Current Federal Tax Developments

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TABLE OF CONTENTS

Unit 1

Introduction to the SECURE Act

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Review Congress's goals in enacting the SECURE Act
- Understand the limitations of the manual and its examples

WHY THE SECURE ACT?

The last time Congress made major changes to the rules for retirement plans was in the Pension Protection Act of 2006. In the intervening years, Congress has only made minor changes to qualified retirement plans. So why are they acting now?

For a number of years, members on both sides of the aisle in Congress have grown concerned about the lack of saving for retirement by Americans in private pension programs. The 401(k)-style plans have become the dominant way that Americans are offered employer-sponsored retirement programs, but Congress believes that certain provisions in the law may serve to discourage employers from offering such plans, cause such plans to not be made available to the increasing number of long-term part-time employees, force funds out of retirement plans too quickly during an employee's lifetime, and encourage the use of such programs to accomplish objectives other than providing for employees' retirement—such as providing a long-term tax deferred or tax exempt stream of income passed to very young beneficiaries of retirement programs that are structured to avoid paying out amounts during retirement.

The Setting Every Community Up for Retirement Enhancement Act of 2019 looks to take action in those areas. As well, the bill serves as a vehicle for dealing with certain perceived unexpected consequences of changes made to the Kiddie Tax in the Tax Cuts and Jobs Act of 2017.

WARNING REGARDING MANUAL EXAMPLES

The manual has been written based on the law as enacted by Congress and the Ways and Means Committee Report. The IRS has yet to issue any regulations or other guidance on this program.

We have included examples in the manual to help you understand these provisions. However, of necessity, such examples require making assumptions regarding how the language in the SECURE Act will be interpreted by Congress. The best that can be done at this point is to attempt to arrive at a reasonable interpretation of the language found in the Act.

While we believe the interpretations we have applied to the law are reasonable, we do not assert that all of our interpretations are the only interpretations possible, nor do we suggest that all of our interpretations are the ones that the IRS and courts will arrive at when they weigh in on this Act.

Thus, we advise that all examples found in this manual be read with the understanding that it is possible (and, in fact, probably almost a certainty) that at least some of them would need to be modified once additional guidance is released. Thus, the reader is cautioned to pay careful attention to additional guidance issued by the IRS and Department of Labor (DOL) to implement the provisions of this law and, eventually, decisions of courts when disputes enter that venue. It is up to the tax professional to make the necessary adjustments to examples and comments in this manual as that additional information becomes available.

Unit

2

SECURE Act: Administrative Improvements

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Explain to clients the additional planning options available due to the extended dates to adopt qualified retirement plans

- Apply the new provisions related to the administration of qualified retirement plans

Congress added a section they labeled "administrative improvements" to the SECURE Act.

PLAN ADOPTED BY FILING DUE DATE FOR YEAR MAY BE TREATED AS IN EFFECT AS OF CLOSE OF YEAR (ACT SECTION 201)

Under the law in place prior to SECURE, a qualified employer retirement plan (aside from a simplified employee pension under IRC §408(p)) had to be established no later than the last day of the taxable year of the plan sponsor.[1] However, the plan itself did not need funds in the retirement trust at that time.[2] Rather, while the plan documents have to be signed by that date, funding could be as late as the extended due date of the plan sponsor's income tax return.

[1] Rev. Rul. 76-28

[2] Rev. Rul. 81-114

EXAMPLE

SPR, Inc. (a C corporation) was looking to establish a profit sharing plan to which it would make contributions for its taxable year ended December 31, 2018. SPR was required to have executed all documents necessary for a qualified retirement plan by December 31, 2018. SPR, Inc. would have until the extended due date of its tax return for the year ended December 31, 2018 (for a C corporation, the date would be October 15, 2019, so long as the extension was properly applied for).

If SPR, Inc. was looking to adopt a simplified employee pension, the documents for that plan could be first executed as late as that same extended due date. But that was the only type of retirement plan that this was true of for SPR's taxable year ending December 31, 2018.

The Committee Report explains why Congress believed there exists a need to change these rules:

> An employer, particularly a small employer, might not know until after the end of a taxable year (the "preceding year") that its profits for the preceding year are sufficient to support the expenses and contributions associated with the establishment of a retirement plan. However, under present law, a plan established at that time can be effective only for the current year, not for the preceding year. The Committee believes that providing employers with more time to establish a retirement plan for their employees will facilitate more employers, especially small employers, establishing such plans, thus leading to more retirement savings by employees. Furthermore, the Committee believes that allowing a plan to be effective for the preceding year provides the opportunity for employees to receive contributions for that earlier year and begin to accumulate retirement savings.[3]

IRC §401(b)(2) provides for a new adoption date, tying it to the due date of the plan sponsor's return:

> If an employer adopts a stock bonus, pension, profit sharing, or annuity plan after the close of a taxable year but before the time prescribed by law for filing the return of the employer for the taxable year (including extensions thereof), the employer may elect to treat the plan as having been adopted as of the last day of the taxable year.[4]

As the Committee Report notes, this does not impact §401(k) plans:

> The provision does not override rules requiring certain plan provisions to be in effect during a plan year, such as the provision for elective deferrals under a qualified cash or deferral arrangement ("generally referred to as a 401(k) plan").[5]

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[3] *Report of the Committee on Ways and Means on HR 1994*, p. 80

[4] IRC §401(b)

[5] *Ibid*

EXAMPLE

SPR, Inc. would be able to adopt a profit sharing plan for 2020 by the due date of its calendar year 2020 income tax return, including extensions—or October 15, 2021. However, if the plan has not been adopted by year end, it cannot contain any cash or deferred arrangement under §401(k) that would apply for 2020.

The §401(k) provision could be added to the plan in 2021, but for 2020, only employer contributions (whether discretionary or not) could be made to any defined contribution plan if not adopted before year end.

The revised plan adoption date rules apply to taxable years beginning after December 31, 2019.[6]

COMBINED ANNUAL REPORT FOR GROUP OF PLANS (ACT SECTION 202)

In a move to reduce the administrative costs of running an employer-sponsored retirement plan, Congress added provisions in the SECURE Act to allow certain groups of plans of unrelated employers to file a single Form 5500. The uncodified provision directs the IRS to develop a group filing option to be implemented by January 1, 2022 and apply to reports for plan years beginning after December 31, 2021.[7]

The law directs the IRS and DOL to develop common filing rules for plans that meet the following requirements:

> (1) are individual account plans or defined contribution plans (as defined in section 3(34) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(34)) or in section 414(i) of the Internal Revenue Code of 1986);
>
> (2) have-
>
> (A) the same trustee (as described in section 403(a) of such Act (29 U.S.C. 1103(a)));
>
> (B) the same one or more named fiduciaries (as described in section 402(a) of such Act (29 U.S.C. 1102(a)));
>
> (C) the same administrator (as defined in section 3(16)(A) of such Act (29 U.S.C. 1002(16)(A))) and plan administrator (as defined in section 414(g) of the Internal Revenue Code of 1986); and
>
> (D) plan years beginning on the same date; and

[6] SECURE Act §201(b)

[7] SECURE Act §202(e)

> (3) provide the same investments or investment options to participants and beneficiaries.[8]

The Committee Reports explains the justification for this change as follows:

> Forms 5500 provide valuable information about plans to plan participants, administrative agencies, and the public, including researchers. However, the preparation of Form 5500 also involves administrative costs that increase plan expenses. The Committee believes that, in the case of identical plans (that is, plans with the same plan year, trustee, administrator and investments) maintained by unrelated employers, permitting a single Form 5500, containing information specific to each plan, rather than requiring a separate Form 5500 for each plan as under present law, can reduce aggregate administrative costs, making it easier for small employers to sponsor a retirement plan and thus improving retirement savings.[9]

The Report goes on to note:

> In developing the consolidated Form 5500, IRS and DOL may require it to include all information for each plan in the group as IRS and DOL determine is necessary or appropriate for the enforcement and administration of the Code and ERISA.[10]

DISCLOSURE REGARDING LIFETIME INCOME (ACT SECTION 203)

Congress has decided to require by statute an item the DOL had proposed in 2013 by regulation to require to be included with information provided to defined contribution plan participants—an estimate lifetime income stream based on the balance in the account.[11]

The Committee Report explains the rationale for this change as follows:

> Defined contribution plans provide a valuable source of retirement savings, generally in the form of a participant's account balance. But generally, defined contribution plans do not offer benefits in the form of annuities or other distribution forms that provide lifetime income. In contrast, defined benefit plans are generally required to provide annuities to plan participants, although such plans may also allow plan participants to choose another form of benefit such as a lump sum. In

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[8] SECURE Act §202(c)

[9] *Report of the Committee on Ways and Means on HR 1994*, pp. 81-82

[10] *Ibid*

[11] ERISA §105(a)(2) as amended by the SECURE Act

> addition, many plan participants do not understand how to correlate their account balance in a defined contribution plan with an annuity or other lifetime income form. The Committee wishes to require information on equivalent lifetime income to be included in benefit statements with respect to defined contribution plan accounts, in a manner that is both useful to participants and practicable for plan administrators.[12]

The law requires that the "lifetime income disclosure shall set forth the lifetime income stream equivalent of the total benefits accrued with respect to the participant or beneficiary."[13]

The required lifetime income stream equivalent of benefits accrued is defined to mean "the amount of monthly payments the participant or beneficiary would receive if the total accrued benefits of such participant or beneficiary were used to provide lifetime income streams" for a qualified joint and survivor annuity.[14]

The DOL is to develop assumptions to be used in computing this qualified joint and survivor annuity amount, "including the assumption that the participant or beneficiary has a spouse of equal age, and a single life annuity." Specifically, Congress authorizes the DOL to provide that "[s]uch lifetime income streams may have a term certain or other features to the extent permitted under rules" prescribed by the DOL.[15]

Within one year of the date of enactment of the SECURE Act, the DOL will issue a model lifetime income disclosure. It is to be written in a manner so that it can be understood by the average plan participant and

- explain the lifetime stream equivalent is only provided as an illustration;
- explain that the actual lifetime payment stream which can actually be purchased with the accrued benefits will depend on many factors and may vary substantially from the illustrated numbers;
- explains the assumption upon which the lifetime stream equivalent was determined; and
- provides such other explanations as the DOL deems necessary.[16]

If the plan permits beneficiaries to invest in a lifetime income stream, the law provides the following:

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[12] *Report of the Committee on Ways and Means on HR 1994*, p. 83

[13] ERISA §102(a)(5)(D)(i)(I) after amendment by the SECURE Act

[14] ERISA §102(a)(5)(D)(i)(II) after amendment by the SECURE Act

[15] ERISA §102(a)(5)(D)(i)(III) after amendment by the SECURE Act

[16] ERISA

> To the extent that an accrued benefit is or may be invested in a lifetime income stream described in clause (i)(III), the assumptions prescribed under sub clause (I) shall, to the extent appropriate, permit administrators of individual account plans to use the amounts payable under such lifetime income stream as a lifetime income stream equivalent.[17]

The obvious concern plan sponsors and administrators will have is that the provided life income stream equivalent number could expose them to liability to plan participants who may not achieve that payment stream. The law provides the following to attempt to address this concern:

> No plan fiduciary, plan sponsor, or other person shall have any liability under this title solely by reason of the provision of lifetime income stream equivalents which are derived in accordance with the assumptions and rules described in clause (iii) and which include the explanations contained in the model lifetime income disclosure described in clause (ii). This clause shall apply without regard to whether the provision of such lifetime income stream equivalent is required by subparagraph (B)(iii).[18]

Plans will be forced to comply with these disclosure requirements 12 months after the latest of the issuance by the DOL of:

- interim final rules for the lifetime income stream equivalent of benefits accrued;
- the model disclosure of such lifetime income stream; or
- the assumptions for the computation of such lifetime income stream.[19]

Observation: At this point, there is much not known about the mechanics of how this lifetime income stream will be computed or the form of the disclosure to be made. Congress did not so much as give us details of how to accomplish this task, but rather turned over broad instructions to the DOL to come up with all of the necessary details to implement this lifetime income disclosure. Plan sponsors and advisers will need to carefully monitor the items issued by the DOL as the agency attempts to carry out this charge.

[17] ERISA §104(a)(5)(D)(iii)

[18] ERISA §104(a)(5)(D)(iv)

[19] ERISA §104(a)(5)(D)(v)

FIDUCIARY SAFE HARBOR FOR SELECTION OF LIFETIME INCOME PROVIDER (ACT SECTION 204)

Having required plans to provide participants in defined contribution plans with an estimate of lifetime income, Congress has moved to encourage defined contribution plans to offer such lifetime option—and is giving some protection from liability under the fiduciary duty standards for selecting a provider for a lifetime income option.

As the Committee Report explains in its justification:

> Unlike defined benefit plans, defined contribution plans generally do not offer benefits in the form of annuities or other distribution forms that provide lifetime income, which, under a defined contribution plan, generally must be provided through a contract issued by an insurance company. In the case of a defined contribution plan subject to ERISA, the selection of a lifetime income provider (such as an insurance company) is a fiduciary act. Uncertainty about the applicable fiduciary standard may discourage plan sponsors and administrators from offering lifetime income benefit options under a defined contribution plan.[20]

The safe harbor for selection of a guaranteed lifetime annuity provider, which will provide that the fiduciary requirements will be deemed satisfied, requires the following steps.

- The fiduciary engages in an objective, thorough, and analytical search for the purpose of identifying insurers from which to purchase contracts;
- With respect to each insurer identified as a potential provider for the guaranteed income contracts, consider:
  - the financial capability of the insurer to satisfy obligations under such guaranteed income contracts; and
  - the cost (including fees and commissions) of the guaranteed retirement income contract offered by the insurer in relation to the benefits and product features of the contract and administrative services to be provided under such contract; and
- On the basis of the above consideration, concludes that:
  - at the time of the selection, the insurer is financially capable of satisfying its obligations under the guaranteed retirement income contract; and

[20] *Report of the Committee on Ways and Means on HR 1994*, p. 85

– the relative cost of the selected guaranteed retirement income contract is reasonable.[21]

For these purposes, a guaranteed retirement income contract is “an annuity contract for a fixed term or a contract (or provision or feature thereof) which provides guaranteed benefits annually (or more frequently) for at least the remainder of the life of the participant or the joint lives of the participant and the participant's designated beneficiary as part of an individual account plan.”[22]

The Committee Report describes the study of financial capability as follows.

A fiduciary will be deemed to satisfy the requirements above with respect to the financial capability of the insurer if:

- The fiduciary obtains written representations from the insurer that it is licensed to offer guaranteed retirement income contracts; that the insurer, at the <u>time of selection</u> and for each of the immediately preceding seven years operates under a certificate of authority from the Insurance Commissioner of its domiciliary state that has not been revoked or suspended, has filed audited financial statements in accordance with the laws of its domiciliary state under applicable statutory accounting principles, maintains (and has maintained) reserves that satisfy all the statutory requirements of all states where the insurer does business, and is not operating under an order of supervision, rehabilitation, or liquidation; and that the insurer undergoes, at least every five years, a financial examination (within the meaning of the law of its domiciliary state) by the Insurance Commissioner of the domiciliary state (or representative, designee, or other party approved thereby);

- In the case that, following the issuance of the insurer representations described above, there is any change that would preclude the insurer from making the same representations at the time of issuance of the guaranteed retirement income contract, the insurer is required to notify the fiduciary, in advance of the issuance of any guaranteed retirement income contract, that the fiduciary can no longer rely on one or more of the representations; and

- The fiduciary has not received such a notification and has no other facts that would cause it to question the insurer representations.[23]

The revision to ERISA states that this study does not require that the plan select the lowest cost contract in order to meet the safe harbor.[24]

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[21] ERISA §404(e)(1) as amended by SECURE Act

[22] ERISA §404(e)(6)(B) as amended by the SECURE Act

[23] *Report of the Committee on Ways and Means on HR 1994*, p. 86, ERISA §404(e)(2) as amended by SECURE Act

[24] ERISA §404(e)(3) as amended by the SECURE Act

For purposes of the above test, the time of selection is defined as one of two times.[25] The Committee Report describes these times as follows:

> For purposes of the provision, the time of selection may be either the time that the insurer for the contract is selected for distribution of benefits to a specific participant or beneficiary or the time that the insurer for the contract is selected to provide benefits at future dates to participants or beneficiaries, provided that the selecting fiduciary periodically reviews the continuing appropriateness of its conclusions with respect to the insurer's financial capability and cost, taking into account the considerations described above. A fiduciary will be deemed to have conducted a periodic review of the financial capability of the insurer if the fiduciary obtains the written representations described above on an annual basis unless, in the interim, the fiduciary has received notification from the insurer that representations cannot be relied on or the fiduciary otherwise becomes aware of facts that would cause it to question the representations.[26]

If a fiduciary satisfies these requirements found in ERISA §404(e), ERISA §404(e)(5) provides:

> A fiduciary which satisfies the requirements of this subsection shall not be liable following the distribution of any benefit, or the investment by or on behalf of a participant or beneficiary pursuant to the selected guaranteed retirement income contract, for any losses that may result to the participant or beneficiary due to an insurer's inability to satisfy its financial obligations under the terms of such contract.

This provision takes effect on the date of enactment.[27]

MODIFICATION OF NONDISCRIMINATION RULES TO PROTECT OLDER, LONGER SERVICE PARTICIPANTS (ACT SECTION 205)

The SECURE Act looks to take on an issue that has arisen as employers have moved to defined contribution plans and ceased taking on new beneficiaries in defined benefit plans. As the Committee notes, the rules, meant to prevent discrimination in plan benefits, have served to, at times, reduce benefit accruals to older employees who are grandfathered into such plans:

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[25] ERISA §404(e)(4) as amended by the SECURE Act

[26] *Report of the Committee on Ways and Means on HR 1994*, pp. 86-87

[27] *Report of the Committee on Ways and Means on HR 1994*, p. 87

> A defined benefit plan may be amended to limit participation in the plan to individuals who are employees as of a certain date. That is, employees hired after that date are not eligible to participate in the plan. Such a plan is sometimes referred to as a "closed" defined benefit plan (that is, closed to new entrants). In such a case, it is common for the employer also to maintain a defined contribution plan and to provide employer matching or nonelective contributions only to employees not covered by the defined benefit plan or at a higher rate to such employees.
>
> Over time, the group of employees continuing to accrue benefits under the defined benefit plan may come to consist more heavily of highly compensated employees, for example, because of greater turnover among nonhighly compensated employees or because increasing compensation causes nonhighly compensated employees to become highly compensated. In that case, the defined benefit plan may have to be combined with the defined contribution plan and tested on a benefit accrual basis. However, under the regulations, if none of the threshold conditions are met, testing on a benefits basis may not be available. Notwithstanding the regulations, recent IRS guidance provides relief for a limited period, allowing certain closed defined benefit plans to be aggregated with a defined contribution plan and tested on an aggregate equivalent benefits basis without meeting any of the threshold conditions. When the group of employees continuing to accrue benefits under a closed defined benefit plan consists more heavily of highly compensated employees, the benefits, rights, and features provided under the plan may also fail the tests under the existing nondiscrimination rules.
>
> In some cases, if a defined benefit plan is amended to cease future accruals for all participants, referred to as a "frozen" defined benefit plan, additional contributions to a defined contribution plan may be provided for participants, in particular for older participants, in order to make up in part for the loss of the benefits they expected to earn under the defined benefit plan ("make-whole" contributions). As a practical matter, testing on a benefit accrual basis may be required in that case, but may not be available because the defined contribution plan does not meet any of the threshold conditions.[28]

The Committee Report explains the reason for the change as follows:

> Some employers that sponsor defined benefit plans have closed such plans to new employees and offer new employees alternative retirement savings plans. Existing employees continue to earn benefits under the

[28] *Report of the Committee on Ways and Means on HR 1994*, pp. 91-92

> defined benefit plan, consistent with their expectations as to retirement income, which is particularly important for employees close to retirement. However, without greater flexibility in the nondiscrimination rules, employers may be forced to freeze their defined benefit plans, thus preventing employees from earning their expected benefits. When a defined benefit plan is frozen, make-whole contributions can offset some of the resulting benefit loss for employees. However, in that case, too, greater flexibility in the nondiscrimination rules is needed. The Committee wishes to provide such flexibility in order to protect benefits for older, longer-service employees.[29]

The Committee Report explains the provision in approximately four pages. It begins by discussing closed or frozen defined benefit plans:

> The provision provides nondiscrimination relief with respect to benefits, rights, and features for a closed class of participants ("closed class"), and with respect to benefit accruals for a closed class, under a defined benefit plan that meets the requirements described below (referred to herein as an "applicable" defined benefit plan). In addition, the provision treats a closed or frozen applicable defined benefit plan as meeting the minimum participation requirements if the plan met the requirements as of the effective date of the plan amendment by which the plan was closed or frozen.
>
> If a portion of an applicable defined benefit plan eligible for relief under the provision is spun off to another employer, and if the spun-off plan continues to satisfy any ongoing requirements applicable for the relevant relief as described below, the relevant relief for the spun-off plan will continue with respect to the other employer.[30]

The next section discusses benefits, rights, or features for a closed class:

> Under the provision, an applicable defined benefit plan that provides benefits, rights, or features to a closed class does not fail the nondiscrimination requirements by reason of the composition of the closed class, or the benefits, rights, or features provided to the closed class, if (1) for the plan year as of which the class closes and the two succeeding plan years, the benefits, rights, and features satisfy the nondiscrimination requirements without regard to the relief under the provision, but taking into account the special testing rules described below, and (2) after the date as of which the class was closed, any plan amendment modifying the closed class or the benefits, rights, and

[29] *Report of the Committee on Ways and Means on HR 1994*, p. 92

[30] *Report of the Committee on Ways and Means on HR 1994*, pp. 92-93

features provided to the closed class does not discriminate significantly in favor of highly compensated employees.

For purposes of requirement (1) above, the following special testing rules apply:

- In applying the plan coverage transition rule for business acquisitions, dispositions, and similar transactions, the closing of the class of participants is not treated as a significant change in coverage;
- Two or more plans do not fail to be eligible to be treated as a single plan solely by reason of having different plan years; and
- Changes in employee population are disregarded to the extent attributable to individuals who become employees or cease to be employees, after the date the class is closed, by reason of a merger, acquisition, divestiture, or similar event.[31]

The Committee Report continues to discuss benefit accruals for a closed class:

> Under the provision, an applicable defined benefit plan that provides benefits to a closed class may be aggregated, that is, treated as a single plan, and tested on a benefit accrual basis with one or more defined contribution plans (without having to satisfy the threshold conditions under present law) if (1) for the plan year as of which the class closes and the two succeeding plan years, the plan satisfies the plan coverage and nondiscrimination requirements without regard to the relief under the provision, but taking into account the special testing rules described above, and (2) after the date as of which the class was closed, any plan amendment modifying the closed class or the benefits provided to the closed class does not discriminate significantly in favor of highly compensated employees.
>
> Under the provision, defined contribution plans that may be aggregated with an applicable defined benefit plan and treated as a single plan include the portion of one or more defined contribution plans consisting of matching contributions, an ESOP, or matching or nonelective contributions under a section 403(b) plan. If an applicable defined benefit plan is aggregated with the portion of a defined contribution plan consisting of matching contributions, any portion of the defined contribution plan consisting of elective deferrals must also be aggregated. In addition, the matching contributions are treated in

[31] *Report of the Committee on Ways and Means on HR 1994*, p. 93

> the same manner as nonelective contributions, including for purposes of permitted disparity.[32]

An applicable defined benefit plan is discussed in the following section of the Committee Report:

> An applicable defined benefit plan to which relief under the provision applies is a defined benefit plan under which the class was closed (or the plan frozen) before April 5, 2017, or that meets the following alternative conditions: (1) taking into account any predecessor plan, the plan has been in effect for at least five years as of the date the class is closed (or the plan is frozen) and (2) under the plan, during the five-year period preceding that date, (a) for purposes of the relief provided with respect to benefits, rights, and features for a closed class, there has not been a substantial increase in the coverage or value of the benefits, rights, or features, or (b) for purposes of the relief provided with respect to benefit accruals for a closed class or the minimum participation requirements, there has not been a substantial increase in the coverage or benefits under the plan.
>
> For purposes of (2)(a) above, a plan is treated as having a substantial increase in coverage or value of benefits, rights, or features only if, during the applicable five-year period, either the number of participants covered by the benefits, rights, or features on the date the period ends is more than 50 percent greater than the number on the first day of the plan year in which the period began, or the benefits, rights, and features have been modified by one or more plan amendments in such a way that, as of the date the class is closed, the value of the benefits, rights, and features to the closed class as a whole is substantially greater than the value as of the first day of the five-year period, solely as a result of the amendments.
>
> For purposes of (2)(b) above, a plan is treated as having had a substantial increase in coverage or benefits only if, during the applicable five-year period, either the number of participants benefiting under the plan on the date the period ends is more than 50 percent greater than the number of participants on the first day of the plan year in which the period began, or the average benefit provided to participants on the date the period ends is more than 50 percent greater than the average benefit provided on the first day of the plan year in which the period began. In applying this requirement, the average benefit provided to participants under the plan is treated as having remained the same between the two relevant dates if the benefit formula applicable to the participants has not changed between the

[32] *Report of the Committee on Ways and Means on HR 1994*, pp. 93-94

> dates and, if the benefit formula has changed, the average benefit under the plan is considered to have increased by more than 50 percent only if the target normal cost for all participants benefiting under the plan for the plan year in which the five-year period ends exceeds the target normal cost for all such participants for that plan year if determined using the benefit formula in effect for the participants for the first plan year in the five-year period by more than 50 percent. In applying these rules, a multiple employer plan is treated as a single plan, rather than as separate plans separately covering the employees of each participating employer.
>
> In applying these standards, any increase in coverage or value, or in coverage or benefits, whichever is applicable, is generally disregarded if it is attributable to coverage and value, or coverage and benefits, provided to employees who (1) became participants as a result of a merger, acquisition, or similar event that occurred during the 7-year period preceding the date the class was closed, or (2) became participants by reason of a merger of the plan with another plan that had been in effect for at least five years as of the date of the merger and, in the case of benefits, rights, or features for a closed class, under the merger, the benefits, rights, or features under one plan were conformed to the benefits, rights, or features under the other plan prospectively.[33]

Next up is the discussion of make-whole contributions under a defined contribution plan in the Committee Report:

> Under the provision, a defined contribution plan is permitted to be tested on an equivalent benefit accrual basis (without having to satisfy the threshold conditions under present law) if the following requirements are met:
>
> - The plan provides make-whole contributions to a closed class of participants whose accruals under a defined benefit plan have been reduced or ended ("make-whole class");
> - For the plan year of the defined contribution plan as of which the make-whole class closes and the two succeeding plan years, the make-whole class satisfies the nondiscriminatory classification requirement under the plan coverage rules, taking into account the special testing rules described above;
> - After the date as of which the class was closed, any amendment to the defined contribution plan modifying the make-whole class or the allocations, benefits, rights, and features provided to the make-

[33] *Report of the Committee on Ways and Means on HR 1994*, pp. 94-95

whole class does not discriminate significantly in favor of highly compensated employees; and

- Either the class was closed before April 5, 2017, or the defined benefit plan is an applicable defined benefit plan under the alternative conditions applicable for purposes of the relief provided with respect to benefit accruals for a closed class.

With respect to one or more defined contribution plans meeting the requirements above, in applying the plan coverage and nondiscrimination requirements, the portion of the plan providing make-whole or other nonelective contributions may also be aggregated and tested on an equivalent benefit accrual basis with the portion of one or more other defined contribution plans consisting of matching contributions, an ESOP, or matching or nonelective contributions under a section 403(b) plan. If the plan is aggregated with the portion of a defined contribution plan consisting of matching contributions, any portion of the defined contribution plan consisting of elective deferrals must also be aggregated. In addition, the matching contributions are treated in the same manner as nonelective contributions, including for purposes of permitted disparity.

Under the provision, "make-whole contributions" generally means nonelective contributions for each employee in the make-whole class that are reasonably calculated, in a consistent manner, to replace some or all of the retirement benefits that the employee would have received under the defined benefit plan and any other plan or qualified cash or deferred arrangement under a section 401(k) plan if no change had been made to the defined benefit plan and other plan or arrangement. However, under a special rule, in the case of a defined contribution plan that provides benefits, rights, or features to a closed class of participants whose accruals under a defined benefit plan have been reduced or eliminated, the plan will not fail to satisfy the nondiscrimination requirements solely by reason of the composition of the closed class, or the benefits, rights, or features provided to the closed class, if the defined contribution plan and defined benefit plan otherwise meet the requirements described above but for the fact that the make-whole contributions under the defined contribution plan are made in whole or in part through matching contributions.

If a portion of a defined contribution plan eligible for relief under the provision is spun off to another employer, and if the spun-off plan continues to satisfy any ongoing requirements applicable for the

> relevant relief as described above, the relevant relief for the spun-off plan will continue with respect to the other employer.[34]

The Committee Report has a long explanation of the effective date of these provisions as well:

> The provision is generally effective on the date of enactment, without regard to whether any plan modifications referred to in the provision are adopted or effective before, on, or after the date of enactment.
>
> However, at the election of a plan sponsor, the provision will apply to plan years beginning after December 31, 2013. For purposes of the provision, a closed class of participants under a defined benefit plan is treated as being closed before April 5, 2017, if the plan sponsor's intention to create the closed class is reflected in formal written documents and communicated to participants before that date. In addition, a plan does not fail to be eligible for the relief under the provision solely because (1) in the case of benefits, rights, or features for a closed class under a defined benefit plan, the plan was amended before the date of enactment to eliminate one or more benefits, rights, or features and is further amended after the date of enactment to provide the previously eliminated benefits, rights, or features to a closed class of participants, or (2) in the case of benefit accruals for a closed class under a defined benefit plan or application of the minimum benefit requirements to a closed or frozen defined benefit plan, the plan was amended before the date of the enactment to cease all benefit accruals and is further amended after the date of enactment to provide benefit accruals to a closed class of participants. In either case, the relevant relief applies only if the plan otherwise meets the requirements for the relief, and, in applying the relevant relief, the date the class of participants is closed is the effective date of the later amendment.[35]

MODIFICATION OF PBGC PREMIUMS FOR CSEC PLANS (ACT SECTION 206)

Congress explains the PBGC premium issue the SECURE Act is trying to correct as follows:

> Private defined benefit plans are also covered by the Pension Benefit Guaranty Corporation (PBGC) insurance program, under which the PBGC guarantees the payment of certain plan benefits, and plans are required to pay annual premiums to the PBGC. Plan sponsors of

[34] *Report of the Committee on Ways and Means on HR 1994*, pp. 95-96

[35] *Report of the Committee on Ways and Means on HR 1994*, pp. 96-97

> single employer plans and multiemployer plans must participate in the PBGC insurance program. Single employer plans and multiple employer plans, including Cooperative and Small Employer Charity (CSEC) plans, are subject to the same PBGC premium requirements, consisting of flat-rate, per participant premiums and variable rate premiums, based on the unfunded vested benefits under the plan. For 2019, flat-rate premiums are $80 per participant, and variable rate premiums are $43 for each $1,000 of unfunded vested benefits, subject to a limit of $541 multiplied by the number of plan participants. For this purpose, unfunded vested benefits under a plan for a plan year is the excess (if any) of (1) the plan's funding target for the plan year, determined by taking into account only vested benefits and using specified interest rates, over (2) the fair market value of plan assets.
>
> Under the funding rules applicable to single employer plans, a plan's funding target is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year, determined using certain specified actuarial assumptions, including specified interest rates and mortality. A single employer plan's funding target is a factor taken into account in determining required contributions for the plan. Although a CSEC plan's funding target is used under present law to determine variable rate premiums, it does not apply in determining required contributions for a CSEC plan. Instead, a CSEC plan's funding liability applies, which is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year, determined using reasonable actuarial assumptions chosen by the plan's actuary.[36]

Congress's reason for the change is explained as follows:

> In 2014, Congress passed legislation resulting in different sets of funding rules for three types of pension plans: single employer plans, multiemployer plans, and CSEC plans. In line with this change, the Committee believes that the three types of pension plans also should have individualized rules for calculating PBGC premiums.[37]

The change to be made is described in the Committee Report as follows:

> Under the provision, for CSEC plans, flat-rate premiums are $19 per participant, and variable rate premiums are $9 for each $1,000 of unfunded vested benefits. In addition, for purposes of determining a CSEC plan's variable rate premiums, unfunded vested benefits for a plan year is the excess (if any) of (1) the plan's funding liability,

[36] *Report of the Committee on Ways and Means on HR 1994*, pp. 97-98

[37] *Report of the Committee on Ways and Means on HR 1994*, p. 98

> determined by taking into account only vested benefits, over (2) the fair market value of plan assets.[38]

The effective date for this change is for plan years beginning after December 31, 2018.[39]

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[38] *Ibid*

[39] ERISA §4006(a)(3)(v) as amended by the SECURE Act

Unit 3

SECURE Act: Expanding and Preserving Retirement Savings

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Recognize clients who may wish to adopt retirement plans due to revised benefits to the plan sponsor
- Understand new and revised credits related to retirement plans

MULTIPLE EMPLOYER PLANS (ACT SECTION 101)

Some of the reasons why small employers might hold back from offering a retirement plan to its employees are the administrative costs of operating a plan and dealing with the various compliance issues if they sponsor a single employer plan. Some of those issues could be reduced by participating in a multiemployer plan to reduce these administrative costs. However, the Committee Report describes two key issues that may cause an employer to be concerned about the risk of being part of a multiemployer plan.

One key problem is the risk that the bad actions of another employer in the group could put the tax qualified status of the plan at risk. The Committee Report describes this by noting that certain:

> …requirements are applied separately, including the minimum coverage requirements, nondiscrimination requirements (both the general requirements and the special tests for section 401(k) plans), and the top-heavy rules. However, the qualified status of the plan as a whole is determined with respect to all employers maintaining the

> plan, and the failure by one employer (or by the plan itself) to satisfy an applicable qualification requirement may result in disqualification of the plan with respect to all employers (sometimes referred to as the "one bad apple" rule).[40]

EXAMPLE

Harry's Flowers has joined as one employer sponsoring a multiemployer plan. Harry has remained fully compliant with all requirements imposed with regard to its employees (such as minimum coverage requirements, nondiscrimination rules, and the top-heavy rules). However, Bad Apple, Inc., another member of the group, has been intentionally ignoring a number of those rules in order to reduce the amounts the organization's costs for employees other than those who are shareholders of the corporation. No one outside of Bad Apple, Inc. is aware that the organization is intentionally ignoring those rules.

Under the "one bad apple" rule, the plan could be disqualified due to the bad actions of the single bad apple. Even though Harry's Flowers had fully complied with all requirements imposed on it to maintain the plan's qualification, the sponsor and its employees are subject to negative consequences of discovering the plan they have been a part of is not a qualified plan.

There are different issues with multiemployer plans meeting the requirements under the Employment Retirement Income Security Act of 1974 (ERISA) as interpreted by the DOL. The House Committee Report describes this issue as follows:

> Under ERISA, an employee benefit plan (whether a pension plan or a welfare plan) must be sponsored by an employer, by an employee organization, or by both. The definition of employer is any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan, and includes a group or association of employers acting for an employer in such capacity.
>
> These definitional provisions of ERISA are interpreted as permitting a multiple employer plan to be established or maintained by a cognizable, bona fide group or association of employers, acting in the interests of its employer members to provide benefits to their employees. This approach is based on the premise that the person or group that maintains the plan is tied to the employers and employees that participate in the plan by some common economic or representational interest or genuine organizational relationship unrelated to the provision of benefits. Based on the facts and circumstances, the employers that participate in the benefit program must, either directly or indirectly, exercise control over that program, both in form and in substance, in order to act as a bona fide employer group or association with respect to the program, or the plan is sponsored by one or more employers as defined in section 3(5) of

[40] *Report of the Committee on Ways and Means on HR 1994*, p. 35

> ERISA. However, an employer association does not exist where several unrelated employers merely execute participation agreements or similar documents as a means to fund benefits, in the absence of any genuine organizational relationship between the employers. In that case, each participating employer establishes and maintains a separate employee benefit plan for the benefit of its own employees, rather than a multiple employer plan.[41]

EXAMPLE

ABC Baking, Inc., Jones Auto Sales, Inc., and Wayne Structural Engineering are looking to form a multiemployer plan to reduce compliance cost. Under the law in place prior to ERISA, they could not form a multiemployer plan, since the only relationship held among the sponsoring group is the provision of benefits. In the eyes of the DOL, there are separate plans in this case, removing much of the cost benefits the sponsors had hoped to achieve from operating a multiemployer plan.

Thus, the Committee Report explains the justification for the changes made to multiemployer plans under SECURE:

> A single, multiple employer plan can provide economies of scale that result in lower administrative costs than apply to a group of separate plans covering the employees of different employers. However, concern that a violation by one or more employers participating in the multiple employer plan may jeopardize the tax-favored status of the plan, or create liability for other employers, may discourage use of multiple employer plans. The Committee believes employers in such a plan should not be subject to the risk that any inadvertent or unintentional violation of Code requirements by a noncompliant employer in the plan could result in negative tax consequences for the employers in the plan that are compliant or for such employers' participants. In addition, under ERISA, a plan covering employees of unrelated employers might not be eligible for multiple employer plan treatment. The Committee wishes to remove possible barriers to broader use of multiple employer plans, including by providing simplified Form 5500 reporting in appropriate cases. Requiring the service provider of a plan covering employees of unrelated employers to take on fiduciary responsibilities will further the protection of participants in such plans.
>
> In the case of any multiple employer plan that, in accordance with the Department of Labor's current interpretations of the definition of employer in section 3(5) of ERISA, is treated currently as a single employer plan under ERISA, the Committee does not intend to modify the existing definition and regulatory guidance thereunder,

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[41] *Report of the Committee on Ways and Means on HR 1994*, pp. 36-37

except insofar as specifically provided herein with respect to relief from disqualification (or other loss of tax-favored status) and simplified annual reports.[42]

Removal of the "One Bad Apple" Rule

Congress has added new IRC §413(e) to specifically remove the risk of "one bad apple" rule for defined contribution plans causing a multiemployer plan to be treated as disqualified for all employers that are involved in sponsoring the plan.

The general rule provides:

> (1) IN GENERAL.-Except as provided in paragraph (2), if a defined contribution plan to which subsection (c) applies-
>
> (A) is maintained by employers which have a common interest other than having adopted the plan, or
>
> (B) in the case of a plan not described in subparagraph (A), has a pooled plan provider,
>
> then the plan shall not be treated as failing to meet the requirements under this title applicable to a plan described in section 401(a) or to a plan that consists of individual retirement accounts described in section 408 (including by reason of subsection (c) thereof), whichever is applicable, merely because one or more employers of employees covered by the plan fail to take such actions as are required of such employers for the plan to meet such requirements.[43]

To gain this protection, the plan is required to have language that will force the "bad apple" employer to be kicked out of the multiemployer plan, with the assets related to their employee's accounts being moved into a separate plan:

> (A) IN GENERAL.-Paragraph (1) shall not apply to any plan unless the terms of the plan provide that in the case of any employer in the plan failing to take the actions described in paragraph (1)-
>
> (i) the assets of the plan attributable to employees of such employer (or beneficiaries of such employees) will be transferred to a plan maintained only by such employer (or its successor), to an eligible retirement plan as defined in section 402(c)(8)(B) for each individual whose account is transferred, or to any other arrangement that the Secretary determines is appropriate, unless the Secretary determines it

[42] *Report of the Committee on Ways and Means on HR 1994*, pp. 37

[43] IRC §413(e)(2)(A) as amended

is in the best interests of the employees of such employer (and the beneficiaries of such employees) to retain the assets in the plan, and

(ii) such employer (and not the plan with respect to which the failure occurred or any other employer in such plan) shall, except to the extent provided by the Secretary, be liable for any liabilities with respect to such plan attributable to employees of such employer (or beneficiaries of such employees).[44]

EXAMPLE

Returning to the example earlier with Bad Apple, Inc., an employer that is part of the multiemployer plan who is intentionally operating in violation of the rules applicable to the individual employer. Now, so long as the plan provides provisions that will move Bad Apple, Inc. employee accounts to a separate plan due to their noncompliance, the plan itself, with regard to the other employers' accounts, will not be at risk of disqualification.

Pooled Providers

SECURE establishes a new category of multiemployer plan: the pooled plan. As was noted earlier, previously there had to be some common interest among the multiple employers beyond simply the employee benefit plans. With SECURE, if the employers do not have that shared interest, they are classified as a *pooled plan provider*.

IRC §413(e)(3)(A) provides a general definition of a *pooled plan provider*.

(3) POOLED PLAN PROVIDER.-

(A) IN GENERAL.-For purposes of this subsection, the term 'pooled plan provider' means, with respect to any plan, a person who-

(i) is designated by the terms of the plan as a named fiduciary (within the meaning of section 402(a)(2) of the Employee Retirement Income Security Act of 1974), as the plan administrator, and as the person responsible to perform all administrative duties (including conducting proper testing with respect to the plan and the employees of each employer in the plan) which are reasonably necessary to ensure that-

(I) the plan meets any requirement applicable under the Employee Retirement Income Security Act of 1974 or this title to a plan described in section 401(a) or to a plan that consists of individual retirement accounts described in section 408 (including by reason of subsection (c) thereof), whichever is applicable, and

(II) each employer in the plan takes such actions as the Secretary or such person determines are necessary for the plan to meet the

[44] IRC §413(e)(2)(B) as amended

> requirements described in subclause (I), including providing to such person any disclosures or other information which the Secretary may require or which such person otherwise determines are necessary to administer the plan or to allow the plan to meet such requirements,
>
> (ii) registers as a pooled plan provider with the Secretary, and provides such other information to the Secretary as the Secretary may require, before beginning operations as a pooled plan provider,
>
> (iii) acknowledges in writing that such person is a named fiduciary (within the meaning of section 402(a)(2) of the Employee Retirement Income Security Act of 1974), and the plan administrator, with respect to the plan, and
>
> (iv) is responsible for ensuring that all persons who handle assets of, or who are fiduciaries of, the plan are bonded in accordance with section 412 of the Employee Retirement Income Security Act of 1974.[45]

Note that such providers will need to register with the IRS as a pooled plan provider and agree to take on certain responsibilities.

As well, the statute provides the IRS with the authority to perform audits, examinations, and investigations of pooled plan providers "as may be necessary to enforce and carry out the purposes" of these provisions.[46] It remains to be seen how the IRS will carry out this mandate.

Aside from the administrative duties that are assigned to the pooled plan provider under IRC §413(e)(3)(A), each employer will be treated as the plan sponsor with regard to the portion of the plan attributable to that employer's employees.[47]

IRC §413(e)(4)(A) authorizes the IRS to issue guidance necessary to carry out the provisions of the pooled plan provider rules. Such guidance is to include guidance:

- to identify the administrative duties and other actions required to be performed by a pooled plan provider,
- that describes the procedures to be taken to terminate a plan that fails to meet the requirements to be a covered multiple employer plan, including the proper treatment of, and actions needed to be taken by, any employer in the plan and plan assets and liabilities attributable to employees of that employer (or beneficiaries of such employees), and

[45] IRC §413(e)(3)(B) as amended

[46] IRC §413(e)(3)(C) as amended

[47] IRC §413(e)(3)(D) as amended

- to identify appropriate cases in which corrective action will apply with respect to noncompliant employers. For this purpose, the IRS is to take into account whether the failure of an employer or pooled plan provider to provide any disclosures or other information, or to take any other action, necessary to administer a plan or to allow a plan to meet the Code requirements for tax-favored treatment, has continued over a period of time that demonstrates a lack of commitment to compliance.[48]

Until such time as this guidance is issued, the law provides that an employer will not be treated as operating in violation so long as the employer or pooled plan provider complies in good faith with a reasonable interpretation of the provisions until such time as the guidance is issued.[49]

EXAMPLE

An entity seeking to be a pooled plan provider will be able to set up a pooled provider program immediately upon the pooled provider provision taking effect without waiting for the IRS to issue guidance on the various provisions contained in these rules, but the provider will need to comply with a reasonable interpretation of these provisions. While it is likely the final IRS guidance will use a number of interpretations that are not consistent with this provider's interpretations, so long as the provider prospectively complies with the IRS's guidance, the fact that the plan's actions before the issuance of the guidance does not comply with that guidance will not put the plan's status at risk.

IRS Directed to Issue Pooled Plan Provider Model Language

Congress has directed the IRS to publish model plan language that complies with the IRC and ERISA requirements under these rules that may be adopted in order to be treated as a pooled employer plan under ERISA.[50]

ERISA Conforming Amendments

The SECURE Act makes a number of amendments to ERISA Section 3 to add similar language to that added to the IRC, as well as other amendments necessary to allow for such plans.[51]

[48] IRC §413(e)(4)(A) as amended, *Report of the Committee on Ways and Means on HR 1994*, p. 40

[49] IRC §413(e)(4)(B) as amended

[50] IRC §413(e)(5)

[51] SECURE Act Section 201(b); ERISA Section 3 as amended

INCREASE IN 10 PERCENT CAP FOR AUTOMATIC ENROLLMENT SAFE HARBOR AFTER FIRST PLAN YEAR (ACT SECTION 102)

§401(k) plans, to avoid issues created by failing to meet the actual deferral percentage (ADP) test, may elect to utilize a *safe harbor* plan design. Such plans will treat the plan as meeting the ADP test, regardless of actual deferrals by the rank and file, so long as certain provisions are included in the plan.

