth Amendment would not have understood compensation for a personal injury—including a nonphysical injury—to be income.

Shortly after *Murphy* was decided, the government petitioned for *en banc* review by the full D.C. Circuit. In an unusual procedural twist, however, the original panel unilaterally (without government motion) withdrew its prior panel opinion and ordered new briefs and re-argument in the case. Because of this action on the part of the original panel, the D.C. Circuit dismissed the *en banc* petition as moot. On July 3, 2006, the original panel issued its replacement opinion, which holds:

[W]e conclude (1) Murphy’s compensatory award was not received on account of personal physical injuries, and therefore is not exempt from taxation pursuant to § 104(a)(2) of the IRC; (2) the award is part of her “gross income,” as defined by § 61 of the IRC; and (3) the tax upon the award is an excise and not a direct tax subject to the apportionment requirement of Article I, Section 9 of the Constitution. The tax is uniform throughout the United States and therefore passes constitutional muster.

See generally Joseph M. Dodge, *Murphy and the Sixteenth Amendment in Relation to the Taxation of Non-Excludable Personal Injury Awards*, 8 FLA. TAX. REV. 369 (2007); Deborah A. Geier, *Murphy and the Evolution of “Basis,”* 113 TAX NOTES 576 (Nov. 6, 2006).

The Supreme Court denied *certiorari* in *Murphy*.

Chapter 12

In *Payne v. Comm’r*, T.C. Memo 2008-66, 95 TCM (CCH) 1253 (2008), taxpayer owed approximately \$21,000 on a credit card. Although taxpayer was neither insolvent nor in bankruptcy proceedings, the creditor bank agreed to accept approximately \$5,000 in full settlement of the account balance. Taxpayer asserted, and the Tax Court did not disagree, that this payment was equal to 100 percent of the principal amount of the credit card debt so that the \$16,000 discharged amount was entirely unpaid interest. Taxpayer argued first that the extension of credit to him under the credit card contract was a sale of property, that the \$16,000 discharge of unpaid interest was a reduction in the price of that property and, therefore, that the \$16,000 of discharged debt was excluded from his gross income by the § 108(e)(5) purchase price reduction exception. The Tax Court held that there had been no sale of property and that “[t]he only relationship between the parties was that of debtor and creditor, and thus section 108(e)(5) does not apply.” The taxpayer next argued that debt discharge income does not arise from the cancellation of an unpaid interest obligation and that because his debt discharge represented unpaid interest in its entirety, he had no income under § 61(a)(12). The Tax Court held that because taxpayer had been forgiven of a \$16,000 obligation, he had \$16,000 of debt-discharge income regardless of whether the cancelled debt was principal or interest. The interest appeared to be entirely nondeductible personal interest. That is probably why the court did not discuss the § 108(e)(2) exclusion for the discharge of obligations that would have been deductible if paid.

Was *Payne* rightly decided? Discharged principal would clearly create § 61(a)(12) debt-discharged income, but the amount discharged here consisted entirely of unpaid interest. Was the court’s result implicitly premised on the antiquated “freeing-of-assets” rationale underlying debt-discharge income and is thus arguably inconsistent with the modern rationale described on pages 304-08 and with the “Joan and Bob” hypothetical on pages 311-12 of the textbook? Recall that the modern rationale is premised on the *prior receipt of wealth* (typically cash) that was excluded from gross income in the year of receipt (Year 1) *solely* because of the repayment obligation. The cash or other wealth received in Year 1 would have been includable *in that year* absent the repayment obligation. When the repayment obligation disappears, the *prior receipt* of wealth (that was excluded) is now included. If the borrowed cash were spent on consumption, inclusion of the discharged amount is necessary to ensure that this consumption is taxed; if it were spent on business or investment activity, thus resulting in deduction or basis, inclusion is necessary to ensure that the same dollars do not produce a double tax benefit to the same taxpayer—a prime directive under an income tax.

If not § 61(a)(12) debt-discharge income, can the discharged interest constitute gross income under the residual language in § 61 (“gross income means all income from whatever source derived”)? Or is this a case of simply avoiding a wealth reduction, which does not typically produce gross income? Did the credit card company, in substance though not in form, loan additional cash to the taxpayer every time an interest payment was due and not paid so that the discharge of this “additional principal” correctly produces § 61(a)(12) debt-discharge income? Or does this argument fail because, although the \$16,000 of discharged interest was a debt, it was not a previously excluded amount that was spent for consumption, business, or investment purposes?

In Revenue Ruling 2008-34, 2008 I.R.B. LEXIS 473, a law school refinanced a student's loan under a Loan Repayment Assistance Program. Under the program, the student agreed to work "in a law-related public service position for, or under the direction of, a tax-exempt charitable organization or a government unit, including a position in (1) a public interest or community service organization, (2) a legal aid office or clinic, (3) a prosecutor's office, (4) a public defender's office, or (5) a state, local, or federal government office." The law school forgives the loan after the graduate works for a specified period of time in a qualifying position. The Ruling concludes that the terms of the loan satisfy the requirements of § 108(f), which allows exclusion of debt-discharge income pertaining to certain student loans.

Chapter 13

Congress created a new category of excluded debt discharge income by adopting §§ 108 (a)(1)(E), (h), which apply to "qualified principal residence indebtedness." To understand these new provisions, assume that there is a \$1 million recourse mortgage debt with respect to individual A's principal residence, that she is not in bankruptcy or insolvent, and that her basis in the residence is \$1 million but the fair market value has fallen to \$750,000. In Scenario 1 (the foreclosure scenario), she transfers the residence, voluntarily or involuntarily, to the lender. In Scenario 2 (the workout scenario), the lender reduces the debt to \$750,000 (the property's fair market value) and allows A to retain ownership and make payments on the diminished debt. A clearly realizes \$250,000 of ordinary debt discharge income in Scenario 2 and the result would usually be the same in Scenario 1 because few mortgage lenders ever attempt to collect a deficiency from a defaulting debtor where the residence is worth less than the amount of the mortgage debt. This \$250,000 outcome would be dictated in Scenario 1 by the two-step approach (explained in the textbook at pages 343-46) and in Scenario 2 by the generic debt discharge income concept embedded in § 61(a)(12).

