

2009 Cumulative Update

For Teachers

Federal Income Tax: Doctrine, Structure, and Policy

by

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This Cumulative Update contains descriptions of legislative and non-legislative developments that have occurred since publication of the third edition in 2004. It also corrects a few errors in the third edition text and Teacher's Manual that have come to our attention. **New material added this summer (i.e., since your receipt of last year's 2008 Update) is in boldface. Thus, familiar users may wish to peruse only the new material in boldface. In particular, we describe the principal tax provisions of interest in the beginning tax course that were enacted as part of the *Housing Assistance Tax Act of 2008* (referred to below as the "Housing Assistance Act"), the *Emergency Economic Stabilization Act of 2008* (referred to below as "Emergency Stabilization Act"), and the *American Recovery and Reinvestment Act of 2009* (referred to below as the "American Recovery Act"). In addition, we describe a few cases and IRS guidance pieces that may be of interest in the basic tax class.**

We decided to include description of legislative changes that are, at this stage, only temporary. We suggest that teacher's use their individual judgment concerning whether to delve into provisions that are likely not to extend beyond the 2009-2010 tax years. (Of course, trying to figure out which changes are truly temporary itself requires judgment!)

Old references below (i.e., not in bold) to "The Tax Increase Prevention Act of 2007" describe provisions in the *Tax Increase Prevention Act of 2007*; old references to the "Debt Relief Act" describe provisions in the *Mortgage Forgiveness Debt Relief Act of 2007*; old references to the "Economic Stimulus Act" describe provisions in the *Economic Stimulus Act of 2008*; old references to the "Small Business Act" describe provisions in the *Small Business and Work Opportunity Tax Act of 2007*; old references to the "Tax Relief Act" describe provisions of the *Tax Relief and Health Care Act of 2006*; old references to the "Reconciliation Act" describe provisions of the *Tax Increase*

Prevention and Reconciliation Act of 2005, which was belatedly enacted in May of 2006; old references to the “Working Families Act” describe provisions of the *Working Families Tax Relief Act of 2004*; and old references to the “Jobs Act” describe provisions of the *American Jobs Creation Act of 2004*.

This Update is prepared primarily for teachers; we do not recommend distributing this document to students. **This year, we have prepared a separate supplement for distribution to students.** You may download this 2009 Teacher Update, **as well as the new 2009 Student Update**, from the “Classroom Preparation” section on the LexisNexis Law School website at www.lexisnexis.com/lawschool/class/.

If you’d like a copy of the textbook and accompanying Teacher’s Manual, please contact LexisNexis at 800-533-1646 or via e-mail at Lisa.A.Hughes@lexisnexis.com or Sean.M.Caldwell@lexisnexis.com. Moreover, please do not hesitate to contact us directly if you have any comments or questions.

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Chapter 1

Regarding § 7491, which shifts the burden of proof to the IRS on factual issues when certain requirements are met, a recent study concludes that “the shift in the burden of proof has had very little impact.” Philip N. Jones, *The Burden of Proof 10 Years after the Shift*, 121 TAX NOTES 287 (Oct. 20, 2008).

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

The Emergency Stabilization Act added new §§ 6045(g), 6045A, and 6045B, which generally require securities brokers, beginning in 2011, 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

The Jobs Act amended § 195 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.

If you really wish to explain this to your students, here is an example. Assume 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 ($\194.44×12). 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 recommend in-depth consideration of them in the basic tax class. 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

As described below in Chapter 18, the Reconciliation Act amended § 1(g) (the “kiddie tax”) by increasing the age threshold from “under 14” to “under 18.” This amendment will change the answer to Problem 3 on page 165. As written, the problem was crafted to avoid discussion of the kiddie tax at this early point in the course because the daughter is aged 17. Under old law, if the stock were given to the daughter and she sold it, her 5% capital gains rate would apply instead of her parent’s 15% rate. Under current law, however, the kiddie tax makes the parent’s rate applicable to the extent that Daughter’s unearned income exceeds the § 1(g) threshold. You can finesse this point by telling students to assume that the daughter is 18 instead of 17 and that you’ll explain why later in the course.

Effective January 1, 2008, the Small Business Act further expanded § 1(g) (the “kiddie tax”) to apply to those who are 18 years old (instead of “under 18”) but only if the child’s earned income does not exceed one-half of the amount of his support. (The kiddie tax applies to all children 17 or younger without regard to this new support test.) In addition,

the kiddie tax will 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. This amendment will change the answer to Problem 3 on page 165. At the time the book was published in 2004, the problem avoided discussion of the kiddie tax at this early point in the course because the daughter is aged 17. Under 2004 law, if the stock were given to the daughter and she sold it, her 5% capital gains rate would apply instead of her parent's 15% rate. Under current law, however, the kiddie tax makes the parent's rate applicable to the extent that Daughter's unearned income exceeds the § 1(g) threshold (\$1,700 for 2007). Last year, we recommended that you finesse this point by telling students to assume that the daughter is 18 instead of 17 and that you'll explain why later in the course. Beginning in January, that tactic will no longer work because the facts of the problem imply that the child will be a full-time student. Unless her earnings provide more than one-half of her support (which would be unlikely), the kiddie tax would apply to the sale. The only way around this problem is to tell your students to assume that Daughter is a 24-year-old graduate student and that you'll explain why later on.

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

The American Recovery Act adds § 85(c) to the Code, which excludes up to \$2,400 per year of unemployment compensation benefits received during a tax year that begins in 2009.

In the next edition, we might extend the Problem on page 197 to ask what the tax consequences would be if Victor is not a professional big game hunter but rather a recreational hunter who kills and eats an elk or has the elk head stuffed for mounting on his living room wall (or for selling, as a hobby). With respect to eating the elk, you could presage Chapter 9, introducing the idea of (non-taxed) imputed income from self-grown crops. With respect to mounting the elk for self-consumption or possibly for sale, you could talk about realization and whether his expenses in hunting the elk as a hobbyist should create basis to offset against his sales proceeds, whether they should be categorized as “expenses” rather than as basis created from capitalized outlays, and whether (if the latter) they should be allowed as expense deductions that effectively offset his gain on the sale in any event. What if they exceed his “gain”? While in-depth discussion of these topics is premature at this point, you could plant the seed that leads eventually to discussion of § 183 in Chapter 21.

Chapter 8

We neglected to provide our thoughts in the Teacher’s Manual with respect to the Problems on page 207.

1. In a barter transaction, there is a bargained-for exchange in the marketplace, which clearly should be (and is) taxable. (The lack of a market exchange is one reason why imputed income and psychic benefits, discussed in Chapter 9, are not gross income.) The informal exchange of services among friends does not involve a bargained-for exchange in the marketplace. The line-drawing can sometimes get a bit messy, of course, but we don’t think it’s crossed in the examples given here.