A plan that is not a safe harbor plan is subject to an ADP test that may require refund back to highly compensated participants a portion of their deferrals. The House Committee Report describes the issue as follows:

> An annual nondiscrimination test, called the actual deferral percentage test (the "ADP" test) applies to elective deferrals under a section 401(k) plan. The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for non-highly compensated employees and requires that the average deferral rate for highly compensated employees not exceed the average rate for non-highly compensated employees by more than certain specified amounts. If a plan fails to satisfy the ADP test for a plan year based on the deferral elections of highly compensated employees, the plan is permitted to distribute deferrals to highly compensated employees ("excess deferrals") in a sufficient amount to correct the failure. The distribution of the excess deferrals must be made by the close of the following plan year.[52]

One option is to include an automatic enrollment provision in the plan as described in IRC §401(k)(13)(C). Prior to the changes found in the SECURE Act, such a program was required to meet the following provisions as described in the House Committee Report.

> An automatic enrollment safe harbor plan must provide that, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals at a default rate equal to a percentage of compensation as stated in the plan and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter. Although an automatic enrollment safe harbor plan generally may provide for default rates higher than these minimum rates, the default rate cannot exceed 10 percent for any year.[53]

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[52] *Report of the Committee on Ways and Means on HR 1994*, pp. 44-45

[53] *Report of the Committee on Ways and Means on HR 1994*, p. 45

EXAMPLE

The TP Computers, Inc. §401(k) plan is designed to meet the safe harbor requirements by use of an automatic enrollment feature. Under this plan, employees who become eligible to participate in the plan by default will have amounts deferred from their pay in the following amounts unless they timely opt-out of the default withholdings:

For the first year, the amount deemed elected will be 4%, increasing by one percent each year until it reaches 10% in the tenth year. At that point, to comply with the maximum automatic deferral limitation found in IRC §401(k)(13)(C)(iii), the automatic deferral percentage no longer increases and remains at 10%.

The House Committee Report notes that Congress had imposed that cap because of concerns that if the rate was too high, it would be more than the employees preferred to defer and they would decide to not have any amounts deferred. Since Congress enacted this provision to help increase savings for retirement by employees, such an action would be counter to what Congress hoped to encourage.

The Committee now believes that such higher rates are less of an issue when they take place years after such deferrals have begun. As well, the Committee was concerned that the very "tyranny of the default" mentality that causes employees to begin to defer when the automatic contributions begin could work to have the maximum automatic deferral percentage artificially cap the amounts that employees would defer.

EXAMPLE

Peter is an employee of TP Computers, Inc. When Peter first became eligible for participation in the §401(k) plan, he did not take any action and 3% was taken from his check. Peter similarly takes no action in each following year and the deferral grows to 10%. In the years following hitting the 10% maximum, Peter continues to take no action, and thus his deferral percentage plateaus at 10%.

Peter, like many people, will follow the "tyranny of the default," accepting whatever deferral of salary takes place if he/she does nothing. They are highly unlikely to begin taking action to increase the deferral percentage once it stops automatically increasing, as that requires taking action—something that they had not done before.

This is true even if Peter would not have taken any action to stop or reduce deferrals if they had continued to increase to 15%.

The SECURE Act increases the maximum permitted automatic deferral for safe harbor plans to 15% of compensation, although continuing to limit the maximum automatic deferral to 10% in the first year.[54] This provision is effective for plan years beginning after December 31, 2019.[55]

[54] IRC §401(k)(13)(C)(iii)

[55] SECURE Act Section 102(b)

RULES RELATING TO ELECTION OF SAFE HARBOR 401(K) STATUS (ACT SECTION 103)

Congress looked to address another issue it saw with safe harbor 401(k) plans, this time with plans that might want to adopt the across-the-board nonelective safe harbor contribution to be treated as a §401(k) plan rather than use an automatic match option.

The House Committee Report describes the "basic 401(k) safe harbor plan" as follows:

> Under one type of 401(k) safe harbor plan ("basic 401(k) safe harbor plan"), the plan either (1) satisfies a matching contribution requirement ("matching contribution basic 401(k) safe harbor plan") or (2) provides for a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each non-highly compensated employee who is eligible to participate in the plan ("nonelective basic 401(k) safe harbor plan"). The matching contribution requirement under the matching contribution basic 401(k) safe harbor requires a matching contribution equal to at least 100 percent of elective contributions of the employee for contributions not in excess of three percent of compensation, and 50 percent of elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contribution under the basic 401(k) safe harbor must be immediately nonforfeitable (that is, 100 percent vested) when made.[56]

EXAMPLE

Calm, Inc. has adopted a basic 401(k) safe harbor plan. To meet the safe harbor, Calm has chosen to have the plan provide that a 3% nonforfeitable contribution will be made on behalf of all employees regardless of whether or not they make any deferrals to the plan.

Calm, Inc. has decided to go this route because the 3% contribution that meets the safe harbor test can also be used as the minimum contribution necessary to the rank and file under a top-heavy plan when the highly compensated are allocated larger percentages of their income from discretionary contributions.

Under the law in effect prior to the SECURE Act, a plan that wished to use the matching contribution 401(k) safe harbor had to be part of the plan adopted prior to the beginning of the plan. The employer could amend a plan to adopt the nonelective 401(k) contribution safe harbor within the first 30 days of the plan year, but only if the plan issued a pair of notices to participants advising them of the possibility the plan might be revised in this way. As the House Committee Report notes:

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[56] *Report of the Committee on Ways and Means on HR 1994*, p. 47

> The plan must also provide a contingent and follow-up notice. The contingent notice must be provided before the beginning of the plan year and specify that the plan may be amended to include the safe harbor nonelective contribution and, if it is so amended, a follow-up notice will be provided. If the plan is amended, the follow-up notice must be provided no later than 30 days before the end of the plan year stating that the safe harbor nonelective contribution will be provided.[57]

While this was meant to ensure employees were aware of the possibility of amendment when they decided initially to defer under the matching contribution, the Committee expressed concern that this might be serving to make it less likely an employer will decide to make nonelective across the board contributions, something the House Committee report notes "is beneficial to employees because it provides employer contributions regardless of whether employees make contributions."[58]

To encourage employers to utilize nonelective 401(k) contributions in safe harbor plans, the SECURE Act eliminates the notice requirement for such contributions[59] and extends the period the plan can be amended to provide such a nonelective 401(k) safe harbor contribution to up until 30 days before the plan year end if a standard nonelective contribution is made and after that through the end of the following plan year if a 4% contribution is made.[60]

The change in the notice requirements is described by the House Committee Report as follows:

> The provision eliminates the safe harbor notice requirement with respect to nonelective 401(k) safe harbor plans. However, the general rule under present law requiring a section 401(k) plan to provide each eligible employee with an effective opportunity to make or change an election to make elective deferrals at least once each plan year still applies. As described above, relevant factors used in determining if this requirement is satisfied include the adequacy of notice of the availability of the election and the period of time during which an election may be made.[61]

The revision to the plan amendment rules applicable to selecting the nonelective 401(k) safe harbor are described as follows:

> Under the provision, a plan can be amended to become a nonelective 401(k) safe harbor plan for a plan year (that is, amended to provide the required nonelective contributions and thereby satisfy the safe harbor

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[57] *Report of the Committee on Ways and Means on HR 1994*, p. 48

[58] *Ibid*

[59] IRC §401(k)(12)(A) and (13)(B) as amended

[60] IRC §401(k)(12)(F) as amended

[61] *Report of the Committee on Ways and Means on HR 1994*, p. 49

requirements) at any time before the 30th day before the close of the plan year.

Further, the provision allows a plan to be amended after the 30th day before the close of the plan year to become a nonelective contribution 401(k) safe harbor plan for the plan year if (1) the plan is amended to provide for a nonelective contribution of at least four percent of compensation (rather than at least three percent) for all eligible employees for that plan year and (2) the plan is amended no later than the last day for distributing excess contributions for the plan year (generally, by the close of following plan year).

EXAMPLE

Dolls of American, Inc. had adopted a 401(k) safe harbor plan before January 1, 2020 effective for calendar year 2020. No notice was given to employees about the right of the employer to amend the plan to provide for a nonelective 401(k) safe harbor contribution to satisfy the safe harbor rules.

Despite not having given notice, Dolls of America, Inc. has the plan amended on October 15, 2020 to make a nonelective 3% 401(k) safe harbor contribution for all employees eligible to participate in the plan, regardless of whether they had deferred any amounts to the plan.

Although for 2019 employees would have been required to be notified of the potential amendment for the plan to be amended to use a nonelective 401(k) safe harbor contribution to meet the safe harbor requirements, the notice is not required for 2020.

As well, in 2019, any allowed amendment would have to have been made by January 30. However, in 2020, the plan could be amended up through December 1, 2020 to make the 3% nonelective contribution.

EXAMPLE

Assume that Dolls of American, Inc. decides after December 1, 2020 that it wishes to make an across-the-board nonelective 401(k) safe harbor contribution. So long as it increases the contribution to 4% of covered compensation for all eligible employees, the plan can be amended as late as December 31, 2021 to provide for the nonelective 401(k) safe harbor contribution.

These provisions are effective for plan years beginning after December 31, 2019.[62]

INCREASE IN CREDIT LIMITATION FOR SMALL EMPLOYER PENSION PLAN START-UP COSTS (ACT SECTION 104)

Congress had previously enacted a tax credit available of up to $500 per year for up to three years to offset qualified start-up costs of a qualified retirement plan, SIMPLE IRA

[62] SECURE Act Section 103(d)

plan, or SEP that covers at least one nonhighly compensated employee. The credit is set at the lesser of $500 per year or 50% of the qualified plan start-up costs.[63]

The House Committee Report describes employers eligible to claim this credit:

> An eligible employer is an employer that, for the preceding year, had no more than 100 employees, each with compensation of $5,000 or more. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of controlled groups and affiliated service groups are treated as a single employer for purposes of these requirements. All eligible employer plans of an employer are treated as a single plan.[64]

Congress appears to have decided that this credit is perhaps not generous enough to encourage small employers to adopt plans to cover nonhighly compensated employees. The Act does so by increasing the flat dollar limit of the credit computation. The new credit is now the lesser of 50% of the qualified plan start-up costs (the other limit which remains unchanged) or the greater of:

- $500 or
- the lesser of
  - $250 multiplied by the number of nonhighly compensated employees eligible to participate in the plan or
  - $5,000.[65]

EXAMPLE

Kansas Windmills is a qualified small employer that establishes a qualified retirement plan that had eight nonhighly compensated employees eligible to participate in the plan in 2020. The company incurs $10,000 of qualified plan start-up costs in 2020.

The company's fixed dollar limit is $2,000 for 2020. That represents eight nonhighly compensated employees eligible to participate multiplied by $250. That number is less than $5,000 but greater than $500.

The credit is also $2,000. One-half of qualified plan start-up costs is $3,500 (50% of $7,000) but the credit is still limited to the newly-calculated fixed dollar amount. Nevertheless, this represents a significantly higher credit than the $500 that would have been available for 2019.

The revised credit applies to taxable years beginning after December 31, 2019.[66]

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[63] *Report of the Committee on Ways and Means on HR 1994*, pp. 49-50, IRC §45E

[64] *Report of the Committee on Ways and Means on HR 1994*, p. 50

[65] IRC §45E(b)(1) as amended

[66] SECURE Act 104(b)

SMALL EMPLOYER AUTOMATIC ENROLLMENT CREDIT (ACT SECTION 105)

Congress has decided that it wishes to encourage automatic enrollment of employees in small employer plans. Thus, it has added a new credit at IRC §45T to small employers in addition to the credit that existed prior to the SECURE Act in IRC §45E. A qualified employer may claim both credits.

The following credits are available under IRC §45T to eligible employers:

- Up to $500 per year for up to three years for start-up costs for a new §401(k) plan or SIMPLE IRA plans that include automatic enrollment
- Up to $500 per year for three years if an eligible employer converts an existing plan to an automatic enrollment plan.[67]

EXAMPLE

If Kansas Windmills includes an automatic enrollment provision and the plan in question is either a §401(k) or SIMPLE IRA plan, it will qualify for an additional $500 credit beyond the standard election for a small employer start-up cost.

The credit applies to taxable years beginning after December 31, 2019.[68]

CERTAIN TAXABLE NON-TUITION FELLOWSHIP AND STIPEND PAYMENTS TREATED AS COMPENSATION FOR IRA ACCOUNTS (ACT SECTION 106)

The SECURE Act expands the type of income that is considered earned income for purposes of IRA accounts to include amounts included in the individual's gross income and paid to aid in the pursuit of a graduate or postdoctoral study.[69]

The House Committee Report provides the following justification for making this change:

> Graduate and postdoctoral students often receive stipends and similar amounts that are not treated as compensation and thus cannot be the basis for IRA contributions. This delays the ability to accumulate tax-favored retirement savings, in some cases for a number of years. The Committee believes that treating such amounts that are includible in gross income as compensation for IRA contribution purposes will

[67] IRC §45T as added by SECURE Act

[68] SECURE Act §105(d)

[69] IRC §219(f)(1) as amended

> enable some graduate and postdoctoral students to begin saving for retirement.[70]

EXAMPLE

Michael's only income subject to tax is a $5,000 stipend he is being paid related to his graduate studies. For 2020, Michael will be able to contribute $5,000 to an IRA based on the receipt of the taxable stipend.

REPEAL OF MAXIMUM AGE FOR TRADITIONAL IRA CONTRIBUTIONS (ACT SECTION 107)

Congress has repealed the provisions that provided individuals who are age 70½ or older at the end of the tax year were not eligible to make traditional IRA contributions.[71]

The House Committee Report justifies this change as follows:

> As Americans live longer, increasing numbers of Americans are continuing to work past traditional retirement ages. This provides such working individuals with current income, as well as the potential for additional retirement savings. An individual working past age 70½ may contribute to an employer-sponsored retirement plan, if available, or to a Roth IRA, but not to a traditional IRA. The Committee wishes to remove this impediment to retirement savings.[72]

The law also makes a modification to the qualified charitable contribution rules, providing that the amount of distributions not includable in gross income for taxable years ending on or after a taxpayer reaches age 70 ½ shall be reduced, but not below zero, by the aggregate amount of deductions allowed to the taxpayer for contributions after achieving age 70½ over the aggregate amount of all such reductions preceding the current taxable year.[73]

This provision is meant to prevent a taxpayer form simply "washing" a charitable contribution through his IRA to obtain what would effectively be a double deduction in that year.

[70] *Report of the Committee on Ways and Means on HR 1994*, p. 52

[71] IRC §219(d)(1) repealed by SECURE Act §107(a)

[72] *Report of the Committee on Ways and Means on HR 1994*, p. 53

[73] IRC §408(d)(8)(A) as amended

EXAMPLE

Maurice, age 72, makes a $20,000 qualified charitable distribution (QCD) in 202X. He also makes a $5,000 deductible IRA contribution in that same year. The amount of his QCD that is excluded from his income will be $15,000 ($20,000 less the $5,000 deductible IRA contribution).

This provision applies to contributions made for taxable years beginning after December 31, 2019.[74]

QUALIFIED EMPLOYER PLANS PROHIBITED FROM MAKING LOANS THROUGH CREDIT CARDS AND OTHER SIMILAR ARRANGEMENTS (ACT SECTION 108)

Retirement plans are barred from making loans through credit cards or similar arrangements.[75] Any such advance to an employee will be treated as a distribution to the employee.[76] This provision applies to loans made after the date of enactment of the SECURE Act.[77]

The Committee Report explains Congress's justification for this change as follows:

> The availability of plan loans may encourage employees to contribute to a retirement plan with the knowledge that funds may be accessed if needed. However, loans that are not repaid have the effect of depleting retirement savings. Easy access to plan loans through credit or debit cards and similar arrangements may lead to the use of retirement plan assets for routine or small purchases and, over time, result in an accumulated loan balance that an employee cannot repay. The Committee believes that appropriate limits should be placed on such arrangements.[78]

EXAMPLE

The Unsafe Profit Sharing plan offers participants the ability to make loans by the use of credit cards and fails to remove this option at the time the SECURE Act is signed into law. Tiffany uses the credit card issued to her by the plan to use $5,000 to buy furniture for her home.

Under the revisions to §72(p) contained in the SECURE Act, this $5,000 transaction is treated as a distribution taxable to Tiffany.

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[74] SECURE Act §107(c)

[75] IRC §72(p)(2)(D) as amended

[76] *Report of the Committee on Ways and Means on HR 1994*, p. 54

[77] SECURE ACT §108(b)

[78] *Report of the Committee on Ways and Means on HR 1994*, p. 54

PORTABILITY OF LIFETIME INCOME OPTIONS (ACT SECTION 109)

The Act provides that certain *lifetime income investments* may be distributed in a trustee-to-trustee transfer (as described in IRC §401(a)(31)(A)) to an eligible retirement plan listed below:

- An individual retirement account described in section 408(a),
- An individual retirement annuity described in section 408(b) (other than an endowment contract),
- A qualified retirement plan trust (profit sharing plan, §401(k) plan, etc.),
- An annuity plan described in section 403(a),
- An eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A), and
- An annuity contract described in section 403(b).[79]

A *lifetime income investment* is an investment option which is designed to provide an employee with election rights:

- which are not uniformly available with respect to other investment options under the plan, and
- which are to a lifetime income feature available through a contract or other arrangement offered under the plan (or under another eligible retirement plan (as so defined), if paid by means of a direct trustee-to-trustee transfer described in paragraph (31)(A) to such other eligible retirement plan).[80]

The term lifetime income feature means:

- a feature which guarantees a minimum level of income annually (or more frequently) for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or
- an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments (not less frequently than annually) over the life of the employee or the joint lives of the employee and the employee's designated beneficiary.[81]

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[79] IRC §401(a)(38)(A)

[80] IRC §401(a)(38)(B)(ii)

[81] IRC §401(a)(38)(B)(iii)

The qualified distribution allowed in this case are:

- qualified distributions of a lifetime income investment, or
- distributions of a lifetime income investment in the form of a qualified plan distribution annuity contract.[82]

These allowed distributions must take place on or after the date that is 90 days prior to the date on which such lifetime income investment is no longer authorized to be held as an investment option under the plan.[83]

The Committee Report explains the reason for this revision as follows:

> The terms of some investments impose a charge or fee when the investment is liquidated, particularly if the investment is liquidated within a particular period after acquisition. For example, a lifetime income product, such as an annuity contract, may impose a surrender charge if the investment is discontinued. If an employee has to liquidate an investment held in an employer-sponsored retirement plan, for example, because of a change in investment options or a limit on investments held in the plan, the employee may be subject to such a charge or fee. Restrictions on in-service distributions may prevent the employee from avoiding such a charge or fee, and also from preserving the investment, through a distribution or rollover of the existing investment. The Committee wishes to allow distributions and rollovers in such cases.[84]

As the report goes on to explain:

> Under the provision, if a lifetime income investment is no longer authorized to be held as an investment option under a qualified defined contribution plan, section 403(b) plan, or governmental section 457(b) plan, except as otherwise provided in guidance, the plan does not fail to satisfy the Code requirements applicable to the plan solely by reason of allowing (1) qualified distributions of a lifetime income investment, or (2) distributions of a lifetime income investment in the form of a qualified plan distribution annuity contract. Such a distribution must be made within the 90-day period ending on the date when the lifetime income investment is no longer authorized to be held as an investment option under the plan.
>
> For purposes of the provision, a qualified distribution is a direct trustee-to-trustee transfer to another employer-sponsored retirement

[82] IRC §401(a)(38)(A)

[83] IRC §401(a)(38)(A)

[84] *Report of the Committee on Ways and Means on HR 1994*, p. 57

plan or IRA. A lifetime income investment is an investment option designed to provide an employee with election rights (1) that are not uniformly available with respect to other investment options under the plan and (2) that are rights to a lifetime income feature available through a contract or other arrangement offered under the plan (or under another employer-sponsored retirement plan or IRA through a direct trustee-to-trustee transfer). A lifetime income feature is (1) a feature that guarantees a minimum level of income annually (or more frequently) for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or (2) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments (not less frequently than annually) over the life of the employee or the joint lives of the employee and the employee's designated beneficiary. Finally, a qualified plan distribution annuity contract is an annuity contract purchased for a participant and distributed to the participant by an employer-sponsored retirement plan or an employer-sponsored retirement plan contract.[85]

EXAMPLE

Duane had invested in an annuity contract in the XYZ Profit Sharing Plan. XYZ has changed its investment options and the annuity contract in question can no longer be held in the plan. The plan provides that such an annuity can be distributed within 90 days of no longer being eligible to be held in the plan to an eligible retirement plan.

Duane establishes an IRA and the annuity is transferred to the IRA in a trustee-to-trustee transfer.

TREATMENT OF CUSTODIAL ACCOUNTS ON TERMINATION OF SECTION 403(B) PLANS (ACT SECTION 110)

Congress directs Treasury to take on some problems that arise when an employer attempts to terminate a §403(b) plan. Because it simply directs Treasury to take on the problem, at this point in time, this simply is a "keep your eyes on this guidance project" notice for those with §403(b) plans.

The House Committee Report describes the issue they are looking to solve in this manner:

> In general, assets of section 403(b) plans can be invested only in annuity contracts or mutual funds. Unlike most qualified defined contribution plans, under which assets are held in a trust, historically, assets associated with section 403(b) plans have often consisted of annuity contracts issued in the name of the particular participant or

[85] *Report of the Committee on Ways and Means on HR 1994*, p. 57

> mutual funds held in a custodial account in the participant's name. In many cases, this prevents an employer from distributing these assets in order to effectuate a plan termination. The Committee wishes to provide a mechanism under which the plan termination may proceed while keeping assets that cannot otherwise be distributed in a tax-favored retirement savings vehicle.[86]

SECURE Act §110 does not modify the IRC—rather, it simply orders Treasury to issue guidance. The Section states:

> Not later than six months after the date of enactment of this Act, the Secretary of the Treasury shall issue guidance to provide that, if an employer terminates the plan under which amounts are contributed to a custodial account under subparagraph (A) of section 403(b)(7), the plan administrator or custodian may distribute an individual custodial account in kind to a participant or beneficiary of the plan and the distributed custodial account shall be maintained by the custodian on a tax-deferred basis as a section 403(b)(7) custodial account, similar to the treatment of fully-paid individual annuity contracts under Revenue Ruling 2011-7, until amounts are actually paid to the participant or beneficiary. The guidance shall provide further (i) that the section 403(b)(7) status of the distributed custodial account is generally maintained if the custodial account thereafter adheres to the requirements of section 403(b) that are in effect at the time of the distribution of the account and (ii) that a custodial account would not be considered distributed to the participant or beneficiary if the employer has any material retained rights under the account (but the employer would not be treated as retaining material rights simply because the custodial account was originally opened under a group contract). Such guidance shall be retroactively effective for taxable years beginning after December 31, 2008.[87]

While the provision takes effect as of the date of enactment, all that really means is that the six-month clock starts as of that date.[88]

[86] *Report of the Committee on Ways and Means on HR 1994*, p. 60

[87] SECURE Act §110

[88] *Report of the Committee on Ways and Means on HR 1994*, p. 61

CLARIFICATION OF RETIREMENT INCOME ACCOUNT RULES RELATING TO CHURCH-CONTROLLED ORGANIZATIONS (ACT SECTION 111)

Congress also wanted to clarify issues related to the use of *retirement income account* (a type of account subject to less restrictive investment rules than standard §403(b) accounts) by church-controlled organizations that are not themselves a *qualified* church-controlled organization, allowing their use in that case.[89]

The House Committee Report notes:

> However, the restrictions on investments do not apply to a retirement income account, which is a defined contribution program established or maintained by a church, or a convention or association of churches, to provide benefits under the plan to employees of a religious, charitable or similar tax-exempt organization.

In recent years, a question has arisen as to whether employees of nonqualified church-controlled organizations may be covered under a section 403(b) plan that consists of a retirement income account.[90]

The House Committee Report explains the change, made to IRC §403(b)(9)(B), as follows:

> The provision clarifies that a retirement income account may cover a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, regardless of the source of his compensation; an employee of an organization, whether a civil law corporation or otherwise, that is exempt from tax under section 501 and is controlled by or associated with a church or a convention or association of churches; and an employee who is included in a church plan under certain circumstances after separation from the service of a church, a convention or association of churches, or an organization described above.[91]

The revision shall apply to all years—or to state it as the law does, "to years beginning before, on, or after the date of the enactment of this Act."[92]

QUALIFIED CASH OR DEFERRED ARRANGEMENTS MUST ALLOW LONG-TERM EMPLOYEES WORKING MORE THAN

[89] *Report of the Committee on Ways and Means on HR 1994*, p. 61

[90] *Report of the Committee on Ways and Means on HR 1994*, p. 61

[91] *Report of the Committee on Ways and Means on HR 1994*, p. 62

[92] SECURE Act §111

500 BUT LESS THAN 1,000 HOURS PER YEAR TO PARTICIPATE (ACT SECTION 112)

A larger portion of the workforce is now working at less than full-time jobs, even though they may continue to work for the same employer for an extended period. Congress has moved to require employers who sponsor retirement plans with cash or deferred arrangements (CODAs), such as §401(k) plans, to allow long-term employees who work more than 500 hours per year to participate in the CODA portion of the plan, down from the previous minimum of 1,000 hours per year (though at 1,000 hours, access to full participation in the plan was and will continue to be required).

EXAMPLE

Martin has worked for ABC Consulting as a part-time employee for the past six years. Martin works, on average, 12 hours a week or 624 hours a year. Under the law in effect before this provision of the SECURE Act takes effect, ABC Consulting could sponsor a §401(k) plan, but was not required to allow Martin to participate in the plan.

But simply requiring employers to bring in participants who work more than 500 hours but less than 1,000 hours per year could have other impacts on plans. For instance, the additional employees would likely be rank-and-file employees which would impact ACP/ADP testing and whether or not the plan is considered top-heavy. As well, it would increase costs for employers who make matching contributions or other employer contributions to the plan, since these new participants would also, if simply allowed into the plan, either require increased employer contributions or, if the employer kept its costs at the same level, a lesser amount of such contributions be credited to full-time employees.

So, to take these items into account, Congress is looking to limit the required access to merely the ability to make employee deferrals into the plan without impacting those other areas.

The House Committee Report explains the justification for the change as follows:

> For long-term part-time workers who work for a number of years with the same employer but do not reach the 1,000 hours of service requirement to become eligible to participate in their employer's qualified retirement plans, present law can prevent, or limit, such employees' ability to save for retirement in an employer-sponsored plan. The Committee wishes to provide a means for such long-term part-time employees to save for retirement by providing eligibility to make elective deferrals in such plans if an employee has worked for at least 500 hours per year with an employer for at least three consecutive years and has met certain other conditions.[93]

There are two provisions added by the bill. The first, found at IRC §401(k)(2)(D), contains the requirements that the plan must allow employees who have incurred 500 hours of service in the three prior years (*long-term, part-time workers*)[94] and who meet the minimum age requirements by the end of the current plan[95] year to participate in the §401(k) plan for that plan to remain a qualified plan.

As the House Committee Report explains:

> The provision requires a section 401(k) plan to permit an employee to make elective deferrals if the employee has worked at least 500 hours

[93] *Report of the Committee on Ways and Means on HR 1994*, p. 68

[94] IRC §401(k)(2)(D) as amended by §112(a)(1) of the SECURE Act

[95] IRC §401(k)(15)(A) as amended by §112(a)(2) of the SECURE Act

per year with the employer for at least three consecutive years and has met the age requirement (age 21) by the end of the three consecutive year period (for this provision, an employee is referred to as a "long-term part-time employee" after having completed this period of service). Thus, a long-term part-time employee could not be excluded from the plan because the employee has not completed a year of service as defined under the participation requirements described above (a 12-month period with at least 1,000 hours of service). Once a long-term part-time employee meets the age and service requirements, such employee must be able to commence participation no later than the earlier of (1) the first day of the first plan year beginning after the date on which the employee satisfied the age and service requirements or (2) the date 6 months after the date on which the individual satisfied those requirements. Employers may, but are not required to, allow long-term part-time employees to participate in the design-based safe harbors (including the automatic enrollment safe harbor). If an employer does permit a long-term part-time employee to participate in such an automatic enrollment 401(k) plan, that employee would have elective deferrals automatically made at the default rate unless the employee affirmatively elects not to make contributions or to make contributions at a different rate.[96]

EXAMPLE

Once these provisions are in effect, the employer plan will be required to allow Martin to elect to defer a portion of his wages to the plan. The fact that he does not have more than 1,000 hours of service will not prevent him from using the deferral provisions of the retirement plan.

The new law adds a number of special rules that apply to long-term part-time workers who are allowed into the plan.[97]

- The plan does not have to allocate either nonelective or matching contributions to individuals who are long-term part-time employees, even if such contributions are made on behalf of other employees;[98]

- Long-term part-time employees can be excluded from the applicable vesting and benefit requirements for top-heavy plans under IRC §416;[99] and

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[96] *Report of the Committee on Ways and Means on HR 1994*, p. 68

[97] IRC §401(k)(15) as amended by §112(a)(2) of the SECURE Act

[98] IRC §401(k)(15)(B)(i) as amended by §112(a)(2) of the SECURE Act

[99] IRC §401(k)(15)(B)(ii) as amended by §112(a)(2) of the SECURE Act

- The time of participation rules of IRC §410(a)(4) that requires two entry dates once an employee meets the participation requirements will not apply if the employee becomes eligible solely due to the long-term part-time employee rules.[100]

EXAMPLE

Although Martin is allowed to defer to the plan, the employer is not required to offer him the matching contributions the employer offers to other employees covered by the plan, nor must the employer include him in any allocation of nonelective contributions.

Long-term part-time employees will be credited with a year of vesting for each twelve month period where the employee has more than 500 hours of service.[101] Since employee deferrals and earnings on those are automatically vested, this mainly applies if the employer does make contributions under the plan that it decides to allocate to these employees.

These special rules cease to apply to an employee on the first day of the first plan year after the year in which an employee completes 1,000 hours of service and the twelve month periods shall be computed with reference to the date the employee's employment commenced as defined in the last sentence of IRC §410(a)(3)(A).[102]

As the House Committee Report explains:

> The provision does not require a long-term part-time employee to be otherwise eligible to participate in the plan. Thus, the plan can continue to treat a long-term part-time employee as ineligible under the plan for employer nonelective and matching contributions based on not having completed a year of service. However, for a plan that does provide employer contributions for long-term part-time employees, the provision requires a plan to credit, for each year in which such an employee worked at least 500 hours, a year of service for purposes of vesting in any employer contributions.
>
> With respect to long-term part-time employees, employers would receive nondiscrimination testing relief (similar to the present-law rules for plans covering otherwise excludable employees), including permission to exclude these employees from top-heavy vesting and top-heavy benefit requirements. However, the relief from the nondiscrimination rules ceases to apply to any employee who becomes a full-time employee (as of the first plan year beginning after the plan

[100] IRC §401(k)(15)(D)(i) as amended by §112(a)(2) of the SECURE Act

[101] IRC §401(k)(15)(B)(iii) as amended by §112(a)(2) of the SECURE Act

[102] IRC §401(k)(15)(B)(iv) as amended by §112(a)(2) of the SECURE Act

> year in which the employee completes a 12-month period with at least 1,000 hours of service).[103]

These rules do not apply to collectively-bargained employees.[104]

The provision contains a unique effective date. As the House Committee Report explains it:

> The provision applies to plan years beginning after December 31, 2020, except that for determining whether the three consecutive year period has been met, 12-month periods beginning before January 1, 2021 will not be taken into account.[105]

EXAMPLE

This provision will not apply to ABC Consulting's plan until the first plan year that begins after December 31, 2020. So if ABC's plan is on the calendar year, then it would begin to apply in 2021. However, any 12-month period beginning before 2021 is not taken into account in determining if the 3 consecutive year test is met. That will serve to delay actual entry under these rules until 2024, at the earliest.

PENALTY-FREE WITHDRAWALS FROM RETIREMENT PLANS FOR INDIVIDUALS IN CASE OF BIRTH OF CHILD OR ADOPTION (ACT SECTION 113)

Congress decided to add special rules that will apply to plan distributions related to the birth or adoption of a child. The House Committee Report explains the reason Congress believed a change was appropriate:

> Births and adoptions are important life events that can come with significant financial costs for a family. The Committee believes that, in these situations, individuals should have access to portions of their retirement savings to help pay for these costs. The ability to access retirement savings on a penalty-free basis at the time of the birth of a child or adoption will provide such flexibility. As a result, the Committee believes this will encourage younger workers to save earlier for their retirement, whether through participation in an employer-sponsored plan or an IRA.

The provision allows penalty-free access to a distribution related to a *qualified birth* or *qualified adoption* of up to $5,000 from an applicable eligible retirement plan.[106]

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103 *Report of the Committee on Ways and Means on HR 1994*, pp. 68-69

104 IRC §401(k)(15)(C) as amended by §112(a)(2) of the SECURE Act

105 *Report of the Committee on Ways and Means on HR 1994*, p. 69; SECURE Act Section 112(b)

106 IRC §72(t)(2)(H)(ii) as amended by the SECURE At

The $5,000 applies on an individual basis—so, as the Committee Report explains, a married couple can each withdraw $5,000, for a total of $10,000 of penalty-free withdrawal, for a single qualified birth or adoption.

> The maximum aggregate amount which may be treated as qualified birth or adoption distributions by any individual with respect to a birth or adoption is $5,000. The maximum aggregate amount applies on an individual basis. Therefore, each spouse separately may receive a maximum aggregate amount of $5,000 of qualified birth or adoption distributions (with respect to a birth or adoption) from applicable eligible retirement plans in which each spouse participates or holds accounts.[107]

A "qualified birth and qualified adoption distribution" is defined in IRC §72(t)(2)(H)(iii)(I) as:

> …any distribution from an applicable eligible retirement plan to an individual if made during the 1-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized.

An *eligible adoptee* is "any individual (other than a child of the taxpayer's spouse) who has not attained age 18 or is physically or mentally incapable of self-support."[108]

The House Committee Report notes that "eligible retirement plans" for this purpose includes:

> eligible retirement plans other than defined benefit plans, including qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, and IRAs.[109]

The Report makes a footnote reference to explain withholding requirements for such distributions:

> A qualified birth or adoption distribution is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.[110]

This footnote highlights a key point—while the distribution is not subject to the premature distribution tax found in IRC §72, it will still initially be subject to inclusions in the income of the employee. However, as will be discussed later, it may be

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[107] *Report of the Committee on Ways and Means on HR 1994*, pp. 70-71

[108] IRC §72(t)(2)(H)(iii)(II) as amended by the SECURE Act

[109] *Report of the Committee on Ways and Means on HR 1994*, p. 70

[110] *Ibid*, Footnote 131

recontributed to an eligible retirement plan and treated as an eligible rollover distribution that was rolled over within 60 days.

While there is a $5,000 limit on what can be considered a qualified birth or adoption expenditure by an individual, plans need not be concerned with assuring that employees have not taken other funds from any other plans and IRAs other than those maintained by the employer or members of a controlled group[111] of which the employer is a member.[112]

EXAMPLE

Mary takes a $5,000 distribution from her IRA at the birth of her child. She also withdraws $5,000 from her employer's 401(k) for the same reason. Although Mary will only escape a premature distribution penalty on $5,000 of the $10,000 in total distributions, the employer will not have violated the provisions of the IRC with regard to qualified plans due to Mary taking excess distributions, since only $5,000 of Mary's distributions came from the employer's retirement plan.

EXAMPLE

Instead of taking $5,000 from her IRA, Mary took $5,000 from a money purchase pension plan maintained by her employer, along with a $5,000 distribution from the §401(k) plan of that same employer. Now the employer is at risk for having violated the requirements for maintaining a qualified plan under the IRC unless these distributions are otherwise allowed under the plan and the IRC.

The recipient of the distribution will be required to provide certain information regarding the qualified birth or adoption with his/her tax return for the year in question. For each child whose birth or adoption qualifies the taxpayer to claim the exception to the 10% tax, the following information must be provided:

- Name;
- Age; and
- Taxpayer identification number.[113]

While the distributions are by default taxable, Congress does provide for a right to repay these distributions by the employee or IRA account holder.[114] IRC §72(t)(2)(H)(v)(I) provides:

> Any individual who receives a qualified birth or adoption distribution may make one or more contributions in an aggregate amount not to

[111] Those treated as a single employer under IRC §414(b), (c), (m) or (o)

[112] IRC §72(t)(2)(H)(iv)(I) as amended by the SECURE Act

[113] IRC §72(t)(2)(H)(vi)(III) as amended by the SECURE Act

[114] IRC §72(t)(2)(H)(v) as amended by the SECURE Act

> exceed the amount of such distribution to an applicable eligible retirement plan of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made under section 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16), as the case may be.

There does not appear to be an explicit date by which the funds must be replaced in the account in order to claim rollover treatment. The provision defining the treatment of the repayment to retirement plans other than IRAs states:

> If a contribution is made under subclause (I) with respect to a qualified birth or adoption distribution from an applicable eligible retirement plan other than an individual retirement plan, then the taxpayer shall, to the extent of the amount of the contribution, be treated as having received such distribution in an eligible rollover distribution (as defined in section 402(c)(4)) and <u>as having transferred the amount to the applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution</u>.[115]

Note that while treated as if the payment was made within 60 days of the distribution, nothing actually requires the recontribution be made within 60 days. IRC §72(t)(2)(H)(v)(IV) provides similar rules for IRA accounts.

While no deadline is stated, it would appear that unless the rollover is made before the statute of limitations for filing a claim for refund for the year of the original distribution is open, the taxpayer will be unable to receive a refund for the tax paid in the year of the distribution.

EXAMPLE

Wayne takes a distribution of $5,000 in 2021 to pay for expenses related to the qualified adoption of a child. Initially, that distribution would appear to be taxable, since only once a contribution is made under IRC §72(t)(2)(H)(v)(I) would the rollover treatment rules be triggered. Thus, if Wayne does not make a contribution to return some or all of the $5,000 by the due date (including extensions) of his 2021 return, tax would be due on the entire $5,000 distribution.

If Wayne makes a $5,000 contribution to the retirement plan in January of 2022, he would be able to file a claim for refund to get a refund of the taxes paid on the 2021 return on the distribution. The repayment would be deemed to have been paid within the 60-day period for the rollover.

However, if Wayne makes the $5,000 contribution in January 2026, it appears, absent some form of relief or option granted by the IRS in regulations or other guidance for this provision, that Wayne will not be able to obtain a refund of the taxes paid on his 2021 return unless, for some reason, the statute for claiming a refund remained open on the 2021 return. While such a payment appears to be allowed under the law, nothing appears to allow the taxpayer to be treated as having basis in the retirement amount for the amount of the repayment.

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[115] IRC §72(t)(2)(H)(v)(III) as amended by the SECURE Act

A special rule applies to amounts contributed back to a plan other than an IRA (that is, employer retirement plans). The amount contributed as repayments to an employer plan is limited to the amounts distributed from that particular plan. As well, the repayment rule only applies if the employee is eligible to make such a repayment to the plan.[116]

The Committee Report explains these rules as follows:

> Generally, any portion of a qualified birth or adoption distribution may, at any time after the date on which the distribution was received, be recontributed to an applicable eligible retirement plan to which a rollover can be made. Such a recontribution is treated as a rollover and thus is not includible in income. If an employer adds the ability for plan participants to receive qualified birth or adoption distributions from a plan, the plan must permit an employee who has received qualified birth or adoption distributions from that plan to recontribute only up to the amount that was distributed from that plan to that employee, provided the employee otherwise is eligible to make contributions (other than recontributions of qualified birth or adoption distributions) to that plan. Any portion of a qualified birth or adoption distribution from an individual's applicable eligible retirement plans (whether employer plans or IRAs) may be recontributed to an IRA held by such an individual which is an applicable eligible retirement plan to which a rollover can be made.[117]

EXAMPLE

Assume that after Wayne withdrew $5,000 from the ABC Corporation 401(k) plan, but before making any contributions to repay the $5,000, he takes a new job with XYZ Corporation and becomes a participant in XYZ's 401(k) plan.

As Wayne is no longer an employee of ABC Corporation, he is no longer eligible to make a contribution to that plan. Although he is an employee of XYZ's 401(k) plan, he cannot make the return contribution to that plan because he did not receive a qualified birth or qualified adoption distribution from XYZ's plan.

However, Wayne is allowed to make the contribution to an IRA account in his name and treat that as an eligible rollover transaction from the ABC Corporation plan.

This provision takes effect for distributions made after December 31, 2019.[118]

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[116] IRC §72(t)(2)(H)(v)(II) as amended by the SECURE Act

[117] *Report of the Committee on Ways and Means on HR 1994*, p. 71

[118] SECURE Act §113(b)

INCREASE IN AGE FOR REQUIRED BEGINNING DATE FOR MANDATORY DISTRIBUTIONS (ACT SECTION 114)

In the SECURE Act, Congress made a minor change in the required beginning date for distributions from IRAs and qualified plans. The House Committee Report describes the current rules, including the differences between rules for IRA and qualified employer retirement plans, with regard to required distributions and the current required beginning date:

> Required minimum distributions generally must begin by April 1 of the calendar year following the calendar year in which the individual (employee or IRA owner) reaches age 70½. However, in the case of an employer-provided qualified retirement plan, the required minimum distribution date for an individual who is not a 5-percent owner of the employer maintaining the plan may be delayed to April 1 of the year following the year in which the individual retires if the plan provides for this later distribution date. For all subsequent years, including the year in which the individual was paid the first required minimum distribution by April 1, the individual must take the required minimum distribution by December 31 of the year.[119]

As the Committee Report notes, the age at which required distributions must begin have been at the same age for 57 years, a reason Congress believes the age needs to be adjusted:

> When mandatory distributions from qualified retirement plans based on age were added to the Code in 1962, the life expectancy of Americans was shorter. In addition, increasing numbers of Americans are continuing to work past traditional retirement ages. The Committee believes it is appropriate to therefore increase the age by which required minimum distributions must be made to more accurately reflect present-day circumstances.[120]

Under the new law, age 72 will be substituted for age 70 ½ in §§401, 408, and 457 for determining the required beginning date for distributions.[121]

Observation: The law does not make a conforming change to IRC §408(d)(8)(B)(ii) for qualified IRA distributions for charitable purposes of up to $100,000 per year, with age 70½ still referenced in that provision. Thus, an individual can make qualified charitable contributions directly from his/her IRA accounts once he/she reaches age 70½ even though minimum distributions will be required until after the taxpayer attains age 72.

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[119] *Report of the Committee on Ways and Means on HR 1994*, p. 72

[120] *Report of the Committee on Ways and Means on HR 1994*, p. 74

[121] IRC §§401(a)(9)(C)(i)(I), §408(b) and §457(d)(1)(A)(i)

The effective dates for these provisions are a bit unique as well. It applies to distributions required to be made December 31, 2019 for individuals who attain 70½ after that date.[122]

EXAMPLE

James turns 70½ on December 30, 2019. He is required to take his first minimum distribution by April 1, 2020 and will be required to take a minimum distribution for 2020 by December 31, 2020. Despite not being 72 by the end of 2020, he is still required to take his minimum distribution for 2020 since he had attained age 70½ by December 31, 2019.

Scott turns 70½ on January 2, 2020. He is not required to take his first minimum distribution until April 1, 2022, as he will turn 72 in 2021.

Both Scott and James will be able to make qualified direct charitable contributions from their IRAs for 2021. That is true even though Scott will not have yet reached his required beginning date.

SPECIAL RULES FOR MINIMUM FUNDING STANDARDS FOR COMMUNITY NEWSPAPER PLANS (ACT SECTION 115)

The Act contains what has to be described as very industry-specific relief in the provision related to an election to apply alternate minimum funding standards to certain single employer community newspaper plans. The law changes IRC §430, adding new IRC §430(m), as well as equivalent changes to Section 300 of ERISA, adding ERISA §303(m).

The Committee Reports describes the reason for this change:

> The Committee believes that providing relief to sponsors of community newspaper pension plans with funding shortfalls will allow sponsors of such plans to maintain and meet plan obligations to covered employees. The Committee understands that the period over which a funding shortfall must be funded affects the amount of the required contribution for a year in that a shorter period results in a higher required contribution for the year and a longer period results in a lower required contribution. Similarly, the interest rates used to determine a plan's funding target and target normal cost affect the amount of required contributions in that lower interest rates result in a higher funding target and target normal cost and, therefore, higher required contributions. Alternatively, higher interest rates result in a lower funding target and target normal cost and, therefore, lower required contributions. Therefore, the relief provided under the provision extends the period over which contributions are required to be made to ameliorate funding shortfalls, and permits the use of a

[122] SECURE Act §114(d)

> generally lower interest rate to determine the plan's funding target and target normal cost.[123]

The Committee Report outlines the general rule:

> Under the provision, an employer maintaining a "community newspaper plan" (as defined below) under which no participant has had the participant's accrued benefit increased (whether because of service or compensation) after December 31, 2017, may elect to apply certain alternative funding rules to the plan and any other plan sponsored by any member of the controlled group (determined as of the date of enactment). An election under the provision to apply the alternative funding rules is to be made at such time and in such manner as prescribed by the Secretary of the Treasury, and once made with respect to a plan year, applies to all subsequent years unless revoked with the consent of the Secretary of the Treasury.[124]

The alternate funding rule, for which the election is allowed, is described in the Committee Report as follows:

> Under the alternative funding rules, an interest rate of eight percent is used to determine a plan's funding target and target normal cost, rather than the first, second, and third segment rates. However, if new benefits are accrued or earned under a plan for a plan year in which the election is in effect, the present value of such benefits must be determined on the basis of the U.S. Treasury obligation yield curve for the day that is the valuation date of such plan for such plan year. In addition, if the value of plan assets is less than the plan's funding target, such that the plan has a funding shortfall, the shortfall is required to be funded by contributions, with interest, over 30 years, rather than over seven years. The shortfall amortization bases determined for all plan years preceding the first plan year to which the election applies (and all related shortfall amortization installments) are reduced to zero. Further, the assumptions applicable to an "at-risk" plan do not apply.[125]

A community newspaper is described in the Committee Report as follows:

> Under the provision, a "community newspaper plan" is a plan to which the new provision applies, which is maintained by an employer that, as of December 31, 2017:

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[123] *Report of the Committee on Ways and Means on HR 1994*, p. 76

[124] *Ibid*

[125] *Ibid*

- publishes and distributes daily, either electronically or in printed form, one or more community newspapers (as defined below) in a single State,

- is not a company the stock of which is publicly traded on a stock exchange or in an over-the-counter market, and is not controlled, directly or indirectly, by such a company,

- is controlled, directly or indirectly (a) by one or more persons residing primarily in the State in which the community newspaper is published; (b) for at least 30 years by individuals who are members of the same family; (c) by a trust created or organized in the State in which the community newspaper is published, the sole trustees of which are persons described in (a) or (b); (d) by an entity described in section 501(c)(3) and exempt from tax under section 501(a) that is organized and operated in the State in which the community newspaper is published, and the primary purpose of which is to benefit communities in the State; or (e) by a combination of persons described in (a), (c), or (d), and

- does not control, directly or indirectly, any newspaper in any other State.