In Scenario 1, the two-step approach would also result in a \$250,000 loss (\$1,000,000 basis *less* \$750,000 amount realized). If the mortgaged property were an investment asset instead of A's personal residence, this loss would be deductible, albeit subject to the capital loss limitations. But because the property is A's personal residence, her loss would be a nondeductible personal loss. Likewise, because of the realization doctrine, A would have no deductible loss in Scenario 2 even though her property had shrunk in value by \$250,000. The nondeductibility of A's loss would not be objectionable in either scenario, however, if the \$250,000 decrease in the value of A's residence merely reflected the impact of her personal use of the residence. In that case, the \$250,000 value decline would simply be a personal consumption cost that ought not to be deductible under general principles. The nondeductibility of the personal loss in both scenarios, coupled with inclusion by the solvent taxpayer of any debt-discharge income, would ensure that debt used to fund personal consumption is either repaid with after-tax dollars or results in includable debt-discharge income (absent application of the bankruptcy or insolvency exclusions).

In the current economic climate, however, many homes are losing value because of general market conditions (and not due to personal consumption by the taxpayer, such as through poor maintenance or through idiosyncratic alterations to the house that the market abhors). Yet, such market losses remain nondeductible in both the foreclosure situation (Scenario 1) and the workout situation (Scenario 2). The legislative history of the new provision states that “where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in foreclosure, ... it is inappropriate to treat discharges of indebtedness as income.” Accordingly, new §§ 108(a)(1)(E) and 108(h) exclude from gross income “qualified principal residence indebtedness” that is discharged before 2012. The apparent intent is to allow exclusion for a period of time during which most home value reductions are more likely due to market conditions than to personal consumption by the taxpayer.

How is “qualified principal residence indebtedness” defined under the statute? Does the excluded amount reduce tax attributes under § 108(b) in the usual fashion?

If only a portion of the discharged debt qualifies as “qualified principal residence indebtedness,” an ordering rule provides that the § 108(a)(1)(E) exclusion is applied last. IRS Publication 4681 provides the following example to illustrate this rule:

Ken incurred a recourse debt of \$800,000 when he purchased his principal residence for \$880,000. When the FMV of the property was \$1,000,000, Ken refinanced the debt for \$850,000. At the time of the refinancing, the principal balance of the original mortgage loan was \$740,000. Ken used the \$110,000 he obtained from the refinancing (\$850,000 minus \$740,000) to pay off his credit cards and to buy a new car.

About two years after the refinancing, Ken lost his job and was unable to get another position paying a comparable salary. Ken’s residence had declined in value to between \$700,000 and \$750,000. Based on Ken’s circumstances, the lender agreed to allow a ... sale of the property for \$735,000 and to cancel the remaining \$115,000 of the \$850,000 debt. Under the ordering rule, Ken can exclude only \$5,000 of the cancelled debt from his income under the exclusion for canceled qualified principal residence indebtedness (\$115,000 canceled debt minus the \$110,000 amount of the debt that was not qualified principal residence indebtedness). Ken must include the remaining \$110,000 of canceled debt in income ... (unless another exception or exclusion applies).

Chapter 16

Revenue Procedure 2005-14, 2005-1 C.B. 528, describes how both §§ 121 and 1031 can apply to the same exchange if the property satisfies the terms of both sections. For example, property may contain a home office (business property) and be a taxpayer’s principal residence. Moreover, property that constituted the taxpayer’s principal

residence for Years 1 through 3, after which it was converted to rental property for Years 4 and 5, can satisfy both sections if it is then exchanged for like-kind business or investment property at the end of Year 5. The Revenue Procedure is taxpayer favorable in that it (1) allows the taxpayer to apply § 121 before applying § 1031, (2) takes § 1031(b) boot gain into account only to the extent that it exceeds the amount excluded under § 121, and (3) treats any § 121 exempted gain as being “recognized” for purposes of applying § 1031(d) to determine the basis of the new property. The Revenue Procedure contains several detailed examples applying these rules.

Revenue Procedure 2008-16, 2008-10 I.R.B. 547, describes a safe harbor that addresses when vacation homes that are rented out to others as well as used for personal purposes can be considered “business” or “investment” property for purposes of a § 1031 exchange.

Chapter 17

Congress created a uniform definition of “qualifying child” in new § 152(c) for purposes of the Dependent Exemption Deduction under §§ 151 and 152, the § 24 Child Tax Credit, the § 32 Earned Income Tax Credit, the § 21 Dependent Care Credit, and the § 2 “Head of Household” filing status. (Individuals who qualify as “dependents” under the traditional “gross income” and “support” tests but who fail to satisfy the definition of “qualifying child” are now called “qualifying relatives” and may still be claimed as dependents.) In general, in order to be a “qualifying child,” the child must be the taxpayer’s son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, a descendant of any of the above, or an eligible foster child. In addition, the child, so defined, (1) must have the same principal place of abode as the taxpayer for more than half the year, (2) must not have provided more than one-half of his or her own support for the year (not applicable for purposes of the Earned Income Tax Credit), and (3) must be either (i) under age 19 or (ii) under age 24 and a student. The new law also provides certain “tie breaker rules” that handle cases where an individual would otherwise be a qualifying child with respect to more than one person. Notwithstanding the age requirements listed above, the § 24 Child Tax Credit is limited to children under age 17, and the § 21 Dependent Care Credit is limited to children under age 13.

See Chapter 8 of this Update regarding the Making Work Pay credit.

Chapter 18

In Chief Counsel Advice No. 200608038 (Feb. 24, 2006), the IRS Chief Counsel’s Office opined that *Poe v. Seaborn* did not apply to registered domestic partners under California’s Domestic Partner Rights and Responsibilities Act of 2003 because “the relationship between registered domestic partners under the California Act is not marriage under California law.”