2.a. Under the analysis in *Old Colony Trust*, the payment is “compensation” deemed paid to the employee (which the employee is deemed to use to pay his tax). Thus, the employer can deduct the payment as “compensation” paid for services rendered under § 162(a)(1) (to the extent “reasonable”), and the employee’s includable deemed receipt cannot be offset by a deduction for the “tax” deemed paid by him.

b. The employee again must include “compensation” income (which is deductible by the employer). Because the employee is deemed to be the actual payor of the tax (under *Old Colony Trust* analysis), the tax payment would be deductible by the employee under § 164. (Because the § 164 deduction for personal real estate taxes is an Itemized Deduction, the inclusion and deduction may not be a wash.)

c. The deemed receipt by the “employee” is now excludable as a “gift” under § 102, and the deemed payment made by the employee is again deductible under § 164.

3. This Problem is similar to the one on Pages 423-24 (with Pilar), involving a “part gift/part sale” transaction. In essence, Freddy “sold” \$16,000 worth of the property to Ginger in the first iteration and donated the remaining \$34,000 value to her for no consideration. Because the property is worth \$50,000, and he “sold” \$16,000 worth of it, you might think that Freddy should use only a proportionate part of his basis in the “part sale” analysis equal to 32% ($\$16,000/\$50,000$). If that were the case, he could use only \$3,200 of his \$10,000 basis in the § 1001 analysis, producing a \$12,800 gain for Freddy ($\$16,000 \text{ A/R less } \$3,200 \text{ A/B}$). But perhaps because we can’t be sure that the property is actually worth \$50,000 (because there is no marketplace transaction establishing value), the regulations allow Freddy to use his *entire* basis (not just a proportionate part) in the “part sale” analysis, producing only a \$6,000 gain. *See* § 1.1001-1(e) (cross-referenced in § 1.1015-4, cited in the problem). In the second iteration, § 1.1001-1(e) prohibits Freddy from realizing a loss when the gift tax paid on his behalf is less than his basis. This makes sense because Freddy’s loss from his gratuitous transfer doesn’t satisfy the deduction requirements of § 165(c). In either case, Ginger takes a basis under § 1.1015-4 equal to the greater of the amount she paid or a carryover basis, plus any eligible gift tax described in § 1015(d). While you might not want to spend precious class time in the basic tax course on the nuances of § 1015(d)(6), the calculation would be the gift tax paid multiplied by a fraction determined by placing the unrealized appreciation in the numerator and the fair market value of the property in the denominator. Thus, in the first iteration, she’ll take a basis equal to \$16,000 (gift tax paid) *plus* \$12,800 ($\$16,000 \times \$40,000/\$50,000$), or \$28,800. In the second iteration, she’ll take a basis equal to \$10,000 (carryover basis) *plus* \$6,400 ($\$8,000 \times \$40,000/\$50,000$, or \$16,400).

The Emergency Stabilization Act amended § 132(f) to add “qualified bicycle commuting reimbursement” to the qualified transportation fringe benefit. Employer reimbursement, not exceeding the “applicable annual limitation,” of the reasonable expenses incurred to purchase, improve, repair, and store a bicycle that is “regularly used for travel between the employee’s residence and place of employment” can be excluded. The exclusion’s “applicable annual limitation”

equals \$20 multiplied by the number of “qualified bicycle commuting months during such year,” with the latter defined as “any month during which [the] employee regularly uses the bicycle for a substantial portion of the travel between the employee’s residence and place of employment,” excluding any month for which the employee received any other qualified transportation fringe benefit. Unlike the limits applicable to van pooling, transit passes, and qualified parking, the qualified bicycle commuting reimbursement is not subject to inflation adjustment.

The American Recovery Act amended § 132(f) to temporarily increase the monthly exclusion for van pooling and transit passes so that it equals the exclusion for qualified parking (\$230 in 2009). The increase is applicable for months beginning on or after February 17, 2009, through 2010.

The American Recovery Act enacted new § 36A, generally known as the “making work pay” credit. 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

The Jobs Act amended § 121 to provide that, if business or investment property is obtained in a § 1031 like-kind exchange 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).

The Debt Relief Act amended § 121 to provide that a surviving spouse can use the \$500,000 exclusion limit for married couples filing jointly (rather than the \$250,000 exclusion limit for single individuals) if the house is sold within two years of the decedent spouse’s death and the ownership and use requirements were satisfied prior to the decedent’s death.

In *Johnson v. U.S.*, 80 Fed. Cl. 96 (2008), the United States Court of Federal Claims denied the government’s contention that Treas. Reg. § 1.165-1(d)(2)(i) required that all portions of a claim be abandoned or denied before any deduction could be allowed for a theft loss under § 165. That regulation provides that “no portion of the loss with respect to which reimbursement may be received is sustained ... until it can be ascertained with reasonable certainty whether or not such reimbursement will be received.” The taxpayers were defrauded of \$78 million in a gem and money laundering scam. In 1998 they began an ultimately successful lawsuit, but the defendant had insufficient assets. In 2001, the taxpayers sued a host of additional parties involved in the scam. In a 2001 criminal proceeding against the principal perpetrator, Justice Department lawyers and a U.S. District Court determined that the total amount likely to ever be recovered by the

taxpayers (including prior recoveries) was approximately \$40 million. The Court of Federal Claims held that this evidence set a cap on taxpayers' recovery prospects "with reasonable certainty" and that, therefore, they were entitled to a 2001 theft loss deduction for the amount of their loss in excess of \$40 million even though they continued recovery litigation until 2005.

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.

The Housing Assistance Act 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.

In addition, the new law will prevent taxpayers who own both a principal residence and a vacation home to exclude 100% of the gain from both homes. For example, 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. Under prior law, the gain from both the Manhattan residence and the home in the Hamptons was eligible for full exclusion (subject to the \$500,000 ceiling for each sale) because the taxpayers both owned and used both residences for at least 2 of the 5 years prior to the respective sales as their principal residence. Under amended § 121, however, only 25% of the gain realized on the Hamptons home could be eligible for exclusion (subject to the \$500,000 ceiling) because 6 of their 8 ownership years constituted periods of “nonqualified use.”

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." Thus, there remains a theoretical possibility that this capitalized-transaction-cost argument can be developed in the lower courts in future cases. An interesting question is whether this argument would be foreclosed by the enactment of the new above-the-line deduction enacted in the Jobs Act 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?

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*.