A "community newspaper" is described as follows:

> A "community newspaper" means a newspaper that primarily serves a metropolitan statistical area, as determined by the Office of Management and Budget, with a population of not less than 100,000. For purposes of the provision, a person (the "first" person) is treated as controlled by another person if the other person possesses, directly or indirectly, the power to direct or cause the direction and management of the first person (including the power to elect a majority of the members of the board of directors of the first person) through the ownership of voting securities.[126]

In this case, the provision has a retroactive effective date, applying to plan years ending after December 31, 2017.[127]

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[126] *Ibid*

[127] *Ibid*

TREATING EXCLUDED DIFFICULTY OF CARE PAYMENTS AS COMPENSATION FOR DETERMINING RETIREMENT CONTRIBUTION LIMITATIONS (ACT SECTION 116)

Under IRC §131(a), gross income does not include difficulty of care payment received by a taxpayer. As the House Committee Report explains this type of payment:

> Qualified foster care payments include any payment made pursuant to a foster care program of a State or political subdivision which is paid by (1) a State or political subdivision thereof or (2) a qualified foster care placement agency, and which is either (1) paid to the foster care provider for caring for a qualified foster individual in the foster care provider's home, or (2) a "difficulty of care" payment. A "qualified foster individual" is any individual who is living in a foster family home in which the individual was placed by either an agency of a State (or a political subdivision thereof) or a qualified foster care placement agency. A qualified foster care placement agency is any placement agency which is licensed or certified by a State (or political subdivision thereof) or an entity designated by a State (or political subdivision thereof).
>
> A "difficulty of care" payment is compensation for providing the additional care needed for certain qualified foster individuals. Such payments are provided when a qualified foster individual has a physical, mental or emotional disability for which the State has determined that (1) there is a need for additional compensation to care for the individual, (2) the care is provided in the home of the foster care provider, and (3) the payments are designated by the payor as compensation for such purpose. An applicant must request an assessment of need from the State agency administering the program and submit a medical evaluation which is reassessed every year.[128]

As these payments are not taxable income to the individual, receiving the payment cannot be used to determine amounts to be paid in as contributions to qualified retirement plans and individual retirement accounts.

The SECURE Act adds provisions to allow such payment to be used to allow for contributions to both defined contribution retirement plans and individual retirement accounts.

For IRAs, the new rule provides that, for a recipient of such payments, if the total contribution limit for IRAs exceeds that individual's earned income includable in gross

[128] *Report of the Committee on Ways and Means on HR 1994*, p. 79

income for the taxable year, the taxpayer may elect to increase the nondeductible IRA limit by the lesser of the difference between the maximum and allowed contribution under prior law or the amount of the excludable difficulty of care payment.[129]

EXAMPLE

Sally receives a $5,000 difficulty of care payment in 2019 that is excludable from her gross income under IRC §131(a). Sally does not have any earned income that would otherwise qualify her to make an IRA contribution for 2019.

If Sally elects, she can increase the maximum amount of a nondeductible contribution she is allowed to make to an IRA from $0 to $5,000 based on the difficulty of care payment.

EXAMPLE

Assume the same facts except Sally is paid $10,000 for the excludable difficulty of care payment. In this case, she can only increase the nondeductible limit to $6,000, which is the maximum amount that anyone can contribute to an IRA for 2019 even with a large amount of earned income.

Assume that, instead of an IRA, the difficulty of care payment provider establishes a qualified defined benefit retirement plan. Under the provisions added by the SECURE Act, a contribution can be made that is based on the SECURE payment to the plan, and this contribution will be treated as an after-tax contribution to the plan—that is, the participant will be treated as an investment in the contract when distributions are made later.[130]

Congress appears to believe that some individuals had made contributions to IRAs and retirement plans based on excludable payments. Thus, the revisions apply to plan years ending after December 31, 2015.

One reason why Congress may have worried about such contribution was the IRS change in position on payments made to parents in caring for disabled adult children. Prior to the issuance of Notice 2014-7, the IRS had taken the position that such a payment could not qualify as a foster care difficulty of care payment, as a biological child could not be foster child.

In Notice 2014-7, the IRS reversed that position, holding that such payments were excludable from income. While being nontaxable was generally a good thing for the recipients, it did create problems for those who were making retirement plan contributions based on such income.

However, at the time this bill was being considered, the Tax Court, in the case of *Feigh v. Commissioner*, 152 TC No. 15, held that the IRS's position in Notice 2014-7 was not in keeping with the clear language of the law. While the case involved whether the

[129] IRC §408(o)(5) as amended by the SECURE Act

[130] IRC §415(c)(8)

taxpayer could qualify for an earned income tax credit, the basis for the decision calls into question whether the IRS will be able to continue to treat such payments as nontaxable. The Tax Court noted that the IRS was initially right—a biological child cannot be a foster child, and §131(a) only excludes payments related to foster children.

At the time this manual was written, the IRS was reportedly still trying to decide what to do about Notice 2014-7's position on the taxability of such payments. Similarly, it is possible that Congress might take some action in this area as well to prevent such payments from being taxable.

But, for now, it could complicate filings for taxpayers that received such payments related to disabled biological children. For many, if the payments are taxable, before-tax contributions would be preferable.

Unfortunately, the area remains uncertain for now. Advisers will need to watch for future IRS and, potentially, Congressional action in the wake of the *Feigh* decision.

NOTES

Unit 4

SECURE Act: Revenue Provisions

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Advise clients on the impact of the modified required minimum distribution (RMD) rules on their current planning in place with regard to IRAs and qualified plan benefits
- Describe other administrative provisions included in the SECURE Act

Although the SECURE Act has a number of provisions that are taxpayer friendly, those provisions impose a budget cost that Congress, under current rules, has to mainly offset. So the law comes with a series of changes meant to raise money.

The primary way that Congress raises money to pay for this bill is by greatly reducing the benefit of so-called "stretch IRAs" by generally requiring plan balances to be paid out no later than 10 years after the interest is transferred to most beneficiaries. Congress also increased penalties as an additional way to pay for the revisions made to the law.

MODIFICATION OF REQUIRED DISTRIBUTION RULES FOR DESIGNATED BENEFICIARIES (ACT SECTION 401)

Congress decided that it no longer wanted to allow most beneficiaries to take an inherited retirement plan interest over his/her life expectancy. Advisers had termed the use of such an option as a "stretch IRA" which could be used to greatly lengthen the time that such funds remained in a tax sheltered plan, especially if the interest was transferred to a Roth IRA before the original account holder died.

Under prior law, an individual inheriting an IRA or retirement account from an individual who died before passing his/her required beginning date (generally the date the individual turned age 70½).

Old Law Rules for Inherited Accounts with Death Prior to Entering Pay Status

To understand the options under the law before SECURE, we'll look first at the issues involved when an IRA or retirement account holder died before the required beginning date with a named beneficiary who is not the account holder's spouse.

As a general rule, the account holder's spouse can always accept the same result as if he was not the spouse—but being the spouse opens up additional alternatives that may serve to stretch out the IRA distributions over a longer period.

Because a Roth IRA does not have a required beginning date, it would always be in "pre-pay" status when the account owner dies.

A key fact to remember is that while these options were available, the actual plan document (for an employer plan) or the IRA custodial agreement (for an IRA) may have set default options or limit the options for the participant.

As such, the documents related to the plan or IRA had to be consulted in addition to the material noted below for use in planning actions related to the retirement accounts.

Life Expectancy (One Year) Rule

Under this rule, the required minimum distribution for the year following the year of death of the account owner will be based on the life expectancy of the designated beneficiary. If there are multiple beneficiaries, the life expectancy of the one with the shortest life expectancy will be used to compute the payout for the entire account [Reg. §1.401(a)(9)-5, Q&A 7(a)(1)].

Only individuals may be designated beneficiaries under these rules. If even a single beneficiary is not an individual as of the September 30 measuring date described below (e.g., a charity or most trusts), the account is treated as having no designated beneficiary, even though there may be individual beneficiaries. Without a designated beneficiary, the life expectancy rule described in this section is not available for the account [Reg. §1.409(a)(9)-4, Q&A 3].

The IRC provides that the life expectancy rule is the rule to be used if the plan does not specify (or allow the election to use) another rule and the participant has a designated beneficiary (measured as of September 30 of the year following the year of death) [Reg. §1.401(a)(9)-3, Q&A 4(a)].

The plan document may allow a choice of methods or may even require the use of the five-year rule even if the participant has a designated beneficiary [Reg. §1.401(a)(9)-3, Q&A 4(c)]. If such an election is allowed, it must be made no later than the earlier of:

- December 31 of the calendar year in which distributions would have to start to satisfy the requirements of the life expectancy distribution provision (normally the year after death); or
- the end of the fifth calendar year following the year of the employee's death.

Because the election deadline date is most often the end of the year following the year of death of the participant, the life expectancy rule is sometimes referred to as the *one-year rule* (for the period during which an election must be made).

Let us consider an example of the use of this rule:

EXAMPLE

Joe dies on June 1, 2018 with an IRA account balance of $100,000. The account names Mary, his daughter, as his sole beneficiary. Joe had not yet passed his required beginning date at the time of his death. The IRA document is silent with regard to the distribution method.

On December 1, 2019, Mary comes to her CPA asking about how much has to be distributed out of the IRA. No distributions have been made at this point and the account retained its value of $100,000 as of December 31, 2018. Mary's life expectancy under the IRS tables is 20 years.

The RMD must be determined under the life expectancy rules. Thus, the distribution is equal to the following: $\frac{\$100{,}000}{20\ years} = \$5{,}000$

Mary must take this distribution by December 31, 2019.

Assume that the account also had named a charity as a 10% beneficiary. Mary pays out the $10,000 amount left to the charity in a distribution to the charity in June of 2019.

Because only eligible designated beneficiaries exist in the account at September 30, the life expectancy rules are used.

Assume all the same facts as in the first case except the IRA provides that the five-year rule must be used and the funds are in this IRA on September 30, 2019. In that case, there is no required distribution that must be made by December 31, 2019.

However, the entire balance will need to be distributed by the end of 2023.

One item to note, which applies for all cases discussed in this section except where the spouse treats the IRA as her own, is that the distribution now switches to a single life calculation of life expectancy and is not recalculated annually. So, if the life expectancy of the designated beneficiary turns out to be 20 years, the account will be fully distributed over that 20-year period even if only RMD distributions are taken.

In the following year, one will be subtracted from the factor instead of going back to the table to recompute the individual's life expectancy. So for the second year in this case, the factor would be 19 years.

One other caveat is that if the spouse is the beneficiary but does not elect to treat the account as his own, the single life is recalculated annually until the spouse dies.

Also, if the owner had not passed his required beginning date, the spouse can delay distributions until the date in which the now-deceased participant would have attained age 70½.

Five-Year Rule

The five-year rule is required to be used in a case where the participant did not have a designated beneficiary as of the September 30 date (which would include cases with a non-individual beneficiary of the account that would eliminate the ability for the account to have a designated beneficiary) or if the plan document requires that the five-year method be used [Reg. §1.401(a)(9)-3, Q&A 4].

Under the five-year rule, the entire balance in the account must be distributed by the end of the fifth calendar year following the employee's death [Reg. §1.401(a)(9)-3, Q&A 2].

EXAMPLE

In the previous example, Mary could hold the entire $100,000 along with any earnings in the account until 2023 and then withdraw the entire balance.

Furthermore, she could withdraw any or all of the account in the intervening years, but the entire balance will have to be paid out by the end of 2023.

Old Law Inherited Account Distribution Rules for Death After Entering Pay Status

The rules change somewhat following a participant passing her required beginning date. Under these rules, the five-year rule goes away, replaced now by a choice of life expectancy payouts.

As a result, if the participant had not taken her required distribution for the year in which she died, that distribution will be taken under the calculation that is applicable prior to the participant's death, paid out by the required distribution date to the named beneficiary (or beneficiaries) of the account.

Generally, the RMD is made based upon the longer of:

- the participant's remaining life expectancy at the date of death (as odd as that sounds), or
- the life expectancy of the designated beneficiary.

The participant's remaining life expectancy at death is based upon the single life (rather than the joint life with a presumed 10-year-younger beneficiary or, if a longer factor, a joint life expectancy with the participant's spouse), using the participant's age as of his birthday for the year of death [Reg. §1.401(a)(9)-5, Q&A 5(c)].

The life expectancy of the designated beneficiary who is not the participant's spouse is determined using that person's age as of his birthday for the year following the year of death of the participant [Reg. §1.401(a)(9)-5, Q&A 5(c) (1)].

If the designated beneficiary is the employee's spouse who does not elect to treat the account as her own, the factor is still a single life factor but it is recalculated each year through the spouse's death [Reg. §1.401(a)(9)-5, Q&A 5(c)(2)].

If there is no designated beneficiary, then the participant's life expectancy must be used.

EXAMPLE

Harry died in March 2018 after beginning minimum distributions. He has named a trust that does not qualify for look-through status as the sole beneficiary of his IRA. The minimum distribution for 2018 would be based on Harry's single life for his age on his 2018 birthday (even if that birthday was after the date of his death).

For future years, the minimum distribution will be reduced by one each year.

Harry names his brother Jack (who is four years younger) as the beneficiary of the IRA. Harry's life expectancy based on his 2018 birthday is 10, while Jack's life expectancy based on his age upon his birthday in 2019 is 14. The 14 will be used for 2019 as the factor to determine the minimum required distribution to Jack. The 14 will be reduced by one each year for future distributions. But if Harry had not taken his minimum distribution for 2018 before he died, that distribution (which will be taken by Jack) will be based on the 10-year factor tied to Harry's life before switching to Jack's life expectancy in the following year.

SECURE Act Revisions to Distribution Rules

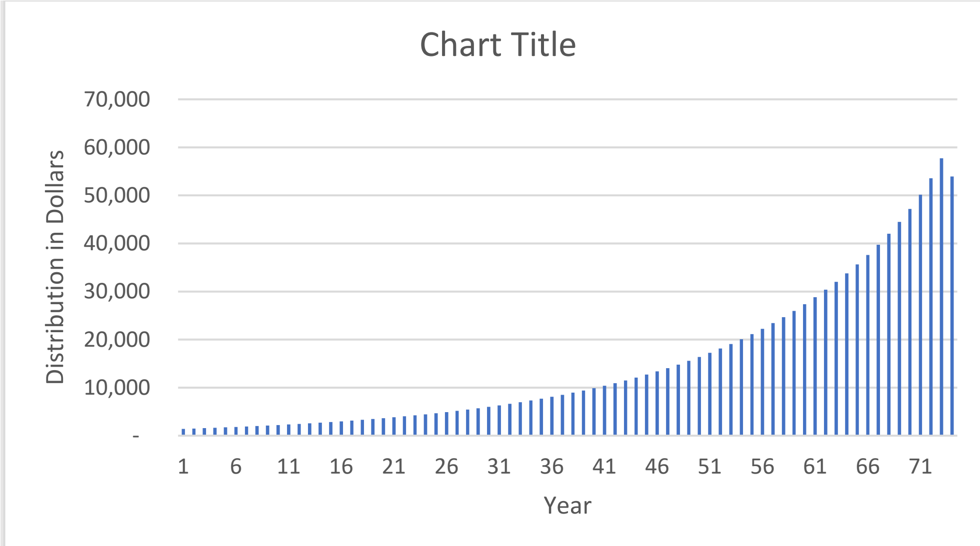
The SECURE Act makes a number of revisions to the rules discussed above. For a defined contribution plan (that is, plans other than defined benefit pension plans), the balance left to an heir generally must be distributed by no later than the tenth year after the owner died.[131] There is no option for most beneficiaries to use the life expectancy options described earlier – that is, neither the life expectancy of the designated beneficiary nor that of the decedent can be used to determine required distributions.

EXAMPLE

Katherine, age 42, has a balance of $100,000 in her profit sharing plan account when she dies on January 1, 2020. Katherine named her niece, Christina, age 9 at end of 2021, as the beneficiary of her account. At the beginning of 2021, the account had grown to $105,000 (5% return). Under the law prior to the SECURE Act, Christina's distribution for 2021 would have been that balance divided by her life expectancy of 73.8 per the IRS single life tables, or $1,423. In each future year, that factor would have reduced by 1.

Assuming a 5% return per year, here is the distributions that would be made each year under the law in effect before the SECURE Act if a stretch IRA approach was taken to maximize the deferral.

[131] IRC §409(a)(9)(H)(i)



Note that distributions begin at a relatively low level in the initial years, then grow over time with a final distribution coming in year 74. In the next to last year, the distributions max out at $57,721.

With the SECURE Act, Christina will not have to take any distributions during the first 9 years, but the entire balance must be paid out by the end of year 10.

Assuming Christina holds the funds in the account until the final year and distributes at the end of year 10 and assuming the same rate of return, she will take out $162,891 at the end of year 10. While that will achieve the maximum deferral, the 19-year-old Christina will likely face a significant income tax liability. In contrast, under the pre-SECURE law, the amounts that would have been required to be distributed to Christina by the year 10 with these assumptions would have been $17,956.

Alternatively, to attempt to reduce the impact of the large distribution in the final year, Christina could take $12,950 out per year which, at 5%, would eliminate the balance at the end of year 10. But now the funds are no longer able to grow tax free inside the IRA.

The House Committee Report notes the following summary of plans covered by these rules:

> A defined contribution plan for this purpose means an eligible retirement plan (qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, and IRAs) other than a defined benefit plan.[132]

Eligible Designated Beneficiary (EDB) Distribution Rules

A select group of beneficiaries will continue to be allowed to use a life expectancy calculation for their minimum required distribution. The individuals in the eligible designated beneficiary group are:

[132] *Report of the Committee on Ways and Means on HR 1994*, p. 108

- the surviving spouse of the original holder/beneficiary of the account;
- the minor child of the original holder/beneficiary of the account (this is subject to a special treatment when the child reaches majority, discussed later);
- a disabled individual (within the meaning of IRC §72(m)(7));
- a chronically-ill individual (within the meaning of IRC §7702B(c)(2) with the added requirement of a certification that the period of inability is an indefinite one which is reasonably expected to be lengthy in nature); and
- an individual who is not more than 10 years younger than the original holder/beneficiary of the account.[133]

The determination of whether a beneficiary is an eligible designated beneficiary is made as of the date of death of the original holder/employee.[134]

EXAMPLE

Assume in the above example that Christina is involved in an automobile accident that renders her permanently disabled within the meaning of IRC §72(m)(7) on January 15, 2020. Because Christina was not disabled when her aunt died, she is not classified as an eligible designated beneficiary even though the account may not actually be retitled to show Christina as the new beneficiary of the inherited IRA until after she becomes disabled. Since she was not disabled on the date her aunt died, she is not able to make use of the lifetime distribution option for the account.

Special Treatment of Minor Child Eligible Designated Beneficiary

Unlike the other eligible designated beneficiaries, a minor child will be able to continue to make use of the lifetime distribution option until the account is exhausted. Rather, a new 10-year period begins on the date the child reaches the age of majority and ends on the tenth anniversary of reaching majority.[135]

EXAMPLE

Assume that rather than being Katherine's niece, Christina was Katherine's daughter. In this case, Christina would begin taking her distributions using the life expectancy tables. Assuming the age of majority is 18 in Christina's state of residence, when she turned 18, the life expectancy rule would cease to apply. Rather, a new 10-year period would begin.

Here are the distributions per year, again assuming a 5% rate of return:

[133] IRC §409(a)(9)(E)(ii) as amended

[134] IRC §409(a)(9)(E)(iv) as amended

[135] IRC §409(a)(9)(E)(iii) as amended

Age	Distribution
9	1,423
10	1,495
11	1,571
12	1,650
13	1,734
14	1,822
15	1,914
16	2,012
17	2,114
18	-
19	-
20	-
21	-
22	-
23	-
24	-
25	-
26	-
27	234,431

Again, the above assumes that once the beneficiary is able to delay distributions, the amount is delayed to maximize the deferral. Again, it's important to note that this will cause a significant amount of income to be recognized in a single year that may create issues with creeping into higher tax brackets.

Note that the law provides only a minor child of the employee qualifies for EDB treatment. Thus, if the decedent names a minor grandchild as a beneficiary, a 10-year payout will still be required—the life expectancy distribution rule is only available to the employee's minor beneficiary.[136]

Surviving Spouse

While the added provision only refers to a 10-year period for distributions to a spouse, the Committee Report notes that old law special rules remain for a spouse. That includes the ability to delay distributions until the year the decedent would have reached 70½ years of age:

> As under present law, if the surviving spouse is the beneficiary, a special rule allows the commencement of distribution to be delayed until end of the year that the employee (or IRA owner) would have attained age 70½. If the spouse dies before distributions were required to begin to the spouse, the surviving spouse is treated as the employee

[136] IRC §401(a)(9)(E)(ii)(II) as amended

(or IRA owner) in determining the required distributions to beneficiaries of the surviving spouse.[137]

Disabled Individuals

The SECURE Act borrows the definition of *disabled* that appears in IRC §72(m)(7) to determine disabled beneficiaries who qualify as EDBs. IRC §72(m)(7) provides the following definition of *disabled*:

> For purposes of this section, an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require.

Reg. §1.72-17(f) provides more detail on the definition of *disabled* for these purposes. A slightly expanded and modified definition of *disabled* is provided at Reg. §1.72-17(f)(1). This definition begins by repeating that found in the IRC itself:

> For taxable years beginning after December 31, 1966, section 72(m)(7) provides that an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.

The regulation provides more detail on what is meant by any inability to engage in any substantial gainful activity:

> In determining whether an individual's impairment makes him unable to engage in any substantial gainful activity, primary consideration shall be given to the nature and severity of his impairment. Consideration shall also be given to other factors such as the individual's education, training, and work experience. The substantial gainful activity to which section 72(m)(7) refers is the activity, or a comparable activity, in which the individual customarily engaged prior to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).

One item of importance to note is that this definition of "substantial gainful activity" is not as limiting as those found for, say, qualification for disability benefits under social security. Rather, the law looks specifically at the activities an individual was engaged in prior to the arising of the disability.

[137] *Report of the Committee on Ways and Means on HR 1994*, p. 109

Reg. §1.72-17(f)(2) provides the following detailed, but not exclusive, list of impairments that would normally be deemed to prevent substantial gainful activity:

- Loss of use of two limbs;
- Certain progressive diseases which have resulted in the physical loss or atrophy of a limb, such as diabetes, multiple sclerosis, or Buerger's disease;
- Diseases of the heart, lungs, or blood vessels which have resulted in major loss of heart or lung reserve as evidenced by X-ray, electrocardiogram, or other objective findings, so that despite medical treatment breathlessness, pain, or fatigue is produced on slight exertion, such as walking several blocks, using public transportation, or doing small chores;
- Cancer which is inoperable and progressive;
- Damage to the brain or brain abnormality which has resulted in severe loss of judgment, intellect, orientation, or memory;
- Mental diseases (e.g., psychosis or severe psychoneurosis) requiring continued institutionalization or constant supervision of the individual;
- Loss or diminution of vision to the extent that the affected individual has a central visual acuity of no better than 20/200 in the better eye after best correction, or has a limitation in the fields of vision such that the widest diameter of the visual fields subtends an angle no greater than 20 degrees;
- Permanent and total loss of speech; and
- Total deafness uncorrectable by a hearing aid.

Reg. §1.72-17(f)(3) provides the terms under which a disability is deemed to be long term enough to meet the requirements of being disabled for these purposes:

> Ordinarily, a terminal illness because of disease or injury would result in disability. Indefinite is used in the sense that it cannot reasonably be anticipated that the impairment will, in the foreseeable future, be so diminished as no longer to prevent substantial gainful activity.

It goes on to provide a specific example of two bone fractures, one which would not meet the long-term requirement for being disabled, and a second situation that would meet the requirements.

> For example, an individual who suffers a bone fracture which prevents him from working for an extended period of time will not be considered disabled, if his recovery can be expected in the foreseeable future; if the fracture persistently fails to knit, the individual would ordinarily be considered disabled.

As well, Reg. §1.72-17(f)(4) clarifies that even if a condition is permanent, if it can be remediated, then it will not count as a disability. The regulation provides:

> An impairment which is remediable does not constitute a disability within the meaning of section 72(m)(7). An individual will not be deemed disabled if, with reasonable effort and safety to himself, the impairment can be diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity.

EXAMPLE

Kevin worked as a CPA. His eyesight deteriorates so that he is no longer able to read documents and his computer screen. If his eyesight could not be corrected using eyeglasses to the point where he could again read those documents, he would be considered disabled under these rules and would qualify as an EDB.

However, if his eyesight can be corrected enough to enable him to read those documents and the computer screen, he would not be considered disabled even though the condition of his eyes might be one that is not reasonably expected to improve in the future.

EXAMPLE

Robin has a serious illness. However, Robin has continued to be employed full time in her sales job she has held for 20 years, traveling between 70 to 240 miles a day selling medical equipment which provides her primary income. Even though Robin's illness may be one that is not expected to improve and/or to result in death, Robin is not disabled because her condition does not prevent her from performing significant gainful activity. Thus, she is not an EDB and cannot use the life expectancy method to calculate required distributions from an inherited IRA as a disabled individual.[138]

EXAMPLE

Chip was diagnosed with a serious heart condition. His doctor recommended that he give up his current full-time employment as a trial attorney and obtain a heart transplant. He receives Social Security disability. Chip spends significant time in hospitals and visiting doctors. When not hospitalized and while at home, Chip performs light office and administrative tasks related to his wife's real estate business for a few hours each week.

Even though Chip performs some services, those services are insufficient to represent substantial gainful activity. Chip is considered disabled and qualifies as an EDB.[139]

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[138] Based on *Totten v. Commission,* TC Summary Opinion 2019-1

[139] Based on *Jacobsen v. Commissioner*, TC Summary Opinion 2002-87

Chronically Ill Individual

Even if a taxpayer is not disabled under the definition found at Reg. §72(m)(7), an individual may still qualify as an EDB if the individual is chronically ill as defined for long-term care purposes at IRC §7702B(c)(2) with a slight modification.

IRC §7702B(c)(2) provides:

> The term "chronically ill individual" means any individual who has been certified by a licensed health care practitioner as—
>
> (i) being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity,
>
> (ii) having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described in clause (i), or
>
> (iii) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

In addition to the three requirements above, for EDB purposes, an additional requirement is imposed, requiring the health care practitioner to also certify that, as of the date of death of the employee or IRA owner, the beneficiary's period of inability is an indefinite one which is expected to be lengthy in nature.

Substantial assistance for these purposes refers to hands-on assistance and standby assistance.

- *Hands-on assistance* means physical assistance of another person without which the person could not perform the applicable *activities of daily living*.
- *Standby assistance* refers to the presence of another person within arm's reach of the individual that is necessary to prevent, by physical intervention when necessary, injury to the individual while performing the applicable *activities of daily living*.[140]

Activities of daily living refers to the following activities listed at IRC §7702B(c)(2)(B):

- Eating;
- Toileting;
- Transferring;

[140] Notice 97-31

- Bathing;
- Dressing; and
- Continence.

EXAMPLE

Stephanie suffers from severe arthritis that greatly limits her mobility. Although able to earn a full-time living as an author, she requires hands-on and standby assistance with transferring, bathing, and dressing in order to prevent her from injuring herself attempting to perform those activities without assistance. Her condition is not expected to improve during her lifetime. Her physician certifies that she needs assistance with those activities of daily living and that her condition is expected to be of an indefinite duration. She qualifies as an EDB if she receives an inherited IRA due to being a disabled individual.

Application to Annuities Held in Defined Contribution Plans and IRAs

The new 10-year distribution rules apply to annuities that are purchased in defined contribution plans and IRAs. That is, acquisition of annuity contracts will provide a way to work around these rules to obtain a longer term payout and longer deferral.[141]

Because this could create issues for contracts that had previously been acquired in a defined contribution plan or IRA, SECURE provides a special exception for such pre-existing contracts in force at the date of enactment.[142]

As the Committee Report notes:

> The modification to the after-death minimum distribution rules does not apply to a qualified annuity that is a binding annuity contract in effect on the date of enactment of the provision and at all times thereafter. A qualified annuity with respect to an individual is a commercial annuity, under which the annuity payments are made over the lives of the individual and a designated beneficiary (or over a period not extending beyond the life expectancy of the individual or the life expectancy of the individual and a designated beneficiary) in accordance with the required minimum distribution regulations for annuity payments as in effect before enactment of this provision. In addition to these requirements, annuity payments to the individual must begin before the date of enactment, and the individual must have made an irrevocable election before that date as to the method and amount of the annuity payments to the individual or any designated beneficiaries. Alternatively, if an annuity is not a qualified annuity solely based on annuity payments not having begun irrevocably before

[141] *Report of the Committee on Ways and Means on HR 1994*, p. 110

[142] SECURE Act Section 401(a)(4)

the date of enactment, an annuity can be a qualified annuity if the individual has made an irrevocable election before the date of enactment as to the method and amount of the annuity payments to the individual or any designated beneficiaries.[143]

Distribution Following Death of Eligible Designated Beneficiary

If the eligible designated beneficiary dies before the entire balance of the plan is distributed, the EDB's beneficiary must take the funds out of the plan within 10 years after the death of the EDB. The law does not provide for any option to have the EDB's beneficiary to be treated as a new EDB—rather this beneficiary, even if otherwise an EDB, will be facing a 10-year distribution rule.

EXAMPLE

James was disabled within the meaning of IRC §72(m) when he inherited an IRA from his mother, Wanda. Ten years later, before the end of the lifetime distribution period, James dies, leaving the IRA to his spouse, Denise. Even though Denise would be an EDB if she was a beneficiary of James' account, she cannot use the lifetime distribution rule on the remaining balance of the IRA James inherited from Wanda, nor does she have the option to treat the IRA as her own IRA—this rule was not impacted by the changes made by the SECURE Act.

Special Exception on Death of Pre-SECURE Designated Beneficiaries

Although the change in the law does not affect existing holders of inherited IRA interests while they are alive, should they die before the entire balance is distributed, the party who is set to receive their interest in the plan will face the 10-year rule for withdrawing all funds from the account, based on the date of death of the inherited IRA's initial beneficiary. The new holder will not be able to base distributions on the remaining years of the original inherited account holder's distribution period.[144]

EXAMPLE

Sheryl inherited an IRA account from her mother when she died in 2019. Sheryl's life expectancy as of the beginning of the year following her mother's death was 28 years. A few years later, Sheryl dies, leaving the remainder of the account to her daughter, Katy. The remaining years in Sheryl's distribution period as of the beginning of the year after her death is 22 years.

Under the law in effect prior to SECURE, Katy would continue to withdraw from the account over 22 years, reducing the factor by one for each year. However, now Katy will not be required to take distributions in the year following the year of Sheryl's death, but she will be required to withdraw the entire balance from the IRA by the end of the 10th year following Sheryl's death.

[143] *Report of the Committee on Ways and Means on HR 1994*, p. 111

[144] SECURE Act Section 401(a)(5)

Effective Date

The rules are generally effective for distributions made with respect to employees and IRA account holders who die after December 31, 2019.[145] However, some defined contribution plans will qualify for later effective dates.

For collectively bargained plans, the rules will apply to employees who die in calendar years beginning after the earlier of:

- The later of:
  - the date on which the agreement in place on the date of enactment expires, determined without regard to extensions agreed to after the date of enactment, *or*
  - December 31, 2019, *or*
  - December 31, 2021.[146]

EXAMPLE

The ABC Pilots Retirement Plan is maintained pursuant to a collective bargain agreement entered into between ABC Airlines, Inc. and the ABC Pilots Union on June 1, 2010. The agreement expires on May 31, 2020. The new distribution rules will apply to distributions related to employees who die on or after January 1, 2021 (the beginning of the first calendar year after the agreement ends).

EXAMPLE

Assume the agreement expires on May 31, 2023. The new distribution rules will apply to distributions related to employees who die on or after January 1, 2022. Although the agreement continues until the middle of 2023, this special effective date rule does not allow delaying application of the rules past the end of 2021 for a collectively bargained plan, even if the contract in place on the enactment date does not expire until after the end of 2021.

Governmental plans[147] also get a special effective date. For those plans, the new rules apply to distributions related to employees who die after December 31, 2021 rather than December 31, 2019.[148]

[145] SECURE Act Section 401(a)(3)(A)

[146] SECURE Act Section 401(a)(3)(B)

[147] As defined in IRC §414(d)

[148] SECURE Act Section 401(a)(3)(C)

Employer Retirement Plan Amendment Period for SECURE Revisions

SECURE provides that employers are given until the date or before the last day of the first plan year beginning after December 31, 2021 to adopt conforming amendments to implement the new inherited interest distribution rules.[149] The special time period also covers any amendments required under regulations adopted by Treasury as deemed necessary to implement these rules, or any later amendment to these provisions.[150] As well, governmental plans will get an additional two years to tie in with their general two-year extension of time to apply these rules.[151]

Even though the plan may not have been amended, the plan must be operating during the period from the date the distribution provisions of SECURE are effective for the plan until the amendment is adopted, and the amendment must provide that it applies retroactively to that effective date.[152]

The plan will not be treated as having violated the provisions of IRC §411(d)(6) and ERISA Section 204(g) by having impermissibly reduced a benefit due to the adoption of these required amendments.[153]

EXAMPLE

HM CPAs Profit Sharing Plan's administrator has determined that its plan must be amended to comply with the new distribution rules found in the SECURE Act for distributions related to employees who die after December 31, 2019, as its current distribution rules no longer implement the rules required for distributions from defined contribution plans. As well, the administrator expects Treasury to issue regulations and language to be used to implement these provisions. The plan operates on a calendar year.

The administrator begins operating the plan in accordance with the new rules for distributions related to employees who die on or after January 1, 2020. The administrator does this even though it does not agree with the requirements found in the plan, since amendments have not yet been adopted to implement these rules.

So long as a plan amendment is adopted by December 31, 2022 (the last of the first plan year to begin after December 31, 2021) that provides for distribution in accordance with both the revised law and how the administrator has been providing for such distributions, the plan will be deemed to have been operated in accordance with its terms for the entire period. As well, the plan will not be treated as having impermissibly reduced a benefit under the plan due to the adoption of these amendments.

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[149] SECURE Act Section 401(b)(2)(A)(ii)

[150] SECURE Act Section 401(b)(2)(A)(i)

[151] SECURE Act Section 401(b)(2)(A)

[152] SECURE Act Section 401(b)(2)(B)

[153] SECURE Act Section 401(b)(1)(B)

INCREASE IN PENALTY FOR FAILURE TO FILE (ACT SECTION 402)

A pure revenue-raising provision is added to increase the minimum failure-to-file penalty is raised from the lesser of $205 or 100% of the tax due for a return filed more than 60 days late to $400 (adjusted for inflation) or 100% of the tax due for that return. The increased minimum penalty applies to tax returns with filing due dates (including extensions) after December 31, 2019.[154]

Note that this increase in penalty applies to all tax returns subject to IRC §6651. Despite the fact that this Act is principally concerned with retirement programs, this revenue raiser is not related to retirement plan filings.

EXAMPLE

The Harry Nace Trust's 2018 income tax return was due on April 15, 2019. No extension was filed for the return and the return was finally filed on July 1, 2019, showing a tax due of $450. In this case, his failure-to-file penalty is $205 (for these purposes we will ignore the reduction of this penalty by the failure to pay penalty). It is not $67.50 (3 months X 5% X $450) because the return was filed more than 60 days after the due date. However, the penalty is not 100% of the tax because $205 is less than 100% of the tax shown on the return.

EXAMPLE

The Harry Nace Trust again does not end up getting its 2019 return filed until July 1 and, yet again, no extension was applied for. The trust again shows $450 tax due. This time, the penalty rises to $400—still more than the standard penalty but less than 100% of the tax due with the return.

INCREASED PENALTIES FOR FAILURE TO FILE RETIREMENT PLAN RETURNS (ACT SECTION 403)

Another revenue-raiser is aimed at returns filed by retirement plans. SECURE Act Section 403 provides for a series of significant increases in penalties related to the failure to file various returns related to retirement accounts.

The penalty for failing to timely file a retirement plan return (Form 5500 series) goes from $25 a day to $105 a day, with the maximum penalty for the late filing increasing from $15,000 to $50,000.[155]

The penalty under IRC §6652(d)(1) for failure to file with the IRS a statement for any participant who separates from service during the plan year and has a deferred vested

[154] IRC §6651(a) as amended

[155] IRC §6652(e) as amended

benefit that remains unpaid is raised from $1 per day to $2 per day for each participant for whom there is a failure to file a return. The maximum penalty for any single plan year is raised from $5,000 to $10,000.[156]

The penalty for failure to notify the IRS of any change in the following items:

- Name of the plan;
- Name or address of the plan administrator;
- The termination of the plan;
- The merger or consolidation of the plan with another plan; or
- The division of the plan into two or more plans is raised from $1 per day to $2 per day, with the maximum penalty raised to $5,000 from $1,000 for any failure.[157]

As well, notices are required to be provided to recipients of distributions from retirement plans and IRAs with regard to withholding. As the House Committee Report notes:

> Withholding requirements apply to distributions from tax-favored employer-sponsored retirement plans and IRAs, but, except in the case of certain distributions, payees may generally elect not to have withholding apply. A plan administrator or IRA custodian is required to provide payees with notices of the right to elect no withholding.[158]

The SECURE Act raises the penalty for failing to provide such notices is raised to $100 from $10 for each failure, with the maximum penalty increasing from $5,000 to $50,000 for all failures during a single plan year.[159]

These provisions are effective for items required to be filed or notices given after December 31, 2019.

INCREASE INFORMATION SHARING TO ADMINISTER EXCISE TAXES (ACT SECTION 404)

The SECURE Act contains a provision authorizing the IRS to share certain tax return information with the U.S. Customs and Border Protection in order to assist in the

[156] IRC §6652(d)(1) as amended

[157] IRC §6652(d)(2) as amended

[158] *Report of the Committee on Ways and Means on HR 1994*, p. 114

[159] IRC §3405 as amended

administration and collection of the heavy vehicle use tax.[160] The provision is effective upon the date of enactment.[161]

[160] IRC §6103(o)(3) as amended

[161] *Report of the Committee on Ways and Means on HR 1994*, p. 116

NOTES

Unit

5

SECURE Act: Other Benefits (Including Kiddie Tax Revision)

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Recognize situations where amended returns may be advisable to reduce taxes imposed under the TCJA's revision to the Kiddie Tax and SECURE's removal of that provision
- Understand special benefits provided to volunteer firefighters and emergency medical responders

BENEFITS PROVIDED TO VOLUNTEER FIREFIGHTERS AND EMERGENCY MEDICAL RESPONDERS (ACT SECTION 301)

Congress looks to create a very short-term (one-year) break for volunteer firefighters and emergency medical responders by adding, for 2020 only, an exclusion from income for certain state or local tax benefits or qualified reimbursement payments received by such individuals.[162]

A similar benefit had existed in the law from 2008-2011, but had not been extended when the provision, found at IRC §139B, expired.

[162] IRC §139B as amended.

The House Committee Report provides that this benefit is available to those that volunteer their services to a qualified volunteer emergency response organization which is described as follows:

> A qualified volunteer emergency response organization is a volunteer organization that is organized and operated to provide firefighting or emergency medical services for persons in a State or a political subdivision and is required (by written agreement) by the State or political subdivision to furnish firefighting or emergency medical services in the State or political subdivision.[163]

The report goes on to describe the excludable items as follows:

> A qualified State or local tax benefit is any reduction or rebate of certain taxes provided by a State or local government on account of services performed by individuals as members of a qualified volunteer emergency response organization. These taxes are limited to State or local income taxes, State or local real property taxes, and State or local personal property taxes. A qualified reimbursement payment is a payment provided by a State or political subdivision thereof on account of reimbursement for expenses incurred in connection with the performance of services as a member of a qualified volunteer emergency response organization.[164]

The amount of qualified reimbursement for expenses that can excluded each month is increased from the $30 amount that was in place from 2008-2011 to $50 under the new law.[165]

For years in which the amounts are included in income, a taxpayer that itemizes deductions can claim the amount of the property tax reduction included in income as a property tax deduction on Schedule A. As well, the expenses incurred as a volunteer are allowed as charitable contributions in full if the reimbursements are required to be included in income, as they were for 2012-2019 and will be for 2021 and later years unless this provision is extended.[166]

EXAMPLE

Phillip serves as a volunteer fireman for a qualified volunteer emergency response organization run by the County. The County gives Phillip a $200 reduction in his property taxes and reimbursement of expenses of $50 a month for his volunteer service. Phillip receives these benefits in both 2019 and 2020.

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[163] *Report of the Committee on Ways and Means on HR 1994*, p. 99

[164] *Ibid*

[165] IRC §139B(c)(2)(B) as amended

[166] *Report of the Committee on Ways and Means on HR 1994*, p. 99

For 2019, Phillip has $800 of taxable income due to these benefits ($200 for the property tax reduction and $600 for the expense reimbursement). As Phillip uses the standard deduction for 2019, he is not able to claim an offsetting deduction for the property taxes paid for by his service, nor for the contribution of the expense items to his local government.

For 2020, Phillip does not have to include that $800 in his income in computing his adjusted gross income. However, if Phillip is able to itemize deductions this year, he will not be able to claim the amount of property taxes he didn't pay due to his volunteer work as a deduction for real estate taxes, and he will have to reduce any charitable contribution for expenses incurred for this volunteer work by that amount of excludable reimbursement received.

EXPANSION OF §529 PLANS (ACT SECTION 302)

The SECURE Act adds two new categories of expenses that can be paid out of §529 plans.

First, amounts paid for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program registered and certified with the Secretary of Labor under section 1 of the National Apprenticeship Act (29 U.S.C. 50) will be treated as qualified education expenses when paid from §529 plans. Thus, the funds can be used to pay these expenses without triggering any income inclusion.[167]

Second, a limited ability to use §529 funds to repay qualified education loans as defined at IRC §221(d) (those loans for which an educational interest deduction is possible). The funds can be used to pay for the qualified education loan of the designated beneficiary of the §529 plan, as well as any sibling of the qualified beneficiary.[168] A sibling for this purpose is defined as the designated beneficiary's brother, sister, stepbrother, or stepsister.[169]

But this provision has a lifetime cap on its use. Only $10,000 of the funds may be used to repay the loan for any individual. This limitation is a lifetime, not an annual, limit on payments.[170]

EXAMPLE

Wayne uses $10,000 to pay for amounts due on his qualified education plan using a distribution from a §529 plan for which he is a qualified beneficiary. The distribution is treated as being used to pay qualified education expenses.

Wayne's sister Karen also has qualified education debt. While no more funds taken out for Wayne's debt will be treated as paying for qualified education expenses, another $10,000 can be taken to pay off Karen's qualified education debt, assuming she has not already used funds from her own account to do so.

[167] IRC §529(c)(8) as amended

[168] IRC §529(c)(9)(A) as amended

[169] IRC §529(c)(9)(C)(ii) as amended; IRC §152(d)(2)(B)

[170] IRC §529(c)(9)(B)

A taxpayer will not be able to claim the educational interest deduction under IRC §221 for any amounts paid from the §529 plan that qualify for this exclusion.[171]

These provisions are effective for distributions made after December 31, 2018. Note that this is earlier than most effective dates in the SECURE Act.

One item not in the final SECURE Act is a provision to allow §529 funds to be used to pay for homeschooling expenses. While such a provision was initially in the SECURE Act this summer, it was removed before it finally passed the House and was not reinserted in the bill when it was attached to the Further Consolidated Appropriations Act, 2020.

MODIFICATION OF RULES RELATING TO THE TAXATION OF UNEARNED INCOME OF CERTAIN CHILDREN (ACT SECTION 501)

As the SECURE Act was being considered by the House Ways and Means Committee, stories were being reported in the press regarding significantly increased taxes being paid by children of armed service members who died while in the services and by students receiving certain taxable education benefits. These taxes were being triggered by the revisions to the Kiddie Tax enacted by Congress as part of the Tax Cuts and Jobs Act.

Prior to TCJA, a child's excess unearned income was taxed at a rate based on their parents' marginal tax rate for the Kiddie Tax. The requirement to know the parents' marginal tax rate meant that a child's tax return could not be completed until the parents' return was complete and their marginal rate known.[172]

Congress looked to simplify this calculation by having the Kiddie Tax now use the trust and estate income tax tables to compute the tax on an amount that was, effectively, the child's excess unearned income.[173] This has the advantage of no longer requiring that the parents' return must be complete and the marginal tax rate known to complete the child's return.