In the second full paragraph on page 491, we state: “As a result of these interrelated changes, in 2004, two-earner couples with aggregate income of up to \$58,100 suffer no

marriage penalty if they use the Standard Deduction instead of itemizing their deductions. But two-earner couples still experience the penalty if they earn above that threshold or itemize.” That’s not correct. The threshold of the 25% bracket for the joint return in 2004 was \$58,100, which is where the number in the text comes from, as that’s where Congress’s action to double the amount of income in the 10% and 15% brackets to exactly twice that of single individuals ended. But our focus should actually have been on where the 25% bracket *ends*, not begins, which was \$117,250 for 2004. If *each spouse* earned exactly \$58,625 (\$117,250 divided by 2) in 2004, then there was no marriage penalty. But if each spouse earned, say, \$58,650, there would be a marriage penalty of \$1.50 after application of the 2004 rate schedules included in the textbook’s Appendix. So the answer to the question of when the marriage penalty kicks in if the spouses take the Standard Deduction is a combined income of *more* than \$117,250, but this answer holds true *only* if each spouse earns exactly half of that combined income. If one spouse earns more than the other, the combined amount at which the penalty kicks in increases, since the marriage bonus starts to offset the marriage penalty in that case. As the gap in earnings between the spouses increases, the marriage penalty declines and eventually turns into a marriage bonus.

Congress amended § 1(g) (the “kiddie tax”) by increasing the age threshold (from “under 14” to “under 18”). Section 1(g) also now applies to 18-year-olds but only if the child’s earned income does not exceed one-half of the amount of his support. Finally, the kiddie tax will now apply to full-time students over age 18 but under age 24 but only if the child’s earned income does not exceed one-half of the amount of his support. However, the kiddie tax is inapplicable in these situations if the child is married and files a joint return for the year.

Our discussion on page 497 (regarding interest-free loans to relatives) neglects to note that § 7872(a)(1) and proposed Treas. Reg. § 1.7872-6 essentially treats term gift loans as “demand” loans for purposes of determining interest accruals for income tax purposes.

Webb v. Comm’r, T.C. Summary Opinion 2007-91 (2007), involved a written court order that supplemented an earlier divorce decree by stating that certain support payments would be made by Ex-Husband to Ex-Wife. The order, however, also stated that “there was no legally actionable duty” on Ex-Husband’s part to make the payment. The payments clearly satisfied § 71(b)(1)(B)-(D), but the IRS argued that the voluntary nature of the payments prevented them from complying with § 71(b)(1)(A). Nevertheless, the Tax Court held that the payments were § 71 alimony because they were made under a divorce or separation instrument, as defined in § 71(b)(2)(A), and they satisfied all other requirements of § 71(b)(1). The court noted that, according to Reg. § 1.71-1T, Q&A 3, “the [requirement] that alimony or separate maintenance payments be ... made in discharge of a legal obligation ... has been eliminated from the current version of § 71.”

Chapter 19

In 2009, a long-running Ponzi scheme operated by Bernard Madoff collapsed. The result was billions of dollars of losses to numerous investors who had transferred money

to Madoff with the understanding that he was investing it for them. He had, of course, embezzled most of the money and spent it for personal purposes. This conduct was criminal fraud or theft under controlling state law. The IRS responded with Rev. Rul. 2009-9, 2009-14 I.R.B. 735, which, although it does not mention Madoff by name, gives detailed guidance regarding the tax consequences of losses suffered by the embezzlement victims of a Ponzi scheme such as Madoff's.

For purposes of the basic income tax course, the significant points in the Ruling are that although the IRS characterized the victims' injuries as theft losses that were deductible under the § 165(e) year-of-discovery timing rule that applies to theft losses (instead of the time-when-sustained rule that applies to other types of losses), the losses were, nevertheless, deductible under § 165(c)(2) as losses incurred in transactions entered into for profit. Consequently, deductions for the losses were not subject to the §§165(h)(1), (h)(2) limitations on personal casualty and theft losses. In addition, the Ruling characterized the losses as ordinary so that the § 1211 capital loss limitation was inapplicable. Finally, the Ruling held that the loss deductions were itemized deductions but that neither the § 67 two percent floor nor the § 68 phaseout applied because of the §§ 67(b)(3), 68(c)(3) exceptions for losses that qualify as both personal theft losses and § 165(c)(2) losses incurred in a transaction entered into for profit.

Chapter 20

Congress amended § 164 for tax years through 2009 to provide that individuals may elect to deduct *either* state and local income taxes *or* state and local sales taxes (but not both). This provision will affect taxpayers primarily in Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming (which have no income taxes), as well as New Hampshire and Tennessee (which tax only interest and dividends). Notice 2005-31 provides details. The IRS has published tables compiling the average sales tax paid by residents of each state by household size, which the taxpayer can use instead of retaining receipts to document actual sales taxes paid.

New § 164(a)(6), (b)(6), allows deduction of state or local sales or excise taxes paid on the purchase of a "qualified motor vehicle" before December 31, 2009. The deduction is not available for those who elect under § 164(b)(5) to deduct sales taxes in lieu of income taxes. For those who do not itemize, the deduction is added to the § 63 Standard Deduction. *See* § 63(c)(1)(E).

Congress amended § 170 to provide that, if a taxpayer donates an automobile, truck, boat, or airplane to a qualified charity, and if the charity or its agent sells the item without a "significant intervening use or material improvement," the amount deductible by the taxpayer is generally limited to the gross sales proceeds. The charity will need to inform the taxpayer of this amount.

