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.

Although relatively little tax legislation was enacted in the last twelve months, there have nevertheless been many significant federal income tax developments. The Treasury Department and the IRS provided an abundance of administrative guidance and the courts issued many significant judicial decisions. 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 for 2020, and providing exclusions for up to $10,200 of unemployment compensation received in 2020 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. The Inflation Reduction Act, Pub. L. No. 117-169, enacted on August 16, 2022, imposes a 15 percent alternative minimum tax (AMT) on corporations with "applicable financial statement income" over $1 billion, imposes an excise tax of 1 percent on

redemptions of stock by publicly traded corporations, extends through 2025 certain favorable changes to the premium tax credit of § 36B, and extends through 2028 the § 461(*l*) disallowance of "excess business losses" for noncorporate taxpayers. This outline discusses the major administrative guidance issued in the last year, summarizes recent legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in the last twelve months.

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

1. Required amortization of specified research or experimental expenditures incurred after 2021. The 2017 Tax Cuts and Jobs Act, § 13206, amended Code § 174 to require the capitalization and amortization of specified research or experimental expenditures. The amortization period is 5 years (15 years for expenditures attributable to foreign research), beginning at the midpoint of the year in which the expenditures are paid or incurred. The term "specified research or experimental expenditures" is defined as research or experimental expenditures paid or incurred by the taxpayer during a taxable year in connection with the taxpayer's trade or business. The term includes expenditures for software development. Expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas) are not subject to the required capitalization and amortization of § 174. Expenditures for the acquisition or improvement of land or for the acquisition or improvement of property that is depreciable under § 167 or subject to depletion under § 611 also are not subject to the required capitalization and amortization of § 174; however, allowances for depreciation under § 167 or for depletion under § 611 are treated as expenditures subject to § 174. For further explanation and details, the complete Conference Report accompanying TCJA may be found here. Amended § 174 applies to amounts paid or incurred in taxable years beginning after 2021.

2. Legal expenses incurred to defend patent infringement suits are currently deductible. Actavis Laboratories, FL, Inc. v. United States, 130 A.F.T.R.2d 2022-5601 (Ct. Fed. Cl. 8/19/22). The plaintiff in this case, Actavis Laboratories Florida, Inc. (Actavis), was the substitute agent for Watson Pharmaceuticals, Inc. (Watson). Watson manufactured both brand name and generic pharmaceutical drugs. To obtain approval of generic drugs, Watson submitted to the Food and Drug Administration abbreviated new drug applications (ANDAs). The ANDA application process for generic drugs includes a requirement that the applicant certify the status of any patents covering the respective brand name drug previously approved by the FDA (referred to as a "paragraph IV certification"). One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this certification is required to send notice letters to the holders of the patents informing them of the certification. Such a certification is treated by statute as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Watson incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Watson in response to the notice letters that Watson sent. Watson deducted these legal expenses on its 2008 and 2009 tax returns. Following audits of these returns, the IRS issued a notice of deficiency disallowing Watson's deductions on the basis that the costs incurred in defending the patent infringement litigation were capital expenditures under § 263(a). Watson paid the amounts sought by the IRS and, after filing amended returns requesting refunds, brought this action in the U.S. Court of Federal Claims seeking refunds of $1.9 million for 2008 and $3.9 million for 2009.

The U.S. Court of Federal Claims (Judge Holte) held that the legal expenses incurred by Watson in defending the patent infringement litigation were currently deductible. The IRS argued that the costs were capital expenditures under Reg. § 1.263(a)-4(b)(1), which requires taxpayers

to capitalize amounts paid to *acquire or create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. According to the government, the costs facilitated the acquisition of an intangible, specifically, an FDA-approved ANDA. The court, however disagreed. The court relied on the "origin of the claim" test established by the U.S. Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963). As interpreted by a later decision, *Woodward v. Commissioner*, 397 U.S. 572 (1970), the deductibility of litigation expenses under the origin of the claim test depends not on the taxpayer's primary purpose in incurring the costs, but "involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition [of a capital asset] itself." Here, the court reasoned, Watson's legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed a long line of decisions, including that of the U.S. Court of Appeals for the Third Circuit in *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), which have held that costs incurred to defend a patent infringement suit are not capital expenditures because they are not costs incurred to defend or protect title but rather are expenses incurred to protect business profits. Because Watson's legal expenses arose out of the patent infringement claims initiated by the patent holders, the court held, they were currently deductible. The court further concluded that Reg. § 1.263(a)-4(b)(1) did not require the costs to be capitalized because Watson's defense of the patent infringement litigation was not a step in the FDA's approval process for a generic drug:

> The FDA's review of an ANDA does not include patent related questions. When a generic drug company files an ANDA with a Paragraph IV certification, it certifies the patents associated with the relevant [drug] are either invalid or will not be infringed by the proposed generic drug. The FDA performs no assessment of that certification as a part of its ANDA review process—"[a]ccording to the agency, it lacks 'both [the] expertise and [the] authority' to review patent claims[.]"

- The court's analysis and conclusions in this case are consistent with those of the Tax Court in *Mylan, Inc. & Subsidiaries v. Commissioner*, 156 T.C. No. 10 (4/27/21).

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Seinfeld warned us: no double-dipping (with your PPP money)! Or, on second thought, maybe you can! Notice 2020-32, 2020-21 I.R.B. 1 (5/1/20). Section 1102 of the CARES Act, in tandem with § 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)), establishes the much-touted Paycheck Protection Program ("PPP"). The PPP was created to combat the devastating economic impact of the coronavirus pandemic. Generally speaking, the PPP facilitates bank-originated, federally-backed loans ("covered loans") to fund payroll and certain other trade or business expenses ("covered expenses") paid by taxpayers during an eight-week period following the loan's origination date. Moreover, § 1106(b) of the CARES Act allows taxpayers to apply for debt forgiveness with respect to all or a portion of a covered loan used to pay covered expenses. Section 1106(i) of the CARES Act further provides that any such forgiven debt meeting specified requirements may be excluded from gross income by taxpayer-borrowers.

Background. The CARES Act does not address whether covered expenses funded by a forgiven covered loan are deductible for federal income tax purposes. Normally, of course, covered expenses would be deductible by a taxpayer under either Code § 162, § 163, or similar provisions; however, a long-standing provision of the Code, § 265(a)(1), disallows deductions for expenses allocable to one or more classes of income "wholly exempt" from federal income tax. Put differently, § 265(a)(1) generally prohibits taxpayers from double-dipping: taking deductions for expenses attributable to tax-exempt income. Section 265 most often has been applied to disallow deductions for expenses paid to seek or obtain tax-exempt income. (For example, a taxpayer claiming nontaxable social security disability benefits pays legal fees to pursue the claim. The legal fees are not deductible under Code § 265(a)(1). *See* Rev. Rul. 87-102, 1987-2 C.B. 78.) Covered expenses, on the other hand, presumably would have been incurred by taxpayers (at least

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