Unfortunately for Congress, not all children who are receiving significant amounts of unearned income are getting that income from traditional investment assets and have parents whose marginal tax rates are in the 37% bracket.

[171] IRC §221(e)(1) as amended

[172] IRC §1(g)

[173] IRC §1(j)(4)

EXAMPLE

A report posted on CBS News' website outlines the problem that arose for children in Gold Star family receiving survivor's benefits. In the case outlined in the story, the widow and children of a Navy helicopter pilot who died during Operation Enduring Freedom in 2013 ran into a significantly higher tax bill.[174]

The two sons each received approximately $15,000 in survivor benefits. Their surviving parent was in a low tax bracket both in 2018 and 2019. In 2018, that meant that the sons' benefits were also subjected to a relatively low tax rate.

But that changed in 2019. While their total tax bill for 2018 was $1,100 for the boys, that soared to $5,400 in 2019.[175] Additional similar stories about surprise tax bills for Gold Star families began to surface.

Needless to say, the unintended consequences that ended up dramatically increasing taxes on a number of children of individuals who died in combat does not make for good political optics, so Congress moved to fix this problem.

The Senate initiated a stand-alone bill unanimously that removed these survivor payments from being included as unearned income for Kiddie Tax purposes. But about the same time, stories began coming out about children with large tax increases triggered by this change that did not fit the "trust fund baby" scenario that Congress believed they were dealing with.

So in the SECURE Act, Congress decided to enter into full-scale retreat on this issue, simply restoring the Kiddie Tax to its more complex pre-TCJA status that avoided cases where children were paying taxes at rates much higher than their parents.[176]

As well, the law removes the special Kiddie Tax rules from the AMT for years 2018-2025.[177] This change is effective for tax years beginning after December 31, 2017.[178]

While the return to the pre-TCJA Kiddie Tax is effective for tax years beginning after December 31, 2018, a special rule is added for 2018 income tax returns to allow taxpayers an election to apply the pre-TCJA rules to that year.[179] Presumably, Congress made this choice elective since children of taxpayers in higher brackets likely saw a decrease in the tax when they filed their 2018 returns, and Congress did not want to attempt to retroactively raise taxes on those children and then attempt to collect the additional taxes (another case of bad optics politically).

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[174] Janet Shamlian, "Gold Star Widow 'Shocked' by New Tax Bill on Sons' Survivor Benefits," CBS News website, April 25, 2019, https://www.cbsnews.com/news/gold-star-widow-shocked-by-new-tax-bill-on-her-sons-survivor-benefits/

[175] *Ibid*

[176] SECURE Act Section 501(a), striking IRC §1(j)(4) that was added by the Tax Cuts and Jobs Act

[177] IRC §55(d)(4)(A)(iii) as amended

[178] SECURE Act Section 501(c)(2)

[179] SECURE Act Section 501(c)(1), (3)

EXAMPLE

The family described in the CBS News article in the previous example will be able to, and almost certainly should, file an amended return for the boys to claim a refund of the $4,400 of additional tax paid due to the change in the Kiddie Tax enacted as part of the TCJA.

But children with significant unearned income whose parents are in the highest marginal rate brackets will almost certainly not wish to make the election to use the SECURE rules for 2018 taxes, as it is likely their taxes would be higher under the old Kiddie Tax rules.

Unit 6

Taxpayer Certainty and Disaster Tax Relief Act of 2019

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Name those provisions that have been extended and when the provisions will again exit the law
- Understand which provisions may require filing of claims for refund
- Understand the implications of the repeal of the treatment of transportation fringe benefits as unrelated business income (the "parking lot tax")

The second major set of tax provisions found in HR 1865, Further Consolidated Appropriations Act, 2020, is found in Division Q of the Act, whose short title is the Taxpayer Certainty and Disaster Relief Act of 2019. For the most part, this portion of the Act provides for a number of provisions being extended that had previously expired under the law.

EXTENDERS

Some, but not all, of the items that had expired at the end of 2017 returned for a short time to the law as part of the Taxpayer Certainty and Disaster Relief Act of 2019. While most are restored as of the date they originally expired and will again expire at the end of 2020, there are some provisions with different dates.

Note that since many of those provisions retroactively restore provisions to the law that expired at the end of 2017, taxpayers may wish to file claims for refund for 2018 to reflect these items coming back into the law.

Sec. 101. Exclusion from gross income of discharge of qualified principal residence indebtedness.

The exclusion from gross income for a discharge of qualified principal residence indebtedness under IRC §108(a)(1)(E) has now been extended to cover debts discharged:

- before January 1, 2021 or
- subject to an arrangement that is entered into and evidenced in writing before January 1, 2021.[180]

Previously, this provision had only applied to debts discharged or arrangements entered into before January 1, 2018. Taxpayers who had qualified debts discharged in 2018 will need to file a claim for refund to obtain the benefit of this provision.

Sec. 102. Treatment of mortgage insurance premiums as qualified residence interest.

Taxpayers will again be able to deduct certain mortgage insurance premiums as qualified residence interest through December 31, 2020.[181]

Such insurance had to be under an insurance contract issued on or after January 1, 2007[182] and fits into one of the following two categories:

- Mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and
- Private mortgage insurance (as defined by section 2 of the Homeowners Protection Act of 1998 (12 U.S.C. 4901).[183]

Previously, the provision had expired at end of 2017. Taxpayers who paid such premiums in 2018 will need to file a claim for refund to obtain the benefit of this provision.

Sec. 103. Reduction in medical expense deduction floor.

The temporary decrease in the floor for deducting medical expenses on Schedule A to 7.5% that expired at the end of 2018 has been extended to apply through the end of

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[180] IRC §108(a)(1)(E) as amended

[181] IRC §163(h)(3)(E)(iv)(I) as amended

[182] IRC §163(h)(3)(E)(iii)

[183] IRC §163(h)(4)(E)

2020.[184] Similarly, there will be no alternative minimum tax adjustment for medical expenses.

Sec. 104. Deduction of qualified tuition and related expenses.

Taxpayers will again be able to claim a deduction for qualified tuition and related expenses in computing adjusted gross income through December 31, 2020.[185]

Previously, the provision had expired at end of 2017. Taxpayers who paid such expenses in 2018 will need to file a claim for refund to obtain the benefit of this provision.

Sec. 105. Black lung disability trust fund excise tax.

The date for a mandatory reduction in the black lung disability trust fund excise tax rate has been pushed back from December 31, 2018 to December 31, 2020.[186]

Sec. 111. Indian employment credit (IRC §45A).

The provision had expired for taxable years beginning after December 31, 2017. Now the expiration moves to years beginning after December 31, 2020.[187]

Sec. 112. Railroad track maintenance credit (IRC §45G).

The provision had expired for expenses paid or incurred after December 31, 2017. Now the expiration moves to expenses paid or incurred after December 31, 2022.[188]

The Act also adds a special rule for assignments under IRC §45G(b)(2):

> Any assignment, including related expenditures paid or incurred, under section 45G(b)(2) of the Internal Revenue Code of 1986 for a taxable year beginning on or after January 1, 2018, and ending before January 1, 2020, shall be treated as effective as of the close of such taxable year if made pursuant to a written agreement entered into no later than 90 days following the date of the enactment of this Act.[189]

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184 IRC §213(f) as amended

185 IRC §222(e) as amended

186 IRC §4121(e)(2)(A)

187 IRC §45A(f)

188 IRC §45G(g) as amended

189 Act Section 112(b)

Sec. 113. Mine rescue team training credit (IRC §45N).

The mine rescue team training credit found at IRC §45N that had expired for taxable years beginning after December 31, 2017 now has new life, expiring for taxable years beginning after December 31, 2020.[190]

Sec. 114. Classification of certain race horses as three-year property (IRC §168).

Certain race horses that were two years old or less will continue to be three-year property if placed in service before January 1, 2021. This preferable life had been removed from the law for horses placed in service after January 1, 2018, but this bill retroactively restores that treatment.[191]

Sec. 115. Seven-year recovery period for motorsports entertainment complexes (IRC §168).

Motorsport entertainment complexes placed in service before January 1, 2021 will have a seven-year recovery period. The rule had previously expired as of January 1, 2018 and the law now retroactively restores the seven-year recovery period.[192]

Sec. 116. Accelerated depreciation for business property on Indian reservations (IRC §168).

The special accelerated recovery periods for qualified Indian reservation property will apply to property placed in service through December 31, 2020. The provision had previously terminated for property placed in service after December 31, 2017, but the Act retroactively restores the provision.[193]

Sec. 117. Expensing rules for certain productions (IRC §181).

The expensing rules for qualified film and television productions that had expired for productions commencing after December 31, 2017 is now retroactively extended to cover productions commencing through December 31, 2020.[194]

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[190] IRC §45N(e) as amended

[191] IRC §168(e)(3)(A)(i) as amended

[192] IRC §168(i)(15(D) as amended

[193] IRC §168(j)(9) as amended

[194] IRC §181(g) as amended

Sec. 118. Empowerment zone tax incentives (IRC §1391).

Empowerment zone tax incentive designations will now end on December 31, 2020 rather than December 31, 2017 as had been the case before this amendment. The change is retroactive in nature.[195]

The Act contains the following special rule for the treatment of certain termination dates specified in nominations:

> In the case of a designation of an empowerment zone the nomination for which included a termination date which is contemporaneous with the date specified in subparagraph (A)(i) of section 1391(d)(1) of the Internal Revenue Code of 1986 (as in effect before the enactment of this Act), subparagraph (B) of such section shall not apply with respect to such designation if, after the date of the enactment of this section, the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary of the Treasury (or the Secretary's designee) may provide.[196]

Sec. 119. American Samoa economic development credit.

The American Samoa economic development credit found in Section 119(d) of Division A of the Tax Relief and Health Care Act of 2006 is extended for three years through the end of 2020.[197]

Sec. 121. Biodiesel and renewable diesel (IRC §§40A and 6426).

The biodiesel credit found at IRC §40A is now retroactively extended to apply to fuel sold or used on or before December 31, 2022.[198]

The excise tax credit under IRC §6426 is also extended retroactively for any sale, use, or removal for any period through December 31, 2022.[199] Similarly, the excise tax credit under §6247 related to biodiesel mixtures is extended to cover any mixture sold or used through December 31, 2022.[200]

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[195] IRC §1391(d)(1)(A)(i) as amended

[196] Act §118(b)

[197] Act §119(a)

[198] IRC §40A(g) as amended

[199] IRC §6246(c)(6) as amended

[200] IRC §6247(e)(b)(B)

The Act also contains the following special rule regarding claims for excise tax refunds:

> Notwithstanding any other provision of law, in the case of any biodiesel mixture credit properly determined under section 6426(c) of the Internal Revenue Code of 1986 for the period beginning on January 1, 2018, and ending with the close of the last calendar quarter beginning before the date of the enactment of this Act, such credit shall be allowed, and any refund or payment attributable to such credit (including any payment under section 6427(e) of such Code) shall be made, only in such manner as the Secretary of the Treasury (or the Secretary's delegate) shall provide. Such Secretary shall issue guidance within 30 days after the date of the enactment of this Act providing for a one-time submission of claims covering periods described in the preceding sentence. Such guidance shall provide for a 180-day period for the submission of such claims (in such manner as prescribed by such Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by such Secretary not later than 60 days after receipt. If such Secretary has not paid pursuant to a claim filed under this subsection within 60 days after the date of the filing of such claim, the claim shall be paid with interest from such date determined by using the overpayment rate and method under section 6621 of such Code.[201]

Sec. 122. Second generation biofuel producer credit (IRC §40).

The second generation biofuel producer credit under IRC §40 is retroactively extended to apply to qualified second generation biofuel production before January 1, 2021.[202]

Sec. 123. Nonbusiness energy property (IRC §25C).

The credit for nonbusiness energy property under IRC §25C is retroactively extended to property placed in service before January 1, 2021.[203]

The law also makes technical corrections to the definition of energy efficient building property, changing the reference in IRC §25C(d)(3)(A) from "an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure" to "an electric heat pump water heater which yields a Uniform Energy Factor of at least 2.2 in the standard Department of Energy test procedure" and

[201] Act Section 121(b)(3)

[202] IRC §40(b)(6)(J)(i) as amended

[203] IRC §25C(g)(2) as amended

revising §25C(d)(3)(D) regarding natural gas, propane, or oil water heaters to change the reference from "energy factor" to "Uniform Energy Factor."[204]

These amendments apply to property placed in service after December 31, 2017.[205]

Sec. 124. Qualified fuel cell motor vehicles (IRC §30B).

The credit for qualified fuel cell motor vehicles found at IRC §30B is retroactively extended to cover the purchase of a new qualified fuel cell motor vehicle through December 31, 2020.[206]

Sec. 125. Alternative fuel refueling property credit (IRC §30C).

The alternative fuel refueling property credit is retroactively extended to cover property acquired before January 1, 2020 for a vehicle that has two wheels.[207]

Sec. 126. Two-wheeled plug-in electric vehicle credit (IRC §30D).

The two-wheeled plug-in electric vehicle credit is modified to apply retroactively to property acquired before January 1, 2021.[208]

Sec. 127. Credit for electricity produced from certain renewable resources (IRC §45(d)).

The credits found at IRC §45(d) for closed-loop biomass facilities, open-loop biomass facilities, geothermal or solar energy facilities, landfill gas facilities, trash facilities, qualified hydropower facilities, and marine and hydrokinetic renewable energy facilities are retroactively extended for items for which construction begins before January 1, 2021.[209]

The election to treat qualified facilities as energy property under IRC §48(a)(5)(C)(ii) is extended to cover facilities placed in service before January 1, 2021.[210]

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[204] IRC §25(c)(d)(3) as amended

[205] Act Section 123(c)

[206] IRC §30B(k)(1) as amended

[207] IRC §30C(g) as amended

[208] IRC §30D(g)(3)(E)(ii) as amended

[209] IRC §45(d) as amended

[210] IRC §48(a)(5)(C)(ii) as amended

The phase-out for wind facilities at IRC §45(b)(5) is modified to add the following clause "in the case of any facility the construction of which begins after December 31, 2019, and before January 1, 2021, 40 percent."[211]

The phase-out for the election to treat wind facilities as energy property found at IRC §48(a)(5)(E) is modified to add the following additional phase-out: "in the case of any facility the construction of which begins after December 31, 2019, and before January 1, 2021, 40 percent."[212]

Sec. 128. Production credit for Indian coal facilities (IRC §45).

The production credit for Indian coal facilities found at IRC §45(e)(10) is retroactively extended by modifying the time period for an additional three years. Now the credit will apply to qualified coal:

- produced by the taxpayer at an Indian coal production facility during the 15-year period (up from 12-year period) beginning on January 1, 2006, and
- sold by the taxpayer
  - to an unrelated person (either directly by the taxpayer or after sale or transfer to one or more related persons) and
  - during such 15-year period (also up from 12-year period) and such taxable year.[213]

Sec. 129. Energy efficient homes credit (IRC §45L(g)).

The energy efficient homes credit found at IRC §45L(g) is retroactively extended to apply to qualified new energy efficient homes acquired on or before December 31, 2020.[214]

Sec. 130. Special allowance for second generation biofuel plant property (IRC §168).

The special allowance for second generation biofuel plan property under IRC §168 is retroactively extended to cover property placed in service by the taxpayer before January 1, 2021.[215]

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[211] IRC §45(b)(5) as amended

[212] IRC §48(a)(5)(E) as amended

[213] IRC §45(e)(10)(A) as amended

[214] IRC §45L(g) as amended

[215] IRC §168(l)(2)(D) as amended

Sec. 131. Energy efficient commercial buildings deduction (IRC §179D).

The energy efficient commercial buildings deduction under IRC §179D is retroactively extended to cover property placed in service through December 31, 2020.[216]

Sec. 132. Special rule for sales or dispositions to implement FERC or state electric restructuring policy for qualified electric utilities (IRC §451(k)).

The special rule found at §451(k) related to sales or dispositions to implement FERC or state electric restructuring policy for qualified electric utilities will retroactively apply to sales or exchanges prior to January 1, 2021.[217]

Sec. 133. Extension and clarification of excise tax credits relating to alternative fuels (IRC §6246).

The excise tax credits related to alternative fuels found at IRC §§6246(d) and (e) are each retroactively extended to apply to any sale or use for any period through December 31, 2020.[218]

The provisions found at §6427(e)(6) for biodiesel and alcohol used to produce alcohol fuel and biodiesel mixtures will retroactively apply to any alternative fuel sold or used through December 31, 2020.[219]

As well, the law adds the following special rule:

> Notwithstanding any other provision of law, in the case of any alternative fuel credit properly determined under section 6426(d) of the Internal Revenue Code of 1986 for the period beginning on January 1, 2018, and ending with the close of the last calendar quarter beginning before the date of the enactment of this Act, such credit shall be allowed, and any refund or payment attributable to such credit (including any payment under section 6427(e) of such Code) shall be made, only in such manner as the Secretary of the Treasury (or the Secretary's delegate) shall provide. Such Secretary shall issue guidance within 30 days after the date of the enactment of this Act providing for a one-time submission of claims covering periods described in the preceding sentence. Such guidance shall provide for a 180-day period for the submission of such claims (in such manner as prescribed by

[216] IRC §179D(h) as amended

[217] IRC §451(k)(3) as amended

[218] IRC §§6246(d)(5) and (e)(3) as amended

[219] IRC §6427(e)(6)(C)

> such Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by such Secretary not later than 60 days after receipt. If such Secretary has not paid pursuant to a claim filed under this subsection within 60 days after the date of the filing of such claim, the claim shall be paid with interest from such date determined by using the overpayment rate and method under section 6621 of such Code.[220]

IRC §6246(e)(2) is clarified by removing the term "mixture of alternative fuel" and substituting "mixture of alternative fuel (other than a fuel described in subparagraph (A), (C), or (F) of subsection (d)(2))" in the provision.[221] This provision applies to:

- fuel sold or used on or after the date of the enactment of this Act, and
- fuel sold or used before such date of enactment, but only to the extent that claims for the credit under section 6426(e) of the Internal Revenue Code of 1986 with respect to such sale or use
  - have not been paid or allowed as of such date, and
  - were made on or after January 8, 2018.[222]

The Act goes on to state:

> Nothing contained in this subsection or the amendments made by this subsection shall be construed to create any inference as to a change in law or guidance in effect prior to enactment of this subsection.[223]

Sec. 134. Oil spill liability trust fund rate (IRC §4611(c)).

The Oil Spill Liability Trust Fund financing rate found in IRC §4611(c) is retroactively extended through December 31, 2020.[224]

[220] Act §133(a)(3)

[221] IRC §6246(e)(2) as amended

[222] Act §133(b)(2)

[223] Act §133(b)(3)

[224] IRC §4611(f)(2) as amended

Sec. 141. New markets tax credit (IRC §45D).

We now begin looking at the items that were set to expire at the end of 2019 and have now been given a new lease on life. The first of these is the new markets tax credit under IRC §45D which has now added a new markets tax credit limitation of $5,000,000 for 2020.[225] Unused credits can now be carried forward to 2025.[226]

Sec. 142. Employer credit for paid family and medical leave (IRC §45S).

The employer credit for paid family and medical leave, a provision originally added for 2018 and 2019 by the Tax Cuts and Jobs Act, will now apply for taxable years beginning on or before December 31, 2020.[227]

Sec. 143. Work opportunity credit (IRC §51).

Wages for the work opportunity credit will include any amount paid or incurred to an individual who begins work for the employer on or before December 31, 2020.[228]

Sec. 144. Certain provisions related to beer, wine, and distilled spirits.

Various relief items for excise taxes related to beer, wine, and distilled spirits are extended through 2020 as well as adding one technical correction to the law.[229] Details of these provisions are outside the scope of this course.

Sec. 145. Look-thru rule for related controlled foreign corporations (IRC §954).

The look-thru rule for related controlled foreign corporations under §954 is extended for one additional year, applying to taxable years beginning before January 1, 2021.[230]

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225 IRC §45D(f)(1)(H) as amended

226 IRC §45D(f)(3) as amended

227 IRC §45S(i) as amended

228 IRC §51(c)(4) as amended

229 IRC §§263A(f)(4)(B), 5051(a), 5414(b)(3), 5041(c)(8)(A), 5041(b), 5001, 5212, 5555(a), and 5041(c)(8) as amended

230 IRC §954(c)(6)(C) as amended

Sec. 146. Credit for health insurance costs of eligible individuals (IRC §35).

The credit for health insurance costs of eligible individuals under IRC §35 is extended to apply to coverage months beginning before January 1, 2021.[231]

DISASTER TAX RELIEF

The law provides broad relief for victims of disasters that took place in 2018, 2019, and up to 30 or 60 days after the date of enactment (December 20, 2019 was the date of enactment, so the 30-day ending date is January 19, 2020 and the 60-day ending date is February 18, 2020).

For purposes of these rules, Act §201 provides the following definitions:

- **Qualified disaster area.** The term "qualified disaster area" means any area with respect to which a major disaster was declared, during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of the enactment of this Act,[232] by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act if the incident period of the disaster with respect to which such declaration is made begins on or before the date of the enactment of this Act.[233] However, the term shall not include the California wildfire disaster area (as defined in section 20101 of subdivision 2 of division B of the Bipartisan Budget Act of 2018).[234]

- **Qualified disaster zone.** The term "qualified disaster zone" means that portion of any qualified disaster area which was determined by the President, during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of the enactment of this Act,[235] to warrant individual or individual and public assistance from the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act by reason of the qualified disaster with respect to such disaster area.[236]

- **Qualified disaster.** The term "qualified disaster" means, with respect to any qualified disaster area, the disaster by reason of which a major disaster was declared with respect to such area.[237]

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[231] IRC §35(b)(1)(B) as amended

[232] February 18, 2020

[233] Act §201(1)(A)

[234] Act §201(1)(B)

[235] February 18, 2020

[236] Act §201(2)

[237] Act §201(3)

- **Incident period.** The term "incident period" means, with respect to any qualified disaster, the period specified by the Federal Emergency Management Agency as the period during which such disaster occurred (except that for purposes of this title such period shall not be treated as beginning before January 1, 2018, or ending after the date which is 30 days after the date of the enactment of this Act).[238]

Sec. 202. Special disaster-related rules for use of retirement funds.

The 10% tax found at IRC §72(t) will not apply to qualified disaster distributions.[239] This relief is limited to the excess of:

- $100,000 over
- amounts previously treated as qualified disaster distributions for all prior taxable years.[240]

The $100,000 limit applies separately with respect to each qualified disaster.[241]

For these purposes, a *qualified disaster distribution* is any distribution from an eligible retirement plan made:

- on or after the first day of the incident period of a qualified disaster and before the date which is 180 days after the date of the enactment of this Act,[242] and
- to an individual whose principal place of abode at any time during the incident period of such qualified disaster is located in the qualified disaster area with respect to such qualified disaster and who has sustained an economic loss by reason of such qualified disaster.[243]

EXAMPLE

Oscar received $50,000 in qualified disaster distributions in 2018. In 2019, he receives another distribution of $60,000 that would otherwise be a qualified disaster distribution for the same qualified disaster.

Because Oscar's limit for 2019 is $100,000, less the prior distribution received ($50,000 in 2018), only $50,000 of the distribution will qualify for the exclusion from the 10% tax under §72(t), as Oscar will now have received $100,000 of lifetime qualified disaster distributions.

[238] January 19, 2020

[239] Act §202(a)(1)

[240] Act §202(a)(2)

[241] Act §202(a)

[242] June 17, 2020

[243] Act §202(a)(4)

An *eligible retirement plan* is one of the following:

- An individual retirement account described in section 408(a),
- An individual retirement annuity described in section 408(b) (other than an endowment contract),
- A qualified trust,
- An annuity plan described in section 403(a),
- An eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A), and
- An annuity contract described in section 403(b).[244]

Qualified retirement plans will not have to worry about whether an employee has cleared the $100,000 limit based on distributions from other employers. The law provides:

> If a distribution to an individual would (without regard to subparagraph (A)) be a qualified disaster distribution, a plan shall not be treated as violating any requirement of the Internal Revenue Code of 1986 merely because the plan treats such distribution as a qualified disaster distribution, unless the aggregate amount of such distributions from all plans maintained by the employer (and any member of any controlled group which includes the employer) to such individual exceeds $100,000.[245]

Individuals are also allowed to return the qualified disaster distribution to a qualified plan or IRA account within three years of the distribution. As the law states:

> Any individual who receives a qualified disaster distribution may, at any time during the 3-year period beginning on the day after the date on which such distribution was received, make 1 or more contributions in an aggregate amount not to exceed the amount of such distribution to an eligible retirement plan of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made under section 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16), of the Internal Revenue Code of 1986, as the case may be.[246]

[244] Act §202(a)(4)(B)

[245] Act §202(a)(2)(D)

[246] Act §202(a)(3)(A)

If the original distribution came from a retirement plan, the following rules apply to convert the transaction to a rollover transaction involving a retirement plan:

> For purposes of the Internal Revenue Code of 1986, if a contribution is made pursuant to subparagraph (A) with respect to a qualified disaster distribution from an eligible retirement plan other than an individual retirement plan, then the taxpayer shall, to the extent of the amount of the contribution, be treated as having received the qualified disaster distribution in an eligible rollover distribution (as defined in section 402(c)(4) of such Code) and as having transferred the amount to the eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution.[247]

Similarly, the following rules apply if the original distribution came from an IRA:

> For purposes of the Internal Revenue Code of 1986, if a contribution is made pursuant to subparagraph (A) with respect to a qualified disaster distribution from an individual retirement plan (as defined by section 7701(a)(37) of such Code), then, to the extent of the amount of the contribution, the qualified disaster distribution shall be treated as a distribution described in section 408(d)(3) of such Code and as having been transferred to the eligible retirement plan in a direct trustee to trustee transfer within 60 days of the distribution.[248]

The qualified disaster distribution is included by the recipient in income ratably over three years, beginning with the year of distribution. The treatment is to be similar to the treatment provided under IRC §408A(d)(3) that applied to Roth IRA conversions made in 2010.[249]

EXAMPLE

Chip receives a $90,000 qualified disaster distribution in 2019 and does not use the three-year rollover option. Chip will include $30,000 in his income for 2019 (the year of distribution) and pick up the remaining $60,000 evenly over the next two years, reporting $30,000 as income for 2020 and $30,000 as income for 2021.

A second special rule applies to funds withdrawn used to purchase a principal residence. The Act allows these funds to be paid back to a retirement account, but under different rules than for the qualified disaster distribution.

A *qualified distribution* for these purposes is a distribution:

- under one of the following provisions:

[247] Act §202(a)(3)(B)

[248] Act §202(a)(3)(C)

[249] Act §202(a)(5), IRC §408A(d)(3)

– §401(k)(2)(B)(i)(IV) hardship distributions,

– §403(b)(7)(A)(ii) (but only to the extent such distribution relates to financial hardship),

– §403(b)(11)(B) hardship distributions, or

– §72(t)(2)(F) IRA distributions for first time homebuyers, and

- which was to be used to purchase or construct a principal residence in a qualified disaster area, but which was not so used on account of the qualified disaster with respect to such area, and

- which was received during the period beginning on the date which is 180 days before the first day of the incident period of such qualified disaster and ending on the date which is 30 days after the last day of such incident period.[250]

The special rollover rule provides:

> Any individual who received a qualified distribution may, during the applicable period, make 1 or more contributions in an aggregate amount not to exceed the amount of such qualified distribution to an eligible retirement plan (as defined in section 402(c)(8)(B) of the Internal Revenue Code of 1986) of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made under section 402(c), 403(a)(4), 403(b)(8), or 408(d)(3), of such Code, as the case may be.[251]

The rollovers will be treated under the same rules described for the three-year rule (though with the special period here) for distributions originally from IRAs and other plans.[252]

The period during which the rollover can take place is the *applicable period* which is defined as follows:

> Any individual who received a qualified distribution may, during the applicable period, make 1 or more contributions in an aggregate amount not to exceed the amount of such qualified distribution to an eligible retirement plan (as defined in section 402(c)(8)(B) of the Internal Revenue Code of 1986) of which such individual is a beneficiary and to which a rollover contribution of such distribution

[250] Act §202(b)(2)

[251] Act §202(b)(1)(A)

[252] Act §202(b)(1)(B)

> could be made under section 402(c), 403(a)(4), 403(b)(8), or 408(d)(3), of such Code, as the case may be.[253]

Next up are special rules for loans from qualified plans impacted by the disasters. The rules for the increase in the limit of amounts treated as loans and not distributions provide:

> In the case of any loan from a qualified employer plan (as defined under section 72(p)(4) of the Internal Revenue Code of 1986) to a qualified individual made during the 180-day period beginning on the date of the enactment of this Act—
>
>> (A) clause (i) of section 72(p)(2)(A) of such Code shall be applied by substituting "$100,000" for "$50,000", and
>>
>> (B) clause (ii) of such section shall be applied by substituting "the present value of the nonforfeitable accrued benefit of the employee under the plan" for "one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan".[254]

Or, to summarize, the loan can be the lesser of $100,000 or 100% of the nonforfeitable accrued benefit in the plan. The loans can be made for 180 days following the enactment of this Act, or through June 17, 2020.

The rules also allow for an extended period of repayment for qualified loans, giving a one year "pause" in the required repayment period:

> In the case of a qualified individual (with respect to any qualified disaster) with an outstanding loan (on or after the first day of the incident period of such qualified disaster) from a qualified employer plan (as defined in section 72(p)(4) of the Internal Revenue Code of 1986)—
>
>> (A) if the due date pursuant to subparagraph (B) or (C) of section 72(p)(2) of such Code for any repayment with respect to such loan occurs during the period beginning on the first day of the incident period of such qualified disaster and ending on the date which is 180 days after the last day of such incident period, such due date shall be delayed for 1 year (or, if later, until the date which is 180 days after the date of the enactment of this Act),

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[253] Act §202(b)(3)

[254] Act §202(c)(1)

> (B) any subsequent repayments with respect to any such loan shall be appropriately adjusted to reflect the delay in the due date under subparagraph (A) and any interest accruing during such delay, and
>
> (C) in determining the 5-year period and the term of a loan under subparagraph (B) or (C) of section 72(p)(2) of such Code, the period described in subparagraph (A) of this paragraph shall be disregarded.

So who can take advantage of this rule? That is limited to a *qualified individual* which is defined as follows:

> For purposes of this subsection, the term "qualified individual" means any individual—
>
> (A) whose principal place of abode at any time during the incident period of any qualified disaster is located in the qualified disaster area with respect to such qualified disaster, and
>
> (B) who has sustained an economic loss by reason of such qualified disaster.[255]

Finally, special rules are provided for any amendments that may be needed to implement these provisions. The plan will be treated as being operated in accordance with the terms of the plan if the amendment is covered by this rule.[256]

For an amendment to be covered by this special rule, the following criteria must be met:

- During the period:
  - Beginning on the date that this section or the regulation described in subparagraph (A)(i) takes effect (or in the case of a plan or contract amendment not required by this section or such regulation, the effective date specified by the plan), and
  - Ending on the date described in subparagraph (A)(ii) (or, if earlier, the date the plan or contract amendment is adopted), the plan or contract is operated as if such plan or contract amendment were in effect, and
- Such plan or contract amendment applies retroactively for such period.[257]

[255] Act §202(c)(3)

[256] Act §202(d)(1)

[257] Act §202(d)(2)(B)

The Act provides the following rules for covered amendments:

> This subsection shall apply to any amendment to any plan or annuity contract which is made—
>
> > (i) pursuant to any provision of this section, or pursuant to any regulation issued by the Secretary or the Secretary of Labor under any provision of this section, and
> >
> > (ii) on or before the last day of the first plan year beginning on or after January 1, 2020, or such later date as the Secretary may prescribe.
>
> In the case of a governmental plan (as defined in section 414(d) of the Internal Revenue Code of 1986), clause (ii) shall be applied by substituting the date which is 2 years after the date otherwise applied under clause (ii).[258]

Sec. 203. Employee retention credit for employers affected by qualified disasters.

Under §38 for 2018 and 2019, the "qualified disaster employee retention credit" will be treated as a current year business credit under IRC §38(b).[259]

The credit for an eligible employer will be equal to:

- 40 percent of the qualified wages with respect to each eligible employee of such employer for such taxable year and
- the amount of qualified wages with respect to any employee which may be taken into account under this subsection by the employer for any taxable year shall not exceed $6,000 (reduced by the amount of qualified wages with respect to such employee which may be so taken into account for any prior taxable year).[260]

An *eligible employer* is any employer:

- which conducted an active trade or business in a qualified disaster zone at any time during the incident period of the qualified disaster with respect to such qualified disaster zone, and
- with respect to whom the trade or business described in subparagraph (A) is inoperable at any time during the period beginning on the first day of the incident

[258] Act §202(d)(2)(A)

[259] Act §203(a)

[260] Act §203(a)

> period of such qualified disaster and ending on the date of the enactment of this Act, as a result of damage sustained by reason of such qualified disaster.[261]

An *eligible employee* means "with respect to an eligible employer an employee whose principal place of employment with such eligible employer (determined immediately before the qualified disaster referred to in paragraph (1)) was in the qualified disaster zone referred to in such paragraph."[262]

The *qualified wages* is defined as follows:

> The term "qualified wages" means wages (as defined in section 51(c)(1) of the Internal Revenue Code of 1986, but without regard to section 3306(b)(2)(B) of such Code) paid or incurred by an eligible employer with respect to an eligible employee at any time on or after the date on which the trade or business described in paragraph (1) first became inoperable at the principal place of employment of the employee (determined immediately before the qualified disaster referred to in such paragraph) and before the earlier of—
>
> > (A) the date on which such trade or business has resumed significant operations at such principal place of employment, or
> >
> > (B) the date which 150 days after the last day of the incident period of the qualified disaster referred to in paragraph (1).
>
> Such term shall include wages paid without regard to whether the employee performs no services, performs services at a different place of employment than such principal place of employment, or performs services at such principal place of employment before significant operations have resumed.[263]

No deduction will be allowed for wages for the employment credit allowed in this provision.[264] As well, the related individual rules found at §51(i)(1) will apply to this credit, as will the rules under §52 that generally apply to the work opportunity credit.[265]

Sec. 204. Other disaster-related tax relief provisions.

A series of special disaster provisions are added by Act §204.

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[261] Act §203(b)(1)

[262] Act §203(b)(2)

[263] Act §203(b)(3)

[264] Act §203(c), IRC §280C(a)

[265] Act §203(c)

The first provision is meant to remove the percentage of adjusted gross income limits for charitable contributions related to the disaster. *Qualified contributions* for this purpose are defined as any charitable contribution under IRC §170 if:

- Such contribution:
  - is paid, during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of the enactment of this Act, in cash to an organization described in section 170(b)(1)(A) of such Code, and
  - is made for relief efforts in one or more qualified disaster areas,
- the taxpayer obtains from such organization contemporaneous written acknowledgement (within the meaning of section 170(f)(8) of such Code) that such contribution was used (or is to be used) for relief efforts, and
- the taxpayer has elected the application of this subsection with respect to such contribution.[266]

If the contribution is made by a partnership or S corporation, the election will be made by the equity holder.[267]

However, a contribution will not be a qualifying contribution if the contribution is:

- to an organization described in section 509(a)(3) of the Internal Revenue Code of 1986, or
- for the establishment of a new, or maintenance of an existing, donor-advised fund (as defined in section 4966(d)(2) of such Code).[268]

For purposes of applying the limitations at §§170(b) and (d), the following rules will apply for individuals:

- LIMITATION. Any qualified contribution shall be allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's contribution base (as defined in subparagraph (H) of section 170(b)(1) of such Code) over the amount of all other charitable contributions allowed under section 170(b)(1) of such Code.
- CARRYOVER. If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(1) of such Code) exceeds

[266] Act §204(a)(3)

[267] Act §204(a)(3)(C)

[268] Act §204(a)(3)(B)

the limitation of clause (i), such excess shall be added to the excess described in section 170(b)(1)(G)(ii).[269]

For corporations, the following rules will apply:

- LIMITATION. Any qualified contribution shall be allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's taxable income (as determined under paragraph (2) of section 170(b) of such Code) over the amount of all other charitable contributions allowed under such paragraph.

- CARRYOVER. If the aggregate amount of qualified contributions made in the contribution year (within the meaning of section 170(d)(2) of such Code) exceeds the limitation of clause (i), such excess shall be appropriately taken into account under section 170(d)(2) subject to the limitations thereof.[270]

Another special rule is allowed for qualified disaster-related personal casualty losses. A *qualified disaster-related personal casualty losses* is defined as "losses described in section 165(c)(3) of the Internal Revenue Code of 1986 which arise in a qualified disaster area on or after the first day of the incident period of the qualified disaster to which such area relates, and which are attributable to such qualified disaster."[271]

The *net disaster loss* is defined as "the excess of qualified disaster-related personal casualty losses over personal casualty gains (as defined in section 165(h)(3)(A) of the Internal Revenue Code of 1986)."

For such losses, the following rules apply:

- The amount determined under section 165(h)(2)(A)(ii) of the Internal Revenue Code of 1986 shall be equal to the sum of:
  - such net disaster loss, and
  - so much of the excess referred to in the matter preceding clause (i) of section 165(h)(2)(A) of such Code (reduced by the amount in clause (i) of this subparagraph) as exceeds 10 percent of the adjusted gross income of the individual;

- Section 165(h)(1) of such Code shall be applied by substituting "$500" for "$500 ($100 for taxable years beginning after December 31, 2009)";

- The standard deduction determined under section 63(c) of such Code shall be increased by the net disaster loss; and

[269] Act §204(a)(2)(A)

[270] Act §204(a)(2)(B)

[271] Act §204(b)(3)

- Section 56(b)(1)(E) of such Code (section 56(b)(1)(D) of such Code in the case of taxable years ending after December 31, 2018) shall not apply to so much of the standard deduction as is attributable to the increase under subparagraph (C) of this paragraph.

Finally, special rules apply in determining earned income for purposes of the refundable child tax credit and the earned income tax credit for *applicable tax years* of *qualified individuals*.

The general rule applies:

> In the case of a qualified individual, if the earned income of the taxpayer for the applicable taxable year is less than the earned income of the taxpayer for the preceding taxable year, the credits allowed under sections 24(d) and 32 of the Internal Revenue Code of 1986 may, at the election of the taxpayer, be determined by substituting—
>
> (A) such earned income for the preceding taxable year, for
>
> (B) such earned income for the applicable taxable year.[272]

If the election is made, it applies for both the refundable child tax credit and the earned income tax credit.[273]

A *qualified individual* is any individual whose principal place of abode at any time during the incident period of any qualified disaster was located:

- in the qualified disaster zone with respect to such qualified disaster, or
- in the qualified disaster area with respect to such qualified disaster (but outside the qualified disaster zone with respect to such qualified disaster) and such individual was displaced from such principal place of abode by reason of such qualified disaster.[274]

An *applicable tax year* means:

- In the case of a qualified individual other than an individual described below, any taxable year which includes any portion of the incident period of the qualified disaster to which the qualified disaster area relates, or

[272] Act §204(c)(1)

[273] Act §204(c)(4)

[274] Act §204(c)(2)

- In the case of a qualified individual described in the second bullet of the qualified individual definition, any taxable year which includes any portion of the period described in such bulleted section.[275]

In the case of a joint return, the following rules apply:

- The special rule shall apply if either spouse is a qualified individual, and
- The earned income of the taxpayer for the preceding taxable year shall be the sum of the earned income of each spouse for such preceding taxable year.[276]

Sec. 205. Automatic extension of filing deadlines in case of certain taxpayers affected by federally-declared disasters.

The Act provides an automatic extension of 60 days for filing certain returns for *qualified taxpayers*.

A *qualified taxpayer* is:

- any individual whose principal residence (for purposes of section 1033(h)(4)) is located in a disaster area,
- any taxpayer if the taxpayer's principal place of business (other than the business of performing services as an employee) is located in a disaster area,
- any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a disaster area,
- any taxpayer whose records, necessary to meet a deadline for an act described in section 7508(a)(1), are maintained in a disaster area,
- any individual visiting a disaster area who was killed or injured as a result of the disaster, and
- solely with respect to a joint return, any spouse of an individual described in any preceding subparagraph of this paragraph.

For such a qualified taxpayer, the period:

- beginning on the earliest incident date specified in the declaration to which the disaster area relates, and

[275] Act §204(c)(3)

[276] Act §204(c)(5)(A)

- ending on the date which is 60 days after the latest incident date so specified, shall be disregarded in the same manner as a period specified under subsection IRC §7508A(a).

Sec. 206. Modification of the tax rate for the excise tax on investment income of private foundations.

The following modifications are being made to the excise tax on investment income of private foundations:

- The tax on net investment income of a private foundation found at §4940(a) is reduced from 2% to 1.39%, and
- IRC §4940(e) which provides for a reduction in tax where the private foundation meets certain distribution requirements is removed from the law.[277]

The provisions apply to tax years beginning after December 20, 2019.[278]

Sec. 207. Additional low-income housing credit allocations for qualified 2017 and 2018 California disaster areas.

The California state housing credit ceiling for California for calendar year 2020 shall be increased by the lesser of:

- the aggregate housing credit dollar amount allocated by the state housing credit agencies of California for such calendar year to buildings located in qualified 2017 and 2018 California disaster areas, or
- Fifty percent of the sum of the state housing credit ceilings for California for calendar years 2017 and 2018.[279]

The allocations are treated as being made first from additional allocation for purposes of determining carryovers.[280]

The following definitions apply for purposes of this provision:

- **Qualified 2017 and 2018 California Disaster Areas.** The term "qualified 2017 and 2018 California disaster areas" means any area in California which was determined by the President (before January 1, 2019) to warrant individual or individual and public assistance from the Federal Government under the Robert T.

[277] Act §§206(a) and (b)

[278] Act §206(c)

[279] Act §207(a)

[280] Act §207(b)

Stafford Disaster Relief and Emergency Assistance Act by reason of a major disaster the incident period of which begins or ends in calendar year 2017 or 2018. Notwithstanding section 201, for purposes of the preceding sentence, the term "incident period" means the period specified by the Federal Emergency Management Agency as the period during which the disaster occurred.[281]

- **Other Definitions.** Terms used in this section which are also used in section 42 of the Internal Revenue Code of 1986 shall have the same meaning in this section as in such section 42.[282]

Sec. 208. Treatment of certain possessions.

Mirror tax jurisdictions shall be paid from the U.S. Treasury for any reduction in revenues due to the disaster provisions added by the Act.[283] Similarly, the Treasury will pay a similar amount to nonmirror territorial jurisdictions for revenue reductions under these rules.[284]

OTHER TAX PROVISIONS

Sec. 301. Modification of income for purposes of determining tax-exempt status of certain mutual or cooperative telephone or electric companies.

In what will probably qualify for most as one of the most obscure provisions in the Act, Congress modified income for purposes of determining tax-exempt status of certain mutual or cooperative telephone or electric companies by adding the following to IRC §501(c)(12) at the end of that provision:

> (J) In the case of a mutual or cooperative telephone or electric company described in this paragraph, subparagraph (A) shall be applied without taking into account any income received or accrued from—
>
> > (i) any grant, contribution, or assistance provided pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act or any similar grant, contribution, or assistance by any local, State, or regional governmental entity for the purpose of relief, recovery, or restoration from, or preparation for, a disaster or emergency, or

[281] Act §207(c)(1)

[282] Act 207(c)(2)

[283] Act §208(a)

[284] Act §208(b)

> (ii) any grant or contribution by any governmental entity (other than a contribution in aid of construction or any other contribution as a customer or potential customer) the purpose of which is substantially related to providing, constructing, restoring, or relocating electric, communication, broadband, internet, or other utility facilities or services.[285]

The provision retroactively applies to taxable years beginning after December 31, 2017.[286]

Sec. 302. Repeal of increase in unrelated business taxable income for certain fringe benefit expenses.

While the prior section might seem obscure, most readers have probably heard references to the "parking lot tax," and, in particular, its impact on tax-exempt organizations. Under a provision added by the Tax Cuts and Jobs Act, costs incurred in providing free parking as a fringe benefit to employees was made either nondeductible for a for-profit undertaking or, for a not-for-profit, treated as unrelated business income subject to tax under IRC §512(a)(7).

The Act maintains the denial of a deduction in the for-profit world, but removes IRC §512(a)(7) which had caused these costs to be treated as unrelated business income.[287]

The provision is treated as if it was part of the Tax Cuts and Jobs Act signed into law by President Trump on December 22, 2017. Thus, the provision is retroactively scrubbed from the law and any not-for-profit organization that paid the tax for 2018 will now have to file a claim for refund to get those taxes back.[288]

[285] Act §301(a), IRC §501(c)(12) as amended

[286] Act §301(b)

[287] Act §302(a)

[288] Act §302(b)

NOTES

Unit

7

Affordable Care Act Taxes

LEARNING OBJECTIVE

After completing this unit, participants will be able to:

› Name the taxes repealed in the Further Consolidated Appropriations Act, 2020

The Further Consolidated Appropriations Act, 2020's final set of tax provisions related to removing various taxes that were part of 2010's Affordable Care Act. These provisions had generally been either delayed or never actually effective, so this just puts the final nail in the coffin for these provisions.

The provisions that were repealed are:

- Medical device excise tax – striking IRC Chapter 32 Subchapter E (Act Section 501)
- Annual fee on health care providers – striking Subtitle A of Title IX of the Patient Protection and Affordable Care Act (Act Section 502)
- Excise tax on high-cost employer-sponsored health coverage – striking IRC §4980I

NOTES

Unit 8

2020 in Taxes: The Quiet Spring That Wasn't Quiet

LEARNING OBJECTIVE

After completing this unit, participants will be able to:

- Understand the events that have led to the significant tax changes we've seen since December of 2019

As we went into December of 2019, I remember thinking that we were likely heading into a relatively quiet period for taxes. A Presidential election year was coming up and Congress had divided control. The likelihood of any significant legislation being enacted seemed remote until the election was over in November. For someone who spends a lot of time analyzing and writing up materials related to developments in taxes, 2020 looked to be a relatively boring year.