Congress has expanded § 170(e)(1)(B) by imposing an additional limitation on the capacity of donors to deduct the full fair market value of contributed intellectual property. New § 170(e)(1)(B)(iii) provides that in the case of a charitable gift of a patent, a

copyright (except a copyright created by the donor or acquired by the donor from the creator in a transfer, such as a gift, that causes the donor to take the creator's basis), a trademark, a trade name, a trade secret, know-how, software (other than software readily available for purchase by the general public that is subject to a nonexclusive license and that has not been substantially modified), or "similar property, or applications or registrations of such property," the donor's deduction is reduced by the amount of gain that would have been long-term capital gain if the donor had sold the donated property for its fair market value at the time of the contribution. This relatively straightforward rule is, however, transformed into a complex monstrosity by new § 170(m). This latter provision allows the donor of property affected by new § 170(e)(1)(B)(iii) to claim additional future-year charitable contribution deductions equal to gradually declining percentages of the income produced for the donee by the donated property up to the 10th anniversary of the contribution (see § 170(m)(5)), but these additional deductions are available only to the extent that their aggregate amount exceeds the donor's deduction at the time of the contribution. These extra deductions are usually not available where the donee is a private foundation.

In *Sklar v. Comm'r*, 125 T.C. 281 (2005), the taxpayers in the Ninth Circuit case at the bottom of page 542 attempted to use the Ninth Circuit's opinion as a roadmap to deducting 55% of a subsequent year's tuition payments by showing that their payments exceeded amounts charged by some secular private schools in the area. Nevertheless, the Tax Court held that no part of the payments was deductible, regardless of how the school day was divided between secular and religious education and regardless of the tuition charged by secular schools, because the taxpayers' payments did not exceed the aggregate value of the secular and religious educational benefits received by their children. The Tax Court specifically held that § 170(f)(8) is an administrative provision that does not change the rule that payments are not deductible under § 170 if they procure an equal or greater reciprocal benefit to the taxpayer. The 9th Circuit affirmed the Tax Court at 549 F.3d 1252 (2008).

As described below in Chapter 26, new § 1221(b)(3) provides that, at the election of the taxpayer, musical works sold by the artist who created them will be capital assets, notwithstanding § 1221(a)(3). Congress did limit its generosity when it comes to charitable contributions of such works, however. Section 170(e)(1)(A) was also amended (by adding "determined without regard to section 1221(b)(3)" after "long-term capital gain") so that these musical works will *not* be treated as "capital assets" for purposes of determining the amount of a charitable contribution deduction. Thus, the deduction amount would generally be limited to the taxpayer's basis in the works, not fair market value.

In *Knight v. Comm'r*, 128 S. Ct. 782 (2008), 2008-1 USTC (CCH) ¶ 50,132, the Supreme Court held that investment advisory fees incurred by a trust are subject to the 2% floor in § 67. The taxpayer claimed that the costs were described in § 67(e), which exempts trust and estate expenses from the 2% floor to the extent that they "would not have been incurred if the property were not held in such trust or estate." The Court, however, interpreted that exemption to apply only to those costs that would be

“uncommon (or unusual, or unlikely)” to be incurred by individuals holding the trust property directly. Because individuals commonly incur investment advisory fees, such costs did not fit within the § 67(e) exemption.

Through 2009, taxpayers who do not itemize can increase their § 63 Standard Deduction by the amount of state and local property taxes paid, unrelated to business use, but not in excess of \$500 (\$1,000 for married individuals filing jointly).

New § 36 creates a refundable tax credit equal to the lower of \$8,000 or 10% of the purchase price of a principal residence purchased before December 1, 2009. The credit phases out for individual taxpayers with modified AGI between \$75,000 and \$95,000 and for married taxpayers filing jointly with modified AGI between \$150,000 and \$170,000.

Section 163(h)(3)(B)(ii) implies that a married couple that jointly incurs acquisition indebtedness with respect to a qualified residence is not entitled to two \$1 million limitations that would effectively raise their acquisition indebtedness ceiling to \$2 million. However, nothing in § 163(h) expressly addresses the situation where unmarried joint owners of a qualified residence are jointly liable for acquisition indebtedness. Nevertheless, Chief Counsel Advice no. 200911007 (March 13, 2009) holds that such joint owners are subject to a single \$1 million limitation like married taxpayers.

Chapter 21

See supra Chapter 10 (regarding attorney fee discussion).

In Technical Advice Memorandum 200629030 (March 31, 2006), the IRS concluded that environmental remediation costs that did not qualify as “expenses,” but rather constituted “capital expenditures,” could neither increase basis nor create depreciation deductions because the IRS found that the costs were incurred to avoid a fine or penalty. While conceding that § 162(f) (denying deduction of “expenses” in the form of fines or penalties paid to a government) did not apply, the IRS reasoned that the “public policy” behind § 162(f) supported its position. The remediation costs were the result of a “project agreement” between the taxpayer and the EPA that required the taxpayer to make certain capital improvements to its facility. The IRS concluded that the costs were fines or penalties even though the EPA did not receive any cash and even though the government never commenced any formal enforcement action.

Congress modified the § 25A Hope Credit for 2009 and 2010, calling the amended credit the “American Opportunity Tax Credit.” The modified credit is equal to 100% of the first \$2,000 of qualified tuition and related expenses and 25% of the next \$2,000 (for a maximum credit of \$2,500) for each of the first four years of higher education. (In contrast, the unmodified Hope Credit is limited to 100% of the first \$1,000 and 50% of the next \$1,000, for a total of \$1,500, for each of the first two years only.) The phase-out

thresholds for the American Opportunity Tax Credit are significantly higher than for the unamended Hope and Lifetime Learning Credits. To be specific, they are \$80,000 for individuals and \$160,000 for married couples filing jointly (compared to the unmodified Hope thresholds of \$40,000 for individuals and \$80,000 for married couples filing jointly). Moreover, up to 40% of the Hope Credit (as amended) is now refundable (unless the taxpayer is subject to the § 1(g) “kiddie tax”) and is creditable against the AMT.

Foster v. Comm’r, T.C. Summary Op. 2008-22, a small tax case that cannot be cited as precedent under § 7463(b), is yet another case dealing with whether the costs of an MBA degree can be deducted under Treas. Reg. § 1.162-5 or whether the MBA leads to qualifying the taxpayer for a new trade or business. Some background may be helpful in evaluating the trend that the Tax Court appears to be cementing recently.