The text on page 384 explains that, by virtue of § 453(f)(4), the seller’s receipt of the buyer’s readily tradable debt instrument is treated as receipt of a “payment” for § 453 proposes, provided that the buyer is a corporation, a government, or a governmental subdivision. The Jobs Act amended § 453(f)(4) to provide that the receipt of a readily tradable debt instrument always counts as receipt of a “payment,” regardless of the nature of the buyer.

In the discussion of § 453A on page 385, if Addie uses the cash method, she will have \$42,000 of Year-1 gain and \$28,000 of future collection gain.

The Jobs Act added new § 409A, which provides that a nonqualified deferred compensation plan, including a deferred compensation contract involving a single employee or independent contractor, must not permit payments of deferred amounts earlier than when called for by a payment schedule specified in advance in the plan, on the occurrence of the service provider’s death or on certain other designated contingencies over which the service provider has no control. At any time a plan fails to contain these payment restrictions with respect to a service provider, or is operated in violation of these restrictions with respect to a service provider, all non-forfeitable compensation amounts deferred under the plan for the service provider that have not previously been included in her income are included at that point, and a 20 % tax thereon is added to the service provider’s regular tax in the inclusion year. In addition, deferral-period interest must be paid with respect to tax that would have been due if the included amounts had been included in income at the earlier of the time of their deferral or their becoming vested.

New § 409A is quite complex. Furthermore, whenever the tax accounting rules discussed in this Chapter or the § 83 rules discussed in Chapter 15 require inclusion at an earlier time than do the rules of § 409A, the tax accounting rules and § 83 prevail over § 409A. *See* § 409A(c). Stated differently, § 409A apparently serves as a backstop to the primary rules of § 83 and tax accounting doctrine. In addition, the types of deferred compensation arrangements discussed in this Chapter and Chapter 15 will usually fall outside of § 409A because that provision is not violated by payments or property transfers that occur “at a specified time (or pursuant to a fixed schedule) specified under the plan at the date of the deferral of such compensation.” § 409A(a)(2)(A)(iv). Indeed, §

409A does not seem to affect any of the deferred compensation problems in this Chapter or Chapter 15 with the possible exception of Problem 3.a. on page 397. (The Year-13 payment in that problem arguably involves contingent compensation rather than an accelerated payment of deferred compensation. See Jack S. Levin, Keith E. Villmow, and Donald E. Rocap, *The JOBS Act's Harsh New Deferred Compensation Rules*, 108 TAX NOTES 1269, 1279-80 (Sept. 12, 2005).) For all these reasons, we recommend that new § 409A be omitted from the basic income tax course and reserved for a business planning course or an advanced seminar.

Chapter 11

Our Teacher's Manual answer to Problem c. on page 291 neglects to note that proposed Treas. Reg. § 1.7872-6 essentially treats term gift loans as "demand" loans for purposes of determining interest accruals for income tax purposes. So dad would include interest not under the more complex OID rules each year (as we incorrectly said in the Teacher's Manual) but rather under the rules that apply to "demand" loans. That is to say, even though this loan is clearly a "term" loan on its actual facts, dad's interest accruals will be determined using the "forgone interest" approach applied to demand loans (multiplying the principal by the "applicable federal rate" each year).

Two recently decided cases and one Revenue Procedure implicate *Indianapolis Power & Light* analysis in the context of advanced trade discounts. An advance trade discount is a transfer of cash from a wholesaler to a retailer to purchase a certain quantity of inventory. If the retailer fails to purchase the required inventory by a certain date, the retailer must return all or a portion of the cash to the wholesaler. The issue is whether the cash received by the retailer is includable in the year received. Cliff and Debby believe that both cases were wrongly decided and that the Revenue Procedure is misguided in its focus. Nevertheless, we reprint below a brief description (drawn from Deborah A. Geier, *Advance Trade Discounts: A Reprise*, 117 TAX NOTES 1155 (2007)) if you wish to delve into this quagmire in the basic tax course—though we strongly advise otherwise! Joseph believes that the doctrinal issue is whether *IP&L* is distinguishable, viewing the latter case as standing for the proposition that what appeared to be one transaction was really two (one of which posed an absolute obligation to repay). This is basically a factual issue, which Joseph thinks would be too much of a distraction. If *IP&L* is distinguishable, then the 3rd Circuit may have been correct in *Karns* to require inclusion of the cash received because the repayment obligation was contingent, even though market-rate interest was paid. On a deeper theoretical level, interest-free loan situations can be correctly resolved by an inclusion/deduction approach, apart from section 7872. Joseph has examined various aspects of borrowing and credit transactions in Joseph M. Dodge, *Exploring the Income Tax Treatment of Borrowing and Liabilities, or Why the Accrual Method Should be Eliminated*, 26 VA. TAX REV. 245 (2006) (exploring, in part, whether a cash-flow approach to borrowing is conceptually superior).

In *Westpac Pacific Food v. Comm'r*, 451 F.3d 970 (9th Cir. 2006), the taxpayer entered into several advance trade discount agreements with various suppliers. Retention of the cash was conditioned on the purchase of a certain product volume from the various

suppliers. If the required volume was not purchased, a *pro rata* portion of the cash had to be returned to the supplier. The taxpayer did not include the cash when received; rather, it reduced its cost-of-goods-sold with respect to the products for which the required volume had been purchased. When the required volume was not purchased, the taxpayer had to repay a *pro rata* portion of the cash and no adjustment to cost-of-goods-sold was made. Thus, the taxpayer achieved deferral of tax with respect to the cash between the time of receipt and effective inclusion (through a reduction to cost-of-goods-sold). From the reported decision, it does not appear that Westpac had to pay interest on the cash received under any of its agreements. The government argued that the cash should be included in the year received, but the 9th Circuit held otherwise, saying:

Because the taxpayer here has to pay the money back if the volume commitments are not met, it is not an “accession to wealth” as required under *Glenshaw Glass*. Westpac either has to buy a specific volume of goods for more than it would otherwise pay or pay the money back. . . . Thus the cash advance discounts are, like a loan or customer security deposit, liabilities rather than income when received.

In *Karns Prime & Fancy Food Ltd. v. Comm’r*, 494 F.3d 404 (3d Cir. 2007), the taxpayer entered into two agreements under it which received \$1.5 million and \$300,000, respectively, from its supplier. Loan agreements were executed, and what looks to be significant interest payments were required (prime plus 1% on the first loan and 10.7% on the second loan). In companion agreements, the taxpayer agreed to purchase a certain product volume from the supplier by certain dates. If the required volume was purchased by the required dates, a portion of the loan repayments were forgiven. The taxpayer did not include the \$1.5 million and \$300,000 cash receipts but rather included as § 61(a)(12) debt-discharge income the amounts that were forgiven as the various volume requirements were achieved (rather than reducing its cost-of-goods sold). As in *Westpac*, the government argued for inclusion of the cash on receipt, and the 3rd Circuit agreed, saying:

The logic of the Supreme Court’s holding in *Indianapolis Power* applies here. According to that decision, if the taxpayer has some guarantee that it will be allowed to retain the funds, then it has complete dominion over the money. . . . Such is the case here. Karns, and Karns alone, was at all times in control of whether it would meet the Supply Agreement. Therefore, the funds provided to Karns were in substance a projected rebate for products to be supplied, analogous to an advance payment, and as such were taxable income.