We knew that we might eventually get the SECURE Act, which passed the House overwhelmingly in the summer of 2019, enacted into law in a year-end tax and appropriations bill. But once that happened it seemed that tax updates for 2020 would mainly look at the SECURE Act changes to retirement plans and continued evolving guidance on implementing the Tax Cuts and Jobs Act.

The Coronavirus changed all of that. As we all moved to "shelter in place," "stay home, stay safe," and other programs that aimed at having people stay home and away from crowds, economic activity dropped dramatically, especially for businesses where large numbers of people congregate (restaurants, bars, sporting events, movies, retail stores, etc.)

The dual health and economic crises spawned by the emergence of COVID-19 pushed Congress into a rare bi-partisan push to enact legislation far broader in scope and more sweeping than anyone would have imagined possible, even without divided control of the government.

Significant portions of this legislation involved tax provisions or other relief provisions that were paired with alternative tax benefits for those who could not or chose not to take advantage of the benefits.

Today's course looks at what has changed since early December of 2019, concentrating primarily on those items enacted into law from March onward, but also looking at the issues we need to remember were created by the SECURE Act. In addition to the tax provisions, we will look at the special Small Business Administration loan programs added to the law, programs that involve making decisions regarding giving up certain tax benefits.

It is important to understand the reason for the CARES Act. As National Taxpayers Union Vice President of Policy Promotion and Economist Nicole Kaeding stated on a phone conference I was involved in, this bill is not really a stimulus bill, though you'll hear many people refer to it as such. A stimulus bill is meant to bring the economy back up to full speed following an economic downturn by getting individuals to spend money to help industries negatively impacted by the changes get back to business. In late March 2020, you really couldn't use your money from the program to go to a movie, attend a sporting event, or enjoy a three-course meal at a good restaurant.

The provisions found in the CARES Act are purely for emergency economic aid to allow individuals to pay for necessities and meet some expenses while economic activity was intentionally slowed dramatically. Any stimulus will need to take place once the economy has returned to something much closer to a normal level of activity. Thus, we should expect more legislative action during the year as events unfold.

Unit

9

Payroll Tax Relief

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Advise clients regarding payroll tax credits available when mandatory sick leave and paid family medical leave take place
- Properly compute the employee retention credit for employers who qualify to claim the tax benefit
- Understand how the deferral of the employer's portion of old age, survivor's and disability insurance works, and when an employer is eligible to take advantage of it
- Assist clients in preparing Form 7200 to obtain an advance payment of the credits in excess of their payroll tax deposits

Congress first turned to payroll taxes as a way to reimburse employers for mandates placed on the employer to help employees when they or a member of their family is impacted by COVID-19 as part of the Families First Coronavirus Response Act. But Congress went back to the payroll tax arena again to provide benefits directly aimed at the employer in the CARES Act—but which would be lost, in whole or part, if the employer took advantage of the Payroll Protection Program loan provisions.

CONGRESS ENACTS SMALL EMPLOYER MANDATORY PAID SICK TIME RULES AND RELATED REFUNDABLE PAYROLL TAX CREDIT

Families First Coronavirus Response Act (HR 6201), 3/18/20

As part of the Families First Coronavirus Response Act (HR 6201),[289] employers of *less than 500 employees* face mandatory provision of sick time[290] and paid family leave[291] but are eligible for a refundable payroll tax credit to offset the costs. The bill was signed into law by the President on March 18, 2020.

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[289] HR 6201, Enacted March 18, 2020, https://www.congress.gov/116/bills/hr6201/BILLS-116hr6201enr.pdf

[290] HR 6201, Act Section 5110(2)(b)(ii)

[291] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(a)(1)(B)

The analysis below is based on a review of the provisions written immediately after the law was enacted. Readers should confirm all details independently. As well, the Department of Labor and other agencies will be issuing guidance in the application and interpretation of these provisions. Readers need to watch for such developments as they occur.

Paid Sick Time

The conditions under which the two week paid sick leave must be paid are the following when the employee is *unable to work or telework* for any of the following:

> (1) The employee is subject to a Federal, State, or local quarantine or isolation order related to COVID–19.
>
> (2) The employee has been advised by a health care provider to self-quarantine due to concerns related to COVID– 19.
>
> (3) The employee is experiencing symptoms of COVID– 19 and seeking a medical diagnosis.
>
> (4) The employee is caring for an individual who is subject to an order as described in subparagraph (1) or has been advised as described in paragraph (2).
>
> (5) The employee is caring for a son or daughter of such employee if the school or place of care of the son or daughter has been closed, or the child care provider of such son or daughter is unavailable, due to COVID–19 precautions.
>
> (6) The employee is experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretary of the Treasury and the Secretary of Labor.[292]

However, the employer of an employee who is a health care provider or an emergency responder can exclude such employees from this provision.[293]

The amount of sick pay, subject to the maximums discussed next, is set at:

- The employee's standard rate of pay (or minimum wage if greater) for leave taken due to situations (1), (2) and (3) and

- Two-thirds of that amount for leave taken due to situations (4), (5), and (6).[294]

The maximum amount of paid sick time is

- $511 per day ($5,110 in total) for leave paid due to situations (1), (2), and (3) and

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[292] HR 6201, Act Section 5102(a)

[293] HR 6201, Act Section 5102(a)

[294] HR 6201, Act Section 5110(5)(B)

- $200 per day ($2,000 in total) for leave paid due to situations (4), (5), and (6).[295]

The duration of the paid sick time is 80 hours for full-time employees and, for part-time employees, equal to the average hours that employee works over a two-week period.[296]

An employer cannot require, as a condition of providing this paid sick time to an employee, that the employee find a replacement employee to cover his/her hours.[297]

The employer must provide this paid sick time to an employee regardless of how long the employee has been working for the employer. The employee may first use this special paid sick time before using other paid sick time available from the employer.[298]

An employer is required to post and keep posted in conspicuous places on the employer's premises where notices are normally place a notice regarding this act. The Department of Labor will make a model notice available by March 26, 2020.[299]

Employers are barred from retaliating against employees for using leave under this Act or filing a complaint or taking any action under this Act.[300]

The Act does not diminish the rights or benefits an employee may be entitled to under any

- Other state or federal law
- Collective bargaining agreement or
- Existing employer policy.[301]

Nor does the law require an employer to provide any sort of financial or other reimbursement to an employee after the employee's termination, retirement, resignation or other separation from service.[302]

The actual sick leave taxes are not subject to the employer portion of FICA taxes (the 6.2% old age, survivor's and disability insurance component of the tax).[303]

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[295] HR 6201, Act Section 5110(5)(A)(ii)(I)
[296] HR 6201, Act Section 5102(b)(1)
[297] HR 6201, Act Section 5102(d)
[298] HR 6201, Act Section 5102(e)
[299] HR 6201, Act Section 5103
[300] HR 6201, Act Section 5104
[301] HR 6201, Act Section 5107
[302] HR 6201, Act Section 5107
[303] HR 6201, Act Section 7005(a)

Employers who pay such leave will be eligible for reimbursement via a credit against employer FICA taxes paid.[304] Any credit in excess of the taxes actually paid by the employer will be refundable[305]

The IRS has determined that, although the law says the tax only reduces the employer FICA tax imposed, as a practical matter, since the credit is refundable, employers are allowed to net the credit against any balance due on payroll tax deposits. Any excess over total payroll taxes will be eligible for a refund via Form 7200 rather than having to wait until Form 941 is filed at the end of the quarter.

The employer will also receive a credit for "qualified health care expenses" allocable to the qualified sick pay,[306] as well as the employer portion of the Medicare tax related to these payments.[307]

A similar credit is available for self-employed individuals who personally have to take qualified sick leave, subject to the same limits.[308]

The paid leave rules sunset on December 31, 2020.[309]

Extended Family Leave

A much more narrow extended paid family leave is also part of the bill. Under Act Section 3102(a), paid leave is available for up to 10 weeks for an employee who is:

> unable to work (or telework) due to a need for leave to care for the son or daughter under 18 years of age of such employee if the school or place of care has been closed, or the child care provider of such son or daughter is unavailable, due to a public health emergency.[310]

A public health emergency is defined as an emergency related to COVID-19 declared by a Federal, State or local authority.[311]

The first 10 days of such leave may consist of unpaid leave.[312] However, the employee may elect to substitute any other accrued paid leave for some or all of the unpaid leave under this provision.[313]

The amount paid per day is calculated on the "two-thirds" rule that applies to the less generous paid leave situations, but with the maximum total paid out now rising to $10,000 per employee.[314]

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[304] HR 6201, Act Section 7001(a),(b)

[305] HR 6201, Act Section 7001(b)(4)

[306] HR 6201, Act Section 7001(d)(2)

[307] HR 6201, Act Section 7005(b)

[308] HR 6201, Act Section 7002

[309] HR 6201, Act Section 5109

[310] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(a)(2)(A)

[311] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(a)(2)(B)

[312] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(b)(1)(A)

[313] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(b)(1)(B)

[314] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(b)(2)

Again, notice provisions apply to this rule as well.[315] As well, health care providers and emergency responders can be excluded from this rule.[316]

As with paid sick leave, paid family leave is also eligible for a similar payroll tax credit[317] which is also available to the self-employed.[318]

NEW FORM 7200 RELEASED BY IRS FOR ADVANCE REFUNDS FOR COVID-19 RELATED PAYROLL TAX CREDITS

Form 7200, 3/31/2020

The IRS has released Form 7200, “Advance Payment of Employer Credits Due to COVID-19” to be used for credits related to mandated sick pay, mandated paid family medical leave and the Employee Retention Credit.

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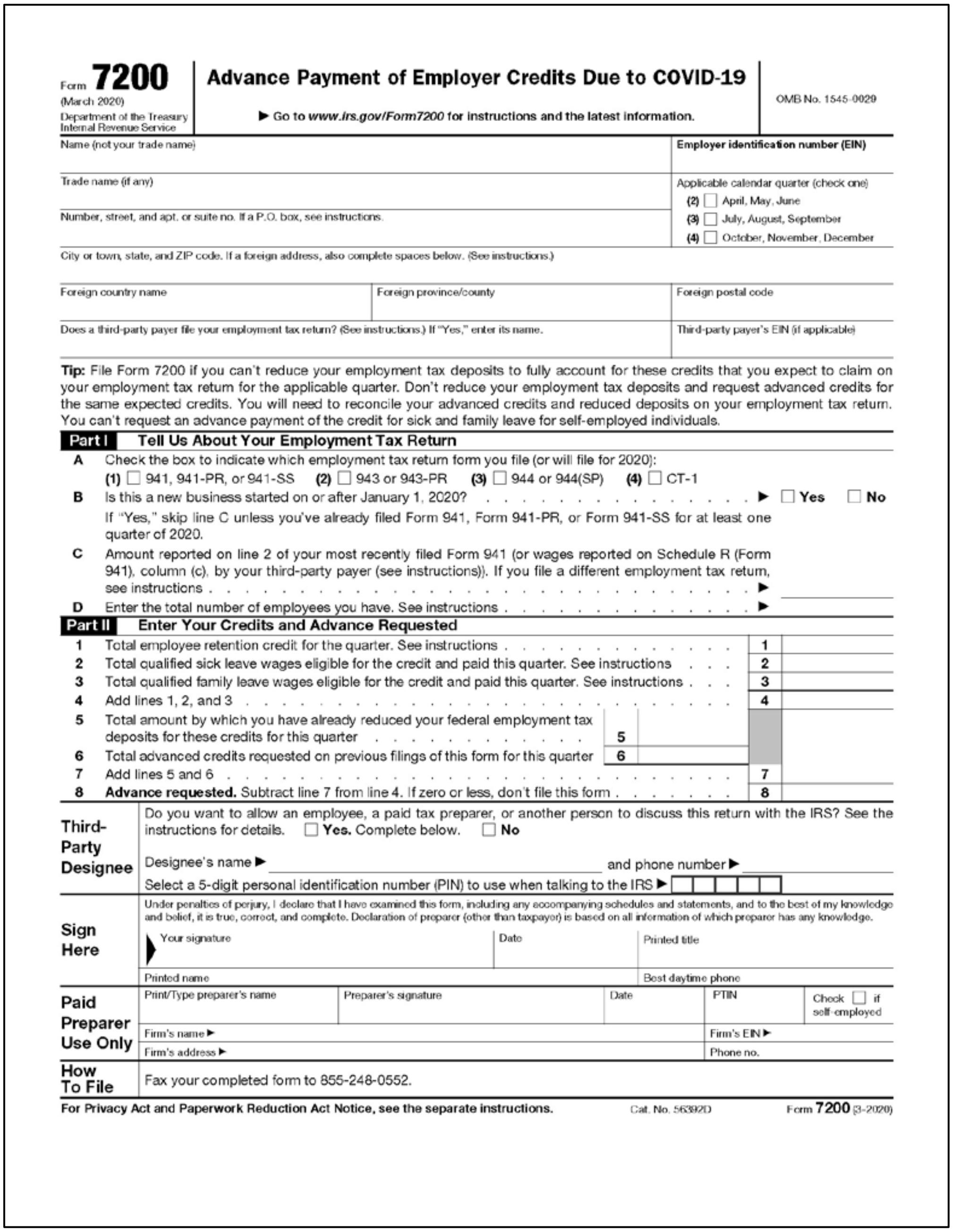
[315] HR 6201, Act Section 3102, amending Family and Medical Leave Act of 1993, Section 110(c)

[316] HR 6201, Act Section 3104

[317] HR 6201, Act Section 7003

[318] HR 6201, Act Section 7004



Form **7200**
(March 2020)
Department of the Treasury
Internal Revenue Service

Advance Payment of Employer Credits Due to COVID-19

► Go to *www.irs.gov/Form7200* for instructions and the latest information.

OMB No. 1545-0029

Name (not your trade name)

Employer identification number (EIN)

Trade name (if any)

Applicable calendar quarter (check one)
(2) ☐ April, May, June
(3) ☐ July, August, September
(4) ☐ October, November, December

Number, street, and apt. or suite no. If a P.O. box, see instructions.

City or town, state, and ZIP code. If a foreign address, also complete spaces below. (See instructions.)

Foreign country name | Foreign province/county | Foreign postal code

Does a third-party payer file your employment tax return? (See instructions.) If "Yes," enter its name. | Third-party payer's EIN (if applicable)

Tip: File Form 7200 if you can't reduce your employment tax deposits to fully account for these credits that you expect to claim on your employment tax return for the applicable quarter. Don't reduce your employment tax deposits and request advanced credits for the same expected credits. You will need to reconcile your advanced credits and reduced deposits on your employment tax return. You can't request an advance payment of the credit for sick and family leave for self-employed individuals.

Part I **Tell Us About Your Employment Tax Return**

A Check the box to indicate which employment tax return form you file (or will file for 2020):
(1) ☐ 941, 941-PR, or 941-SS **(2)** ☐ 943 or 943-PR **(3)** ☐ 944 or 944(SP) **(4)** ☐ CT-1

B Is this a new business started on or after January 1, 2020? . . . ► ☐ **Yes** ☐ **No**
If "Yes," skip line C unless you've already filed Form 941, Form 941-PR, or Form 941-SS for at least one quarter of 2020.

C Amount reported on line 2 of your most recently filed Form 941 (or wages reported on Schedule R (Form 941), column (c), by your third-party payer (see instructions)). If you file a different employment tax return, see instructions . . . ►

D Enter the total number of employees you have. See instructions . . . ►

Part II **Enter Your Credits and Advance Requested**

1	Total employee retention credit for the quarter. See instructions	1	
2	Total qualified sick leave wages eligible for the credit and paid this quarter. See instructions	2	
3	Total qualified family leave wages eligible for the credit and paid this quarter. See instructions	3	
4	Add lines 1, 2, and 3	4	
5	Total amount by which you have already reduced your federal employment tax deposits for these credits for this quarter (5)		
6	Total advanced credits requested on previous filings of this form for this quarter (6)		
7	Add lines 5 and 6	7	
8	**Advance requested.** Subtract line 7 from line 4. If zero or less, don't file this form	8	

Third-Party Designee
Do you want to allow an employee, a paid tax preparer, or another person to discuss this return with the IRS? See the instructions for details. ☐ **Yes.** Complete below. ☐ **No**
Designee's name ► and phone number ►
Select a 5-digit personal identification number (PIN) to use when talking to the IRS ►

Sign Here
Under penalties of perjury, I declare that I have examined this form, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.
Your signature | Date | Printed title
Printed name | Best daytime phone

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How To File Fax your completed form to 855-248-0552.

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 56392D Form **7200** (3-2020)

The information page for the form, which includes a link to the instructions, is found at https://www.irs.gov/forms-pubs/about-form-7200.

The CARES Act provides for a number of business tax benefits, though some are only available to businesses that don't make use of certain other relief provisions related to SBA loans.

EMPLOYEE RETENTION CREDIT FOR EMPLOYERS SUBJECT TO CLOSURE DUE TO COVID-19 (CARES ACT §2301)

Note: this credit cannot be claimed by taxpayers who obtain the new SBA payroll protection program loan. See the details at the end of this section.

The law provides for a refundable payroll tax credit, equal to 50% of *qualified wages* with respect to each employee of an *eligible employer*.[319] The maximum wages per employee that can be taken into account for all quarters an employer may be eligible for this credit is $10,000.[320]

An *eligible employer* is defined as any employer:

- Which was carrying on a trade or business in 2020 and
- With respect to any calendar quarter:
  - The operation of the business was fully or partially suspended due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19 or
  - The calendar quarter is within a *substantial decline in gross receipts* period.[321]

While tax exempt organizations can qualify for relief, they cannot use the gross receipts option for qualification—only the suspension rule.[322]

A *substantial decline in gross receipts* period is the period:

- Beginning with first calendar quarter beginning after December 31, 2019, for which gross receipts (as defined in IRC §448(c)) for the calendar quarter are less than 50% of the gross receipts for the same calendar quarter in the prior year and,
- Ending with the next calendar quarter for which gross receipts of the employer are greater than 80% of gross receipts for the same quarter in the prior year.[323]

IRC §448(c) is the provision we referenced for determining gross receipts for allowing the use of the cash method and other small business accounting methods following the enactment of TCJA.

Qualified wages are defined based on the average number of employees employed by such employer during 2019.

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[319] Act §2301

[320] Act §2301(b)(1)

[321] Act §2301(c)(2)(A)

[322] Act §2301(c)(2)(C)

[323] Act §2301(c)(2)(B)

- If that number is greater than 100, wages paid with respect to which an employee is not providing services due to a business suspension or due to substantial decline in gross receipts will represent qualified wages. In addition, these wages must not be more than the employee would have been paid for working an equivalent duration during the 30 days immediately preceding such period.[324]

- If the number is 100 or less, wages paid to any employee (including those providing services to the employer) during a period of business suspension or during a quarter with a substantial decline in gross receipts will be qualified wages.[325]

Qualified wages include not just wages (as defined under IRC §3121(a)) and compensation (as defined under IRC §3231(e)), but also *qualified health care expenses.* Such expenses are "amounts paid or incurred by the eligible employer to provide and maintain a group health plan …, but only to the extent that such amounts are excluded from the gross income of employees by reason of IRC §106(a)…" Or, to put it more simply, employer paid health insurance.[326] The IRS is given the authority to write regulations defining proper allocation, but absent contrary guidance "such allocation shall be treated as properly made if made on the basis of being pro rata among employees and pro rata on the basis of periods of coverage (relative to the periods to which such wages relate)."[327]

The jobs credit aggregation rules found at IRC §52, along with the qualified plan aggregation rules found at IRC §414(m) or (o) will apply to treat such related entities as one employer (which would impact the 100 or fewer employee test).[328]

Certain individuals are excluded from the credit, using rules similar to those found at IRC §51(i)(1). That section provides:

> No wages shall be taken into account under subsection (a) with respect to an individual who--
>
> > (A) bears any of the relationships described in subparagraphs (A) through (G) of section 152(d)(2) to the taxpayer, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation, or, if the taxpayer is an entity other than a corporation, to any individual who owns, directly or indirectly, more than 50 percent of the capital and profits interests in the entity (determined with the application of section 267(c)),
> >
> > (B) if the taxpayer is an estate or trust, is a grantor, beneficiary, or fiduciary of the estate or trust, or is an individual who bears any of the relationships

[324] Act §2301(c)(3)(A)(i); §2301(c)(3)(B)

[325] Act §2301(c)(3)(A)

[326] Act §2301(c)(3)(C)(ii)

[327] Act §2301(c)(3)(C)(iii)

[328] Act §2301(d)

> described in subparagraphs (A) through (G) of section 152(d)(2) to a grantor, beneficiary, or fiduciary of the estate or trust, or
>
> (C) is a dependent (described in section 152(d)(2)(H)) of the taxpayer, or, if the taxpayer is a corporation, of an individual described in subparagraph (A), or, if the taxpayer is an estate or trust, of a grantor, beneficiary, or fiduciary of the estate or trust.[329]

Similarly, no deductions are allowed for the amount of credit received, as described in IRC §280C(a):

> No deduction shall be allowed for that portion of the wages or salaries paid or incurred for the taxable year which is equal to the sum of the credits determined for the taxable year under sections 45A(a), 45P(a), 45S(a), 51(a), and 1396(a). In the case of a corporation which is a member of a controlled group of corporations (within the meaning of section 52(a)) or a trade or business which is treated as being under common control with other trades or businesses (within the meaning of section 52(b)), this subsection shall be applied under rules prescribed by the Secretary similar to the rules applicable under subsections (a) and (b) of section 52.[330]

The credit does not apply to governmental entities.[331]

A taxpayer can elect not to have this credit apply to otherwise-qualified payments.[332]

The biggest caveat is that this credit is not available to an employer who receives a covered loan under subparagraph (36) of section 7(a) of the Small Business Act.[333] This is the special "payroll protection program" loan created by Act §1102 and which potentially may be partially or fully forgiven under Act §1106. So a taxpayer eligible for a payroll protection program loan who elects to obtain one will not be able to claim this credit.

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[329] Act §2301(e)

[330] Act §2301(e)

[331] Act §2301(f)

[332] Act §2301(g)

[333] Act §2301(h)

In frequently asked questions published on the IRS website,[334] the agency clarifies that employers are allowed to reduce their deposits of *all* payroll taxes deposited, including those withheld from employees.

> **Can an Eligible Employer paying qualified wages fund its payments of qualified wages before receiving the credits by reducing its federal employment tax deposits?**
>
> Yes. An Eligible Employer may fund the qualified wages by accessing federal employment taxes, including those that the Eligible Employer already withheld, that are set aside for deposit with the IRS, for other wage payments made during the same quarter as the qualified wages.
>
> That is, an Eligible Employer that pays qualified wages to its employees in a calendar quarter before it is required to deposit federal employment taxes with the IRS for that quarter may reduce the amount of federal employment taxes it deposits for that quarter by half of the amount of the qualified wages paid in that calendar quarter. The Eligible Employer must account for the reduction in deposits on the Form 941, Employer's Quarterly Federal Tax Return, for the quarter.
>
> Example: An Eligible Employer paid $10,000 in qualified wages (including qualified health plan expenses) and is therefore entitled to a $5,000 credit, and is otherwise required to deposit $8,000 in federal employment taxes, including taxes withheld from all of its employees, for wage payments made during the same quarter as the $10,000 in qualified wages. The Eligible Employer has no paid sick or family leave credits under the FFCRA. The Eligible Employer may keep up to $5,000 of the $8,000 of taxes the Eligible Employer was going to deposit, and it will not owe a penalty for keeping the $5,000. The Eligible Employer is required to deposit only the remaining $3,000 on its required deposit date. The Eligible Employer will later account for the $5,000 it retained when it files Form 941, Employer's Quarterly Federal Tax Return, for the quarter.
>
> **May an Eligible Employer reduce its federal employment tax deposit by the qualified wages that it has paid without incurring a failure to deposit penalty?**
>
> Yes. An Eligible Employer will not be subject to a penalty under section 6656 of the Code for failing to deposit federal employment taxes relating to qualified wages in a calendar quarter if:
>
> 1. the Eligible Employer paid qualified wages to its employees in the calendar quarter before the required deposit,
>
> 2. the amount of federal employment taxes that the Eligible Employer does not timely deposit, reduced by any amount of federal employment taxes not

[334] "FAQs: Employee Retention Credit under the CARES Act," IRS Website, April 10, 2020, https://www.irs.gov/newsroom/faqs-employee-retention-credit-under-the-cares-act, April 22, 2020

deposited in anticipation of the paid sick or family leave credits claimed under the FFCRA, is less than or equal to the amount of the Eligible Employer's anticipated Employee Retention Credit for the qualified wages for the calendar quarter as of the time of the required deposit, and

3. the Eligible Employer did not seek payment of an advance credit by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19, with respect to any portion of the anticipated credits it relied upon to reduce its deposits.

For more information, about the relief from the penalty for failure to deposit federal employment taxes on account of qualified wages, see Notice 2020-22.[335]

The FAQ also describes the use of Form 7200 to get an advance on the credits if the taxpayer is eligible for more in employee retention credits than there are available payroll tax deposits to offset.

How can an Eligible Employer that is paying qualified wages fund the payment of these wages if the Eligible Employer does not have sufficient federal employment taxes set aside for deposit to cover those payments? Can the employer get an advance of the credits?

Yes. Because quarterly returns are not filed until after qualified wages are paid, some Eligible Employers may not have sufficient federal employment taxes set aside for deposit to the IRS to fund their qualified wages. Accordingly, the IRS has established a procedure for obtaining an advance of the refundable credits.

The Eligible Employer should first reduce its remaining federal employment tax deposits for wages paid in the same calendar quarter by the maximum allowable amount. If the anticipated credit for the qualified wages exceeds the remaining federal employment tax deposits for that quarter, the Eligible Employer can file a Form 7200, Advance Payment of Employer Credits Due to COVID-19, to claim an advance refund for the full amount of the anticipated credit for which it did not have sufficient federal employment tax deposits.

If an Eligible Employer fully reduces its required deposits of federal employment taxes otherwise due on wages paid in the same calendar quarter to its employees in anticipation of receiving the credits, and it has not paid qualified wages in excess of this amount, it should not file the Form 7200. If it files the Form 7200, it will need to reconcile this advance credit and its deposits with the qualified wages on Form 941 (or other applicable federal employment tax return such as Form 944 or Form CT-1), and it may have an underpayment of federal employment taxes for the quarter.

Example: An Eligible Employer paid $20,000 in qualified wages, and is therefore entitled to a credit of $10,000, and is otherwise required to deposit $8,000 in federal

[335] "FAQs: Employee Retention Credit under the CARES Act," IRS Website, April 10, 2020

employment taxes, including taxes withheld from all of its employees, on wage payments made during the same calendar quarter. The Eligible Employer has no paid sick or family leave credits under the FFCRA. The Eligible Employer can keep the entire $8,000 of taxes that the Eligible Employer was otherwise required to deposit without penalties as a portion of the credits it is otherwise entitled to claim on the Form 941. The Eligible Employer may file a request for an advance credit for the remaining $2,000 by completing Form 7200.

BORROWERS WHO RETURN PPP LOANS UNDER SBA SAFE HARBOR WILL BE ALLOWED TO CLAIM EMPLOYEE RETENTION CREDIT

"COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs," Internal Revenue Service web page, 5/6/20

As the SBA has advised borrowers who don't want to have to worry about being asked about whether their certification that their loan application was necessary was made in good faith to repay those loans by May 7 (recently extended to May 14), a question has arisen regarding the employee retention credit (ERC).

An employer who receives a PPP loan is not eligible to claim the employee retention credit per CARES Act §2301(g). If an employer decides to return its PPP loan under the SBA's safe harbor repayment program, are they still ineligible for the ERC since they did have a PPP loan, even though they have now repaid it?

In the current Question 80 on the IRS's page for "COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs,"[336] the answer is that employers who return the funds by May 7 will be able to claim the ERC if otherwise eligible. The question and answer read:

> **80. Is an employer that repays its Paycheck Protection Program (PPP) loan by May 7, 2020, eligible for the Employee Retention Credit? (updated May 4, 2020)**
>
> Yes. An employer that applied for a PPP loan, received payment, and repays the loan by May 7, 2020 (in accordance with the Limited Safe Harbor With Respect to Certification Concerning Need for PPP Loan Request in the Interim Final Rules issued by the Small Business Administration effective on April 28, 2020) will be treated as though the employer had not received a covered loan under the PPP for purposes of the Employee Retention Credit. Therefore, the employer will be eligible for the credit if the employer is otherwise an Eligible Employer. For more information, see Business Loan Program Temporary Changes; Paycheck Protection

[336] "COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs," Internal Revenue Service web page, May 6, 2020, https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-interaction-with-other-credit-and-relief-provisions-faqs (retrieved May 6, 2020)

Program—Requirements—Promissory Notes, Authorizations, Affiliation, and Eligibility (PDF).

The IRS later updated the guidance to allow for repayment by the May 14 extended repayment date announced by the SBA around the same time the IRS indicated that repayment would lead to restoring the employer's ability to claim the employee retention credit.

IRS REVERSES COURSE, QUALIFYING EMPLOYERS PAYING ONLY HEALTH CARE COSTS CAN CLAIM EMPLOYEE RETENTION CREDIT

"COVID-19-Related Employee Retention Credits: Amount of Allocable Qualified Health Plan Expenses FAQs," IRS website, 5/7/20

Following a letter written by Senator Chuck Grassley (R-IA, Chair Senate Finance Committee), Rep. Richard Neal (D-MA, Chair House Ways & Means Committee) and Senator Ron Wyden (D-OR, Ranking Member Senate Finance Committee) that was critical of the IRS FAQ on the Employee Retention Credit stating that employers could not claim the credit for paying health care benefits for employees on furlough, the IRS has now reversed course.[337]

New questions 64 and 65 provide that employers who are otherwise eligible to claim the credit can claim the credit for employees for whom the employer only pays health care expenses. The updated questions and answers read:

> **64. May an Eligible Employer that averaged 100 or fewer full-time employees in 2019 treat its health plan expenses as qualified wages for purposes of the Employee Retention Credit? (updated May 7, 2020)**
>
> Yes. An Eligible Employer that averaged 100 or fewer full-time employees in 2019 may treat its health plan expenses paid or incurred, after March 12, 2020, and before January 1, 2021, during any period in a calendar quarter in which the employer's business operations are fully or partially suspended due to a governmental order or a calendar quarter in which the employer experiences a significant decline in gross receipts as qualified wages, subject to the maximum of $10,000 per employee for all calendar quarters for all qualified wages. Eligible Employers may treat health plan expenses allocable to the applicable periods as qualified wages even if the employees are not working and the Eligible Employer does not pay the employees any wages for the time they are not working.
>
> Example 1: Employer Y averaged 100 or fewer employees in 2019. Employer Y is subject to a governmental order that partially suspends the operation of its trade or business. In response to the governmental order, Employer Y reduces all employees' hours by 50 percent. It pays wages to the employees only for the time the employees

[337] "COVID-19-Related Employee Retention Credits: Amount of Allocable Qualified Health Plan Expenses FAQs," IRS website, May 7, 2020, https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-amount-of-allocable-qualified-health-plan-expenses-faqs (retrieved May 8, 2020)

are providing services, but Employer Y continues to provide the employees with full health care coverage. Employer Y's health plan expenses allocable to wages paid during the period its operations were partially suspended may be treated as qualified wages for purposes of the Employee Retention Credit.

Example 2: Employer Z averaged 100 or fewer employees in 2019. Employer Z is subject to a governmental order that suspends the operation of its trade or business. In response to the governmental order, Employer Z lays off or furloughs all of its employees. It does not pay wages to its employees for the time they are laid off or furloughed and not working, but it continues the employees' health care coverage. Employer Z's health plan expenses allocable to the period its operations were partially suspended may be treated as qualified wages for purposes of the Employee Retention Credit.

65. May an Eligible Employer that averaged more than 100 full-time employees in 2019 treat its health plan expenses as qualified wages for purposes of the Employee Retention Credit? (updated May 7, 2020)

Yes. An Eligible Employer that averaged more than 100 full-time employees in 2019 may treat its health plan expenses paid or incurred, after March 12, 2020, and before January 1, 2021, allocable to the time that the employees are not providing services during any period in a calendar quarter in which the employer's business operations are fully or partially suspended due to a governmental order or a calendar quarter in which the employer experiences a significant decline in gross receipts as qualified wages, subject to the maximum of $10,000 per employee for all calendar quarters for all qualified wages. However, an Eligible Employer may not treat health plan expenses allocable to the time for which the employees are receiving wages for providing services as qualified wages; only the portion of health plan expenses allocable to the time that the employees are not providing services are treated as qualified wages.

Example 1: Employer A averaged more than 100 full-time employees in 2019. Employer A is subject to a governmental order that partially suspends the operation of its trade or business. In response to the governmental order, Employer A reduces all employees' hours by 50 percent and pays wages to its employees only for the time that the employees are providing services, but Employer A continues to provide the employees with full health care coverage. Employer A's health plan expenses allocable to the time that employees are not providing services may be treated as qualified wages. However, Employer A may not treat health plan expenses allocable to the time for which the employees are receiving wages for providing services as qualified wages.

Example 2: Employer B averaged more than 100 full-time employees in 2019. Employer B is subject to a governmental order that partially suspends the operations of its trade or business. In response to the governmental order, Employer B reduces its employees' hours by 50 percent, but it reduces its employees' wages by only 40 percent, so that the employees receive 60 percent of their wages for 50 percent of their normal hours. Employer B continues to cover 100 percent of the employees' health plan expenses. In this case, Employer X may treat as qualified wages: (i) the 10 percent of the wages that it pays employees for time the employees are not providing services, plus (ii) 50 percent of the health plan expenses, because the health plan expenses are allocable to the time that employees were not providing services.

Example 3: Employer C is subject to a governmental order that fully suspends the operations of its trade or business. Employer C lays off or furloughs its employees and does not pay wages to the employees, but does continue to cover 100 percent of the employees' health plan expenses. In this case, Employer C may treat as qualified wages the health plan expenses that are allocable to the time that the employees are not providing services.

Advisers must remember that an employer who obtains a loan under the payroll protection program, even if the employer does not seek forgiveness of debt, is not eligible to claim this credit unless the employer returns the funds by May 14, 2020.

UPDATED IRS FAQ OUTLINES HOW ACQUISTIONS IMPACT CLAIMING EMPLOYEE RETENTION CREDIT

COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, 11/16/20

The IRS has updated their FAQ on the Employee Retention Credit (ERC) added by the CARES Act in March to give guidance when an employer acquires stock or assets of another employer that received a Paycheck Protection Program (PPP) loan.[338]

Under the ERC, no credit may be claimed by an employer who received a PPP program loan, regardless of whether or not the employer sought forgiveness of some or all of the loan. This raises a question about what happens if an employer who did not obtain a PPP loan later acquires an employer who did obtain such a loan. Does that employer and related entities now lose access to the ERC due to having acquired a "tainted" entity?

The new FAQ questions sought to give some guidance on these issues to help clarify matters.

[338] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-interaction-with-other-credit-and-relief-provisions-faqs (retrieved November 18, 2020)

Acquisition of the Equity of an Employer Who Took Out a PPP Loan

The first new question looks at the situation when an entity acquires the stock or equity interests of another entity that had taken out a PPP loan and where the target employer becomes a member of an aggregated group with the acquiring employer under the PPP rules.[339]

The IRS outlines two structures under which the employer is eligible for the ERC on and after the transaction date. The first deals with the case when the acquired employer's loan is fully satisfied or an escrow was established prior to the transaction:

> **PPP loan is fully satisfied or escrow established pre-transaction**
>
> If the Target Employer had received a PPP loan, but prior to the transaction closing date, the Target Employer fully satisfied the PPP loan in accordance with paragraph 1 of the Small Business Administration Notice effective October 2, 2020 (the SBA October 2 Notice), or submitted a forgiveness application to the PPP lender and established an interest-bearing escrow account in accordance with paragraph 2.a of the SBA October 2 Notice, then, after the closing date, the Aggregated Employer Group will not be treated as having received a PPP loan, provided that the Acquiring Employer (including any member of the Acquiring Employer's pre-transaction Aggregated Employer Group) had not received a PPP loan before the closing date and no member of the Aggregated Employer Group receives a PPP loan on or after the closing date. In this case, any employer that is a member of the Aggregated Employer Group, including the Target Employer, may claim the Employee Retention Credit for qualified wages paid on and after the closing date, provided that the Aggregated Employer Group otherwise meets the requirements to claim the Employee Retention Credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer's pre-transaction Aggregated Employer Group for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act.[340]

If the above conditions are not met, the IRS outlines the following method by which the employer continues to be able to claim the credit—but not for amounts paid to the target employer's employees:

> **PPP loan is not fully satisfied and no escrow established pre-transaction**
>
> If the Target Employer had received a PPP loan, but prior to the transaction closing date, the PPP Loan is not fully satisfied and no escrow account was established in accordance with paragraphs 1 or 2.a of the SBA October 2 Notice, then, after the closing date, the Aggregated Employer Group (other than the Target Employer) will not be treated as having received a PPP loan, provided that the Acquiring Employer

[339] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81a

[340] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81a

> (including any member of the Acquiring Employer's pre-transaction Aggregated Employer Group) had not received a PPP loan before the closing date and no member of the Aggregated Employer Group receives a PPP loan on or after the closing date. Any employer (other than the Target Employer) that is a member of the Aggregated Employer Group may claim the Employee Retention Credit for qualified wages paid on and after the closing date, provided that the Aggregated Employer Group otherwise meets the requirements to claim the Employee Retention Credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer's pre-transaction Aggregated Employer Group for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act. *However, the Target Employer that received the PPP loan prior to the transaction closing date and that continues to be obligated on the PPP loan after the closing date is ineligible for the Employee Retention Credit for any wages paid to any employee of the Target Employer before or after the closing date.*[341]

Note that the key difference is that, if the loan was not paid off and no escrow had been established, the acquired entity's payroll would not qualify for the ERC. But the other members of the group could continue to qualify for the ERC credit.

Acquisition of the Assets of an Employer Who Took Out a PPP Loan

If the acquiring employer acquires the assets, rather than the equity interests, of a target employer, the rules are somewhat different depending on whether the acquiring employer does or does not assume the PPP loan obligations of the target employer.

If the acquiring employer *does not* assume the PPP loan obligations of the target employer, the following rules apply:

> **No assumption of PPP loan obligations**
>
> An Acquiring Employer that acquires the assets of a Target Employer that had received a PPP loan will not be treated as having received a PPP loan by virtue of the asset acquisition, provided that the Acquiring Employer does not assume the Target Employer's obligations under the PPP loan. In this case, the Acquiring Employer will be eligible for the Employee Retention Credit after the transaction closing date if the employer otherwise meets the requirements to claim the credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act.[342]

[341] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81a

[342] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81b

However, the results are not quite as good for the combined organization if the entity *does* assume the PPP loan obligations:

> **Assumption of PPP loan obligations**
>
> If, as part of the acquisition of the Target Employer's assets and liabilities, the Acquiring Employer assumes the Target Employer's obligations under the PPP loan, then after the transaction closing date, the Acquiring Employer generally will not be treated as having received a PPP loan, provided that the Acquiring Employer had not received a PPP loan before or on or after the closing date; however, the wages that may be treated as qualified wages after the closing date will be limited. *Specifically, the wages paid by the Acquiring Employer after the closing date to any individual who was employed by the Target Employer on the closing date shall not be treated as qualified wages.* Subject to this limitation, the Acquiring Employer may claim the Employee Retention Credit for qualified wages paid on and after the closing date, provided that the employer otherwise meets the requirements to claim the Employee Retention Credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act.[343]

If the PPP obligation is assumed by the buyer, the employees of the target will not be allowed to be treated as employees on which the ERC can be claimed.

DELAY OF PAYMENT OF EMPLOYER PAYROLL TAXES (CARES ACT §2302)

While not the payroll tax holiday that was 12initially proposed, the CARES Act does allow for a significant deferral of the payment of employer payroll taxes with a new provision found at Act §2302. This deferral will allow employers and the self-employed to defer paying the employer portion of certain payroll taxes for the remainder of 2020 and split the payment over two years, with the first half due on December 31, 2021 and the second half due on December 31, 2022.

But this time the use of this provision is contingent on not using the forgiveness of indebtedness option for the SBA "payroll protection program loans" added by §1109 of the CARES Act.[344] It appears that if a taxpayer merely takes out the loan but opts not to ask for debt forgiveness this deferral would still be available.

The *applicable payroll taxes* subject to deferral are:

- Old age, survivor's and disability insurance portion of FICA imposed on the employer; and

[343] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81b

[344] Act §2302(a)(3)

- RRTA taxes imposed on the employer up to the amount of regular FICA tax (6.2%).[345]

The *payroll tax deferral period* runs from March 27, 2020 (the date of enactment) through December 31, 2020.[346]

The payment dates (referred to as the *applicable dates*) are

- December 31, 2021 with respect to 50% of the amounts allowed for deferral and
- December 31, 2022 for the remaining balance.[347]

So long as those payments are timely made, the deposits shall be treated as if made on the original due date.[348]

Similar rules deferring the payment of ½ of a self-employed individual's portion of the self-employment tax related to old-age, survivors, and disability insurance imposed by §1401(a) are found in the CARES Act.[349] Note that the deferral does not include the Medicare portion of the self-employment tax imposed by IRC §1401(b), with the provision only referring to taxes under §1401(a).

IRS EXPLAINS EMPLOYER PAYROLL TAX DEFERRAL PROVISION OF THE CARES ACT

Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, April 10, 2020 version, 4/10/20

The IRS has released a set of frequently asked questions on the deferral of the employer's share of the FICA Old Age Survivor's and Disability insurance tax, a provision added by the CARES Act.[350] While summarizing the relief provided in the Act, the FAQ also provides answers to some questions that had been raised under the provision.

The IRS describes the program generally as follows in the FAQ:

> Section 2302 of the CARES Act provides that employers may defer the deposit and payment of the employer's portion of social security taxes and certain railroad retirement taxes. These are the taxes imposed under section 3111(a) of the Internal

[345] Act §2302(d)(1)

[346] Act §2302(d)(2)

[347] Act §2302(d)(3)

[348] Act §2302(a)(2)

[349] Act §2302(b)

[350] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, April 10, 2020 version, https://www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020 , retrieved April 10, 2020

Revenue Code (the "Code") and, for Railroad employers, so much of the taxes imposed under section 3221(a) of the Code as are attributable to the rate in effect under section 3111(a) of the Code (collectively referred to as the "employer's share of social security tax"). Employers that received a Paycheck Protection Program loan may not defer the deposit and payment of the employer's share of social security tax that is otherwise due after the employer receives a decision from the lender that the loan was forgiven. (See FAQ 4).[351]

The time period covered by the program is outlined by the IRS, as well as the fact that a revised Form 941 is coming for the second quarter and instructions are to come on how to report for the first quarter:

> The deferral applies to deposits and payments of the employer's share of social security tax that would otherwise be required to be made during the period beginning on March 27, 2020, and ending December 31, 2020. (Section 2302 of the CARES Act calls this period the "payroll tax deferral period.")
>
> The Form 941, Employer's QUARTERLY Federal Tax Return, will be revised for the second calendar quarter of 2020 (April - June, 2020). Information will be provided in the near future to instruct employers how to reflect the deferred deposits and payments otherwise due on or after March 27, 2020 for the first quarter of 2020 (January – March 2020). In no case will Employers be required to make a special election to be able to defer deposits and payments of these employment taxes.[352]

While all employers can initially defer taxes under this program, an employer who has debt forgiven on a PPP loan will lose that ability at the time the debt forgiveness is approved.[353]

How an employer who gets PPP debt forgiveness will deal with this issue is explained. Some observers had expressed a concern that an employer might retroactively lose the ability to defer, resulting in a sudden payroll tax liability, but the IRS held that is not the case. Rather the IRS provides:

> **4. Can an employer that has applied for and received a PPP loan that is not yet forgiven defer deposit and payment of the employer's share of social security tax without incurring failure to deposit and failure to pay penalties?**
>
> Yes. Employers who have received a PPP loan, but whose loan has not yet been forgiven, may defer deposit and payment of the employer's share of social security tax that otherwise would be required to be made beginning on March 27, 2020, through the date the lender issues a decision to forgive the loan in accordance with paragraph (g) of section 1106 of the CARES Act, without incurring failure to deposit and failure to pay penalties. Once an employer receives a decision from its lender that its PPP loan is forgiven, the employer is no longer eligible to defer

[351] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 1

[352] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 2

[353] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 3

deposit and payment of the employer's share of social security tax due after that date. However, the amount of the deposit and payment of the employer's share of social security tax that was deferred through the date that the PPP loan is forgiven continues to be deferred and will be due on the "applicable dates," as described in FAQs 7 and 8.[354]

This will serve to relieve employers of most of the burden of paying payroll taxes during the 8-week period given to spend the funds received from a PPP loan, as the debt forgiveness won't take place until after that period has concluded. As well, recall that state payroll taxes are generally considered part of payroll costs for PPP loan forgiveness purposes, so the employer may not initially end up with having to dive into the employer's other funds to pay most taxes during the 8-week period.