Outside fields involving professional licensure, several Treasury regulations and an earlier Revenue Ruling imply that specialization within a larger field is not a “new” trade or business within the meaning of Treas. Reg. § 1.162-5. For example, education incurred by a general dentist that qualifies him or her to perform orthodontia work is not education leading to qualification to enter a new trade or business. Rev. Rul. 74-78, 1974-1 C.B. 44. Education allowing a classroom teacher to become a guidance counselor or principal (or allowing him or her to teach a different subject matter) similarly does not lead to a new trade or business. Treas. Reg. § 1.162-5(b)(3). Finally, education allowing a general psychiatrist to engage in the specialized work of psychoanalysis does not lead to qualification to enter a new trade or business. *Id.*, Ex. (4).

It appears that this general approach has never applied, however, if licensure is involved—even if the person will be engaging in tasks or activities in the licensed profession that are similar to those engaged in prior to obtaining the education. So, for example, a legal education leads to qualification to enter a new trade or business when undertaken by an accountant who performs similar tasks and activities as she performed before obtaining the legal education simply (it appears) because law is a licensed profession. *Id.*, Ex. (1). Similarly, the costs of a bar review course undertaken by a tax lawyer licensed to practice law in New York in order to practice in California (in the tax field) is education leading to a new trade or business simply (it appears) because of the new California license involved. *Sharon v. Comm’r*, 66 T.C. 515 (1976), *aff’d*, 591 F.2d 1273 (9th Cir. 1978) (per curiam). And education undertaken by a public accountant that allows her to become a “certified” public accountant leads to a new trade or business. *Glenn v. Comm’r*, 62 T.C. 270 (1974).

Under this dichotomy, taxpayers obtaining education allowing someone already in a field to specialize within that field without obtaining a new form of licensure seemed to have an advantage under the “new trade or business” inquiry. Thus, for example, the taxpayers won in *Blair v. Comm’r*, T.C. Memo. 1980-488, and *Allemeier v. Comm’r*, T.C. Memo. 2005-207, allowing deduction of MBA expenses, and in *Ruehmann v. Comm’r*, T.C. Memo. 1971-57, allowing deduction of Harvard LL.M. expenses by a practicing lawyer. Neither an MBA nor an LL.M. leads to licensure but rather can allow greater specialization within the fields of “business” and “law.”

Recently, however, the Tax Court seems to be tightening up its inquiry outside the licensure area, taking a more searching and discerning approach to the “tasks and activities” test (and seemingly ignoring the “specialization” regulations and ruling described above). Thus, the Tax Court denied deduction of LL.M. expenses by a practicing lawyer in *Hudgens v. Comm’r*, T.C. Memo. 1997-33. Before the LL.M., Mr. Hudgens primarily prepared tax returns and researched tax issues for an accounting firm. After obtaining his LL.M., Mr. Hudgens worked for a trust company where he engaged in some of the same activities. Nevertheless, the Tax Court concluded that these activities were ancillary to his new activity of managing client assets and acquiring new clients—a “new” trade or business.

Foster is another new case solidifying this trend. Prior to obtaining her MBA at Harvard, Ms. Foster, a chemical engineer, worked for a beverage company “as a project manager on the upgrade of a milk factory” in Sydney, Australia. During her MBA studies, she worked at Snapple beverage company as a “corporate strategy consultant,” where she “completed marketing projects related to beverage consumption in the United States and to Snapple strategy and profitability.” After she completed her MBA, she accepted the job of “vice president of marketing” at a beverage company in California. The Tax Court denied deduction of her MBA expenses because she did not work in “marketing” prior to matriculating into the MBA program. The fact that she worked in the beverage industry both before and after earning her MBA was not sufficient to show that the MBA did not qualify her for a new trade or business. The Tax Court also upheld a § 6662 accuracy-related penalty.

Can you articulate a coherent principal underlying the approach to “new trade or business” under Treas. Reg. § 1.162-5?

At the least, taxpayers wishing to deduct under Treas. Reg. § 1.162-5 the costs (including living expenses in a different city under Treas. Reg. § 1.162-5(e)) of post-graduate education that does not lead to licensure should be encouraged to return to the same job, or take a job as close as possible to the old job, for a period subsequent to completing the education.

In GLAM 2008-011 (Dec. 5, 2008), the IRS described how a casual gambler determines wagering gains and losses for purposes of applying § 165(d). The taxpayer gambled at casino slot machines on 10 separate occasions during the year. On each occasion, she began with \$100 and gambled until she either lost it all or terminated her play. On five occasions, she lost her entire \$100. On the remaining five occasions, she had the following amounts of cash at the termination of play: \$20, \$70, \$150, \$200, and \$300.

Noting that § 165(d) uses the words “gains” and “losses” from “wagering transactions,” the IRS rejected both the view that casual gamblers can net their gains and losses from play throughout the year and report only the net amount for the year and the view that a “transaction” within the meaning of § 165(d) referred to every single play in a

game of chance or every wager made. Rather, the government's opinion is that a "gain" or "loss" is determined when the taxpayer "can definitively calculate the amount above or below basis (the wager)." The ruling states:

For example, a casual gambler who enters a casino with \$100 and redeems his or her tokens for \$300 after playing the slot machines has a wagering gain of \$200 (\$300 - \$100). This is true even though the taxpayer may have had \$1,000 in winning spins and \$700 in losing spins during the course of play. Likewise, a casual gambler who enters a casino with \$100 and loses the entire amount after playing the slot machines has a wagering loss of \$100, even though the casual gambler may have had winning spins of \$1,000 and losing spins of \$1,100 during the course of play.