In Revenue Procedure 2007-53, 2007-30 I.R.B. 233, the Internal Revenue Service said that it will follow *Westpac Pacific Food* (and thus allow deferral) in the case of accrual taxpayers who agree to reduce the cost-of-goods-sold by the amount of the excluded cash, consistent with generally accepted accounting principles, so long as they report the transaction in this same manner for financial accounting purposes. The procedure never mentions the word “interest.”

In Debby's and Cliff's view, all three of these authorities came to the wrong result. To understand why, recall that both taxpayers achieved deferral of income tax on their respective cash receipts until they effectively included the cash in income by reducing cost of goods sold (*Westpac*) or recognizing debt-discharge income (*Karns*). The *Westpac* taxpayer did not incur an interest charge during the deferral period. Therefore, this taxpayer achieved a cash-flow consumption tax result. This means that income earned by investing the cash during the deferral period was effectively tax exempt, as illustrated at pages 72-73 of the textbook. The only way for the tax system to prevent this outcome was to require inclusion of the cash at the time of receipt. This would have forced the *Westpac* taxpayer into the income tax result illustrated on page 73 of the textbook, and the court erred when it failed to do so.

In contrast, the *Karns* taxpayer paid a market-rate interest charge during the deferral period. This effectively eliminated the value of deferral and the need to force the taxpayer into an income tax result by requiring inclusion of the cash receipt. Thus, the *Karns* court erred when it insisted on inclusion.

Finally, the Revenue Procedure is wrong to focus solely on whether the taxpayer is also deferring the income for financial accounting purposes, as well. Nowhere does it mention whether interest is paid on the amount excluded as a "loan," which properly should be at the heart of the analysis.

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.

We believe that *Payne* was wrongly decided, as it appears to be 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. 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.

Under this reading of the modern rationale, only discharged principal (received in Year 1) can create § 61(a)(12) debt-discharge income. If discharged interest (rent paid for the time value of money) creates an income inclusion, it would have to be plain vanilla gross income under the residual language in § 61 (“gross income means all income from whatever source derived”). But simply being able to avoid a *reduction* in wealth does not typically produce gross income. One might respond that the credit card company, in substance though not in form, loaned additional cash to the taxpayer every time an interest payment was due and not paid and that the discharge of this additional principal correctly produces § 61(a)(12) debt-discharge income. The problem with this argument, however, is that, 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. Thus, the *Payne* decision appears to be an example of a literal “textualist” reading of the language “income from the discharge of indebtedness” that is severed from the deep norms underlying an income tax. Cliff, however, believes that being relieved of an obligation to pay for services actually received is taxable under the residual clause of § 61.

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.

The American Recovery Act enacted new § 108(i), which allows taxpayers who realize debt-discharge income on the reacquisition of an “applicable debt instrument” during 2009 and 2010 to irrevocably elect to include the income ratably over a 5-year period beginning generally in 2014. This deferral election allows

taxpayers to avoid immediate inclusion. Moreover, if the election is made, other § 108 exclusions become inapplicable. Thus, the deferral election effectively allows taxpayers otherwise eligible to exclude the income under the bankruptcy or insolvency exclusions to avoid a reduction of the tax attributes listed in § 108(b). An “applicable debt instrument” is a debt instrument issued by a C corporation or any other person in connection with that person’s trade or business.

Chapter 13

The Debt Relief Act 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 non-deductible personal item. 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 Debt Relief Act 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 after December 31, 2006, and before January 1, 2010. 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.

“Qualified principal residence indebtedness” is “acquisition indebtedness” within the meaning of § 163(h)(3)(B), except that the \$1 million and \$500,000 ceilings are increased to \$2 million and \$1 million, respectively. “Principal residence” has the same meaning as in § 121. Contrary to the usual rules in § 108(b), the amount excluded reduces the basis (but not below zero) of the principal residence but other tax attributes are unaffected. This effectively means that the taxpayer will realize either a smaller nondeductible loss or increased gain on a simultaneous or later sale of the residence, though any such gain may be excludable under § 121.

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).

Joseph does not believe that, in principle, the cause of the decline in value in the home is relevant. The deep structural issue is, “How much has the taxpayer spent on consumption in the form of housing?” In the case of acquisition debt, the taxpayer arguably spends only the down payment plus actual principal paid, so that relief from paying principal is not income, but rather a price reduction. He agrees, therefore, with the

decision by the legislation's drafters that a discharge of debt secured by the home that was not used to acquire, construct, or substantially improve the home, but rather was spent on consumption (such as to purchase a car, a vacation, education, *etc.*) should not qualify for exclusion, because that debt supported actual consumption outlays by the taxpayer.

The Emergency Stabilization Act extended § 108(a)(1)(E), (h) through 2012.

Chapter 14

Treasury Regulations issued in 1996 and dealing primarily with the treatment of contingent debt also seem to change the rule in *Warren Jones* (on page 380) that the § 1001 "amount realized" by an accrual-method taxpayer on the sale of property for a note is the face amount of the note (rather than the fair market value of the note, as in the case of a cash-method taxpayer). Treas. Reg. § 1.1001-1(g) now provides that the § 1001 amount realized is the real "principal" of the note, as determined under §§ 1273 and 1274, regardless of the taxpayer's method of accounting. We shall therefore reduce *Warren Jones* to a note in the next edition.

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.

Personal residences cannot be exchanged tax-free under § 1031 because they are neither business nor investment property. 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. In general, the taxpayer must own the property exchanged as well as the property received for at least 24 months before and after the exchange, respectively. In addition, in each of the two 12-month periods preceding the exchange, as well as in each of the two 12-month periods following the exchange, the taxpayer must rent the property to another at fair market value for at least 14 days and must not use the property for personal purposes for more than the greater of 14 days or 10 percent of the number of rental days.

Chapter 17

The Working Families Act 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 Act 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.

For tax years beginning in 2009 and 2010, the American Recovery Act makes changes to the earned income credit to provide an increased maximum credit. For example, an individual with three or more qualifying children is entitled to a maximum 2009 credit (subject to phaseout) of \$5,657.