The FAQ provides that this deferral is available to an employer who is receiving the payroll related tax credits from the Families First Coronavirus Relief Act (FFCRA) and the CARES Act employee retention credit:

> Notice 2020-22 provides relief from the failure to deposit penalty under section 6656 of the Code for not making deposits of employment taxes, including taxes withheld from employees, in anticipation of the FFCRA paid leave credits and the CARES Act employee retention credit. The ability to defer deposit and payment of the employer's share of social security tax under section 2302 of the CARES Act applies to all employers, not just employers entitled to paid leave credits and employee retention credits. (But see the limit described in FAQ 4 for employers that have a PPP loan forgiven.)[355]

The FAQ also discusses the interaction of the deferral and the refundable payroll tax credits.

> **6. Can an employer that is eligible to claim refundable paid leave tax credits or the employee retention credit defer its deposit and payment of the employer's share of social security tax prior to determining the amount of employment tax deposits that it may retain in anticipation of these credits, the amount of any advance payments of these credits, or the amount of any refunds with respect to these credits?**
>
> Yes. An employer is entitled to defer deposit and payment of the employer's share of social security tax prior to determining whether the employer is entitled to the paid leave credits under sections 7001 or 7003 of FFCRA or the employee retention credit under section 2301 of the CARES Act, and prior to determining the amount of employment tax deposits that it may retain in anticipation of these credits, the amount of any advance payments of these credits, or the amount of any refunds with respect to these credits.[356]

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[354] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 4

[355] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 5

[356] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 6

The FAQ notes that the deferred deposit dates are:

- December 31, 2021 for deposit of 50% of the amount deferred; and
- December 31, 2022 for the deposit of the remaining taxes.

So long as the deposits are made by those dates, they will be treated as timely paid and the taxpayer will avoid a failure to deposit penalty and a failure to pay penalty.[357]

Questions 9-11 describe the similar rules for self-employed taxpayers:

> **9. Are self-employed individuals eligible to defer payment of self-employment tax on net earnings from self-employment income?**
>
> Yes. Self-employed individuals may defer the payment of 50 percent of the social security tax on net earnings from self-employment income imposed under section 1401(a) of the Code for the period beginning on March 27, 2020, and ending December 31, 2020. (Section 2302 of the CARES Act calls this period the "payroll tax deferral period.")
>
> **10. Is there a penalty for failure to make estimated tax payments for 50 percent of social security tax on net earnings from self-employment income during the payroll tax deferral period?**
>
> No. For any taxable year that includes any part of the payroll tax deferral period, 50 percent of the social security tax imposed on net earnings from self-employment income during that payroll tax deferral period is not used to calculate the installments of estimated tax due under section 6654 of the Code.
>
> **11. What are the applicable dates when deferred payment amounts of 50 percent of the social security tax imposed on self-employment income must be paid?**
>
> The deferred payment amounts are due on the "applicable dates" as described in FAQ 7.[358]

[357] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 7, 8

[358] Deferral of employment tax deposits and payments through December 31, 2020, IRS Website, FAQ 9-11

IRS GIVES INSTRUCTIONS FOR PREPARATION OF FORMS W-2 FOR EMPLOYERS WHO DEFERRED EMPLOYEE OASDI UNDER EXECUTIVE ORDER

"Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website, 10/30/20

The IRS has released guidance for preparing Forms W-2 for employers who have deferred employee old age, survivors and disability taxes pursuant to the President's August 8 memorandum, as provided for in Notice 2020-65.[359]

The page describes the impact of the Notice for employers that participated as follows:

> The Notice allows employers the option to defer the employee portion of Social Security tax from September 1, 2020 through December 31, 2020, for eligible employees who earn less than $4,000 per bi-weekly pay period (or the equivalent threshold amount with respect to other pay periods) on a pay period-by-pay period basis. To pay the deferred amount of the employee portion of Social Security tax, the employer will ratably withhold the amount of Social Security tax deferred from the employees' paychecks from January 1, 2021 through April 30, 2021.[360]

The IRS begins by instructing employers that they should continue to report any wages from which social security was not withheld as social security wages, but not include the deferred social security tax withholdings in the social security withheld box:

> If you deferred the employee portion of Social Security tax under Notice 2020-65, when reporting total Social Security wages paid to an employee on Form W-2, Wage and Tax Statement, include any wages for which you deferred withholding and payment of employee Social Security tax in box 3 (Social security wages) and/or box 7 (Social security tips). However, do not include in box 4 (Social security tax withheld) any amount of deferred employee Social Security tax that has not been withheld. [361]

The IRS has decided to require such employers to file Forms W2c, Corrected Tax and Wage Statement, once the taxes have been withheld in 2021:

> Employee Social Security tax deferred in 2020 under Notice 2020-65 that is withheld in 2021 and not reported on the 2020 Form W-2 should be reported in box 4 (Social security tax withheld) on Form W-2c, Corrected Wage and Tax

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[359] "Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website, October 30, 2020, https://www.irs.gov/forms-pubs/form-w-2-reporting-of-employee-social-security-tax-deferred-under-notice-2020-65 (retrieved October 30, 2020)

[360] "Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website

[361] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 3-5 "Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website

Statement. On Form W-2c, employers should enter tax year 2020 in box c and adjust the amount previously reported in box 4 (Social security tax withheld) of the Form W-2 to include the deferred amounts that were withheld in 2021. All Forms W-2c should be filed with SSA, along with Form W-3c, Transmittal of Corrected Wage and Tax Statements, as soon as possible after you have finished withholding the deferred amounts. See the 2021 General Instructions for Forms W-2 and W-3 (to be published in January 2021) for more information about completing and filing Forms W-2c and Forms W-3c. Forms W-2c should also be furnished to employees, and you may direct your employees to (or otherwise provide to them) the Instructions for Employees, below, for instructions specific to this correction. [362]

The IRS provides similar guidance for Railroad Retirement Tax Act items:

> Similarly, when reporting total Railroad Retirement Tax Act (RRTA) compensation include any compensation for which you deferred withholding and payment of the employee Social Security tax equivalent of Tier 1 RRTA tax under Notice 2020-65 in box 14 of the 2020 Form W-2, Wage and Tax Statement. However, do not include in box 14 any amount of deferred employee Tier 1 RRTA tax that has not been withheld.
>
> Employee RRTA tax deferred in 2020 under Notice 2020-65 that is withheld in 2021 and not reported on the 2020 Form W-2 should be reported in box 14 on Form W-2c for 2020. On Form W-2c, employers should adjust the amount previously reported as Tier 1 tax in box 14 of the Form W-2 to include the deferred amounts that were withheld in 2021. See the 2021 General Instructions for Forms W-2 and W-3 (to be published in January 2021) for more information about completing and filing Forms W-2c and Form W-3c, Transmittal of Corrected Wage and Tax Statements. Employee copies of Forms W-2c should be furnished to employees, and you may direct your employees to (or otherwise provide to them) the Instructions for Employees, below, for instructions specific to this correction. [363]

The IRS provides guidance to employees, primarily warning those that have multiple employers that they may need to wait for the Form W2c to determine if there has been excess FICA withheld from those employers:

> If you had only one employer during 2020 and your Form W-2c, Corrected Wages and Tax Statement, for 2020 only shows a correction to box 4 (or to box 14 for employees who pay RRTA tax) to account for employee Social Security (or Tier 1 RRTA tax) that was deferred in 2020 and withheld in 2021 pursuant to Notice 2020-65, no further steps are required. However, if you had two or more employers in 2020 and your Form W-2c for 2020 shows a correction to box 4 (or to box 14 for employees who pay RRTA tax) to account for employee Social Security (or Tier 1 RRTA tax) that was deferred in 2020 and withheld in 2021, you should use the amount of Social Security tax (or Tier 1 RRTA tax) withheld reported on the Form

[362] "Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website

[363] "Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website

W-2c to determine whether you had excess Social Security tax (or Tier 1 RRTA tax) on wages (or compensation) paid in 2020.

If the corrected amount in box 4 of the Form W-2c for 2020 causes the total amount of employee Social Security tax (or equivalent portion of the Tier 1 RRTA tax) withheld by all of your employers to exceed the maximum amount ($8,537.40) of tax that you owe, or increases an already existing excess amount of employee Social Security tax (or Tier 1 RRTA tax withheld), then you should file Form 1040-X, Amended U.S. Individual Income Tax Return, to claim a credit for the excess Social Security tax (or Tier 1 RRTA tax) withheld. See the instructions to line 10 of Schedule 3 in the 2020 Instructions for Form 1040 and Form 1040-SR for more information. [364]

[364] "Form W-2 Reporting of Employee Social Security Tax Deferred under Notice 2020-65," IRS website

NOTES

Unit

10

Payroll Protection Program Loans

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Be able to compute the maximum available borrowing and the amount of loan forgiveness available to an employer under the Payroll Protection Program loans
- Advise clients on the pros and cons of making use of this program, as compared to relying on other portions of the CARES Act economic relief package

Two key provisions relate to Small Business Administration loan programs. Businesses making use of these programs will give up either one or two of the payroll tax credits in the CARES Act, but the program offers the possibility of a "loan" that the business will never have to repay—and not have to include the debt discharge in income.

Note—this course is not a course in SBA loan rules and the descriptions here are meant to allow the reader to generally understand the program for purpose of understanding the related payroll tax credits that are available in lieu of taking advantage of the loan and the forgiveness provisions.

PAYCHECK PROTECTION PROGRAM (CARES ACT §1102)

A new category of Section 7(a) loans are provided as part of the CARES Act. Payroll Protection Program loans are added at Small Business Act Section 7(a)(36).

A business that took out a disaster loan under Section 7(b)(2) during the period beginning on January 31, 2020 is allowed to refinance the loan as a 7(a) payroll protection loan, allowing use of the more generous terms allowed for such loans.[365]

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[365] Small Business Act Section 7(a)(36)(F)(iv)

As long as the loan is used for the authorized purposes, the debt will be a nonrecourse debt.[366] As well, during the covered period no personal guarantee of the loan is required, nor is any collateral required for the covered loan.[367]

The loan bears interest at a maximum rate of 4%.[368]

Repayments on the loans for those who were in operation on February 15, 2020 and who have an application for a covered loan approved on or after March 27, 2020 were originally scheduled to be deferred for a minimum of 6 months but not more than 1 year.[369]

However, the Paycheck Protection Program Flexibility Act, signed into law on June 6, 2020, changed this deferral period. The PPPFA expands the deferral period found in Section 7(a)(36)(M) of the Small Business Act, now providing that the SBA will require lenders under this program to "provide complete payment deferral relief for impacted borrowers with covered loans, including payment of principal, interest, and fees, until the date on which the amount of forgiveness determined under section 1106 of the CARES Act is remitted to the lender."[370]

A similar deferral rule applies to loans sold on the secondary market.[371]

However, if a borrower waits too long to apply for forgiveness, the law will require payments to begin. The PPPFA adds Section 7(a)(36)(M)(iv) of the Small Business Act which reads:

> (v) RULE OF CONSTRUCTION.—If an eligible recipient fails to apply for forgiveness of a covered loan within 10 months after the last day of the covered period defined in section 1106(a) of the CARES Act, such eligible recipient shall make payments of principal, interest, and fees on such covered loan beginning on the day that is not earlier than the date that is 10 months after the last day of such covered period.

The Treasury/SBA announcement provides a summary of this, noting the limit applied by the 10-month rule:

> Extend the deferral period for borrower payments of principal, interest, and fees on PPP loans to the date that SBA remits the borrower's loan forgiveness amount to the lender (or, if the borrower does not apply for loan forgiveness, 10 months after the end of the borrower's loan forgiveness covered period).[372]

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[366] Small Business Act Section 7(a)(36)(F)(v)

[367] Small Business Act Section 7(a)(36)(J)

[368] Small Business Act Section 7(a)(36)(L)

[369] Small Business Act Section 7(a)(36)(M)

[370] HR 7010, Act Section 3(c)(1)

[371] HR 7010, Act Section 3(c)(2)

[372] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

To the extent the loan is not forgiven under CARES Act §1106, the debt may have a maximum maturity of 10 years from the date the borrower applies for loan forgiveness.[373]

The SBA had previously provided that PPP loans would have a 2-year maturity, even though the law provided for a maximum maturity of up to 10 years. Congress has now modified the law to provide that PPP loans will have a minimum maturity of 5 years.[374]

The Paycheck Protection Program Flexibility Act revised the rules, providing the following effective date for this provision:

> The amendment made by this section shall take effect on the date of the enactment[375] of this Act and shall apply to any loan made pursuant to section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)) on or after such date. Nothing in this Act, the CARES Act (Public Law 116–136), or the Paycheck Protection Program and Health Care Enhancement Act (Public Law 116–139) shall be construed to prohibit lenders and borrowers from mutually agreeing to modify the maturity terms of a covered loan described in subparagraph (K) of such section to conform with requirements of this section.[376]

Thus, while lenders and borrowers are not required to modify loans to provide for a longer payment period, the law will allow such a modification to be made.

The Treasury/SBA announcement clarifies the date for the 5-year loan is based on when the SBA approves the loan:

> Increase to five years the maturity of PPP loans that are approved by SBA (based on the date SBA assigns a loan number) on or after June 5, 2020.[377]

A party applying for one of these loans must make a good faith certification:

- That the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient;
- Acknowledging that funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments;
- That the eligible recipient does not have an application pending for a loan under this subsection for the same purpose and duplicative of amounts applied for or received under a covered loan; and

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[373] Small Business Act Section 7(a)(36)(K)

[374] HR 7010, Act Section 2(a)

[375] June 5, 2020

[376] HR 7010, Act Section 2(b)

[377] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

- During the period beginning on February 15, 2020 and ending on December 31, 2020, that the eligible recipient has not received amounts under this subsection for the same purpose and duplicative of amounts applied for or received under a covered loan.[378]

Following reports of receipts of PPP loan proceeds being received by three prominent restaurant chains that are public companies, Senator Marco Rubio (R-Fla) took to Twitter with comments that suggest a different interpretation of the first certification than many applicants likely believed was the case. In a *Tax Notes Today Federal* story published on April 22, 2020, the Senator's tweet was quoted as follows:

> A lawmaker who helped create the federal loan program to aid struggling businesses during the economic downturn warns that some companies that took advantage of the program could be in trouble down the road.
>
> Sen. Marco Rubio, R-Fla., said in a tweet April 20 that the Paycheck Protection Program (PPP) loan certification is "real and enforceable."
>
> "That is why any company (of any size) that hasn't been harmed by the current economic conditions & nevertheless applies for & receives a #PPP has a big problem. They made a false certification to the federal government," Rubio wrote.[379]

The Senator, who chairs the Senate Committee on Small Business and Entrepreneurship, followed up that tweet with a press release on his website where he went on to state:

> "The Paycheck Protection Program was designed to help small businesses keep employees on payroll during incredibly difficult economic circumstances," Chairman Rubio said. "More than one million small businesses have used the program exactly as intended, and by some estimates it has saved 30 million jobs. However, we also have multiple reports of companies abusing the program.
>
> "Any business, regardless of size, must certify it has been harmed by the coronavirus crisis and that PPP is necessary to maintain operations," Chairman Rubio continued. "This fall, the Senate Committee on Small Business and Entrepreneurship will conduct aggressive oversight into the use of the PPP. If companies are not forthcoming, the Committee will use its subpoena power to compel cooperation."[380]

The *covered period* runs from February 15, 2020 to June 30, 2020.[381]

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[378] Small Business Act Section 7(a)(36)(G)

[379] Eric Yauch, "Rubio's Comments on PPP Loans Cause Confusion," *Tax Notes Today Federal*, April 22, 2020, https://www.taxnotes.com/tax-notes-today-federal/politics-taxation/republican-senator-raises-eyebrows-comments-ppp-loans/2020/04/22/2cftk, (subscription required – retrieved April 22, 2020)

[380] "Rubio: Small Business Committee Will Use Subpoena Power to Review Paycheck Protection Program Compliance", Website of Senator Marco Rubio, https://www.rubio.senate.gov/public/index.cfm/press-releases?ID=B19E0714-0DED-408C-A564-F0E6AF01CEEA, April 20, 2020, retrieved April 22, 2020

[381] Small Business Act Section 7(a)(36)(A)(iii)

Payroll costs means the sum of payments of any compensation with respect to:

- Salary, wage, commission, or similar compensation;
- Payment of cash tip or equivalent;
- Payment for vacation, parental, family, medical or sick leave;
- Allowance for dismissal or separation;
- Payments required for provision of group health benefits, including insurance premiums;
- Payment of any retirement benefit; or
- Payment of State or local tax assessed on the compensation of employees.[382]

In addition, payroll costs include the sum of payments of any compensation to or income of a sole proprietor or independent contractor that is a wage, commission, income, net earnings from self-employment or similar compensation.[383]

However, payroll costs do not include:

- The compensation of an individual employee in excess of an annual salary of $100,000 as prorated for the covered period (the same rule applies to the self-employed person or independent contractor's compensation);
- Payroll taxes under Chapters 21 (Federal Insurance Contributions Act), 22 (Railroad Retirement Act) or 24 (Collection of Income Tax at Source) of the Internal Revenue Code;
- Any compensation of an employee whose principal place of residence is outside the United States; and
- Qualified sick leave or family leave for which a credit is available under the Families First Coronavirus Response Act.[384]

The maximum loan amount under this program is the sum of:

- The product obtained by multiplying
  - The average total amount for monthly payroll costs incurred in the 1-year period prior to the date on which the loan is made by
  - 2.5 and

[382] Small Business Act Section 7(a)(36)(A)(vii)(I)

[383] Small Business Act Section 7(a)(36)(A)(vii)(I)

[384] Small Business Act Section 7(a)(36)(A)(vii)(II)

- The outstanding amount of a (b)(2) disaster loan made during the period beginning on January 31, 2020 and ending on the date on which covered loans are made available to be refinanced under the covered loan.[385]

An alternative maximum calculation can be requested by otherwise eligible borrowers who were not in business during the period beginning on February 15, 2019 and ending on June 30, 2019 that uses wages from the first two months of 2020.[386]

In no event will the loan be for more than $10,000,000.[387]

A sense of the Senate clause indicates that guidance should be issued to lenders and agents to ensure processing and disbursement of the loans prioritizes small business concerns and entities in underserved and rural markets including:

- Veterans and members of the military community;
- Small business concerns owned and controlled by socially and economically disadvantaged individuals;
- Women; and
- Businesses in operation less than 2 years.[388]

There will be no penalty for prepaying this loan.[389]

On March 31, 2020, the U.S. issued a press release[390] that provided the following information about these loans.

LOAN TERMS & CONDITIONS

- Eligible businesses: All businesses, including non-profits, Veterans organizations, Tribal concerns, sole proprietorships, self-employed individuals, and independent contractors, with 500 or fewer employees, or no greater than the number of employees set by the SBA as the size standard for certain industries
- Maximum loan amount up to $10 million

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[385] Small Business Act Section 7(a)(36)(E)(i)(I)

[386] Small Business Act Section 7(a)(36)(E)(i)(II)

[387] Small Business Act Section 7(a)(36)(E)(ii)

[388] Small Business Act Section 7(a)(36)(P)(iv)

[389] Small Business Act Section 7(a)(36)(R)

[390] "With $349 Billion in Emergency Small Business Capital Cleared, Treasury and SBA Begin Unprecedented Public-Private Mobilization Effort to Distribute Funds," United States Treasury website, March 31, 2020, https://home.treasury.gov/news/press-releases/sm961

- Loan forgiveness if proceeds used for payroll costs and other designated business operating expenses in the 8 weeks following the date of loan origination (due to likely high subscription, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs)

- All loans under this program will have the following identical features:

  - Interest rate of 0.5% (later changed to 1% before the first loans were issued)

  - Maturity of 2 years[391]

  - First payment deferred for six months

  - 100% guarantee by SBA

  - No collateral

  - No personal guarantees

  - No borrower or lender fees payable to SBA

Following the passage of the Paycheck Protection Program Flexibility act, the Treasury Department posted updated borrower[392] and lender[393] application forms.

[391] This term was changed to 5 years by the Paycheck Program Flexibility Act enacted on June 5, 2020 for loans approved by the SBA on or after June 5, 2020. Borrowers and lenders that had loans approved before that date can agree to change the term to five years.

[392] https://home.treasury.gov/system/files/136/PPP-Borrower-Application-Form-Revised-June-12-2020.pdf

[393] https://home.treasury.gov/system/files/136/PPP-Lender-Application-Form-Revised-June-12-2020.pdf

The revised four-page borrower form is reproduced below:

Paycheck Protection Program
Borrower Application Form Revised June 12, 2020

OMB Control No.: 3245-0407
Expiration Date: 10/31/2020

Check One: ❑ Sole proprietor ❑ Partnership ❑ C-Corp ❑ S-Corp ❑ LLC ❑ Independent contractor ❑ Eligible self-employed individual ❑ 501(c)(3) nonprofit ❑ 501(c)(19) veterans organization ❑ Tribal business (sec. 31(b)(2)(C) of Small Business Act) ❑ Other	DBA or Tradename if Applicable	
Business Legal Name		
Business Address	Business TIN (EIN, SSN)	Business Phone
		( ) -
	Primary Contact	Email Address

Average Monthly Payroll:	$	x 2.5 + EIDL, Net of Advance (if Applicable) Equals Loan Request:	$	Number of Employees:	
Purpose of the loan (select more than one):	❑ Payroll ❑ Lease / Mortgage Interest ❑ Utilities ❑ Other (explain): ________________				

Applicant Ownership

List all owners of 20% or more of the equity of the Applicant. Attach a separate sheet if necessary.

Owner Name	Title	Ownership %	TIN (EIN, SSN)	Address

If questions (1) or (2) below are answered "Yes," the loan will not be approved.

Question	Yes	No
1. Is the Applicant or any owner of the Applicant presently suspended, debarred, proposed for debarment, declared ineligible, voluntarily excluded from participation in this transaction by any Federal department or agency, or presently involved in any bankruptcy?	❑	❑
2. Has the Applicant, any owner of the Applicant, or any business owned or controlled by any of them, ever obtained a direct or guaranteed loan from SBA or any other Federal agency that is currently delinquent or has defaulted in the last 7 years and caused a loss to the government?	❑	❑
3. Is the Applicant or any owner of the Applicant an owner of any other business, or have common management with any other business? If yes, list all such businesses and describe the relationship on a separate sheet identified as addendum A.	❑	❑
4. Has the Applicant received an SBA Economic Injury Disaster Loan between January 31, 2020 and April 3, 2020? If yes, provide details on a separate sheet identified as addendum B.	❑	❑

If questions (5) or (6) are answered "Yes," the loan will not be approved.

Question	Yes	No
5. Is the Applicant (if an individual) or any individual owning 20% or more of the equity of the Applicant subject to an indictment, criminal information, arraignment, or other means by which formal criminal charges are brought in any jurisdiction, or presently incarcerated, or on probation or parole? Initial here to confirm your response to question 5 → ____________	❑	❑
6. Within the last 5 years, for any felony involving fraud, bribery, embezzlement, or a false statement in a loan application or an application for federal financial assistance, or within the last year, for any other felony, has the Applicant (if an individual) or any owner of the Applicant 1) been convicted; 2) pleaded guilty; 3) pleaded nolo contendere; or 4) been placed on any form of parole or probation (including probation before judgment)? Initial here to confirm your response to question 6 → ____________	❑	❑
7. Is the United States the principal place of residence for all employees of the Applicant included in the Applicant's payroll calculation above?	❑	❑
8. Is the Applicant a franchise that is listed in the SBA's Franchise Directory?	❑	❑

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SBA Form 2483 (06/20)

Paycheck Protection Program
Borrower Application Form Revised June 12, 2020

<u>By Signing Below, You Make the Following Representations, Authorizations, and Certifications</u>

<u>CERTIFICATIONS AND AUTHORIZATIONS</u>

I certify that:

- I have read the statements included in this form, including the Statements Required by Law and Executive Orders, and I understand them.
- The Applicant is eligible to receive a loan under the rules in effect at the time this application is submitted that have been issued by the Small Business Administration (SBA) implementing the Paycheck Protection Program under Division A, Title I of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (the Paycheck Protection Program Rule).
- The Applicant (1) is an independent contractor, eligible self-employed individual, or sole proprietor or (2) employs no more than the greater of 500 or employees or, if applicable, the size standard in number of employees established by the SBA in 13 C.F.R. 121.201 for the Applicant's industry.
- I will comply, whenever applicable, with the civil rights and other limitations in this form.
- All SBA loan proceeds will be used only for business-related purposes as specified in the loan application and consistent with the Paycheck Protection Program Rule.
- To the extent feasible, I will purchase only American-made equipment and products.
- The Applicant is not engaged in any activity that is illegal under federal, state or local law.
- Any loan received by the Applicant under Section 7(b)(2) of the Small Business Act between January 31, 2020 and April 3, 2020 was for a purpose other than paying payroll costs and other allowable uses loans under the Paycheck Protection Program Rule.

For Applicants who are individuals: I authorize the SBA to request criminal record information about me from criminal justice agencies for the purpose of determining my eligibility for programs authorized by the Small Business Act, as amended.

<u>CERTIFICATIONS</u>

The authorized representative of the Applicant must certify in good faith to all of the below by **initialing** next to each one:

_____ The Applicant was in operation on February 15, 2020 and had employees for whom it paid salaries and payroll taxes or paid independent contractors, as reported on Form(s) 1099-MISC.

_____ Current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.

_____ The funds will be used to retain workers and maintain payroll or make mortgage interest payments, lease payments, and utility payments, as specified under the Paycheck Protection Program Rule; I understand that if the funds are knowingly used for unauthorized purposes, the federal government may hold me legally liable, such as for charges of fraud.

_____ The Applicant will provide to the Lender documentation verifying the number of full-time equivalent employees on the Applicant's payroll as well as the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the 24-week period following this loan.

_____ I understand that loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities, and not more than 40% of the forgiven amount may be for non-payroll costs.

_____ During the period beginning on February 15, 2020 and ending on December 31, 2020, the Applicant has not and will not receive another loan under the Paycheck Protection Program.

_____ I further certify that the information provided in this application and the information provided in all supporting documents and forms is true and accurate in all material respects. I understand that knowingly making a false statement to obtain a guaranteed loan from SBA is punishable under the law, including under 18 USC 1001 and 3571 by imprisonment of not more than five years and/or a fine of up to $250,000; under 15 USC 645 by imprisonment of not more than two years and/or a fine of not more than $5,000; and, if submitted to a federally insured institution, under 18 USC 1014 by imprisonment of not more than thirty years and/or a fine of not more than $1,000,000.

_____ I acknowledge that the lender will confirm the eligible loan amount using required documents submitted. I understand, acknowledge and agree that the Lender can share any tax information that I have provided with SBA's authorized representatives, including authorized representatives of the SBA Office of Inspector General, for the purpose of compliance with SBA Loan Program Requirements and all SBA reviews.

______________________________ ______________
Signature of Authorized Representative of Applicant Date

______________________________ ______________
Print Name Title

Paycheck Protection Program
Borrower Application Form Revised June 12, 2020

Purpose of this form:

This form is to be completed by the authorized representative of the Applicant and ***submitted to your SBA Participating Lender***. Submission of the requested information is required to make a determination regarding eligibility for financial assistance. Failure to submit the information would affect that determination.

Instructions for completing this form:

With respect to "purpose of the loan," payroll costs consist of compensation to employees (whose principal place of residence is the United States) in the form of salary, wages, commissions, or similar compensation; cash tips or the equivalent (based on employer records of past tips or, in the absence of such records, a reasonable, good-faith employer estimate of such tips); payment for vacation, parental, family, medical, or sick leave; allowance for separation or dismissal; payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums, and retirement; payment of state and local taxes assessed on compensation of employees; and for an independent contractor or sole proprietor, wage, commissions, income, or net earnings from self-employment or similar compensation.

For purposes of calculating "Average Monthly Payroll," most Applicants will use the average monthly payroll for 2019, excluding costs over $100,000 on an annualized basis for each employee. For seasonal businesses, the Applicant may elect to instead use average monthly payroll for the time period between February 15, 2019 and June 30, 2019 or any 12-week period between May 1, 2019 and September 15, 2019, excluding costs over $100,000 on an annualized basis for each employee. For new businesses, average monthly payroll may be calculated using the time period from January 1, 2020 to February 29, 2020, excluding costs over $100,000 on an annualized basis for each employee.

If Applicant is refinancing an Economic Injury Disaster Loan (EIDL): Add the outstanding amount of an EIDL made between January 31, 2020 and April 3, 2020, less the amount of any "advance" under an EIDL COVID-19 loan, to Loan Request as indicated on the form.

All parties listed below are considered owners of the Applicant as defined in 13 CFR § 120.10, as well as "principals":

- For a sole proprietorship, the sole proprietor;
- For a partnership, all general partners, and all limited partners owning 20% or more of the equity of the firm;
- For a corporation, all owners of 20% or more of the corporation;
- For limited liability companies, all members owning 20% or more of the company; and
- Any Trustor (if the Applicant is owned by a trust).

Paperwork Reduction Act – You are not required to respond to this collection of information unless it displays a currently valid OMB Control Number. The estimated time for completing this application, including gathering data needed, is 8 minutes. Comments about this time or the information requested should be sent to: Small Business Administration, Director, Records Management Division, 409 3rd St., SW, Washington DC 20416, and/or SBA Desk Officer, Office of Management and Budget, New Executive Office Building, Washington DC 20503. **PLEASE DO NOT SEND FORMS TO THESE ADDRESSES.**

Privacy Act (5 U.S.C. 552a) – Under the provisions of the Privacy Act, you are not required to provide your social security number. Failure to provide your social security number may not affect any right, benefit or privilege to which you are entitled. (But see Debt Collection Notice regarding taxpayer identification number below.) Disclosures of name and other personal identifiers are required to provide SBA with sufficient information to make a character determination. When evaluating character, SBA considers the person's integrity, candor, and disposition toward criminal actions. Additionally, SBA is specifically authorized to verify your criminal history, or lack thereof, pursuant to section 7(a)(1)(B), 15 USC Section 636(a)(1)(B) of the Small Business Act (the Act).

Disclosure of Information – Requests for information about another party may be denied unless SBA has the written permission of the individual to release the information to the requestor or unless the information is subject to disclosure under the Freedom of Information Act. The Privacy Act authorizes SBA to make certain "routine uses" of information protected by that Act. One such routine use is the disclosure of information maintained in SBA's system of records when this information indicates a violation or potential violation of law, whether civil, criminal, or administrative in nature. Specifically, SBA may refer the information to the appropriate agency, whether Federal, State, local or foreign, charged with responsibility for, or otherwise involved in investigation, prosecution, enforcement or prevention of such violations. Another routine use is disclosure to other Federal agencies conducting background checks but only to the extent the information is relevant to the requesting agencies' function. See, 74 F.R. 14890 (2009), and as amended from time to time for additional background and other routine uses. In addition, the CARES Act, requires SBA to register every loan made under the Paycheck Protection Act using the Taxpayer Identification Number (TIN) assigned to the borrower.

Debt Collection Act of 1982, Deficit Reduction Act of 1984 (31 U.S.C. 3701 et seq. and other titles) – SBA must obtain your taxpayer identification number when you apply for a loan. If you receive a loan, and do not make payments as they come due, SBA may: (1) report the status of your loan(s) to credit bureaus, (2) hire a collection agency to collect your loan, (3) offset your income tax refund or other amounts due to you from the Federal Government, (4) suspend or debar you or your company from doing business with the Federal Government, (5) refer your loan to the Department of Justice, or (6) foreclose on collateral or take other action permitted in the loan instruments.

Right to Financial Privacy Act of 1978 (12 U.S.C. 3401) – The Right to Financial Privacy Act of 1978, grants SBA access rights to financial records held by financial institutions that are or have been doing business with you or your business including any financial institutions participating in a loan or loan guaranty. SBA is only required provide a certificate of its compliance with the Act to a financial institution in connection with its first request for access to your financial records. SBA's access rights continue for the term of any approved loan guaranty agreement. SBA is also authorized to transfer to another Government authority any financial records concerning an approved loan or loan guarantee, as necessary to process, service or foreclose on a loan guaranty or collect on a defaulted loan guaranty.

Freedom of Information Act (5 U.S.C. 552) – Subject to certain exceptions, SBA must supply information reflected in agency files and records to a person requesting it. Information about approved loans that will be automatically released includes, among other things, statistics on our loan programs (individual borrowers are not identified in the statistics) and other information such as the names of the borrowers (and their officers, directors, stockholders or partners), the collateral pledged to secure the loan, the amount of the loan, its purpose in general terms and the maturity. Proprietary data on a borrower would not routinely be made available to third parties. All requests under this Act are to be addressed to the nearest SBA office and be identified as a Freedom of Information request.

Occupational Safety and Health Act (15 U.S.C. 651 et seq.) – The Occupational Safety and Health Administration (OSHA) can require businesses to modify facilities and procedures to protect employees. Businesses that do not comply may be fined, forced to cease operations, or prevented from starting operations. Signing this form is certification that the applicant, to the best of its knowledge, is in compliance with the applicable OSHA requirements, and will remain in compliance during the life of the loan.

Civil Rights (13 C.F.R. 112, 113, 117) – All businesses receiving SBA financial assistance must agree not to discriminate in any business practice, including employment practices and services to the public on the basis of categories cited in 13 C.F.R., Parts 112, 113, and 117 of SBA Regulations. All borrowers must display the "Equal Employment Opportunity Poster" prescribed by SBA.

Equal Credit Opportunity Act (15 U.S.C. 1691) – Creditors are prohibited from discriminating against credit applicants on the basis of race, color, religion, national origin, sex, marital status or age (provided the applicant has the capacity to enter into a binding contract); because all or part of the applicant's income derives from any public assistance program; or because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

Debarment and Suspension Executive Order 12549; (2 CFR Part 180 and Part 2700) – By submitting this loan application, you certify that neither the Applicant or any owner of the Applicant have within the past three years been: (a) debarred, suspended, declared ineligible or voluntarily excluded from participation in a transaction by any Federal Agency; (b) formally proposed for debarment, with a final determination still pending; (c) indicted, convicted, or had a civil judgment rendered against you for any of the offenses listed in the regulations or (d) delinquent on any amounts owed to the U.S. Government or its instrumentalities as of the date of execution of this certification.

PAYROLL PROTECTION PROGRAM FLEXIBILITY ACT OF 2020 ENACTED INTO LAW

Paycheck Protection Program Flexibility Act of 2020, 6/4/20

Congress has now passed the Paycheck Protection Program Flexibility Act of 2020 (PPPFA),[394] with the Act passing the Senate by unanimous consent in the early evening hours of June 3, 2020. The Act changes a number of provisions in the original PPP loan program enacted as part of the CARES Act. The President signed the bill into law on June 5, 2020 (the date of enactment).

On Monday June 8, 2020, Treasury Secretary Steven Mnuchin and SBA Administrator Jovita Carranza have issue a joint statement that provides certain details about the SBA's planned implementation of changes found in the law.[395]

Change in Loan Maturity

The SBA had previously provided that PPP loans would have a 2-year maturity, even though the law provided for a maximum maturity of up to 10 years. Congress has now modified the law to provide that PPP loans will have a minimum maturity of 5 years.[396]

The Act provides the following effective date for this provision:

> The amendment made by this section shall take effect on the date of the enactment[397] of this Act and shall apply to any loan made pursuant to section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)) on or after such date. Nothing in this Act, the CARES Act (Public Law 116–136), or the Paycheck Protection Program and Health Care Enhancement Act (Public Law 116–139) shall be construed to prohibit lenders and borrowers from mutually agreeing to modify the maturity terms of a covered loan described in subparagraph (K) of such section to conform with requirements of this section.[398]

Thus, while lenders and borrowers are not required to modify loans to provide for a longer payment period, the law will allow such a modification to be made.

The Treasury/SBA announcement clarifies the date for the 5-year loan is based on when the SBA approves the loan:

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[394] HR 7010, "Paycheck Protection Program Flexibility Act of 2020," Passed United States Senate June 3, 2020, https://www.congress.gov/bill/116th-congress/house-bill/7010/text (retrieved June 3, 2020)

[395] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020, https://home.treasury.gov/news/press-releases/sm1026#.Xt5OGz-FqJc.mailto (retrieved June 8, 2020)

[396] HR 7010, Act Section 2(a)

[397] June 5, 2020

[398] HR 7010, Act Section 2(b)

> Increase to five years the maturity of PPP loans that are approved by SBA (based on the date SBA assigns a loan number) on or after June 5, 2020.[399]

Covered Period Extension for a PPP Loan

The Act has modified the *covered period* in the PPP loan program definition found at Small Business Act §7(a)(36)(A)(iii) to change the ending date from June 30, 2020 to December 31, 2020.[400] The covered period in this section now runs from February 15, 2020 to December 31, 2020. A *covered loan* is a loan made under this program during the covered period, and this covered period is referenced in other portions of the PPP loan provisions found in the CARES Act Section 1102.

Senator Johnson of Wisconsin had initially withheld his support until he received assurance that the intent of the bill was not to extend the period when loans would be approved past June 30, 2020. The statement provides: "the new rules will confirm that June 30, 2020, remains the last date on which a PPP loan application can be approved."[401]

Forgiveness Changes

The separate CARES Act Section 1106 *covered period* is also modified by the PPPFA. Under the CARES Act this covered period was the 8-week period beginning with the date of origination of the PPP loan. The date of origination was later defined by the SBA as the date that funds were received by the borrower from the loan. This *covered period* is the period that a borrower had to spend the funds for appropriate uses to obtain forgiveness.

Under the revised rule, that period is now tripled for most loans. The new provision reads:

> (3) the term 'covered period' means, subject to subsection (l), the period beginning on the date of the origination of a covered loan and ending the earlier of—
>
> > (A) the date that is 24 weeks after such date of origination; or
> >
> > (B) December 31, 2020[402]

However, as noted above, "subsection (l)" modifies this period to allow those who had the PPP loans before this revision was passed to retain the 8-week covered period. That provision provides:

> An eligible recipient that received a covered loan before the date of enactment[403] of this subsection may elect for the covered period applicable to such covered loan to

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[399] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

[400] HR 7010, Act Section 3(a)

[401] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

[402] HR 7010, Section 3(b)(1)

[403] June 5, 2020

> end on the date that is 8 weeks after the date of the origination of such covered loan.[404]

Why would a borrower want an 8-week period rather than a 24-week period? A key reason is that the FTE reduction rule measures average FTEs during the covered period. So while 24 weeks gives borrowers a longer period during which they can spend the money and qualify for forgiveness, it also increases the period over which the employer

- Must maintain the FTE level under CARES Act Section 1106(d)(2) and
- Must avoid a reduction of salary and wages under CARES Act Section 1106(d)(3)

if the employer cannot meet the restoration of FTEs and salary/wages under CARES Act Section 1106(d)(5). The restoration deadline under that section is moved by the PPPFA from June 30, 2020 to December 31, 2020.[405]

One key issue not yet addressed by Treasury or the SBA is the impact on the extension of this period on the limitation on owner compensation allowed to be used to obtain forgiveness of the loan. While the $100,000 limits on each employee's compensation generally should rise (since has that limit prorated over the covered period, which now is three times longer, raising the number to $46,154), the limits based on 2019 income were the SBA's own creations, presumably to keep owners from using the funds solely to pay themselves. Whether the SBA will decide that number should rise to 24/52 remains to be determined.

Added Exemption Based on Employee Availability

The PPPFA adds a new relief provision that will prevent a reduction in forgiveness in additional circumstances.

The new provision, found at revised CARES Act Section 1106(d)(7), provides:

> (7) EXEMPTION BASED ON EMPLOYEE AVAILABILITY.—During the period beginning on February 15, 2020, and ending on December 31, 2020, the amount of loan forgiveness under this section shall be determined without regard to a proportional reduction in the number of full-time equivalent employees if an eligible recipient, in good faith—
>
> > (A) is able to document—
> >
> > > (i) an inability to rehire individuals who were employees of the eligible recipient on February 15, 2020; and
> > >
> > > (ii) an inability to hire similarly qualified employees for unfilled positions on or before December 31, 2020; or

[404] HR 7010, Section 3(b)(3)

[405] HR 7010, Section 3(b)(2)

> (B) is able to document an inability to return to the same level of business activity as such business was operating at before February 15, 2020, due to compliance with requirements established or guidance issued by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration during the period beginning on March 1, 2020, and ending December 31, 2020, related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID–19.[406]

This change may serve to grant relief if the employer is unable to rehire employees or has to reduce staff to comply with requirements imposed on a business to control COVID-19, such as reducing the number of customers served to enable social distancing.

The Treasury/SBA announcement provides a limited amount of information on these safe harbors.

The statement describes the first safe harbor related to being unable to return to the same level of activity, noting that the rules will:

> Provide a safe harbor from reductions in loan forgiveness based on reductions in full-time equivalent employees for borrowers that are unable to return to the same level of business activity the business was operating at before February 15, 2020, due to compliance with requirements or guidance issued between March 1, 2020 and December 31, 2020 by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration, related to worker or customer safety requirements related to COVID–19.[407]

The second safe harbor deals with employers that are unable to rehire employees they had on staff on February 15. The rules will:

> Provide a safe harbor from reductions in loan forgiveness based on reductions in full-time equivalent employees, to provide protections for borrowers that are both unable to rehire individuals who were employees of the borrower on February 15, 2020, and unable to hire similarly qualified employees for unfilled positions by December 31, 2020.[408]

60% of Loan Proceeds on Payroll Costs

In what initially appeared something that could have been either good news or bad news for a borrower, the PPPFA added a minimum payroll cost requirement for use of the funds in order, the

[406] HR 7010, Section 3(b)(2)(B)

[407] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

[408] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

law stated, to obtain forgiveness. Under the rules established by the SBA for the original PPP loan program, a minimum of 75% of the amount forgiven for a PPP loan had to be paid for payroll costs.

EXAMPLE OF ORIGINAL FORGIVENESS 75% TEST

Arrow, Inc. obtained a PPP loan of $100,000. During the covered period, Arrow Inc. spends $60,000 on payroll costs and $40,000 on other allowable costs. Under the original rules for forgiveness for the PPP program, Arrow, Inc. is eligible for forgiveness of $80,000 ($60,000 is 75% of $80,000) and would need to repay the $20,000 additional portion of the loan under the repayment terms.

Under the PPPFA, the law now provides, in revised CARES Act Section 1106(d)(8):

> (8) LIMITATION ON FORGIVENESS.—To receive loan forgiveness under this section, an eligible recipient shall use at least 60 percent of the covered loan amount for payroll costs, and may use up to 40 percent of such amount for any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation), any payment on any covered rent obligation, or any covered utility payment.[409]

The reduction in the percentage to 60% was clearly good news, since many businesses had reported that they could not meet that standard. In fact, under the 8/52 and 2.5 months rules for a sole proprietor, the maximum loan allowed for to a proprietor with no employees would be larger than the allowed amount to be treated as income replacement (8/52 of 2019 net income on Schedule C) divided by 0.75, which represented the maximum loan forgiveness.

EXAMPLE UNDER NEW PROVISION

In the earlier example, Arrow, Inc. would now qualify for full forgiveness of the loan, as they spent 60% of the borrowed funds on payroll costs and used the remaining funds for other covered costs.

Note that since the requirement is that a minimum be spent on payroll costs, Arrow could have spent $75,000 or even the entire $100,000 on payroll costs and still receive full forgiveness.

But the statement that the 60% of the covered loan amount had to be used for payroll costs "to receive loan forgiveness" under CARES Act 1106 suggested that falling short by $1 could cause the borrower to be denied any forgiveness

EXAMPLE UNDER WHAT APPEARED TO BE THE RULES UNDER PPPFA

If, in fact, 60% of the original $100,000 loan amount had to be spent to receive any forgiveness under CARES Act §1106, if Arrow, Inc. only spends $59,999 on payroll costs and $40,001 on other allowable costs, Arrow would be required to repay the entire loan under the revised provision added by the PPPFA.

However, the announcement indicates that the SBA guidance will provide that a minimum of 60% of the amount forgiven must consist of payroll costs, rather than providing that if less than 60% of the loan proceeds are used for payroll costs there would be no forgiveness of the loan.

[409] HR 7010, Section 3(b)(2)(B)

The statement provides that the change will:

> Lower the requirements that 75 percent of a borrower's loan proceeds must be used for payroll costs and that 75 percent of the loan forgiveness amount must have been spent on payroll costs during the 24-week loan forgiveness covered period to 60 percent for each of these requirements. If a borrower uses less than 60 percent of the loan amount for payroll costs during the forgiveness covered period, the borrower will continue to be eligible for partial loan forgiveness, subject to at least 60 percent of the loan forgiveness amount having been used for payroll costs.[410]

Extension of Deferral Period

The PPPFA also expands the deferral period found in Section 7(a)(36)(M) of the Small Business Act, now providing that the SBA will require lenders under this program to "provide complete payment deferral relief for impacted borrowers with covered loans, including payment of principal, interest, and fees, until the date on which the amount of forgiveness determined under section 1106 of the CARES Act is remitted to the lender."[411]

A similar deferral rule applies to loans sold on the secondary market.[412]

However, if a borrower waits too long to apply for forgiveness, the law will require payments to begin. The PPPFA adds Section 7(a)(36)(M)(iv) of the Small Business Act which reads:

> (v) RULE OF CONSTRUCTION.—If an eligible recipient fails to apply for forgiveness of a covered loan within 10 months after the last day of the covered period defined in section 1106(a) of the CARES Act, such eligible recipient shall make payments of principal, interest, and fees on such covered loan beginning on the day that is not earlier than the date that is 10 months after the last day of such covered period.