Under the facts presented, therefore, the IRS concluded that the taxpayer realized \$500 of wagering losses on the five occasions when she lost the entire \$100, as well as an \$80 loss on the day she ended with \$20 and a \$30 loss on the day she ended with \$70. She realized wagering gains on the three days on which she ended up with more than the \$100 she began with: a \$50 gain on the day she ended with \$150, a \$100 gain on the day she ended with \$200, and a \$200 gain on the day she ended with \$300. For the year, the taxpayer had aggregate wagering gains of \$350 and aggregate wagering losses of \$610. Thus, the taxpayer must report \$350 of gross income and can deduct only \$350 of her \$610 in wagering losses under § 165(d). The remaining \$260 in wagering losses cannot be deducted against non-wagering income in the current year or deducted against wagering gains in any other year.

Chapter 22

Congress amended § 274(e)(2) to ensure that an employer deduction for compensation paid to certain employees (a "specified individual") in the form of entertainment does not exceed the amount of gross income included by the employee. A "specified individual" is an officer, director, or 10%-or-greater owner. This amendment overrules *Sutherland Lumber-Southwest, Inc.*, 114 T.C. 197 (2000), *aff'd* 255 F3d 495 (8th Cir. 2001), which allowed an employer to deduct the actual cost of operating an airplane used by an employee for a vacation, even though the fair market value of the employee use (which was included in gross income by the employee) was less.

In *Boyd v. Comm'r*, T.C. Summ. Op. 2006-36, No. 13780-02S, which you can find at 2006 TNT 42-8, the Tax Court held that a Pentecostal evangelist and his wife who traveled the country in a recreational vehicle to minister at various churches for days or weeks at a time had no "tax home" within the meaning of § 162(a)(2). Thus, they could not deduct their travel expenses. The couple maintained that Prentice, Mississippi was their "tax home." Their daughter lived there, and they used her residence as their mailing address. She would forward their mail, consisting mostly of invitations to minister from churches across the country, to wherever they were staying at the time. The couple returned to Prentice three times during the tax year at question, where they stayed as guests at the local church. They also owned burial plots in Prentice and maintained that

all their friends and relatives considered their home to be in Prentice. The court ruled against the couple by stressing that the couple “bore no expenses in maintaining a home there in addition to their recreational vehicle. Thus, [they] could not be ‘away from home’ within the intent and meaning of section 162(a)(2) because they had no ‘home’ to be away from.” This case is distinguishable from *Henderson v. Comm’r* on page 641 in that Mr. Henderson actually did have a permanent residence (albeit a cost-free one) with his parents when not on a temporary job with the Disney Tour. In other words, Mr. Henderson’s room and board costs on the road with Disney were incremental costs that would not have been incurred by him absent the Disney job. It appears that the Boyds only place of residence was their RV, the costs of which would have been incurred even absent an invitation from a church to preach. Thus, they incurred no incremental costs that would not have been incurred but for their preaching jobs.

In connection with scenario (3) in the problem on page 618, consider *Xiong v. Commissioner*, T.C. Summary Opinion 2007-96 (June 14, 2007). An Assistant Professor of Biology at Texas A&M University wrote a book on “bioinformatics” at his home office, which was published by Cambridge University Press in 2006. The professor was denied deductions for his home office expenses and depreciation, as well as deductions for commuting costs (from his home to his University office) and the costs of his daily lunches at the University, for 2003. The Tax Court rejected the taxpayer’s contention that his book-writing activities were a separate trade or business from his business as a University Professor and held that the “principal” place of business for his single business was the University, not his home. The court said:

Petitioner has not convinced us that his book writing project is a separate activity rather than an outgrowth of his university teaching and research. While it may be true, as petitioner suggests, that university professors generally are not required to write books, it does not follow that a university professor who writes a book is engaged in a separate business activity. Petitioner’s book is in the same academic discipline as the one petitioner teaches at the university. Petitioner’s contract with Cambridge University Press clearly identifies petitioner as a university professor. Petitioner based his book, at least in part, on teaching notes he had developed over the years, and he used the book in teaching courses at the university. We find that petitioner’s book writing project is so interconnected with his university teaching and research as to not constitute an activity separate from that of his occupation as a university professor....

Because he was a university professor, petitioner’s teaching and research functions at the university were of primary importance. Petitioner’s book writing project (which was performed at his home) was of secondary importance. Petitioner did not show that as a university professor he spent more time working at home than at the university. Accordingly, petitioner’s principal place of business as a university professor was the university. Moreover, we believe petitioner maintained

an office in his home not for the convenience of the university, his employer, but rather for his own convenience.

The court noted in a footnote that, even if the taxpayer had won on his principal contentions, he would still have been denied any deductions for 2003, the year at issue, under the ceiling rule in § 280A(c)(5). Because the book had not yet been published, he received no income from the project in that year.

Do you think the result would have been the same for someone like Joyce Carol Oates, who both teaches at Princeton University and publishes very successful novels for, we suspect, millions in royalties?

Chapter 24

Congress increased the amount that can be expensed under § 179 to \$250,000 and increased the phase-out threshold to \$800,000 for tax years through 2009. Moreover, Congress also revived § 168(k) 50% bonus depreciation for eligible property placed in service before 2010. Finally, Congress increased the § 280F limitations by \$8,000 for those taxpayers eligible to take § 168(k) bonus depreciation. Thus, Revenue Procedure 2009-24, 2009-17 I.R.B. 1, provides that the 2008 inflation-adjusted § 280F limits for cars without bonus depreciation are \$2,960 for Year 1 and \$4,800 for Year 2, and the § 280F limits for cars with bonus depreciation are \$10,960 for Year 1 and \$4,800 for Year 2.

What would be the result in problem c. if the industrial machine had cost \$800,000? \$1 million?

Congress has provided that certain qualified leasehold improvements made to nonresidential real property before 2010 can be depreciated under the straight-line method over 15 years (rather than 39 years).

Congress amended § 167(g) to allow taxpayers to elect to amortize the costs of creating or acquiring a musical composition ratably over 5 years if the musical composition is placed in service before 2011. Absent the election, these costs must be amortized under the income-forecast method. (See the reference to the country music lobby in Chapter 26, below.)