The Working Families Act extended through 2010 the \$1,000 credit amount under the § 24 Child Tax Credit and increased the amount of the credit that can be refunded from 10% of earned income in excess of certain threshold amounts to 15%.

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

The highest average personal income tax rate ever experienced in the United States was 16.1% for 1981. In 2004 and 2005, the most recent years for which data are available, the U.S. average personal income tax rate was 13.1%. *See* Scott Hollenbeck & Maureen Keenan Kahr, *Ninety Years of Individual Income and Tax Statistics, 1916-2005*, IRS STATISTICS OF INCOME BULLETIN, Winter 2008, available at <http://www.irs.gov/pub/irs-soi/16-05intax.pdf>.

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.

The Working Families Act extended marriage penalty relief in two ways: (1) it extended the doubling of the amount of income in the 15% bracket for joint filers (as compared to single individuals) through 2010, and (2) it extended the doubling of the Standard Deduction for joint filers (as compared to single individuals) through 2010. (It also increased the amount of income subject to the 10% bracket for all filers.)

The Reconciliation Act amended § 1(g) (the “kiddie tax”) by increasing the age threshold (from “under 14” to “under 18”) under which investment income will be taxed to children at their parent’s highest marginal rate. The Act also makes the kiddie tax inapplicable if the child is married and files a joint return for the year.

Effective January 1, 2008, the Small Business Act further extended § 1(g) (the “kiddie tax”) to apply to those who are 18 years old (instead of “under 18”) but only if the child’s earned income does not exceed one-half of the amount of his support. (The kiddie tax applies to all children 17 or younger without regard to this new support test.) In addition, the kiddie tax will 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.

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. So dad would include interest not under the more complex OID rules each year but rather under the rules that apply to “demand” loans. That is to say, even though this loan is clearly a “term” loan on its actual facts, dad’s interest accruals will be determined using the “forgone interest” approach applied to demand loans (multiplying the principal by the “applicable federal rate” each year).

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

Somehow the facts in our problem on page 531 changed in the new edition slightly, which makes the answer in our Teacher’s Manual (based on the old version of the problem) incorrect. In our second edition, the accident occurred in Year 1, and the theft loss and reimbursement occurred in Year 2. In the current third edition, the accident occurred in Year 2—the same year in which the theft loss is discovered and the insurance payment for the theft is received. Below is our *revised* answer based on the problem as it appears in the third edition:

Steve has an accident in Year 2. How much is deductible? Under Reg. § 1.165-7(b)(1), the loss calculation begins at the *lesser* of (i) A/B (\$20,000) and (ii) the decline in value (stipulated to be \$12,000: \$16,000 *less* \$4,000). In real life, about the only way one would know the value of a wrecked automobile would be to offer it for sale to a junk yard or two. The regulations allow use of repair costs as a measure of loss (here, \$11,000), but they do not require it. We’ll take whichever is greater, \$12,000.

Next, what about the \$9,000 insurance recovery? This ties into the question of whether and when the loss is “sustained.” Under Reg. § 1.165-1(d)(2), no loss is sustained to the extent there is a “claim for reimbursement” for which there is a “reasonable prospect of recovery.” A “claim for reimbursement” would exist by reason of insurance coverage but usually not on account of the possibility of suing somebody (too many contingencies). (This approach is 180° opposite the year-by-year approach for medical expenses and reimbursements.) Here, there is no prospect of recovery for \$3,000 (\$12,000 loss, as defined under § 1.165-7(b), *less* the \$9,000 to which their insurance contract entitles them). That is to say, apparently their insurance contract defines their “loss” by reference to the \$11,000 repair costs because the facts state that they have a \$2,000 “deductible” and are entitled to recover \$9,000 (which they receive in Year 3). But, as stated above, the “loss” for tax purposes is governed by the Treasury Regulations, not the insurance contract. Hence, their loss is not equal to the \$2,000 “deductible” but the \$3,000 difference between their \$12,000 “loss” under the Regs and the \$9,000 to which their contract entitles them to recover. Thus, Steve and Janice have a sustained loss in Year 2 of \$3,000.

Because this is a personal loss (rather than a business or investment loss), we next apply § 165(h). First, you subtract \$100 (per casualty event) under § 165(h)(1), leaving \$2,900. The ability to deduct this amount under § 165(h)(2)(A) and (h)(2)(B) depends on whether or not there are recognized personal casualty gains in the same year. A recognized personal casualty gain occurs if the recovery is greater than basis, and the proceeds are not “rolled over” into similar-use property under § 1033. Hence, we must analyze part b. of the Problem.

Steve and Janice actually do have a personal casualty gain in Year 2 (the same year in which they suffer their personal casualty loss). While Janice’s art work is stolen in Year 1, the theft is not discovered until Year 2. (As we shall shortly see, this is likely a personal-use item, as opposed to an investment item, unless stored in a vault at all times.) Section 165(e) says that a theft loss is not sustained any earlier than the year of discovery. Thus, any loss here would be sustained in Year 2, which is also the year of the insurance recovery. Moreover, since the \$20,000 recovery is greater than her \$16,000 basis in the item, Janice doesn’t suffer a tax “loss” at all under § 1001 but rather a “gain” of \$4,000 (\$20,000 A/R less \$16,000).

Some students see the \$5,000 “deductible” as a “loss,” but remind them that “loss” is a tax term of art that means a loss of *basis* (where A/R is less than basis). The “deductible” merely reduces her realized “gain,” but she still realizes a “gain” nonetheless (and no “loss”). If Janice had been entitled to the full \$25,000 replacement value under her policy, without the \$5,000 deductible, she would have realized a \$9,000 gain instead of a \$4,000 gain. In other words, failing to get a reimbursement for \$5,000 of her lost *value* (representing untaxed appreciation, not basis) simply reduces her “gain.” She recovers every dollar of her basis, and thus has no unrecovered basis to deduct as a “loss.” (Moreover, remind them why it would be wrong to allow Janice and Steve a deduction for the \$5,000 of untaxed appreciation that is not covered under the insurance policy: that would provide a double tax benefit for the same dollars—both exclusion and deduction.)

So Steve and Janice have both a personal casualty *loss* (with respect to the automobile) and a personal casualty *gain* (with respect to the art work) in Year 2, and the gain exceeds the loss. Therefore, § 165(h)(2)(B) applies. Both the gain and the loss are treated as “capital,” thanks to § 165(h)(2)(B), even though there is no “sale or exchange” of these capital assets. This favorable rule usually ensures that every dollar of the loss will be deductible (notwithstanding § 1211), and the excess has a good chance of creating low-taxed “net capital gain” (depending on the taxpayer’s other capital gains and losses for the year).

