RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

We apologize to our readers. If we had more time, this outline would be much shorter.

By

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code are discussed to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected items previously covered in the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

The last twelve months have yielded many significant federal income tax developments. The Treasury Department and the Service provided an abundance of administrative guidance and the courts issued many significant judicial decisions. But many of the most significant developments in federal income taxation have been legislative. The Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136 ("CARES Act"), enacted on March 27, 2020, also in response to the COVID-19 pandemic, is economic stimulus legislation that provides, among other things, targeted tax relief for individuals and businesses including (i) a one-time rebate to taxpayers; (ii) modification of the tax treatment of certain retirement fund withdrawals and charitable contributions; (iii) a delay of employer payroll taxes and taxes paid by certain corporations; and (iv) other changes to the tax treatment of business income, interest deductions, and net operating losses. The Paycheck Protection Program Flexibility Act of 2020, Pub. L. No. 116-142 ("PPP Flexibility Act"), enacted on June 5, 2020, modifies several aspects of the forgivable Paycheck Protection Program loans authorized by the CARES Act and made available through the Small Business Administration (commonly referred to as PPP loans), including a repeal of the rule that precluded employers whose PPP loans are forgiven from deferring deposits of the

employer's share of Social Security tax. The Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, enacted on December 27, 2020, made permanent several Code provisions that previously had been temporarily extended for many years, temporarily extended several expiring provisions, and provided tax relief to those in areas affected by certain natural disasters. The American Rescue Plan Act of 2021, Pub. L. No. 117-2, enacted on March 11, 2021, made several significant changes. The changes made by this legislation include expanding credits such as the child tax credit and earned income credit, suspending the requirement to repay excess advance premium tax credit payments, and providing exclusions for up to $10,200 of unemployment compensation and for cancellation of student loans. The Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, enacted on November 15, 2021, contains relatively few significant tax provisions but ends the employee retention credit of Code § 3134 for the fourth quarter of 2021. This outline discusses the major administrative guidance issued in the last year, summarizes the recent legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in the last twelve months.

I. ACCOUNTING

A. Accounting Methods

1. It pays to make less money, especially less than $25 million. T.D. 9942, Small Business Taxpayer Exceptions Under Sections 263A, 448, 460, and 471, 86 F.R. 254 (1/5/21). These final regulations implement changes made to §§ 263A, 448, 460, and 471 by the 2017 Tax Cuts and Jobs Act (TCJA). The TJCA enacted several simplifying provisions that are available to a business if the business's average annual gross receipts, measured over the three prior years, do not exceed $25

million. These include the following: **(1)** the ability of C corporations or partnerships with a C corporation as a partner to use the cash method of accounting (§ 448(b)(3)), **(2)** the ability to use a method of accounting for inventories that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories (§ 471(c)(1)), **(3)** the ability to be excluded from applying the uniform capitalization rules of § 263A (§ 263A(i)), **(4)** the small construction contract exception that permits certain taxpayers not to use the percentage-of-completion method of accounting for certain construction contracts (§ 460(e)(1)(B)), and **(5)** the ability to be excluded from the § 163(j) limit on deducting business interest (§ 163(j)(3)). These final regulations provide guidance on the first four of these simplifying provisions. The regulations apply to taxable years beginning on or after January 5, 2021, but taxpayers can apply them to earlier taxable years beginning after December 31, 2017, provided that, if the taxpayer applies any aspect of the final regulations under a particular Code provision, the taxpayer must follow all of the applicable rules contained in the regulations that relate to that Code provision for such taxable year and all subsequent taxable years (and also must follow the relevant administrative procedures for filing a change in method of accounting).