Chapter 26

Beginning in 2011, brokers will be required to provide sellers of securities and the IRS a statement showing the seller's adjusted basis and whether the gain or loss is long-term or short-term.

The 15 percent and 5 percent capital gains rates referred to on page 730 were scheduled to expire at the close of 2008. Congress has, however, extended those rates (which also apply to qualifying dividends) through 2010. Thus, the maximum capital

gains rate (except for collectibles (28%) and unrecaptured § 1250 gain (25%)) is generally 15 percent through 2010. For those taxpayers whose 15% capital gains would otherwise fall in the 10- or 15-percent brackets, the rate is 5 percent through 2007 and zero from 2008 through 2010 (though empirical evidence shows that there are very few taxpayers with taxable capital gains in the 10- and 15-percent brackets).

Congress added new § 1221(b)(3) (and re-designated old § 1221(b)(3) as (b)(4)), to provide that, at the election of the taxpayer, musical works sold by the artist who created them will be capital assets, notwithstanding § 1221(a)(3). No similar amendment was made for other works of art. (The country music lobby has been working hard on this for more than a year.) Congress did limit its generosity when it comes to charitable contributions of such works, however. Section 170(e)(1)(A) was also amended (by adding “determined without regard to section 1221(b)(3)” after “long-term capital gain”) so that these musical works will *not* be treated as “capital assets” for purposes of determining the amount of a charitable contribution deduction. Thus, the deduction amount would generally be limited to the taxpayer’s basis in the works, not fair market value. Why should musical compositions sold by the artists who create them produce capital gain, while other creative artists who sell their own works, such as paintings and sculptures, realize ordinary gain?

Can rental property held by a non-real-estate professional be considered “§ 1231 property,” which requires (under § 1231(b)) that the property be “used in the trade or business”? Consider, for example, a full-time lawyer who purchases a duplex as an investment and rents it to tenants.* The question of whether rental property can be considered “business” property is a factual one that must be determined by examining the facts and circumstances of each case, but there is favorable precedent on this issue. For example, *Wasnok v. Comm’r*, T.C. Memo. 1971-6, held that even a single house rented to a tenant by someone not otherwise engaged in real estate or rental activity was “business” property and, thus, § 1231 property. *See also Elek v. Comm’r*, 30 T.C. 731 (1958) (stating that “[t]he rental and management of an apartment building or residential property amounts to a trade or business of the owner, and this is true where an agent acts for the owner”). Whether “leasing” activity is “business” or “investment” is an important issue in other areas of the income tax, as well, which you may study in other courses. For example, the tax-free division of a single corporation into two under § 355 requires (among many other things) that each surviving corporation engage in “the active conduct of a trade or business,” which does not include leasing activity “unless the owner performs significant services with respect to the operation and management of the property.” *Treas. Reg. § 1.355-3(b)(iv)(B)*. So called Subchapter S corporations can incur a penalty tax for earning too much passive income, including income from leasing

* The issue of whether rental property is “business” or “investment” should not be important in most instances. For example, even if not “business” property, any allowable deductions would be taken above the line in any event under § 62(a)(4). Moreover, if it’s sold at a gain, and it’s *not* § 1231 property, then it should trigger capital gain in any event. *See* § 1221(a) (first three lines) and § 1221(a)(2). But if it *is* § 1231 property, and it is sold at a loss, the loss could be treated as ordinary (rather than capital). Moreover, even if sold at a gain, characterization of the gain as either § 1231 gain or plain vanilla capital gain could affect whether *other* § 1231 gains and losses of the taxpayer would be considered capital or ordinary, as the outcome depends on whether aggregate § 1231 gains exceed § 1231 losses, or vice versa.

activity that does not involve the performance of significant services. *See* Treas. Reg. § 1.1362-2(c)(5)(ii)(B)(2). Finally, the U.S. income tax rules that apply to international transactions differ substantially depending on whether the activity at issue is “business” or “investment.” *See, e.g.*, Rev. Rul. 73-522, 1973-2 C.B. 226 (holding that a “net lease,” under which the lessee is responsible for the payment of real estate taxes, operating expenses, ground rent, repairs, interest and principal on existing mortgages, and insurance, does not constitute a “trade or business”).

Lattera v. Comm’r, 437 F.3d 399 (3rd Cir. 2006), held that a lottery winner’s sale of the right to receive a future stream of lottery payments does not generate capital gain. While the issue is not a new one, Judge Ambro does a particularly nice job of discussing the theoretical difficulties concerning the traditional approach of asking whether the amount received on sale is a substitute for ordinary income in view of the fact that the fair market value (and thus the amount realized) on the sale of *any* capital asset is (theoretically speaking) the present discounted value of future ordinary income expected to be generated by the asset.

Chapter 27

So far, the ticking time bomb that is the AMT has been defused by a series of temporary “patches.” For tax years beginning in 2009 Congress enacted exemption levels of \$70,950 for married couples filing jointly, \$46,700 for single individuals, and \$35,475 for married persons filing separately.

Chapter 28

Under the recurring-item exception to the economic performance rule in § 461(h)(3), taxpayers can accrue deductions no sooner than the year in which the all-events test is satisfied. In Rev. Rul. 2007-3, 2007-4 I.R.B. 350, the IRS addressed whether liabilities were “established” under the all-events test in the year in which two contracts were executed and found that they were not. In the first, the contract, executed in Year 1, did not require the performance of services and payment until Year 2. In the second, the contract, executed in Year 1, did not provide insurance coverage or payment for that coverage until Year 2. The IRS concluded that, in both cases, the mere execution of the contract, “without more,” did not establish the taxpayer’s liability. Thus, the recurring-item exception could not apply.