What if Janice took her \$20,000 insurance proceeds and rolled 100% of the cash over into another artwork, *i.e.*, property “related in service or use” within the meaning of § 1033? She could then elect to defer recognition of her realized gain. In that case, she would have only a realized personal casualty loss in Year 2, so § 165(h)(2)(A) would apply (instead of (h)(2)(B)). Since 10% of AGI is \$6,000 (10% x \$60,000), none of the \$2,900 personal casualty loss would be deductible. It’s not one of those extraordinary

losses outside the normal vicissitudes of life that so significantly compromise ability to pay that a normally nondeductible “personal” loss should be made deductible in part.

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

For 2004 and 2005 only, the Jobs Act amended § 164 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.

The Tax Relief Act extended § 164(b)(5), pertaining to elective deduction of state sales taxes in lieu of state income taxes, through the end of 2007. **The Emergency Stabilization Act extended § 164(b)(5) through 2009.**

The American Recovery Act enacted new § 164(a)(6), (b)(6), which allow deduction of state or local sales or excise taxes paid on the purchase of a “qualified motor vehicle” before December 31, 2009. A “qualified motor vehicle” is a new (not used) car, light truck, or motorcycle that does not exceed 8,500 pounds or a new

motor home. Only the tax paid on the first \$49,500 of purchase price can qualify, the deduction phases out between \$125,000 and \$135,000 of modified AGI for single individuals (\$250,000 and \$260,000 for married couples filing jointly), and 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).

The Jobs Act 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.

The Jobs Act has imposed 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. Where the donated property is a long-term capital gain asset, this new provision effectively limits the donor’s deduction to the lesser of the affected property’s adjusted basis or its fair market value. This relatively straightforward rule is, however, transformed into a complex monstrosity by new § 170(m), also added to the Code by the Jobs Act. 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, the Reconciliation Act 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 before 2011 by the artist who created them will be capital assets, notwithstanding § 1221(a)(3). The Tax Relief Act has now made this change permanent. The Reconciliation Act 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. These changes do not affect the answers to the Problems on pages 549-50.

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.

The Debt Relief Act amended § 163(h)(3)(E) to provide that through December 31, 2010, premiums paid for qualified mortgage insurance in connection with acquisition indebtedness with respect to a qualified residence are treated as qualified residence interest.

The Housing Assistance Act allows taxpayers to increase their § 63 Standard Deduction for 2008 only 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). The Emergency Stabilization Act extended the increased Standard Deduction through 2009.

The Housing Assistance Act enacted new § 36, which created a refundable tax credit equal to the lower of \$7,500 or 10% of the purchase price of a principal residence purchased after April 8, 2008, and before July 1, 2009, by those who have not owned a home for at least three years prior to the purchase. The maximum credit is \$3,750 for a married taxpayer filing a separate return. If two or more eligible unmarried individuals purchase a home jointly, their aggregate credit is limited to \$7,500. See § 36(b). 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. As enacted in the Housing Assistance

Act, the credit is in effect an interest-free loan, because the taxpayer claiming the credit must include 1/15th of the credit (6 2/3%) in gross income over a 15-year period beginning in the second year following the year of purchase. If the home ceases to be used as a principal residence or is sold prior to the expiration of the 15-year recapture period, the remaining unrecaptured amount must be included in the year of sale (or changed use). In the case of a sale, however, the recapture amount cannot exceed the realized gain. The recapture amount disappears on death. A spouse receiving the house under § 1041 prior to full recapture steps into the shoes of the transferor with respect to the liability to include the remaining recapture amount.

The American Recovery Act amended new § 36 by (1) increasing the maximum credit to \$8,000 (\$4,000 for marrieds filing separately), (2) extending the credit to homes purchased before December 1, 2009, and (3) eliminating the repayment requirement (transforming the “interest-free loan” of prior § 36 into a true credit) for purchases made after December 31, 2008, and before December 1, 2009. Recapture of the credit is still required, however, if the home is sold or ceases to be used as a principal residence within 36 months of purchase.

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).

The Jobs Act created new § 199, which allows U.S. manufacturers to deduct a specified percentage of the lesser of (1) their “qualified production activities income” or (2) taxable income. The “specified percentage” is 3% for 2005 and 2006, 6% for 2007 through 2009, and 9% after 2009. The deduction is capped at 50% of an employer’s W-2 wages paid for the year. (The Reconciliation Act changes this to 50% of W-2 wages for the year that are allocable to domestic production gross receipts.) If the income is earned by a corporation or individual otherwise subject to tax at the top marginal rate of 35%, the effect of the deduction is to reduce the effective marginal rate to 32%. The deduction is also allowed for AMT purposes.

“Qualified production activities” is defined quite broadly to include not only traditional manufacturing activities but also certain service activities in the fields of U.S.

construction, engineering, and architecture, and it also includes the production of U.S. movies, videos, electricity, natural gas, or potable water.

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 Service 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 Service 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 Service 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.

In *Toth v. Comm’r*, 128 T.C. 1 (2007), the Tax Court held that start-up expenses were deductible under § 212 in spite of § 195(c)(1)(A)(iii). The taxpayer purchased 17 acres of Oregon property in 1998 in order to commence a business in horse boarding, training, and lessons. She was one of only six individuals in the Pacific Northwest qualified to teach “Eventing,” an Olympic equestrian sport. The Service did not dispute that the activity was engaged in for profit but rather claimed only that the outlays that taxpayer sought to deduct in 1998 were nondeductible start-up expenses. In holding for the taxpayer, the Court said:

This Court construes the term “startup expenditure” to denote an expenditure that is capital rather than ordinary. This Court will not interpret section 195 to override the deductibility of ordinary and necessary expenses petitioner incurred in an ongoing section 212 activity any more than it would do so for an ongoing section 162 activity.... Once her section 212 activity has begun, the deduction of ordinary and necessary expenses paid or incurred in that activity is not precluded by section 195 regardless of whether that activity is subsequently transformed into a trade or business. This interpretation is consistent with section 195 and its legislative history.

The decision is puzzling. The first statement that § 195 applies only to outlays that are categorized as “capital expenditures” rather than “expenses” is wrong or at least misleading. Section 195 deals primarily with the § 162 “carrying on” requirement and denies current deductibility for what would otherwise qualify as immediately deductible “expenses” if the business had already commenced. They are rendered “capital” outlays by § 195 only because the business is not yet being carried on. The court appears to have concluded that the taxpayer’s § 212 activity had already commenced (even though the “business” that it later turned into had not), which means that the “carrying on” requirement implied in § 212 is satisfied, rendering § 195 inapplicable. This case cannot mean, however, that the taxpayer’s activity qualified under § 212 solely because of her intent to build it into a business in the future or § 195 would be eviscerated. Perhaps the

decision was based on the fact that the activity involved the purchase of real estate that could be sold for a profit even if the business never developed. Unfortunately, the court did not elaborate on why the activity qualified as a § 212 activity that had already started up or describe the outlays that the taxpayer was attempting to deduct. Moreover, the court's second statement seems to conflict with § 195(c)(1)(A)(iii) unless the taxpayer did not anticipate her activity becoming a trade or business, a matter which the court did not discuss. These shortcomings that make it difficult to predict the future impact of this decision.