The Treasury/SBA announcement provides a summary of this, noting the limit applied by the 10-month rule:

> Extend the deferral period for borrower payments of principal, interest, and fees on PPP loans to the date that SBA remits the borrower's loan forgiveness amount to the lender (or, if the borrower does not apply for loan forgiveness, 10 months after the end of the borrower's loan forgiveness covered period).[413]

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[410] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

[411] HR 7010, Act Section 3(c)(1)

[412] HR 7010, Act Section 3(c)(2)

[413] "Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act," U.S. Department of the Treasury website, June 8, 2020

Payroll Tax Deferral Available Through End of the Year for Borrowers With Forgiven PPP Debt

The PPPFA removed the provision found at CARES Act Section 2302(a)(3)[414] that required borrowers who received forgiveness of debt to cease the deferral of payment of employer old age, survivors and disability insurance (OASDI).

Now all employers may defer the payment of such taxes for wages paid after March 27, 2020 and before January 1, 2021, paying half of the deferred balance on December 31, 2021 and the other half on December 31, 2022.

IRS RULES THAT NO DEDUCTION WILL BE ALLOWED FOR EXPENSES PAID THAT RESULT IN PPP LOAN FORGIVENESS

Notice 2020-32, 4/30/20

The IRS has answered one of the key unanswered tax questions involving the PPP loan program, and the answer is one that taxpayers will not like. In Notice 2020-32[415] the IRS has provided that any otherwise deductible expenses that result in forgiveness of a PPP loan pursuant to Section 1106 of the CARES Act will not be deductible in computing the taxpayer's income.

The Notice begins by pointing out that while Congress told us PPP loan forgiveness is not taxable income, they said nothing about deducting the expenses paid with such loan proceeds:

> Neither section 1106(i) of the CARES Act nor any other provision of the CARES Act addresses whether deductions otherwise allowable under the Code for payments of eligible section 1106 expenses by a recipient of a covered loan are allowed if the covered loan is subsequently forgiven under section 1106(b) of the CARES Act as a result of the payment of those expenses. This Notice addresses the effect of covered loan forgiveness on the deductibility of payments of eligible section 1106 expenses.[416]

IRC §265(a)(1), the provision the IRS will look at to see if the deduction is barred, states the following:

> **(a) General rule** No deduction shall be allowed for—
>
> **(1) Expenses**

[414] HR 7010, Act Section 4(a)

[415] Notice 2020-32, April 30, 2020, https://www.irs.gov/pub/irs-drop/n-20-32.pdf (retrieved April 30, 2020)

[416] Notice 2020-32, Section II

> Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

The Notice explains the meaning of a class of income wholly exempt from tax in general terms:

> The term "class of exempt income" means any class of income (whether or not any amount of income of such class is received or accrued) that is either wholly excluded from gross income under any provision of subtitle A of the Code or wholly exempt from the taxes imposed by subtitle A of the Code under the provisions of any other law. See §1.265-1(b)(1). The purpose of section 265 of the Code is to prevent a double tax benefit.

The key part of the Notice comes next, as the IRS analyzes §265(a)(1) and related case law that has interpreted that section in the past:

> Section 265(a)(1) of the Code applies to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax-exempt income. It also applies where tax exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose. In such event, it is proper to conclude that some or all of the deductions are allocable to the tax-exempt income. See *Christian v. United States*, 201 F. Supp. 155 (E.D. La. 1962) (school teacher was denied deductions for expenses incurred for a literary research trip to England because the expenses were allocable to a tax-exempt gift and fellowship grant); *Banks v. Commissioner*, 17 T.C. 1386 (1952) (certain educational expenses paid by the Veterans' Administration that were exempt from income tax, were not deductible); *Heffelfinger v. Commissioner*, 5 T.C. 985 (1945), (Canadian income taxes on income exempt from U.S. tax are not deductible in computing U.S. taxable income); and Rev. Rul. 74-140, 1974-1 C.B. 50, (the portion of a state income tax paid by a taxpayer that is allocable to the cost-of-living allowance, a class of income wholly exempt under section 912, is nondeductible under section 265).
>
> In *Manocchio v. Commissioner*, 78 T.C. 989 (1982), a taxpayer attended a flight-training course that maintained and improved skills required in the taxpayer's trade or business. As a veteran, the taxpayer was entitled to an educational assistance allowance from the Veterans' Administration pursuant to 38 U.S.C. section 1677 (1976) equal to 90 percent of the costs incurred. Because the payments received were exempt from taxation under 38 U.S.C. section 310(a) (1976), the taxpayer did not report them as income. The taxpayer did, however, deduct the entire cost of the flight training course, including the portion that had been reimbursed by the

> Veterans' Administration. In a reviewed opinion, the court held that the reimbursed flight-training expenses were nondeductible under section 265(a)(1) of the Code.[417]

After reading that analysis the IRS puts forth, it seems clear that this will not be a good Notice for taxpayers—and the final portion of the Notice explicitly states the bad news, beginning with an all uppercase header that reads "NON-DEDUCTIBILITY OF PAYMENTS TO THE EXTENT INCOME RESULTING FROM LOAN FORGIVENESS IS EXCLUDED UNDER SECTION 1106(i) OF THE CARES ACT."

That section begins with the agency's conclusion:

> To the extent that section 1106(i) of the CARES Act operates to exclude from gross income the amount of a covered loan forgiven under section 1106(b) of the CARES Act, the application of section 1106(i) results in a "class of exempt income" under §1.265-1(b)(1) of the Regulations. Accordingly, section 265(a)(1) of the Code disallows any otherwise allowable deduction under any provision of the Code, including sections 162 and 163, for the amount of any payment of an eligible section 1106 expense to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven) because such payment is allocable to tax-exempt income. Consistent with the purpose of section 265, this treatment prevents a double tax benefit.[418]

The agency follows this with a defense of the ruling:

> This conclusion is consistent with prior guidance of the IRS that addresses the application of section 265(a) to otherwise deductible payments. In particular, Rev. Rul. 83-3, 1983-1 C.B. 72, provides that, where tax exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, section 265(a) applies because such deductions are allocable to the tax-exempt income. In accordance with the analysis set forth in Rev. Rul. 83-3, the direct link between (1) the amount of tax exempt covered loan forgiveness that a recipient receives pursuant to section 1106 of the CARES Act, and (2) an equivalent amount of the otherwise deductible payments made by a recipient for eligible section 1106 expenses, constitutes a sufficient connection for section 265(a) to apply to disallow deductions for such payments under any provision of the Code, including sections 162 and 163, to the extent of the income excluded under section 1106(i) of the CARES Act.
>
> The deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement. See, e.g., *Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966); *Wolfers v. Commissioner*, 69

[417] Notice 2020-32, Section III

[418] Notice 2020-32, Section III (It appears the IRS may have intended to label the header as IV, but the initial version posted did not do so. It is possible the agency will post a corrected Notice that will label this as Section IV.)

> T.C. 975 (1978); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80- 348, 1980-2 C.B. 31; Rev. Rul. 80-173, 1980-2 C.B. 60.[419]

Is this Notice the final word on this issue? Very possibly not. First, it is possible a taxpayer may decide to challenge this position in court. Whether they would or would not prevail is open to question, and the other big problem is being able to afford the litigation to begin with.

The more likely road to relief would be if Congress were to act in the next Coronavirus bill (assuming there will be such a bill, as many do assume) to simply enact an amendment to make clear that expenses used to justify PPP loan forgiveness are deductible, regardless of any provision in the IRC contrary to that conclusion. But that assumes Congress can agree that this is a step they want to take.

IRS RULES TAXPAYERS MAY NOT DEDUCT EXPENSES THAT LEAD TO PPP FORGIVENESS IF TAXPAYER REASONABLY BELIEVED FORGIVENESS WOULD BE GRANTED AT YEAR END

Revenue Ruling 2020-27, Revenue Procedure 2020-51, 11/18/20

In an earlier article we had discussed reports that the IRS was planning to issue guidance to block borrowers from claiming a deduction for expenses they expected to use for Paycheck Protection Program (PPP) loan forgiveness even if they had not yet applied for or received forgiveness.[420] Now that shoe has dropped with the issuance of Revenue Ruling 2020-27.[421]

IRS Original Primary Theory – It's a Deduction Related to Tax Exempt Income

The IRS issued Notice 2020-32 in April that took the position that expenses that led to the obligation to repay a PPP loan being forgiven could not be deducted. In the ruling, the IRS spends virtually the entire notice outlining a justification for denial of the deduction that relies on treating the forgiveness income as tax exempt income once CARES Act §1106(i) is considered (which provides the forgiveness will not be taxable to the borrower), triggering IRC §265(a)(1) which bars a deduction for expenses related to tax exempt income.

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[419] Notice 2020-32, Section III

[420] Ed Zollars, "Guidance Denying Deduction for PPP Forgivable Expenses Even if Forgiveness Not Granted by Year End Reported to Be on the Way from Treasury," *Current Federal Tax Developments* website, November 14, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/11/14/guidance-denying-deduction-for-ppp-forgivable-expenses-even-if-forgiveness-not-granted-by-year-end-reported-to-be-on-the-way-from-treasury (retrieved November 19, 2020)

[421] Revenue Ruling 2020-27, November 18, 2020, https://www.irs.gov/pub/irs-drop/rr-20-27.pdf (retrieved November 19, 2020)

However, in the very last paragraph before the contact information, the IRS poses an alternative theory for why the expenses cannot be deducted:

> The deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement. See, e.g., *Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966); *Wolfers v. Commissioner*, 69 T.C. 975 (1978); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80- 348, 1980-2 C.B. 31; Rev. Rul. 80-173, 1980-2 C.B. 60.[422]

As Nathan Smith of CBIZ Inc. remarked in an article published in *Tax Notes Today Federal* on November 11[423] discussing speculation that the IRS would issue a ruling dealing with the status of payments made when, at year end, no forgiveness had been obtained, the two theories advanced by Treasury appear to lead to different results prior to forgiveness being obtained.

> Because the government offered two different positions for nondeductible treatment, the ancillary question about timing must be addressed discretely under each of those positions, Smith said. And as it turns out, the answer to the timing question appears to be different depending on which of the two positions from Notice 2020-32 a taxpayer chooses to follow, he added.
>
> The primary and the alternative positions in Notice 2020-32 are distinct because receiving tax-exempt income isn't the same as receiving an expense reimbursement, Smith said. He pointed to a few court decisions that held that expense reimbursements aren't tantamount to gross income, and other cases showing instead that the reimbursement reduces the amount of the deduction. The rationale for that conclusion is that the taxpayer hasn't made an expenditure or cost outlay, Smith said.
>
> "On the other hand, the primary position that relies on section 265 relies on the existence of tax-exempt income — in this case loan forgiveness income," Smith said. "So pick your poison — either tax-exempt income (income exists) or expense reimbursement (no income exists). Two different timing answers, depending on which one you pick."[424]

As was noted in our article, the Supreme Court's ruling in *Bliss Dairy* would seem to require use of the tax benefit rule, giving a deduction in the current year and then picking up income in the following year if the "tax exempt income" view is correct. But if this is an expected reimbursement,

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[422] Notice 2020-32, https://www.irs.gov/pub/irs-drop/n-20-32.pdf (retrieved November 19, 2020)

[423] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, 2020 TNTF 218-1, November 11, 2020 , https://www.taxnotes.com/tax-notes-today-federal/partnerships/ppp-borrowers-brace-potentially-problematic-irs-guidance/2020/11/11/2d5zd (retrieved November 19, 2020)

[424] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, 2020 TNTF 218-1, November 11, 2020

then a taxpayer would not be allowed a deduction even if the reimbursement had not yet been received.[425]

So Let's Go With Reimbursement as Our Primary Theory…

Revenue Ruling 2020-27 bars a deduction for expenses paid prior to receiving PPP loan forgiveness if a taxpayer has a reasonable expectation of receiving forgiveness based on those expenses. The holding provides:

> A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period, even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year.[426]

While the IRS in the analysis does note that the original ruling discussed the "tax exempt income" with a deduction denial under §265(a)(1) theory, this time only a single paragraph is devoted to that justification.[427]

The bulk of the analysis of the law this time turns to the reimbursement theory to disallow the deduction.

> Notice 2020-32 also relied on authorities holding that deductions for otherwise deductible expenses are disallowed if the taxpayer receives reimbursement for such expenses. Authorities addressing reimbursement further hold that an otherwise allowable deduction is disallowed if there is a reasonable expectation of reimbursement. See *Burnett v. Commissioner*, 356 F. 2d 755 (5th Cir. 1966) *cert. denied* 385 U.S. 832 (1966); *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), *aff'd* 447 F.2d 484 (9th Cir.1971); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 60; Rev. Rul. 79-263, 1979-2 C.B. 82.
>
> In *Burnett*, a lawyer advanced expenses to clients that the clients were obligated to repay only to the extent the lawyer was successful in obtaining recovery on the client's claim. The taxpayer argued that the advances were deductible trade or business expenses under section 162 of the Code because there was no unconditional obligation on the part of the clients to repay the advances. The court noted that the taxpayer provided assistance only to clients with claims that were likely to be successful and that the advances were "made to clients with the expectation, substantially realized, that they would be recovered." 356 F.2d at 758. On that basis, the court affirmed the Tax Court's holding that the advances were not deductible.

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[425] Ed Zollars, "Guidance Denying Deduction for PPP Forgivable Expenses Even if Forgiveness Not Granted by Year End Reported to Be on the Way from Treasury," *Current Federal Tax Developments* website, November 14, 2020

[426] Revenue Ruling 2020-27, p. 8

[427] Revenue Ruling 2020-27, pp. 3-4

Similarly, in *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), *aff'd* 447 F.2d 484 (9th Cir.1971), a personal injury law firm advanced litigation costs on behalf of its clients, and the clients had no obligation to repay the costs unless their case was successful. The law firm deducted the litigation costs in the year paid and included the reimbursed costs in income in the year of reimbursement. The law firm screened clients to reduce the risk that the advanced costs would not be repaid and took cases when there was a "good hope" of recovery. The court determined that the law firm's advances operated as loans to its clients for which the law firm had an expectation of reimbursement. Therefore, deductions for the advances under section 162 were not allowed. See also *Herrick v. Commissioner*, 63 T.C. 562 (1975) (similar effect); *Silverton v. Commissioner*, T.C. Memo. 1977-198 (1977) (similar effect).[428]

Examples

The ruling provides us with two examples of applying this holding.

SITUATION 1, REVENUE RULING 2020-27

During the period beginning on February 15, 2020, and ending on December 31, 2020 (covered period), Taxpayer A (A) paid expenses that are described in section 161 of the Internal Revenue Code (Code) and section 1106(a) of the CARES Act (eligible expenses). These expenses include payroll costs that qualify under section 1106(a)(8) of the CARES Act, interest on a mortgage that qualifies as interest on a covered mortgage obligation under section 1106(a)(2) of the CARES Act, utility payments that qualify as covered utility payments under section 1106(a)(5) of the CARES Act, and rent that qualifies as payment on a covered rent obligation under section 1106(a)(4) of the CARES Act. In November 2020, pursuant to the terms of section 1106 of the CARES Act, A applied to the lender for forgiveness of the covered loan on the basis of the eligible expenses it paid during the covered period. At that time, and based on A's payment of the eligible expenses, A satisfied all requirements under section 1106 of the CARES Act for forgiveness of the covered loan. The lender does not inform A whether the loan will be forgiven before the end of 2020.

Based on the foregoing, when A completed its application for covered loan forgiveness, A knew the amount of its eligible expenses that qualified for reimbursement, in the form of covered loan forgiveness, and had a reasonable expectation of reimbursement. The reimbursement, in the form of covered loan forgiveness, was foreseeable. Therefore, pursuant to the foregoing authorities, A may not deduct A's eligible expenses.

In the alternative, section 265(a)(1) disallows a deduction of A's otherwise deductible eligible expenses because the expenses are allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness.[429]

SITUATION 2, REVENUE PROCEDURE 2020-27

During the covered period, Taxpayer B (B) paid the same types of eligible expenses that A paid in Situation 1. B, unlike A, did not apply for forgiveness of the covered loan before the end of 2020, although, taking into account B's payment of the eligible expenses during the covered period, B satisfied all other requirements under section 1106 of the CARES Act for forgiveness of the covered loan. B expects to apply to the lender for forgiveness of the covered loan in 2021.

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[428] Revenue Ruling 2020-27, pp. 4-5

[429] Revenue Ruling 2020-27

Although B did not complete an application for covered loan forgiveness in 2020, at the end of 2020, B satisfied all other requirements under section 1106 of the CARES Act for forgiveness of the covered loan and at the end of 2020 expected to apply to the lender for covered loan forgiveness of the covered loan in 2021. Thus, at the end of 2020 B both knew the amount of its eligible expenses that qualified for reimbursement, in the form of covered loan forgiveness, and had a reasonable expectation of reimbursement. The reimbursement in the form of covered loan forgiveness was foreseeable. Therefore, pursuant to the foregoing authorities, B may not deduct B's eligible expenses.

In the alternative, section 265(a)(1) disallows a deduction of B's otherwise deductible eligible expenses because the expenses are allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness.

Note that in both cases, the bulk of the reasoning supporting the answer relies on the reimbursement theory. In each case, a short sentence is added to the end to mention a §265(a)(1) tax exempt income theory.

Is It a Reimbursement?

It is not clear to this author that the reimbursement theory is necessarily the proper way to view this program, since it is pretty clear that Congress consistently referred to it as a *loan* program in the CARES Act. As well, the inclusion of §1106(i)'s rules on not picking up the forgiveness as taxable income also seems to argue in favor of the view that Congress was enacting a loan program—reimbursements would not have been income to the taxpayer. Thus, §1106(i) becomes a provision that does nothing under the law.

It is reasonable to suspect that the reason the IRS led with the tax exempt income theory in Notice 2020-32 and devoted most of the analysis to that view is because while you might argue this has the same effect as viewing the transaction in the form of a reimbursement, it is pretty clear that Congress had chosen the form of a loan for the structure rather than making the amounts into an advance reimbursement that would need to be returned if not used for appropriate purposes.

But when the Paycheck Protection Program Flexibility Act (PPPFA) greatly lengthened the time period for spending the funds and applying for forgiveness without having to make payments on the loans, the IRS now faced the situation where many (and perhaps most) borrowers with calendar year ends would not have received a forgiveness decision by December 31. So now the question of whether the expense could be disallowed based on being paid from tax exempt income before any such tax exempt income was generated became a real problem for the agency.

What the IRS appears to be doing now is trying to argue substance over form in this case. And, clearly, the IRS has won numerous cases against taxpayers by taking that position to treat a transaction differently from its formal structure. But note that the primary justification for allowing such a restructuring is that the *taxpayer was in charge of establishing the form of the transaction*. In this case, the borrower had no choice about the structure of this program—it was a loan.

At the time Notice 2020-32 was released, the PPP loan program was structured to make it likely most borrowers would apply for forgiveness well before their year-end unless that fiscal year end was in the summer. The issue of timing was not going to arise in that context, as the borrower would have received forgiveness by the end of the calendar year, by far the most popular fiscal year end.

And even if reimbursement would be allowed as a possible route to non-deductibility, the IRS conceded in Notice 2020-32 and even in this ruling that it is possible to view it as a loan that is forgiven.

The switch in emphasis from "tax exempt income-no deduction under IRC §265(a)(1)" to "no deduction due to expected reimbursement" presumably has taken place because the IRS recognizes the relative weakness of their position on timing in the loan scenario if forgiveness has not yet taken place.

IRS Addressing the Tax Benefit Rule

If we accept that these expenses will be eventually non-deductible if forgiveness is obtained, the primary argument for allowing a deduction initially if no forgiveness is obtained by the year end is that the tax benefit rule will serve to pick up the income in a later year.

The IRS does address the issue in their ruling, arguing the following:

> Under the related "tax benefit rule," if a taxpayer takes a proper deduction and, in a later tax year, an event occurs that is fundamentally inconsistent with the premise on which the previous deduction was based (for example, an unforeseen refund of deducted expenses), the taxpayer must take the deducted amount into income. See section 111 of the Code (providing that gross income does not include income attributable to the recovery during a taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by chapter 1 of the Code). The Supreme Court applied the tax benefit rule in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983). In that case, the Court observed that "[t]he basic purpose of the tax benefit rule is to achieve rough transactional parity in tax . . . and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule." *Id.* at 383.[430]

Those who have read articles arguing for a deduction of such expense and later inclusion of income under the tax benefit rule may note those articles refer to *Bliss Dairy* for their support. What is of interest is that the Supreme Court decided *Hillsboro* and *Bliss Dairy* at the same time in the same opinion. So is the opinion internally inconsistent?

Not really. While the quote noted by the IRS is in the opinion, when the Court looked at a case with the following facts *in the very same opinion*, the Court found the tax benefit rule applied and did

[430] Revenue Ruling 2020-27

not suggest the original deduction should have been disallowed as the reversal was clearly foreseeable at the end of the tax year:

- A cash basis taxpayer (Bliss Dairy) claimed a deduction for feed purchased just before the end of the taxpayer's fiscal year ended June 30, 1973. The vast majority of the feed was not used by June 30, 1973.

- The taxpayer liquidated the corporation on July 2, 1973 (two days later) and distributed the feed to the shareholders. Under the then existing version of IRC §336, the corporation did not recognize any gain when this feed was transferred out to the shareholders in liquidation.

- Under the then in force "one-month liquidation rule" of §333, the shareholders were also able to limit the amount of gain they recognized on disposing of their stock. Under those rules, they were able to allocate a portion of the basis in their stock to the feed.

- Finally, they continued to operate the dairy as an unincorporated entity, claiming a deduction again for the grain that was used.[431]

While the decision found that Bliss was required to reverse the deduction for the portion of the feed on hand at the date of the liquidation under the tax benefit rule, it is important to note that it was clearly foreseen that Bliss would be liquidating immediately after that year end—in fact, that was the key to their tax planning strategy to effectively get a double deduction.

The Court did not use the IRS approach proposed in Revenue Ruling 2020-27 to find the tax benefit rule inapplicable, as no deduction should have been allowed for the year ended June 30, 1973. Rather, the Supreme Court agreed with the IRS position at that time that the deduction was allowed, but once the event occurred inconsistent with the deduction (in this case, the one-month liquidation) the tax benefit rule forced a reversal of the deduction related to the feed that would be distributed to the shareholders.

Again, a skeptic might assume that the IRS intentionally ignored the Bliss facts in this ruling but cited a sentence in the decision to give the appearance they were dealing with the well-known criticism of denying the deduction in this case (see, your case supports our position!), but without having to deal with those pesky facts that were the basis of the position for those citing *Bliss*.

So What Does a Taxpayer Do?

This is where things get complicated. It certainly appears there is still a reasonable basis to argue that if the expenses are not deductible eventually, it is via the §265(a)(1) nontaxable income standard the IRS emphasized in Notice 2020-32. And, if that is the case, the event is inconsistent with a deduction that had not occurred by year end if there was not forgiveness granted—no tax-exempt income yet existed to which the deduction could relate. You can argue this view is consistent with the treatment of the program as a loan with a later forgiveness of indebtedness, which is the only view Congress expressed in the CARES Act. The "reimbursement" construct is one that was created by the IRS.

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[431] *Hillsboro National Bank v. Commissioner*, 460 US 370 (consolidated with *United States v. Bliss Dairy Inc.,* 81-930)

So it is possible to claim the deduction on the return and simply disclose the position on a Form 8275. That would serve to limit the taxpayer's exposure to penalties.

But a taxpayer that takes this position needs to be aware of some key facts:

- The IRS is not likely to concede this issue if the return is pulled for examination, nor is it likely that an appellate conferee will go against this ruling of the National Office unless the IRS has already been defeated on the issue in court.
- Taking this issue to Court entails a very significant amount of expense that the taxpayer will need to pay up front, and they aren't likely to win an award of these expenses by the court even if the taxpayer prevails.
- Even if the taxpayer decides not to take the matter to court, there will still be the costs of representation and dealing with the examination, which could include a period of dealing with proposed penalties and the mere fact the IRS may raise other issues as long as they are looking at the return.

So the client needs to understand the uncertainty that exists here, as well as the fact that it may simply not prove to be cost-effective to take the more aggressive position to claim the deduction if the IRS challenges that position—and that might be the case even if the taxpayer ultimately prevails.

There is still a possibility that Congress will address the deductibility of these expenses in legislation in the next few months. One option that should be given to taxpayers is to extend the return to see if Congress does act to allow the deduction.

What if My Reasonable Expectation of Forgiveness Turns Out to Be Mistaken?

Assuming a taxpayer follows the IRS ruling and does not deduct the expenses on their 2020 return, what happens if the taxpayer later finds that some or all of the loan is not going to be forgiven? Does the taxpayer now have to go back and amend the 2020 return?

The situation does create a quirky problem. Generally, the Supreme Court has ruled that we have an annual tax system and the results have to be based on applying facts there were at least *knowable* at year end to the law ultimately in effect at that time. When the forgiveness applicable is fully or partially denied by the lender in 2021 is a fact that was not knowable at the end of 2020. But it is also clear the expense was actually paid in 2020 and was only not deducted because we believed the amount would be reimbursed—a belief that proved, ultimately, to be in error.

To deal with this conundrum, the IRS has released Revenue Procedure 2020-51[432] to provide a safe harbor to deal with some of these issues.

[432] Revenue Procedure 2020-51, November 18, 2020, https://www.irs.gov/pub/irs-drop/rp-20-51.pdf (retrieved November 19, 2020)

A taxpayer who meets the following tests is eligible to use the safe harbor:

- The taxpayer paid or incurred eligible expenses in the 2020 taxable year for which no deduction is permitted because at the end of the 2020 taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan based on those eligible expenses (non-deducted eligible expenses);

- The taxpayer submitted before the end of the 2020 taxable year, or as of the end of the 2020 taxable year intends to submit in a subsequent taxable year, an application for covered loan forgiveness to the lender; and

- In a subsequent taxable year, the lender notifies the taxpayer that forgiveness of all or part of the covered loan is denied.[433]

As well, a taxpayer may use this safe harbor by meeting the following requirements:

- The taxpayer meets the first two requirements cited under the immediately preceding test; and

- In a subsequent taxable year, the taxpayer irrevocably decides not to seek forgiveness for some or all of the covered loan. For example, a taxpayer that determines that it will not qualify for covered loan forgiveness and withdraws the application submitted to the lender would be such a taxpayer.[434]

Taxpayers meeting one of those two sets of conditions can make use of one of two options to deal with deducting these expenses for which no forgiveness will be granted.

- **Deduct the expenses on the 2020 tax return**. A qualified taxpayer may deduct non-deducted eligible expenses on the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the 2020 taxable year, or amended return or AAR under section 6227 of the Code for the 2020 taxable year, as applicable;[435] *or*

- **Deduct the expenses on the 2021 tax return.** A qualified taxpayer may deduct non-deducted eligible expenses on the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the subsequent taxable year (normally a 2021 taxable year).[436]

The ruling clarifies that if a taxpayer applies for forgiveness and has amounts formally denied (the taxpayer meets the first set of conditions to use the safe harbor), the taxpayer may use the second safe harbor but is not required to formally elect to use the safe harbor to deduct the expenses in the subsequent tax year. Such a taxpayer would only need to use the safe harbor to claim the deduction for the 2020 tax year.

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[433] Revenue Procedure 2020-51, Section 3.01

[434] Revenue Procedure 2020-51, Section 3.02

[435] Revenue Procedure 2020-51, Section 4.01

[436] Revenue Procedure 2020-51, Section 4.02

The procedure provides the deduction is limited as noted:

> A taxpayer applying …[one of the safe harbors] may not deduct an amount of non-deducted eligible expenses in excess of the principal amount of the taxpayer's covered loan for which forgiveness was denied or will no longer be sought.[437]

A taxpayer making use of this safe harbor must attach a statement to the tax return containing the following information:

- The taxpayer's name, address, and social security number or employer identification number;
- A statement specifying whether the taxpayer is an eligible taxpayer under either section 3.01 or section 3.02 of Revenue Procedure 2020-51;
- A statement that the taxpayer is applying section 4.01 or section 4.02 of Revenue Procedure 2020-51;
- The amount and date of disbursement of the taxpayer's covered loan;
- The total amount of covered loan forgiveness that the taxpayer was denied or decided to no longer seek;
- The date the taxpayer was denied or decided to no longer seek covered loan forgiveness; and
- The total amount of eligible expenses and non-deducted eligible expenses that are reported on the return.[438]

The IRS concludes by noting that merely because this procedure is used for a particular expense, the IRS can still look at the underlying details of an expense and challenge it for other reasons:

> Nothing in this revenue procedure precludes the IRS from examining other issues relating to the claimed deductions for non-deducted eligible expenses, including the amount of the deduction and whether the taxpayer has substantiated the deduction claim. It also does not preclude the IRS from requesting additional information or documentation verifying any amounts described in the statement described in section 4.04 of this revenue procedure.[439]

[437] Revenue Procedure 2020-51, Section 4.03

[438] Revenue Procedure 2020-51, Section 4.04

[439] Revenue Procedure 2020-51, Section 4.05

SBA ANNOUNCES WILL CREATE QUESTIONNAIRE TO DETERMINE NEED FOR PPP LOANS, PURPORTED COPIES BEING CIRCULATED ONLINE

Purposed Form 3509, Loan Necessity Questionnaire (For-Profit Borrowers), 10/30/20

A number of sources are reporting that the SBA has begun circulating two forms to be completed by borrowers with PPP loans in excess of $2 million to provide information for determining the necessity of their borrowings.[440] The SBA had published a notice in the *Federal Register* on October 26, 2020 indicating that there would be two such forms (Forms 3509, *Loan Necessity Questionnaire (For-Profit Borrowers)* and 3510 *Loan Necessity Questionnaire (Non-Profit Borrowers)*).[441] The agency had not posted such forms on any website as of October 30.

However, copies of such forms did show up on various websites, all of which reported that the SBA had not return requests for comments on whether the forms published were authentic. One such copy of the Form 3509 can be found on *Politico's* website,[442] and other sites have identical copies of the form.

Eric Asgeirsson of the AICPA posted the following note on Twitter related to the forms:

> AICPA is in the process of following up with Treasury/SBA on PPP loan necessity 3509 & 3510 forms to better understand. The forms have not yet been officially released. We don't think the information requested is in line with the intent of the PPP act.[443]

As Mr. Asgeirsson notes, the information being requested on the form has raised questions about whether the SBA is changing the rules after the fact with the program.

SBA Description of the Form

Although the form has not yet been released by the SBA, nor have the copies posted online confirmed by the agency as being from the agency, the agency has not taken steps to indicate the form is not from the agency and the agency did indicate such a form was coming.

[440] Zachary Warmbrodt, "SBA presses big businesses to justify aid, sparking uproar," *Politico* website, October 30, 2020, https://www.politico.com/news/2020/10/30/sba-big-businesses-ppp-loans-433736 (retrieved October 31, 2020), Eric Yauch, "PPP Borrowers May Need to Explain Themselves in New Forms," *Tax Notes Today Federal*, November 2, 2020, https://www.taxnotes.com/tax-notes-today-federal/partnerships/ppp-borrowers-may-need-explain-themselves-new-forms/2020/11/02/2d4rv (retrieved October 31, 2020 subscription required)

[441] Small Business Administration, 30-Day Notice, 85 FR 67809, *Federal Register*, October 30, 2020, pp. 67809-67810, https://www.govinfo.gov/content/pkg/FR-2020-10-26/pdf/2020-23594.pdf (retrieved October 31, 2020)

[442] Form 3509, Paycheck Protection Program Loan Necessity Questionnaire, https://www.politico.com/f/?id=00000175-7c07-d665-a1ff-fe0fd5390000 (retrieved October 31, 2020)

[443] https://twitter.com/ErikAsgeirsson/status/1322329528694353921?s=20, October 30, 2020, (retrieved October 31, 2020)

The copy of the form that is in circulation has the following information from the SBA indicating the purpose of the Form 3509:

> The purpose of this form is to facilitate the collection of supplemental information that will be used by SBA loan reviewers to evaluate the good-faith certification that you made on your PPP Borrower Application (SBA Form 2483 or Lender's equivalent form) that economic uncertainty made the loan request necessary. Each for-profit Borrower that, together with its affiliates,1 received PPP loans with an original principal amount of $2 million or greater is required to complete this form and submit it, along with the required supporting documents, to the Lender servicing Borrower's PPP loan. The completed form is due to the Lender servicing your PPP loan within ten business days of receipt from your Lender.[444]

The Form 3509 goes on to provide the following information to the borrower that receives the questionnaire:

> SBA is reviewing these loans to maximize program integrity and protect taxpayer resources. The information collected will be used to inform SBA's review of your good-faith certification that economic uncertainty made your loan request necessary to support your ongoing operations. Receipt of this form does not mean that SBA is challenging that certification. After this form is submitted, SBA may request additional information, if necessary, to complete the review. SBA's determination will be based on the totality of your circumstances.
>
> Failure to complete the form and provide the required supporting documents may result in SBA's determination that you were ineligible for either the PPP loan, the PPP loan amount, or any forgiveness amount claimed, and SBA may seek repayment of the loan or pursue other available remedies.
>
> Within five business days after you provide a complete form with all required responses, supporting documents, and signatures and certifications, the Lender servicing your loan is required to upload the form and documents to the SBA PPP Forgiveness Platform (forgiveness.sba.gov) and separately input your responses to each question into the web form available in the platform[445]

Information Requested

Pages 2-8 has a series of questions, divided into two categories:

- Business Activity Assessment and
- Liquidity Assessment.

[444] Form 3509 from Politico site, p. 1

[445] Form 3509 from Politico site, p. 1

Business Activity Assessment

The first question in the business activity assessment requests information on the borrower's gross revenue for the second calendar quarter of 2020 and the same quarter in 2019. A business that is seasonal may optionally use the third quarter for each year. [446]

A business that was not in existence in the second quarter of 2019 will enter revenue for the first quarter of 2020. However, a seasonal business that chooses the third quarter of 2020 revenue report cannot use the first quarter of 2020 to compare to and must, instead, provide the third quarter of 2019's revenue. [447]

The second question asks the business if it had been ordered to shut down at some time after the declaration of the COVID-19 National Emergency on March 13, 2020 by a state or local government order. If the business was subject to such an order, the form asks for the name of the governmental authority and dates of the shutdown. [448]

The third question asks if the business has been ordered to significantly alter its operations by a state or local entity. If the business has, it again is to provide the dates involved with the modification. The question then asks for the nature of the modification, specifically asking whether any of the following were part of the modification:

- Number of people permitted in a location at one time was reduced or capped;
- Service was restricted to outdoors; or
- Employee workspaces were reconfigured.

If there were other restrictions, the borrower is allowed 1,000 characters to describe such restrictions. As well, the business is asked for cash outlays related to these alterations. [449]

The fourth and fifth question repeat the last two inquiries, except this time asking for times the borrower voluntarily, without a governmental order, took any of the above actions. If the business closed, the questionnaire asks for the reason why, this time having the following two checkbox reasons:

- An employee or multiple employees contracted COVID-19 or
- COVID-19 disrupted the business's supply chain.

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[446] Form 3509 from Politico site, p. 2

[447] Form 3509 from Politico site, p. 3

[448] Form 3509 from Politico site, p. 3

[449] Form 3509 from Politico site, p. 3

A business that closed for some other reason can explain that reason, again limited to 1,000 characters. [450]

In question 6, the questionnaire asks if the business, between March 13, 2020 and the end of the loan forgiveness covered period, began any capital improvement projects not related to COVID-19. If the borrower did undertake such capital improvements, the borrower is asked to provide the approximate cash outlays for that improvement. [451]

Question 7 asks for the borrower's NAICS six digit code, [452] while question 8 provides one more 1,000 character box where any additional comments on the above questions can be provided by the borrower. [453]

Liquidity Assessment

The second section of the questionnaire inquires about items related to the borrower's liquidity status.

The first question asks the borrower to provide the amount of cash and cash equivalents the borrower had on hand on the last day of the calendar quarter immediately before the date of the borrower's PPP loan application, and to provide supporting documentation. [454]

Question 2 asks if the borrower has paid any dividends or other capital distributions (other than for pass-through estimated tax payments) to its owners during the period from March 13, 2020 to the end of the PPP loan forgiveness period. [455] If any such distributions were made, the borrower is asked to provide the total of such distributions. [456]

A footnote discusses the estimated tax exception as follows:

> Distributions made by a partnership or S-corporation that are designed to be used only for owners' estimated quarterly tax payments are excepted, as long as they do not exceed the tax liability on profits earned in the first three quarters of 2020, 110 percent of the pro-rata share of last year's tax liability on distributions, and/or 100 percent of the pro-rata share of tax liability on total distributions in 2020.[457]

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[450] Form 3509 from Politico site, pp. 4-5

[451] Form 3509 from Politico site, p. 5

[452] Form 3509 from Politico site, p. 5

[453] Form 3509 from Politico site, p. 5

[454] Form 3509 from Politico site, p. 5

[455] Form 3509 from Politico site, p. 5

[456] Form 3509 from Politico site, p. 6

[457] Form 3509 from Politico site, p. 5, Footnote 2

Question 3 asks if the borrower has prepaid any outstanding debts (paid before contractually due) during the period from March 13, 2020 to the end of the PPP loan forgiveness covered period and, if so, the amount of such prepayment and documentation related to that prepayment. [458]

Question 4 asks if any of the borrower's employees were compensated during the loan forgiveness covered period of the PPP loan in an amount that exceeds $250,000 on an annualized basis. If the answer is yes, the borrower is asked how many employees were compensated at such levels and the total amount of such compensation paid to all such employees during the loan forgiveness covered period. [459]

Question 5 repeats question 4, this time narrowing the request to only refer to owners of the borrower who received such compensation. [460]

Question 6 asks if the borrower had any equity securities listed on a national securities exchange and, if so, what was the borrower's market capitalization as of the date of the borrower's loan application. [461]

Question 7 inquires if any public company owned more than 20% of any class of the borrower's outstanding equity securities. If so, the borrower is asked to give the name and market capitalization of each such public company equity holder as of the date of the borrower's loan application. [462]

If the company did not have any equity securities listed on a national exchange (that is, it answered question 6.A "No"), question 8 asks for the shareholder equity value (book value) of the borrower as of the end of the calendar quarter immediately before the date of the borrower's loan application. [463]

Question 9 asks questions regarding a parent company, asking if the borrower was a subsidiary of another company at the date of the borrower's PPP application. A subsidiary is defined as having a parent that holds 50% or more of the borrower's common stock or similar equity interest.[464]

If a parent does exist, the borrower is asked to name that parent, whether the parent was organized under U.S. laws or that of another country. If the parent has shares listed on a U.S. or other national securities exchange, the borrower also is asked to supply the market capitalization of the parent on the date of the borrower's PPP loan application. [465]

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[458] Form 3509 from Politico site, p. 6

[459] Form 3509 from Politico site, p. 6

[460] Form 3509 from Politico site, p. 6

[461] Form 3509 from Politico site, pp. 6-7

[462] Form 3509 from Politico site, p. 7

[463] Form 3509 from Politico site, p. 7

[464] Form 3509 from Politico site, p. 7

[465] Form 3509 from Politico site, p. 7

Question 10 asks if 20% or more of any class of the borrower's outstanding equity securities are held by a private equity firm, venture capital firm, or hedge fund, including a fund managed by any such firm.[466]

Question 11 moves on to ask if the borrower was an affiliate or subsidiary of a foreign, state-owned enterprise or of a department, agency or instrumentality of a foreign state. For purposes of this question:

- An affiliate is defined by reference to the SBA's interim final rule on affiliates, 85 FR 20817 (April 15, 2020)[467] and
- Subsidiary is defined as having at least 50% of the borrower's common equity owned, directly or indirectly, or controlled by the foreign entity.[468]

If the answer to question 11 is yes, the borrower is asked to enter the name of the foreign entity. [469]

Question 13 asks about whether the borrower received funds from any other CARES Act program (such as the EIDL grant program), excluding tax benefits and, if the answer is yes, to give the funding amounts.[470]

Again, the final question gives the borrower another 1,000 characters to expand upon any of the answers provided to other liquidity assessment questions. [471]

The final page contains three certifications that the authorized representative of the borrower must initial, along with the signature block. Those certifications are:

- I certify that I have the authority to sign and submit this questionnaire on behalf of the Borrower.
- I certify that the information provided in this questionnaire and in all supporting documentation is true and correct in all material respects. I make this certification after reasonable inquiry of people, systems, and other information available to the Borrower.
- I understand that knowingly making a false statement to obtain a guaranteed loan or forgiveness of an SBA-guaranteed loan is punishable under the law, including under 18 U.S.C. 1001 and 3571 by imprisonment of not more than five years and/or a fine of up to $250,000; under 15 U.S.C. 645 by imprisonment of not more than two years and/or a fine of not more than $5,000; and, if submitted to a federally insured institution, under 18 U.S.C. 1014 by imprisonment of not more than thirty years and/or a fine of not more than $1,000,000. [472]

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466 Form 3509 from Politico site, p. 7

467 Form 3509 from Politico site, p 8, Footnote 3

468 Form 3509 from Politico site, p. 8

469 Form 3509 from Politico site, p. 8

470 Form 3509 from Politico site, p. 8

471 Form 3509 from Politico site, p. 8

472 Form 3509 from Politico site, p. 9

Materials to be Provided

Along with answering the questions, borrowers are asked to provide documentation for the following items:

- For the Business Activity Assessment, the borrower must include supporting documentation for the borrower's answers to question 1 on relative revenues in the appropriate two quarters and
- For the Liquidity Assessment section the borrower must provide supporting documentation for the answers to:
  - Question 1 on available cash and cash equivalents;
  - Question 2.B on amounts of distributions to owners;
  - Question 3.B on the amounts of any debt prepayments;
  - Question 4.C on compensation for employees paid an annualized amount of greater than $250,000 during the PPP loan forgiveness period and
  - Question 5.C on compensation for owners paid an annualized amount of greater than $250,000 during the PPP loan forgiveness period.[473]

As well, for each question, the borrower is to indicate whether the information provided for each answer normally is kept confidential.[474]

The SBA also indicates that during the loan review, the SBA may request additional information.[475]

So What Does This Mean?

The questionnaire does not indicate why each item of information is being requested or what the SBA plans to do with the data, but many advisers are making inferences based on the stated purpose of the form—to evaluate the borrower's need for the loan—to determine the likely use of the requested information. And many aren't terribly happy.

For instance, in an article found in the November 2 issue of *Tax Notes Today Federal*, Eric J. Kodesch of Lane Powell PC is cited as suspecting that the SBA is comparing revenue in the second quarter of 2020, which was not a known value when many borrowers applied for their PPP loan, with revenue

[473] Form 3509 from Politico site, p. 2

[474] Form 3509 from Politico site, p. 2

[475] Form 3509 from Politico site, p. 2

for the same period in 2019, looking for an actual drop in revenue in the second quarter vs. the prior year in order to show a need for the loan.[476] But Mr. Kodesch is quoted in the article as stating:

> "The certification, however, was about uncertainty so that an actual drop is not required," Kodesch said. "Also, it disregards the impact on the pipeline for future projects."
>
> For example, the 2020 second-quarter cash flow for many businesses was from pre-COVID-19 projects that were approved and budgeted, Kodesch said. Those businesses wouldn't have a drop in second-quarter 2020 revenue, but could have a drop in future quarters, he added.[477]

Similar complaints about the relationships of the information provided in response to other questions as being relevant to the uncertainty at the time of application (as opposed to what the actual eventual resolution of that uncertainty might be) are voiced by other advisers.

As David Mayo, JD and Matthew Walsh, CPA noted in an article published on the website of Withum Smith+Brown, PC on October 30:

> The questions in these forms suggest the SBA is evaluating how borrowers were affected by COVID-19 at the loan application date, and for some period of time period after the loan application date. This is odd because the certification addressed in FAQ #31 addresses the borrower's good faith only as of the loan application date, and not at any point in time after that date.
>
> As we have seen time and time again, the PPP loan eligibility and loan forgiveness process evolves over time.[478]

EMERGENCY EIDL GRANTS (CARES ACT §1110)

The law also provides for an expansion of Emergency Injury Disaster Loans (EIDLs), simplifying the application process and providing for a waiver of repayment of up to $10,000 for such loans if used for approved purposes.[479]

The *covered period* runs from January 31, 2020 to December 31, 2020.[480]

Eligible entity is defined to mean:

- A business with not more than 500 employees;

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[476] Eric Yauch, "PPP Borrowers May Need to Explain Themselves in New Forms," *Tax Notes Today Federal*, November 2, 2020

[477] Eric Yauch, "PPP Borrowers May Need to Explain Themselves in New Forms," *Tax Notes Today Federal*, November 2, 2020

[478] Daniel Mayo and Matthew Walsh, "SBA Intends to Release Two New Forms for Large PPP Borrowers," *Withum+* website, October 30, 2020, https://www.withum.com/resources/two-new-forms-released-by-sba/ (retrieved October 31, 2020)

[479] Act §1110

[480] Act §1110(a)(1)

- Any individual who operates under a sole proprietorship, with or without employees, or as an independent contractor;

- A cooperative with not more than 500 employees;

- An ESOP with not more than 500 employees; or

- A tribal business concern with not more than 500 employees.[481]

The following rules will be waived on these EIDL loans:

- Any rules related the personal guarantee on advances and loans of not more than $200,000 during the covered period for all applicants;

- The requirement that an applicant needs to be in business for the 1-year period before the disaster, except that no waiver may be made for a business that was not in operation on January 31, 2020; and

- The requirement that an applicant be unable to obtain credit elsewhere.[482]

The law also provides for a simplified approval process for such EIDL loans, as the Administrator may:

- Approve an applicant based solely on the credit score of the applicant and shall not require an applicant to submit a tax return or a tax return transcript for such approval; or

- Use alternative appropriate methods to determine an applicant's ability to repay.[483]

The applicant may request that the funds be disbursed within 3 days after the Administrator receives an application.[484] The amount of this advance shall not be more than $10,000.[485] The proceeds of the advance are to be used to address "any allowable purpose" for a loan made under Section 7(b)(2) of the Small Business Act including:

- Providing paid sick leave to employees unable to work due to the direct effect of the COVID–19;

- Maintaining payroll to retain employees during business disruptions or substantial slowdowns;

- Meeting increased costs to obtain materials unavailable from the applicant's original source due to interrupted supply chains;

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[481] Act §1110(a)(2)

[482] Act §1110(c)

[483] Act §1110(d)

[484] Act §1110(e)(1)

[485] Act §1110(e)(3)

- Making rent or mortgage payments; and
- Repaying obligations that cannot be met due to revenue losses.[486]

An applicant will not be required to repay any amounts of an advance under this provision, even if the taxpayer is later denied a loan under Section 7(b)(2).[487] However, if a taxpayer has an amount with repayment waived under this provision, it will reduce the amount the taxpayer may have waived under the Payroll Protection Program loans under Act §1110.[488]

[486] Act §1110(e)(4)

[487] Act §1110(e)(5)

[488] Act §1110(e)(6)

Unit

11

Tax Relief Provisions, Including Due Date Relief

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Recognize which actions and filings have and have not been deferred to July 15, 2020 under IRS administrative guidance.
- Advise clients who have had a Form 706 returned by a private delivery service on steps to take to preserve the original date given to the PDS as the deemed date of filing

The IRS administratively moved to grant various types of relief in response to the COVID-19 crises.