- The final regulations provide limited relief from the rule that prohibits "tax shelters" from taking advantage of the five simplifying provisions for small businesses described above. These simplifying provisions each state that they are not available to "a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)." Section 448(a)(3) provides that a "tax shelter" cannot compute taxable income under the cash receipts and disbursements method of accounting, and according to § 448(d)(3), the term "tax shelter" for this purpose is defined in § 461(i)(3). Section 461(i)(3) defines the term "tax shelter" as "(A) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale, *(B) any syndicate (within the meaning of section 1256(e)(3)(B))*, and (C) any tax shelter (as defined in section 6662(d)(2)(C)(ii))." The term "syndicate," according to § 1256(e)(3)(B), is "any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs." Many small businesses will meet this definition and therefore will be precluded from using the simplifying provisions enacted by the TCJA. Businesses that fluctuate between having income and having losses could be in the position of having to change accounting methods. The final regulations address this concern in Reg. § 1.448-2(b)(2)(iii)(B), which permits a taxpayer to make an annual election to use the allocated taxable income or loss of the immediately preceding taxable year (rather than the current year) to determine whether the taxpayer is a syndicate for the current taxable year. This election would prevent a business that is normally profitable but experiences an unforeseen loss from being treated as a syndicate and therefore ineligible for the cash method of accounting and for the simplifying provisions described earlier. However, it would not prevent a business with consistent losses, such as a business in the start-up phase, from being treated as a syndicate.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes. The 2017 Tax Cuts and Jobs Act, § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the IRS.

All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, "the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in" either (1) an applicable financial statement, or (2) another financial statement specified by the IRS. Thus, taxpayers subject to this rule

must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. Income from mortgage servicing contracts is not subject to the new rule. The new rule also does not apply to a taxpayer that does not have either an applicable financial statement or another specified financial statement. An "*applicable financial statement*" is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by IRS.

Advance payments for goods or services. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(c). This provision essentially codifies the deferral method of accounting for advance payments reflected in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. New § 451(c) provides that an accrual-method taxpayer who receives an advance payment can either (1) include the payment in gross income in the year of receipt, or (2) elect to defer the category of advance payments to which such advance payment belongs. If a taxpayer makes the deferral election, then the taxpayer must include in gross income any portion of the advance payment required to be included by the applicable financial statement rule described above, and include the balance of the payment in gross income in the taxable year following the year of receipt. An advance payment is any payment: (1) the full inclusion of which in gross income for the taxable year of receipt is a permissible method of accounting (determined without regard to this new rule), (2) any portion of which is included in revenue by the taxpayer for a subsequent taxable year in an applicable financial statement (as previously defined) or other financial statement specified by the IRS, and (3) which is for goods, services, or such other items as the IRS may identify. The term "advance payment" does *not* include several categories of items, including rent, insurance premiums, and payments with respect to financial instruments.

a. Guidance on accounting method changes relating to new § 451(b). Rev. Proc. 2018-60, 2018-51 I.R.B. 1045 (11/29/18). Rev. Proc. 2018-60 modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide procedures under § 446 and Reg. § 1.446-1(e) for obtaining automatic consent with respect to accounting method changes that comply with § 451(b), as amended by 2017 Tax Cuts and Jobs Act, § 13221. In addition, Rev. Proc. 2018-60 provides that for the first taxable year beginning after December 31, 2017, certain taxpayers are permitted to make a method change to comply with § 451(b) without filing a Form 3115, Application for Change in Accounting Method.

b. Proposed regulations issued on requirement of § 451(b)(1) that an accrual method taxpayer with an applicable financial statement treat the all events test as satisifed no later than the year in which it recognizes the revenue in an applicable financial statement. REG-104870-18, Taxable Year of Income Inclusion Under an Accrual Method of Accounting, 84 F.R. 47191 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding the requirement of § 451(b)(1), as amended by the 2017 Tax Cuts and Jobs Act, that accrual method taxpayers with an applicable financial statement must treat the all events test with respect to an item of gross income (or portion thereof) as met no later than when the item (or portion thereof) is taken into account as revenue in either an applicable financial statement (AFS) or another financial statement specified by the IRS (AFS income inclusion rule). New Prop. Reg. § 1.451-3 clarifies how the AFS income inclusion rule applies to accrual method taxpayers with an AFS. Under Prop. Reg. § 1.451-3(d)(1), the AFS income inclusion rule applies only to taxpayers that have one or more AFS's covering the entire taxable year. In addition, the proposed regulations provide that the AFS income inclusion rule applies on a year-by-year basis and, therefore, an accrual method taxpayer with an AFS in one taxable year that does not have an AFS in another taxable year must apply the AFS income inclusion rule in the taxable year that it has an AFS, and does not apply the rule in the taxable year in which it does not have an AFS. The proposed regulations clarify that the AFS income inclusion rule does not

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