In *Tschetschot v. Commissioner*, T.C. Memo. 2007-38, the taxpayer won more than \$11,000 in nine "tournament poker" games. Because of expenses, however, she claimed a net loss of nearly \$30,000 on her Schedule C. The government contended that the taxpayer's deductions were limited to her \$11,000 of winnings under § 165(d). (The government conceded that the taxpayer was a "professional gambler" and thus could deduct her expenses, as limited by § 165(d), on her Schedule C. Non-professional gamblers can deduct only to the extent that they itemize deductions on Schedule A.) The Tax Court, agreeing with the government, rejected the taxpayer's argument that tournament poker should be considered an entertainment activity (to which § 165(d) does not apply), like other professional sporting tournaments, rather than a wagering activity. "Betting is so intrinsic to poker," the court said, that playing it in a tournament "does not change the basic nature of the game as a wagering activity."

A recent Tax Court case provides what some might say is a generous interpretation of whether two or more "undertakings" constitute a single "activity" under Reg. § 1.183-1(d)(1). The taxpayer in *Topping v. Commissioner*, T.C. Memo. 2007-92, was an equestrian competitor (generating losses) who started an interior design business (generating a profit) that specialized in horse barns and second homes. The taxpayer sought to deduct her horse-related expenses against her design income. Holding for the taxpayer that these two undertakings constituted a single "activity" for purposes of § 183, the court stressed that the unique nature of the taxpayer's design undertaking made it necessary for her to participate in her equestrian engagements in order to attract clients. The court found significant her contention that more than 90% of her design clients came from her equestrian contacts. She maintained that conventional advertising was disliked by her client base and, thus, that participation in her equestrian competitions was the only effective means of generating her clients.

The Tax Relief Act extended § 222, pertaining to the above-the-line deduction for certain higher education costs, through the end of 2007. The same act also extended § 62(a)(2)(D), pertaining to the above-the-line deduction for certain expenses of elementary and secondary school teachers, through the end of 2007. **The Emergency Stabilization Act extended both §§ 222 and 62(a)(2)(D) through 2009.**

The American Recovery Act created a modified § 25A Hope Credit for 2009 and 2010 called 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.

Revenue Ruling 2008-13, 2008-10 I.R.B. 518, provides that compensation that will be paid under a contract notwithstanding the failure to achieve performance-based goals if the service provider voluntarily retires, is terminated without cause, or terminates his or her employment for good reason is not deductible performance-based compensation within the meaning of § 162(m).

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 § 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).

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.

At the least, taxpayers wishing to deduct under Treas. Reg. § 1.162-5 the costs (including living expenses in a different city) 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

The Jobs Act 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.

In connection with scenario (3) in the problem on page 618, you can usefully talk about a new case, *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.

In Notice 2007-47, 2007-24 I.R.B. 1393 (June 11, 2007), the IRS announced that when an employer requires an employee to stay temporarily at a lodging facility so that the employee can participate in the employer's business meeting or function, the employee can deduct her lodging cost, or exclude the value of lodging provided by the employer, even if the lodging is in the general geographical area of the employee's principal place of work so that the employee is not away from home.

Chapter 23

In the basic income tax course, we recommend that you limit coverage of the pre-death income tax treatment of life insurance to the material on pages 675-76. If, nevertheless, you choose to go deeper, see Rev. Ruls. 2009-13, 2009-21 I.R.B. 1029, and 2009-14, 2009-21 I.R.B. 1031, for detailed analysis of advanced issues.

Chapter 24

The Jobs Act extended the increased expensing limit in § 179 (from \$25,000 to \$100,000, adjusted for inflation) to all taxable years beginning before 2008, except that the \$25,000 limit applies with respect to vehicles in excess of 6,000 pounds but less than 14,000 pounds (such as SUVs). The prior law exemption from § 280F for these SUVs continues to apply to these vehicles, however.

The Jobs Act extended the § 168(k) placed-in-service period through the end of 2006 for certain aircraft, but otherwise § 168(k) has not been extended. The Reconciliation Act replaces "2008" with "2010" wherever it appears in § 179. Thus, the increase in the amount that can be expensed (from \$25,000 to \$100,000) and the increase in the phase-out threshold (from \$100,000 to \$400,000) apply for any taxable year beginning before 2010.

For tax years beginning in 2007 through 2010, the Small Business Act increases the amount that may be "expensed" under § 179 from \$100,000 to \$125,000 and increases

the threshold at which phase-out begins from \$400,000 to \$500,000. These amounts are indexed for inflation for years beginning after 2007 and before 2011.

The Economic Stimulus Act increased the amount that can be expensed under § 179 to \$250,000 and increased the phase-out threshold to \$800,000 for tax years beginning in 2008. The \$250,000 and \$800,000 amounts are not indexed for inflation, however. Moreover, the Act also revived § 168(k) 50% bonus depreciation for eligible property placed in service before January 1, 2009 (January 1, 2010, for certain property with a recovery period of 10 years or longer or for certain transportation property, including aircraft). Property eligible for 50% bonus depreciation includes § 168 property with a recovery period of 20 years or less, water utility property, off-the-shelf computer software, and qualified leasehold property. Finally, the Act increases the § 280F limitations by \$8,000 for those taxpayers eligible to take § 168(k) bonus depreciation. Thus, Revenue Procedure 2008-22, 2008-12 I.R.B. 658, 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.

The American Recovery Act extended through 2009 the increased expensing limits in § 179 and bonus depreciation in § 168(k). Moreover, Rev. Proc. 2009-24, 2009-17 I.R.B. 1, provides the same § 280F limits for cars as noted above. We describe the answers to problems c. and f. on page 705 for both the fall 2009 and spring 2010 semesters.

In problem c., the taxpayer may elect to “expense” the entire \$150,000 cost under § 179 for an industrial machine considered during the fall semester (placed in service in 2009). Because the entire cost would be deducted in 2009, no deduction would be allowed in the second year of service (2010). For an industrial machine considered during the spring semester (placed in service in 2010), if the taxpayer does *not* elect to apply § 179 to this property, the taxpayer’s Year-1 deduction is \$30,000 (.20 x \$150,000), his Year-2 deduction is \$48,000 (.32 x \$150,000), and so on. If our taxpayer elects to apply § 179, he “expenses” \$125,000 and deducts \$5,000 under § 168 (.20 x \$25,000) in Year 1 (for a total of \$130,000 of the total \$150,000 cost), and he deducts \$8,000 under § 168 in Year 2 (.32 x \$25,000), and so on.