In TAM 200849015 (Aug. 22, 2008), the accrual method taxpayer made cash sales of gift cards that were redeemable by the holders for merchandise and services. The IRS held that taxpayer had to include the cash received for the cards in the year of receipt because “[t]here is no certainty at the time of Taxpayer’s receipt of the payment for gift cards that the cards will be redeemed in full or in part and whether any refund will be issued.” Taxpayer was not allowed to treat the receipts as excludable deposits because “Taxpayer receives payments over which it exercises complete dominion and control, and over which it holds a claim of right unless, and until, a subsequent event occurs.” Taxpayer argued that if the cash paid for the cards had to be included in income at the

time of receipt, an offsetting deduction should be allowed at the same time to reflect the corresponding liability to provide goods and services. The IRS rejected this claim by holding that, under *General Dynamics*, the taxpayer's liability was not fixed until the cardholder redeemed the card for goods or services and, therefore, the all events test was not satisfied before that time. *Hughes Properties* was held to be inapplicable because "there is no law which has the effect of irrevocably setting aside a specific amount, as if it were to be put into an escrow account, by the close of the tax year."

In *Trinity Industries, Inc. v. Comm'r*, 132 T.C. No. 2 (2009), the accrual method taxpayer sold and delivered barges to two customers in 2002 pursuant to terms that required 78% of the purchase price to be paid at time of delivery and the remaining 22% to be paid with interest within the following 18 months. After the 2002 deliveries, defects were discovered in barges that taxpayer had delivered to the two customers in earlier years under different contracts, and the customers claimed the right to withhold the 22% deferred portion of the purchase price of the 2002 barges as damages for the defects in the earlier barges. The customers did not, however, dispute their liability for the full purchase price of the 2002 barges. This matter was settled after 2002 by agreements allowing the customers to credit the withheld amounts against damages owed them by taxpayer with respect to the earlier barges. Taxpayer argued that the amount includable in its 2002 income was limited to the 78% of the purchase price of the 2002 barges that was actually received in 2002. The Tax Court held that 100 % of the purchase price of the 2002 barges had to be included in 2002 income because taxpayer's right to the full purchase price became fixed when the barges were delivered in 2002, the amount thereof was known with reasonable certainty, and there were no facts regarding the financial condition of the purchasers that made collection of the deferred 22% doubtful. The court observed that taxpayer effectively collected the withheld 22% in the later year when it was credited against damages owed to the customers for defects in the earlier barges. According to the court, "the offset claims affected only the timing of petitioner's receipt of income under the second contract and not its right to receive the income." Because taxpayer disputed the defect claims that were raised in 2002, taxpayer was not allowed a 2002 deduction for these liabilities under the all events test. Therefore, taxpayer claimed a 2002 deduction under the § 461(f) exception to the all events requirements. The court rejected taxpayer's claim that it was entitled to an offsetting deduction in 2002 under § 461(f) for the withheld 22%. According to the court, the customers' action in withholding payment of that amount did not amount to a transfer of money by the taxpayer as required by § 461(f)(2).

Chapter 30

The proposed amendments to Circular 230 have been adopted. They provide that when giving "written advice (including electronic communications) concerning one or more Federal tax issues," a practitioner is prohibited from (1) basing the advice on "unreasonable factual or legal assumptions," (2) unreasonably relying on "representations, statements, findings or agreements of the taxpayer or any other person," (3) failing to "consider all relevant facts that the practitioner knows or should know," and (4) taking account of the audit lottery. See 31 C.F.R. §10.37(a). Moreover, the

amendments require that written advice with respect to tax shelters and other tax-motivated transactions must satisfy numerous additional requirements designed to ensure that the practitioner has made “reasonable efforts” to obtain the relevant facts, that the written advice expresses rigorous reasoning, and that the written advice makes sufficient disclosures to adequately apprise a reader of all important limitations and risks and to ensure that the advice cannot be misrepresented or misused by a promoter. *See* 31 C.F.R. § 10.35. The ultimate sanctions for violating these Circular 230 rules are that the guilty practitioner can be disbarred from representing clients before the IRS and/or financially sanctioned in an amount up to the gross income derived by the practitioner from his or her misconduct. *See* 31 U.S.C. § 330. But whether such a practitioner can continue to hold a state license to practice law, including the conduct of a tax planning and transactional practice that does not involve contact with the IRS, continues to be governed by the principles of Opinion 85-352, discussed on page 880.

Congress imposed a host of new provisions applicable to tax shelters, including repeal of the registration rule for tax shelters and substitution of a new disclosure requirement imposed on each “material advisor” of a reportable or listed transaction (§§ 6111 and 6707), a new penalty for failure to disclose a “reportable transaction” (§ 6707A), a new accuracy-related penalty for “listed” and other “reportable” transactions having a “significant tax avoidance purpose,” (§ 6662A), related changes to the substantial understatement penalty (§ 6662), changes to the civil action provision to expand the use of injunctions (§ 7408), changes to the promoter penalty (§ 6700), and the granting of authority to Treasury to impose monetary penalties on individuals or firms that violate the rules in Circular 230, which governs the practice of tax law before the IRS. As a result of the amendments to § 6662, the substantial authority/reasonable belief defense explained in the first paragraph of page 880 is no longer available to non-corporate taxpayers in tax shelter cases.

Congress amended § 6694 to craft three different standards of “reasonableness” for return preparers (including lawyers who give retrospective advice leading to a position taken by the taxpayer that constitutes a substantial portion of the return) for three different categories: a general category, a disclosed position category, and a tax shelters and reportable transactions category. For the “general” category, the reasonableness standard is now “substantial authority,” which conforms to the taxpayer accuracy-related standard in § 6662 and is weaker than the “more likely than not will be sustained” standard. For the “disclosed position” category, the reasonableness standard is “a reasonable basis for the position.” For the “tax shelters and reportable transactions” category, the more stringent reasonableness standard is maintained: that the preparer had a reasonable belief that “the position would more likely than not be sustained on the merits.” No penalty is imposed for any category if there is “reasonable cause of the understatement and the tax return preparer acted in good faith.” For a comprehensive discussion see Charles F. Rettig, *Practitioner Penalties: Potential Pitfalls in the Tax Trenches*, 123 TAX NOTES 207 (April 13, 2009).