In problem f., if the car is placed in service in the fall semester (2009), our taxpayer has \$100,000 of § 179 ceiling remaining (after analyzing the industrial machine, above). But under § 280F, only \$8,220 will be permitted to be deducted (\$10,960 reduced by 25% for the personal use). In 2010, only \$3,600 can be deducted (\$4,800 reduced by 25% for the personal use). For a car considered during the spring semester (2010), you can assume that the § 179 ceiling (once again reduced) was used entirely with the industrial machine, leaving only § 168 depreciation for the car. Only \$2,220 can be deducted in 2010 (\$2,960 reduced by 25% for the personal use), and \$3,600 can be deducted in 2011 (\$4,800 reduced by 25% for the personal use).

In order to illustrate the interaction between §§ 179 and 168 for property placed in service in 2009 (the fall semester), including the 50% bonus depreciation under § 168(k), you might ask your students what the result would be in problem c. if the industrial machine had cost \$800,000. In that case, the § 179 phase-out threshold would not be triggered, so the first \$250,000 of the \$800,000 cost could be expensed under § 179 (assuming the taxpayer so elected). Next, \$275,000 could be deducted as bonus depreciation under § 168(k) (.50 x \$550,000). Finally, \$55,000 could be deducted in 2009 as “regular” depreciation (.20 x \$275,000). A grand total of \$580,000 of the \$800,000 (72.5%) could be deducted in 2009. Thus, in 2009, the taxpayer would achieve almost $\frac{3}{4}$ of the full expensing that would occur under a cash-flow consumption tax, and then an additional \$88,000 (.32 x \$275,000) could be deducted in 2010.

In order to illustrate the § 179 phase-out rule, you might ask the same question but with a \$1 million purchase price for the industrial machine in 2009. In that case, only \$50,000 could be expensed in 2009 under § 179 (\$250,000 less [\$1 million less \$800,000]). Next, \$475,000 could be deducted as bonus depreciation under § 168(k) (.50 x \$950,000). Finally, \$95,000 could be deducted as regular depreciation (.20 x \$475,000), for a grand total of \$620,000 of the \$1 million purchase price. In 2010, \$152,000 could be deducted (.32 x \$475,000).

The Jobs Act provides that certain qualified leasehold improvements made to nonresidential real property before 2006 can be depreciated under the straight-line method over 15 years (rather than 39 years). The Tax Relief Act extended this provision through the end of 2007. **The Emergency Stabilization Act extended this provision through 2009.**

The Reconciliation Act 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

The Emergency Stabilization Act added new §§ 6045(g), 6045A, and 6045B, which generally require securities brokers, beginning in 2011, 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.

The 15 percent and 5 percent capital gains rates referred to on page 730 were scheduled to expire at the close of 2008. The Reconciliation Act 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).

The Reconciliation Act 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 before 2011 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.) The Act 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.

Students sometimes question whether rental property held by a non-real-estate professional can 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.* In the next edition, we shall add to the notes on page 735 a short discussion of this issue. We think that 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”). While it may not be worth pursuing the issue beyond this level in the basic tax course, we think that the result would probably be different in a “net lease,” where the tenant is responsible for all expenses, upkeep, real estate taxes, *etc.* *See, e.g.*, Rev. Rul. 73-522, 1973-2 C.B. 226.

You might consider distributing *Lattera v. Comm’r*, 437 F.3d 399 (3rd Cir. 2006), which holds 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

* 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.

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.

The Tax Relief Act made permanent § 1221(b)(3), allowing self-created musical works to be treated as capital assets for purposes of a sale or exchange, though not for purposes of charitable contributions.

Chapter 27

So far, the ticking time bomb that is the AMT has been defused by a series of temporary “patches.” The Working Families Act extended the increased exemption amounts under the AMT for 2005 only and allowed the use of the Hope Scholarship Credit, the Lifetime Learning Credit, and certain other personal credits for taxable years beginning in 2004 and 2005.

The Reconciliation Act increased the AMT exemption levels from their 2005 levels but only through the end of 2006. For 2006, the exemptions are \$62,550 for joint returns (increased from \$58,000) and \$42,500 for most single individuals (increased from \$40,250). Moreover, the Act extends through 2006 the ability to use most nonrefundable personal credits (including, most notably, the § 21 dependent care credit and § 25A Hope and Lifetime Learning Credits) against AMT liability.

The Tax Increase Prevention Act once again (in December of 2007) extended and increased the AMT exemption levels, but only for taxable year 2007, to \$66,250 for married couples filing jointly and \$44,350 for single individuals. **The Emergency Stabilization Act extended the AMT patch for tax years beginning in 2008 with exemption levels of \$69,950 for married couples filing jointly, \$46,200 for single individuals, and \$34,975 for married persons filing separately. Moreover, the Act also extended through 2008 the ability to use most nonrefundable personal credits against AMT liability. The American Recovery Act extended the AMT patch for tax years beginning in 2009 with exemption levels of \$70,950 for married couples filing jointly, \$46,700 for single individuals, and \$35,475 for married persons filing separately. The Act also extended through 2009 the ability to use most nonrefundable personal credits against AMT liability.**

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 Service 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 Service 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 Rev. Rul. 2007-12, 2007-11 I.R.B. 685, the Service ruled that payroll tax liability accrues and is deductible in the year in which it arises even if it related to deferred compensation that is not, itself, deductible until a later year under the rules of § 404.

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.

The Jobs Act 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. The other Jobs Act tax shelter changes are outside the scope of the basic income tax course.

The Small Business Act amended § 6694 pertaining to certain penalties, introducing a higher standard of reasonable cause for practitioners and preparers than for taxpayers in the case of an understatement arising from transactions that are not disclosed. Under old law, the preparer could be liable for a \$250 penalty for a tax understatement only if the return position were undisclosed and there were no “realistic possibility of being sustained on the merits” or if the position were disclosed and “frivolous.” For positions not disclosed on the return, the new higher standard requires “a reasonable belief that the position would more likely than not be sustained on its merits.” With respect to disclosed positions, the not-frivolous standard has been replaced with a requirement that there be a reasonable basis for the position taken on the return. The penalty has been increased to the greater of \$1,000 or 50% of the adviser’s fees. “Willful” or “reckless” conduct increases the penalty to the greater of \$5,000 or 50% of the adviser’s fees.

The Emergency Stabilization Act 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 prior “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).