IRS AND DEPARTMENT OF LABOR ISSUE RELIEF RELATED TO EMPLOYEE BENEFIT PLANS FOR TIMEFRAMES DUE TO COVID-19 EMERGENCY

"Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," Internal Revenue Service and Department of Labor, 4/30/20

The IRS and U.S. Department of Labor have issued a notice on relief for certain timeframes for employee benefit plans, participants and beneficiaries related to the COVID-19 emergency.[489]

[489] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," Internal Revenue Service and Department of Labor, April 30, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-09399.pdf?utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov&utm_medium=email (retrieved April 30, 2020)

The agencies describe the need for such relief as follows:

> As a result of the National Emergency, participants and beneficiaries covered by group health plans, disability or other employee welfare benefit plans, and employee pension benefit plans may encounter problems in exercising their health coverage portability and continuation coverage rights, or in filing or perfecting their benefit claims. Recognizing the numerous challenges participants and beneficiaries already face as a result of the National Emergency, it is important that the Employee Benefits Security Administration, Department of Labor, Internal Revenue Service, and Department of the Treasury (the Agencies) take steps to minimize the possibility of individuals losing benefits because of a failure to comply with certain preestablished timeframes. Similarly, the Agencies recognize that affected group health plans may have difficulty in complying with certain notice obligations.[490]

Special Enrollment Periods

The guidance describes special enrollment periods affected by the guidance as follows:

> In general, HIPAA requires a special enrollment period in certain circumstances, including when an employee or dependent loses eligibility for any group health plan or other health insurance coverage in which the employee or the employee's dependents were previously enrolled (including coverage under Medicaid and the Children's Health Insurance Program), and when a person becomes a dependent of an eligible employee by birth, marriage, adoption, or placement for adoption. ERISA section 701(f), Code section 9801(f), 29 CFR 2590.701–6, and 26 CFR 54.9801–6.Generally, group health plans must allow such individuals to enroll in the group health plan if they are otherwise eligible and if enrollment is requested within 30 days of the occurrence of the event (or within 60 days, in the case of the special enrollment rights added by the Children's Health Insurance Program Reauthorization Act of 2009). ERISA section 701(f), Code section 9801(f), 29 CFR 2590.701–6, and 26 CFR 54.9801–6.[491]

COBRA Timeframes

COBRA timeframes impacted by this guidance are described as follows:

> The COBRA continuation coverage provisions generally provide a qualified beneficiary a period of at least 60 days to elect COBRA continuation coverage under a group health plan. ERISA section 605 and Code section 4980B(f)(5).Plans are required to allow payment of premiums in monthly installments, and plans cannot require payment of premiums before 45 days after the day of the initial COBRA election. ERISA section 602(3) and Code section 4980B(f)(2)(C). COBRA

[490] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 5

[491] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 6

continuation coverage may be terminated for failure to pay premiums timely. ERISA section 602(2)(C) and Code section 4980B(f)(2)(B)(iii).Under the COBRA rules, a premium is considered paid timely if it is made not later than 30 days after the first day of the period for which payment is being made. ERISA section 602(2)(C), Code section 4980B(f)(2)(B)(iii), and 26 CFR 54.4980B–8 Q&A–5(a).Notice requirements prescribe time periods for employers to notify the plan of certain qualifying events and for individuals to notify the plan of certain qualifying events or a determination of disability. Notice requirements also prescribe a time period for plans to notify qualified beneficiaries of their rights to elect COBRA continuation coverage. ERISA section 606, Code section 4980B(f)(6), and 29 CFR 2590.606–3.[492]

Claims Procedure Timeframes

Claims procedure timeframes impacted by the guidance are described as follows:

> Section 503 of ERISA and 29 CFR 2560.503–1, as well as section 2719 of the PHS Act, incorporated into ERISA by ERISA section 715and29CFR 2590.715–2719,and into the Code by Code section 9815 and 26 CFR 54.9815–2719, require ERISA-covered employee benefit plans and non-grandfathered group health plans and health insurance issuers offering non-grandfathered group or individual health insurance coverage to establish and maintain a procedure governing the filing and initial disposition of benefit claims, and to provide claimants with a reasonable opportunity to appeal an adverse benefit determination to an appropriate named fiduciary. Plans may not have provisions that unduly inhibit or hamper the initiation or processing of claims for benefits. Further, group health plans and disability plans must provide claimants at least 180 days following receipt of an adverse benefit determination to appeal (60 days in the case of pension plans and other welfare benefit plans). 29 CFR 2560.503–1(h)(2)(i)and (h)(3)(i), 29 CFR 2590.715–2719(b)(2)(ii)(C), and 26 CFR 54.9815–2719(b)(2)(ii)(C).[493]

External Process Review Timeframes

The external process review timeframes impacted by this guidance are described as follows:

> PHS Act section 2719, incorporated into ERISA by ERISA section 715 and into the Code by Code section 9815, sets out standards for external review that apply to non-grandfathered group health plans and health insurance issuers offering non-grandfathered group or individual health insurance coverage and provides for either a state external review process or a Federal external review process. Standards for external review processes and timeframes for submitting claims to the independent reviewer for group health plans or health insurance issuers may vary depending on

[492] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," pp. 6-7

[493] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 7

> whether a plan uses a State or Federal external review process. For plans or issuers that use the Federal external review process, the process must allow at least four months after the receipt of a notice of an adverse benefit determination or final internal adverse benefit determination for a request for an external review to be filed. 29 CFR 2590.715–2719(d)(2)(i) and 26 CFR 54.9815–2719(d)(2)(i). The Federal external review process also provides for a preliminary review of a request for external review. The regulation provides that if such request is not complete, the Federal external review process must provide for a notification that describes the information or materials needed to make the request complete, and the plan or issuer must allow a claimant to perfect the request for external review within the four-month filing period or within the 48-hour period following the receipt of the notification, whichever is later. 29 CFR 2590.715–2719(d)(2)(ii)(B) and 26 CFR 54.9815–2719(d)(2)(ii)(B).[494]

Relief Described for Plan Participants, Beneficiaries, Qualified Beneficiaries and Claimants

The IRS and DOL provide specific relief in this section of the document. The agencies also offer a number of examples that will be referenced in this section. For purposes of those examples, the guidance contains the following overall description:

> The following examples illustrate the time frame for extensions required by this document. An assumed end date for the National Emergency was needed to make the examples clear and understandable. Accordingly, the Examples assume that the National Emergency ends on April 30, 2020,with the Outbreak Period ending on June 29, 2020 (the 60th day after the end of the National Emergency).To the extent there are different Outbreak Period end dates for different parts of the country, the Agencies will issue additional guidance regarding the application of the relief in this document.[495]

The IRS and DOL provide the following details of the relief offered:

> Subject to the statutory duration limitation in ERISA section 518 and Code section 7508A, all group health plans, disability and other employee welfare benefit plans, and employee pension benefit plans subject to ERISA or the Code must disregard the period from March 1, 2020 until sixty (60) days after the announced end of the National Emergency or such other date announced by the Agencies in a future notification(the "Outbreak Period")for all plan participants, beneficiaries, qualified

[494] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," pp. 10-11

[495] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," pp. 8-9

> beneficiaries, or claimants wherever located in determining the following periods and dates—[496]

The notice provides the following special footnote disclosure related to the "Outbreak Period" that applies to all relief:

> To the extent there are different Outbreak Period end dates for different parts of the country, the Agencies will issue additional guidance regarding the application of the relief in this document.[497]

The guidance continues as the list of relief items begins:

(1) The 30-day period (or 60-day period, if applicable) to request special enrollment under ERISA section 701(f) and Code section 9801(f),

The guidance provides the following example of the use of the special enrollment period relief:

> Example 2 (Special enrollment period). (i) Facts. Individual B is eligible for, but previously declined participation in, her employer-sponsored group health plan. On March 31, 2020, Individual B gave birth and would like to enroll herself and the child into her employer's plan; however, open enrollment does not begin until November 15. When may Individual B exercise her special enrollment rights?
>
> (ii) Conclusion. In Example 2, the Outbreak Period is disregarded for purposes of determining Individual B's special enrollment period. Individual B and her child qualify for special enrollment into her employer's plan as early as the date of the child's birth. Individual B may exercise her special enrollment rights for herself and her child into her employer's plan until 30 days after June 29, 2020, which is July29, 2020, provided that she pays the premiums for any period of coverage.

The guidance next goes on to describe the relief for the period for an employee to elect COBRA continuing coverage following a qualifying event:

> (2) The 60-day election period for COBRA continuation coverage under ERISA section 605 and Code section 4980B(f)(5),[498]

This COBRA relief item has the following footnote attached.

> The term "election period" is defined as "the period which—(A) begins not later than the date on which coverage terminates under the plan by reason of a qualifying event, (B) is of at least 60 days' duration, and (C) ends not earlier than 60 days after the later of—(i) the date described in subparagraph (A), or (ii) in the case of any qualified beneficiary who receives notice under section 1166(a)(4) of this title, the

[496] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," pp. 8-9

[497] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 9

[498] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 9

> date of such notice."29 USC 1165(a)(1), ERISA section 605(a)(1). See also Code section 4980B(f)(5).[499]

The guidance also provides an example of the relief related to electing COBRA:

> Example 1 (Electing COBRA).
>
> (i) Facts. Individual A works for Employer X and participates in X's group health plan. Due to the National Emergency, Individual A experiences a qualifying event for COBRA purposes as a result of a reduction of hours below the hours necessary to meet the group health plan's eligibility requirements and has no other coverage. Individual A is provided a COBRA election notice on April1, 2020. What is the deadline for A to elect COBRA?
>
> (ii) Conclusion. In Example 1, Individual A is eligible to elect COBRA coverage under Employer X's plan. The Outbreak Period is disregarded for purposes of determining Individual A's COBRA election period. The last day of Individual A's COBRA election period is 60 days after June 29, 2020, which is August 28, 2020.[500]

The guidance has a second item of COBRA relief for premium payments, providing:

> (3) The date for making COBRA premium payments pursuant to ERISA section 602(2)(C) and (3) and Code section 4980B(f)(2)(B)(iii) and (C)[501]

The following footnote is attached to the COBRA premium payment provision:

> Under this provision, the group health plan must treat the COBRA premium payments as timely paid if paid in accordance with the periods and dates set forth in this document. Regarding coverage during the election period and before an election is made, see 26 CFR 54.4980B-6, Q&A 3; during the period between the election and payment of the premium, see 26 CFR 54.4980B-8, Q&A 5(c).[502]

The guidance provides two examples of applying this provision:

> Example 3 (COBRA premium payments).
>
> (i) Facts. On March 1, 2020, Individual C was receiving COBRA continuation coverage under a group health plan. More than 45 days had passed since Individual C had elected COBRA. Monthly premium payments are due by the first of the month. The plan does not permit qualified beneficiaries longer than the statutory 30-day grace period for making premium payments. Individual C made a timely February payment, but did not make the March payment or any subsequent payments during the Outbreak Period. As of July 1, Individual C has made no premium payments for March, April, May, or June. Does Individual C lose COBRA coverage, and if so for which month(s)?
>
> (ii) Conclusion. In this Example 3, the Outbreak Period is disregarded for purposes of determining whether monthly COBRA premium installment payments are timely. Premium payments made by 30 days after June

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[499] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 9

[500] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 10

[501] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 9

[502] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 9

29, 2020, which is July 29, 2020, for March, April, May, and June2020, are timely, and Individual C is entitled to COBRA continuation coverage for these months if she timely makes payment. Under the terms of the COBRA statute, premium payments are timely if made within 30 days from the date they are first due. In calculating the 30-day period, however, the Outbreak Period is disregarded, and payments for March, April, May, and June are all deemed to be timely if they are made within 30 days after the end of the Outbreak Period. Accordingly, premium payments for four months (i.e., March, April, May, and June) are all due by July 29, 2020. Individual C is eligible to receive coverage under the terms of the plan during this interim period even though some or all of Individual C's premium payments may not be received until July 29, 2020. Since the due dates for Individual C's premiums would be postponed and Individual C's payment for premiums would be retroactive during the initial COBRA election period, Individual C's insurer or plan may not deny coverage, and may make retroactive payments for benefits and services received by the participant during this time.[503]

Example 4 (COBRA premium payments).

(i) Facts. Same facts as Example 3. By July 29, 2020, Individual C made a payment equal to two months' premiums. For how long does Individual C have COBRA continuation coverage?

(ii) Conclusion. Individual C is entitled to COBRA continuation coverage for March and April of 2020, the two months for which timely premium payments were made, and Individual C is not entitled to COBRA continuation coverage for any month after April 2020. Benefits and services provided by the group health plan (e.g., doctors' visits or filled prescriptions) that occurred on or before April 30, 2020 would be covered under the terms of the plan. The plan would not be obligated to cover benefits or services that occurred after April 2020.[504]

The relief provisions continue with the following items:

> (4) The date for individuals to notify the plan of a qualifying event or determination of disability under ERISA section 606(a)(3) and Code section 4980B(f)(6)(C),
>
> (5) The date within which individuals may file a benefit claim under the plan's claims procedure pursuant to 29 CFR 2560.503–1,

An example of the pause in the claims period is outlined in the following example found in the document:

Example 5 (Claims for medical treatment under a group health plan).

(i) Facts. Individual Dis a participant in a group health plan. On March 1, 2020, Individual D received medical treatment for a condition covered under the plan, but a claim relating to the medical treatment was not submitted until April 1, 2021. Under the plan, claims must be submitted within 365 days of the participant's receipt of the medical treatment. Was Individual D's claim timely?

[503] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 12-13

[504] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 13

(ii) Conclusion. Yes. For purposes of determining the 365-day period applicable to Individual D's claim, the Outbreak Period is disregarded. Therefore, Individual D's last day to submit a claim is 365 days after June 29, 2020, which is June 29, 2021, so Individual D's claim was timely.[505]

The document next discusses an appeal of an adverse determination:

> (6) The date within which claimants may file an appeal of an adverse benefit determination under the plan's claims procedure pursuant to 29 CFR 2560.503–1(h),

Examples are provided of the application of this relief in the document:

Example 6 (Internal appeal-disability plan).

(i) Facts. Individual E received a notification of an adverse benefit determination from Individual E's disability plan on January 28, 2020. The notification advised Individual E that there are 180 days within which to file an appeal. What is Individual E's appeal deadline?

(ii) Conclusion. When determining the 180-day period within which Individual E's appeal must be filed, the Outbreak Period is disregarded. Therefore, Individual E's last day to submit an appeal is 148 days (180 –32 days following January 28 to March 1) after June 29, 2020, which is November 24, 2020.[506]

Example 7 (Internal appeal –employee pension benefit plan). (i) Facts. Individual F received a notice of adverse benefit determination from Individual F's 401(k) plan on April 15, 2020. The notification advised Individual F that there are 60days within which to file an appeal. What is Individual F's appeal deadline?

(ii) Conclusion. When determining the 60-day period within which Individual F's appeal must be filed, the Outbreak Period is disregarded. Therefore, Individual F's last day to submit an appeal is 60 days after June 29, 2020, which is August 28, 2020.[507]

The general date relief concludes with.

> (7) The date within which claimants may file a request for an external review after receipt of an adverse benefit determination or final internal adverse benefit determination pursuant to 29 CFR 2590.715–2719(d)(2)(i) and 26 CFR 54.9815–2719(d)(2)(i), and
>
> (8) The date within which a claimant may file information to perfect a request for external review upon a finding that the request was not complete pursuant to 29 CFR 2590.715–2719(d)(2)(ii) and 26 CFR 54.9815–2719(d)(2)(ii).[508]

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505 "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," pp. 13-14

506 "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 14

507 "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 14

508 "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," pp. 9-10

COBRA Election Notice for Group Health Plans

The guidance provides the following relief related to the COBRA notice rules:

> With respect to group health plans, and their sponsors and administrators, the Outbreak Period shall be disregarded when determining the date for providing a COBRA election notice under ERISA section 606(c) and Code section 4980B(f)(6)(D).[509]

Later Extensions

The guidance notes that the agencies will continue to monitor the situation and may provide additional relief.[510]

RELIEF GRANTED FOR TIME TO TAKE CERTAIN ACTIONS RELATED TO EMPLOYEE BENEFIT PLANS, PAYROLL TAXES AND RELATED TO EXEMPT ORGANIZATIONS

Notice 2020-35, 5/28/20

The IRS has expanded relief for the performance of certain time sensitive actions in Notice 2020-35.[511] The relief provision covers:

- Certain employment taxes,
- Employee benefit plans,
- Exempt organizations,
- Individual retirement arrangements (IRAs),
- Coverdell education savings accounts,
- Health savings accounts (HSAs), and
- Archer and Medicare Advantage medical saving accounts (MSAs).

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[509] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 10

[510] "Extension of Certain Timeframes for Employee Benefit Plans, Participants, and Beneficiaries Affected by the COVID-19 Outbreak," p. 10

[511] Notice 2020-35, May 28, 2020, https://www.irs.gov/pub/irs-drop/n-20-35.pdf (retrieved May 28, 2020)

The notice also provides "a temporary waiver of the requirement that Certified Professional Employer Organizations (CPEOs) file certain employment tax returns and their accompanying schedules on magnetic media."[512]

The relief provided covers the following items.

General Relief

The ruling will provide a general extension of time to perform certain events specified in the Notice. As the Notice states:

> This notice amplifies the definition of Affected Taxpayer as provided in Notice 2020-23 to include Affected Taxpayers as defined in section III.A of this notice. This notice also amplifies the definition of Specified Time-Sensitive Actions as provided in Notice 2020-23 to include the Time-Sensitive Actions described in section III.B of this notice that are due to be performed on or after March 30, 2020, and before July 15, 2020. These amplified definitions, rather than the definitions in Notice 2020-23, apply for purposes of the relief described in this section III.
>
> Pursuant to this notice, the revised deadline for an Affected Taxpayer to perform a Time-Sensitive Action described in section III.B of this notice is July 15, 2020, unless a different revised deadline is specified under section III.B.2(e) or III.B.4 of this notice. In the case of Time-Sensitive Actions with respect to provisions of the Code for which there are parallel provisions in ERISA, the relief provided under this section III also applies for purposes of those provisions under ERISA.[513]

As was noted above, a few of the items have a date for performance that is other than July 15, 2020. The dates in question are both earlier and later than the standard July 15 date in these cases, so the adviser needs to check the details of each item of relief to insure the proper date for performance is being used.

The following taxpayers (defined as "Affected Taxpayers" under IRC §4508A) are eligible for relief:

- With respect to employment taxes, employers who perform a Time Sensitive Action described in section III.B.1 of this notice.
- With respect to employee benefit plans, the plan (including a section 403(b) plan, a governmental section 457(b) plan, a SEP plan described in section 408(k), or a SIMPLE IRA plan described in section 408(p)), or any sponsor, administrator, participant, beneficiary, disqualified person, or other person with respect to such a plan who performs a Time-Sensitive Action (as provided for in the Notice).

[512] Notice 2020-35, May 28, 2020, p. 2

[513] Notice 2020-35, May 28, 2020, p. 12

- With respect to exempt organizations, those persons performing a Time-Sensitive Action (as provided for in the Notice).

- Filers of a Form 5498, Form 5498-SA, or 5498-ESA for whom filing the form is a Time-Sensitive Action (as provided for in the Notice).[514]

Employment Taxes

The IRS has announced a pair of relief provisions related to payroll taxes.

Interest-free Adjustments to Correct Employment Tax Reporting Errors

The notice describes the following issue that the notice will address:

> For purposes of this notice, "employment tax" means Federal Insurance Contributions Act (FICA) tax imposed on employees by sections 3101(a) and 3101(b) and on employers by sections 3111(a) and 3111(b); Railroad Retirement Tax Act (RRTA) tax imposed on employees by sections 3201(a) and 3201(b) and on employers by sections 3221(a) and 3221(b); and income tax withholding (ITW) imposed by section 3402. To the extent other types of withholding are treated as ITW under section 3402(a) (such as gambling withholding, pension withholding, and backup withholding as set forth in sections 3402(q)(7), 3405(f), and 3406(h)(10), respectively), these other types of withholding are also included in the term "employment tax."
>
> Sections 6205 and 6413 permit interest-free adjustments to correct employment tax reporting errors, and sections 31.6205-1, 31.6413(a)-1 and 31.6413(a)-2 of the Regulations provide related rules for making these adjustments. Notice 2020-23 provided relief for filing claims for credit or refund of any tax, including employment tax, due to be filed on or after April 1, 2020, and before July 15, 2020. However, Notice 2020-23 did not provide relief for employers making interest-free adjustments to correct employment tax reporting errors.[515]

The general relief is provided for making interest free adjustments of employment tax reporting errors that had a due date to be filed between March 30, 2020 and July 15, 2020, making the action timely if taken by July 15:

> 1. Correction of employment tax reporting errors using the interest-free adjustment process under sections 6205 and 6413
>
> > Actions to correct underpayments or overpayments pursuant to sections 6205 and 6413, respectively.[516]

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[514] Notice 2020-35, May 28, 2020, p. 13

[515] Notice 2020-35, May 28, 2020, pp. 4-5

[516] Notice 2020-35, May 28, 2020, p. 14

Electronic Filing Requirements for CPEOs

The notice describes the following electronic filing rules for Certified Professional Employer Organizations (CPEOs) for which specific relief will be provided:

> Section 31.3511-1(g)(2) provides that CPEOs must file on magnetic media any Form 941, Employer's QUARTERLY Federal Tax Return, and Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, along with all required accompanying schedules. However, § 31.3511-1(g)(2)(ii) provides that the IRS may waive the requirements to file on magnetic media in cases of undue economic hardship. Individual requests for waivers from CPEOs must be made in accordance with applicable guidance. The term "magnetic media" generally includes electronic filing as well as other media specifically permitted under applicable guidance.[517]

The following relief is granted under the Notice:

> This notice also provides a temporary waiver of the requirement under § 31.3511-1(g)(2) that CPEOs file certain employment tax returns, and their accompanying schedules, on magnetic media (including electronic filing). This temporary waiver is extended to all CPEOs; individual requests for waiver do not need to be submitted. The waiver applies only to Forms 941 filed for the second, third, and fourth quarter of 2020 and only to Forms 943 filed for calendar year 2020, and their accompanying schedules. Accordingly, CPEOs are permitted, but not required, to file a paper Form 941, and its accompanying schedules, in lieu of electronic submission for the second, third, and fourth quarters of calendar year 2020. In addition, CPEOs are permitted, but not required, to file a paper Form 943, and its accompanying schedules, in lieu of electronic submission for calendar year 2020.[518]

Employee Benefits

A number of relief provisions related to employee benefit plans are provided under the Notice.

Funding Provisions for Qualified Defined Benefit Pension Plans

The following items related to the funding for defined benefit pension plans are subject to specified relief provided for in the Notice.

> Section 412 provides minimum funding standards for qualified defined benefit and other pension plans. Section 412(c) provides for waivers of the minimum funding requirements in the event of temporary substantial business hardship. In order for a plan other than a multiemployer plan to receive a waiver, section 412(c)(5) provides that an application for a waiver must be submitted no later than the 15th day of the 3rd month beginning after the close of the plan year for which the waiver is sought.

[517] Notice 2020-35, May 28, 2020, pp. 5-6

[518] Notice 2020-35, May 28, 2020, pp. 12-13

Section 432(b)(3)(A) provides special rules for certain multiemployer defined benefit plans. For a plan that is subject to those requirements, the plan actuary must make certain certifications each year regarding the plan's funded status. The deadline for these certifications for a plan year is the 90th day of the plan year. Under section 432(b)(3)(D), in certain circumstances, the plan sponsor is required to provide notice regarding the plan's funded status to the participants and beneficiaries, the bargaining parties, the Pension Benefit Guaranty Corporation, the Secretary of Labor and, if applicable, the Secretary of the Treasury. Section 432(c)(1) requires, for the first plan year that a multiemployer plan is in endangered status, that the plan sponsor adopt a funding improvement plan providing one or more schedules of revised benefit structures, revised contribution structures, or both, no later than 240 days following the required date for the actuarial certification of endangered status and notify the bargaining parties of the schedules within 30 days after their adoption. Section 432(c)(6) requires the plan sponsor to update the funding improvement plan and schedules annually and attach that update to the Form 5500 filed for the plan year. Section 432(e)(1)(A) and (3)(B) impose similar adoption, notification, and update requirements with respect to a rehabilitation plan for a multiemployer plan that is certified to be in critical status.

Section 433 provides special funding rules for cooperative and small employer charity pension (CSEC) plans as defined under section 414(y), including rules for certification of funded status and the adoption of a funding restoration plan.

Sections 302, 305 and 306 of ERISA contain provisions that are parallel to sections 412, 432 and 433 of the Code, respectively.

The relief provided for these defined benefit plans covers certain acts that were required to take place between March 30, 2020 and July 15, 2020, making the action timely if taken by July 15:

2. Qualified retirement plans

a. Funding waiver

Application for a funding waiver under section 412(c) for a defined benefit pension plan that is not a multiemployer plan.

b. Multiemployer plan funding

With respect to a multiemployer defined benefit pension plan, actions due to be performed on or before the dates described in:

- Section 432(b)(3) for the certification of funded status and the notice to interested parties of that certification.
- Sections 432(c)(1) and 432(e)(1) for the adoption of, and the notification to the bargaining parties of the schedules under, a funding improvement plan or rehabilitation plan.

- Sections 432(c)(6) and 432(e)(3) for the annual update of a funding improvement plan and its contribution schedules, or rehabilitation plan and its contribution schedules, and the filing of those updates with the Form 5500 annual return.

c. CSEC plans

With respect to a CSEC plan, actions to be performed on or before the date described in:

- Section 433(c)(9) for making the contribution required to be made for the plan year.
- Section 433(f)(3)(B) for making required quarterly installments.
- Section 433(j)(3) for the adoption of a funding restoration plan.
- Section 433(j)(4) for the certification of funded status.[519]

Form 5330

The Form 5330 is used to report and pay a number of excise taxes with respect to employee benefit plans and tax-exempt entities.

The relief granted for Form 5330 is described below:

> Filing of Form 5330 and payment of the associated excise taxes. The period beginning on March 30, 2020, and ending on July 15, 2020, will be disregarded in the calculation of any interest or penalty for failure to file the Form 5330 or to pay the excise tax postponed by this notice. Interest and penalties with respect to such postponed filing and payment obligations will begin to accrue on July 16, 2020.[520]

Tax Exempt and Government Entities Division, Employee Plans Programs – Initial Remediation Period for §403(b) Plans

The Notice describes the following issue for which certain relief will be granted with regard to §403(b) plans:

> Section 21.02 of Rev. Proc. 2013-22, 2013-18 IRB 985, as modified by Rev. Proc. 2014-28, 2014-16 IRB 944, and Rev. Proc. 2015-22, 2015-11 IRB 754, and clarified by Rev. Proc. 2017-18, 2017-5 IRB 743, establishes a remedial amendment period that permits an eligible employer to retroactively correct form defects in its written section 403(b) plan by timely adopting a section 403(b) pre-approved plan or by otherwise timely amending its section 403(b) individually designed plan. Rev.

[519] Notice 2020-35, May 28, 2020, pp. 14-15

[520] Notice 2020-35, May 28, 2020, p. 15

Proc. 2017-18 provides that March 31, 2020, is the last day of this initial remedial amendment period.

> Rev. Proc. 2019-39, 2019-42 IRB 945, sets forth a system of recurring remedial amendment periods for correcting form defects in section 403(b) individually designed plans and section 403(b) pre-approved plans first occurring after the initial remedial amendment period ends, and provides a limited extension of the initial remedial amendment period for certain form defects that is based, in part, on the initial March 31, 2020, deadline. Rev. Proc. 2019-39 also provides deadlines for the adoption of plan amendments for section 403(b) individually designed plans and section 403(b) preapproved plans with respect to a form defect first occurring after the end of the initial remedial amendment period.[521]

In this case relief is granted, *but only to June 30, 2020* rather than July 15, 2020. The Notice provides:

> *Extension of initial remedial amendment period for section 403(b) plans*. With respect to the remedial amendment period and plan amendment rules for section 403(b) plans described in Rev. Proc. 2017-18 and Rev. Proc. 2019-39, actions that are otherwise required to be performed on or before March 31, 2020, with respect to form defects or plan amendments. The deadline for those actions is postponed to June 30, 2020 (and "June 30, 2020" should be substituted for all references to "March 31, 2020" in Rev. Proc. 2017-18 and in Rev. Proc. 2019-39).[522]

Tax Exempt and Government Entities Division, Employee Plans Programs – Pre-approved Defined Benefit Plans

The Notice provides more amendment relief, this time for certain pre-approved defined benefit plans. The issue is described as follows:

> Rev. Proc. 2016-37, 2016-29 IRB 136, provides a regular six-year remedial amendment cycle that applies for pre-approved plans. Section 15.03(1) of Rev. Proc. 2016-37 provides that the remedial amendment period for a disqualifying provision will not end before the last day of a plan's first applicable remedial amendment cycle in which an application for an opinion or advisory letter that considers the disqualifying provision may be submitted.
>
> Announcement 2018-05, 2018-13 IRB 461, provides that an adopting employer who adopts, by April 30, 2020, a master and prototype (M&P) or volume submitter (VS) defined benefit plan that was approved based on Notice 2012-76, 2012-52 IRB 775 (2012 Cumulative List), will be considered to have adopted the plan within the second six-year remedial amendment cycle. Announcement 2018-05 also provides that an adopting employer of an M&P or VS plan may apply for an individual determination letter (if otherwise eligible) during the period beginning on

[521] Notice 2020-35, May 28, 2020, pp. 7-8

[522] Notice 2020-35, May 28, 2020, pp. 15-16

> May 1, 2018, and ending April 30, 2020. Announcement 2018-05 further provides that April 30, 2020, is the end of the second six-year remedial amendment cycle for pre-approved defined benefit plans. Rev. Proc. 2020-10, 2020-2 IRB 295, provides that the third six-year remedial amendment cycle for pre-approved defined benefit plans begins on the following day, and ends on January 31, 2025.

This time the relief offered will move the date to take action to ***July 31, 2020***. As the relief language in the Notice states:

> *Pre-approved defined benefit plans.* With respect to pre-approved defined benefit plans, the deadline for the following actions is postponed until July 31, 2020:
>
> - Adoption of a pre-approved defined benefit plan that was approved based on the 2012 Cumulative List;
> - Submission of a determination letter application under the second six-year remedial amendment cycle; and
> - Actions that are otherwise required to be performed with respect to disqualifying provisions during the remedial amendment period that would otherwise end on April 30, 2020.[523]

Tax Exempt and Government Entities Division, Employee Plans Programs – Deadline for a Voluntary Correction Under Employee Plans Compliance Resolution System (EPCRS)

The Notice describes issues that may arise under EPCRS for which the notice is giving certain relief:

> Rev. Proc. 2019-19, 2019-19 IRB 1086, sets forth a system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of section 401(a), 403(a), 403(b), 408(k), or 408(p). The Employee Plans Compliance Resolution System (EPCRS) permits employers sponsoring these plans to correct certain failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. The components of EPCRS are the Self-Correction Program (SCP), the Voluntary Correction Program (VCP), and the Audit Closing Agreement Program (Audit CAP).
>
> Under VCP, a plan sponsor may, at any time before audit, pay a limited fee and receive the IRS's approval for correction of a plan failure that has been identified to the IRS, in writing, by the plan sponsor. Once agreement has been reached with the plan sponsor as to the appropriate corrective action to be undertaken, the IRS will send the plan sponsor a compliance statement specifying the corrective action required. Pursuant to section 10.06(9) of Rev. Proc. 2019-19, the plan sponsor must implement the corrective action set forth in the compliance statement within 150 days of the date of the compliance statement. In addition, if the corrective action specified in the compliance statement includes the adoption of a corrective plan

[523] Notice 2020-35, May 28, 2020, p. 16

> amendment, the corrective amendment must be adopted no later than 150 days after the date of the compliance statement (with a later deadline in the case of a governmental plan described in section 414(d)).[524]

The relief now returns to the standard date relief, providing relief for the following actions that were required to take place between March 30, 2020 and July 15, 2020, making the action timely if taken by July 15, 2020:

> *EPCRS.* With respect to a compliance statement issued under VCP, implementation of all corrective actions, including adoption of corrective amendments, required by the compliance statement.

Tax Exempt and Government Entities Division, Employee Plans Programs – Substitute Mortality Tables

The Notice concludes the portion of the notice dealing with employee benefit plans by dealing with the deadline to file a request for approval of a substitute mortality table:

> Rev. Proc. 2017–55, 2017–43 IRB 373, provides guidance with respect to the use of a substitute mortality table in accordance with section 430(h)(3)(C). Section 4 of Rev. Proc. 2017-55 notes that, under section 430(h)(3)(C)(v)(I), a request for approval to use substitute mortality tables generally must be submitted at least 7 months before the first day of the first plan year for which the substitute mortality tables are to apply.[525]

Thus, the relief is provided for making a request originally due between March 30, 2020 through July 15, 2020, so long as it is made by July 15, 2020 for a "[r]equest for approval of a substitute mortality table in accordance with section 430(h)(3)(C)."[526]

Exempt Organizations

The Notice provides two types of relief for situations encountered by certain exempt organizations.

Form 990-N Electronic Notice Requirement for Certain Small Exempt Organizations

The Notice grants relief for small tax exempt organizations subject to the "e-Postcard" filing of Form 990-N.

> Section 6033(i) requires organizations that are excused from filing an annual information return (Form 990 series) by reason of normally having annual gross receipts below a certain specified amount (currently $50,000) to furnish an annual electronic notification. The annual electronic notification (Form 990-N, e-Postcard)

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[524] Notice 2020-35, May 28, 2020, pp. 9-10

[525] Notice 2020-35, May 28, 2020, p. 10

[526] Notice 2020-35, May 28, 2020, p. 16

> is due by the 15th day of the fifth month after the close of the organization's tax year.[527]

The Notice authorizes relief, providing that if an organization was required to file the Form 990-N between March 30, 2020 and July 15, 2020 it will be timely if filed by July 15, 2020.[528]

Time for Filing Suit for Declaratory Judgment

The second relief provided for exempt organizations relates to the time for filing suit for declaratory judgement under IRC §7428.

> Section 7428 provides that an organization may file, within a specified period, an appropriate pleading for declaratory judgment with the United States Tax Court, the United States Court of Federal Claims, or the district court of the United States for the District of Columbia, involving the IRS's determination, or failure to make a determination, with respect to the organization's initial or continuing qualification or classification as an exempt organization described in section 501(c) or (d) and exempt from tax under section 501(a), an organization described in section 170(c)(2), a private foundation under section 509(a), a private operating foundation under section 4942(j)(3), or a cooperative described in section 521(b). Although Notice 2020-23 postponed the time to commence an action for declaratory judgment with the United States Tax Court, it did not cover similar suits filed with the Court of Federal Claims or the district court of the United States for the District of Columbia.[529]

Thus, the Notice provides an extension of any filing dates between March 30, 2020 and July 15, 2020 for "[f[ilings by organizations listed in section 7428(a)(1) of an appropriate pleading for declaratory judgment with the United States Court of Federal Claims or the district court of the United States for the District of Columbia, within the period specified in section 7428(b)(3)."[530]

Forms 5498, -ESA, -SA

The final area of relief granted impacts the filing of Forms 5498, Form 5498-ESA and Form 5498-SA. The Notice states:

> Form 5498, IRA Contribution Information, Form 5498-ESA, Coverdell ESA Contribution Information, and Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, must be filed with the IRS and furnished to participants and beneficiaries by the times specified in the instructions to these forms.[531]

[527] Notice 2020-35, May 28, 2020, p. 11

[528] Notice 2020-35, May 28, 2020, p. 16

[529] Notice 2020-35, May 28, 2020, p. 11

[530] Notice 2020-35, May 28, 2020, p. 16

[531] Notice 2020-35, May 28, 2020, p. 12

In this case, the Notice provides a special relief period allowing the filing by August 31, 2020 (not the standard relief to July 15, 2020):

> With respect to the Form 5498, IRA Contribution Information, Form 5498- ESA, Coverdell ESA Contribution Information, and the Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, the due date for filing and furnishing the forms is postponed to August 31, 2020. The period beginning on the original due date of those forms and ending on August 31, 2020, will be disregarded in the calculation of any penalty for failure to file those forms. Penalties with respect to such a postponed filing will begin to accrue on September 1, 2020.[532]

RELIEF PROVIDED FROM THE PHYSICAL PRESENCE OF A NOTARY OR PLAN REPRESENTATIVE FOR 2020 FOR CERTAIN PLAN ELECTIONS

Notice 2020-42, 6/4/20

In Notice 2020-42[533] the IRS has provided relief from a physical presence requirement for spousal and other qualified retirement plan related consents in recognition of the COVID-19 emergency. The purpose of the notice is described as follows:

> In response to the unprecedented public health emergency caused by the Coronavirus Disease 2019 (COVID-19) pandemic, and the related social distancing that has been implemented, this notice provides temporary relief from the physical presence requirement in Treasury Regulations § 1.401(a)-21(d)(6) for participant elections required to be witnessed by a plan representative or a notary public, including a spousal consent required under § 417 of the Internal Revenue Code (Code). While this temporary relief, which covers the period from January 1, 2020, through December 31, 2020, is intended to facilitate the payment of coronavirus-related distributions and plan loans to qualified individuals, as permitted by section 2202 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136, 134 Stat. 281 (2020) (CARES Act), the temporary relief applies to any participant election that requires the signature of an individual to be witnessed in the physical presence of a plan representative or notary.[534]

[532] Notice 2020-35, May 28, 2020, p. 17

[533] Notice 2020-43, June 4, 2020, https://www.irs.gov/pub/irs-drop/n-20-42.pdf (retrieved June 5, 2020)

[534] Notice 2020-43, June 4, 2020, Section I

Physical Presence Rule

The physical presence issue arises under the rules found at Reg. §1.401(a)-21(d)(6). That regulation contains the following physical presence standards that may present issues during the COVID-19 emergency:

> Section 1.401(a)-21(d)(6)(i) provides that, in the case of a participant election that is required to be witnessed by a plan representative or a notary public (such as a spousal consent to a waiver of a QJSA under § 417), the signature of the individual making the participant election must be witnessed in the physical presence of a plan representative or a notary public. Section 1.401(a)-21(d)(6)(ii) provides that, if the signature is witnessed in the physical presence of a notary public, an electronic signature acknowledging the signature (in accordance with section 101(g) of the Electronic Signatures in Global and National Commerce Act, Pub. L. 106-229, 114 Stat. 464 (2000) (E-SIGN), and applicable state law for notaries public) will not be denied legal effect.[535]

A footnote reference provides the following information on E-SIGN:

> Section 101(g) of E-SIGN provides that "[i]f a statute, regulation, or other rule of law requires a signature or record relating to a transaction in or affecting interstate or foreign commerce to be notarized, acknowledged, verified, or made under oath, that requirement is satisfied if the electronic signature of the person authorized to perform those acts, together with all other information required to be included by other applicable statute, regulation, or rule of law, is attached to or logically associated with the signature or record."[536]

Relief Granted

The Notice grants temporary relief during 2020 from the physical presence requirement of Reg. §1.401(a)-21(d)(6) described in the prior section:

- Temporary relief from the physical presence requirement for any participant election witnessed by a notary public of a state that permits remote electronic notarization, and

- Temporary relief from the physical presence requirement for any participant election witnessed by a plan representative.[537]

[535] Notice 2020-43, June 4, 2020, Section II

[536] Notice 2020-43, June 4, 2020, Section II

[537] Notice 2020-42, June 4, 2020, Section III

Notary Public Physical Presence Relief

The temporary relief provided from the physical presence requirement for a notary public is:

> In the case of a participant election witnessed by a notary public, for the period from January 1, 2020, through December 31, 2020, the physical presence requirement in § 1.401(a)-21(d)(6) is deemed satisfied for an electronic system that uses remote notarization if executed via live audio-video technology that otherwise satisfies the requirements of participant elections under § 1.401(a)-21(d)(6) and is consistent with state law requirements that apply to the notary public.[538]

In this case the IRS is leaning heavily on provisions found in state law, so the relief is only possible if the state law will allow the notary public to execute a remote notarization.

Plan Representative Physical Presence Relief

More detailed rules are provided by the IRS in the case of gaining an exception from the physical presence rule for a plan representative, since there is no underlying state law for the IRS to rely upon. For 2020, the physical presence requirement of Reg. §1.401(a)-21(d)(6) will be deemed satisfied for an electronic system if the electronic system using audio-video technology satisfies the following requirements:

- The individual signing the participant election must present a valid photo ID to the plan representative during the live audio-video conference, and may not merely transmit a copy of the photo ID prior to or after the witnessing;
- The live audio-video conference must allow for direct interaction between the individual and the plan representative (for example, a pre-recorded video of the person signing is not sufficient);
- The individual must transmit by fax or electronic means a legible copy of the signed document directly to the plan representative on the same date it was signed; and
- After receiving the signed document, the plan representative must acknowledge that the signature has been witnessed by the plan representative in accordance with the requirements of this notice and transmit the signed document, including the acknowledgement, back to the individual under a system that satisfies the applicable notice requirements under § 1.401(a)-21(c).[539]

Online meeting systems such as Zoom, Google Meet, Microsoft Teams, and Apple Facetime should be sufficient to allow the signing to meet the first two requirements. The individual could then transmit their signed form to the plan representative using a scanner or even a picture of the signed form.

[538] Notice 2020-42, June 4, 2020, Section III.A.

[539] Notice 2020-42, June 4, 2020, Section III.B.

The representative's retransmission system must meet the requirements of Reg. §1.401(a)-21(c). The two key requirements are:

- The electronic medium used to provide an applicable notice must be a medium that the recipient has the effective ability to access and
- At the time the applicable notice is provided, the recipient must be advised that he or she may request and receive the applicable notice in writing on paper at no charge, and, upon request, that applicable notice must be provided to the recipient at no charge.[540]

MAXIMUM FSA CARRYOVER SET TO 20% OF MAXIMUM DEFERRAL AND CHANGE IN TIMING FOR REIMBURSEMENT FOR INDIVIDUAL PREMIUM PROVIDED FOR IN IRS NOTICE

Notice 2020-33, 5/12/2020

In Notice 2020-23[541] the IRS revised the maximum amount a cafeteria plan may allow a participant to carry over to the next year for a medical flexible savings account and clarified that a health plan may reimburse individual insurance policy premium expenses incurred prior to the beginning of the current year.

Health FSA Carryover Rule

In 2013, the IRS in Notice 2013-71 provided that a cafeteria plan with a flexible spending account could provide for a carryover of up to $500 into the following year, reducing the impact of the "use it or lose it" rule when an employee who deferred more to the account than he/she incurred in medical expenses for a year would forfeit the extra deferral.

This $500 amount was not indexed for inflation, while the maximum annual deferral is tied to inflation. When Notice 2013-71 was issued, the maximum deferral amount was $2,500. In 2020 that amount has grown to $2,750. Notice 2020-23 allows a plan to permit a participant to carryover up to 20% of the year's maximum contribution, thus effectively tying the carryover to inflation.

The Notice provides:

> …[T]his notice expands the exception to the prohibition on providing deferral of compensation through a § 125 cafeteria plan described in Notice 2013-71, which provides that a § 125 cafeteria plan may allow up to $500 of unused amounts in a participant's health FSA as of the end of a plan year to be carried over to pay or reimburse the participant for medical care expenses incurred in the immediately following plan year. Specifically, this notice increases the maximum $500 carryover amount for a plan year to an amount equal to 20 percent of the maximum salary

[540] Reg. §1.401(a)-21(c)

[541] Notice 2020-23, May 12, 2020, https://www.irs.gov/pub/irs-drop/n-20-33.pdf (retrieved May 12, 2020)

> reduction contribution under § 125(i) for that plan year. Because, by statute, the increase to the § 125(i) limit is rounded to the next lowest multiple of $50, increases to the maximum carryover amount, as the result of that indexing, will be in multiples of $10 (20 percent of any $50 increase to the § 125(i) limit). Thus, the maximum unused amount from a plan year starting in 2020 allowed to be carried over to the immediately following plan year beginning in 2021 is $550 (20 percent of $2,750, the indexed 2020 limit under § 125(i)).

Any plan wishing to take advantage of the enhanced carryover will need to amend the plan document to provide for this carryover. The IRS provides

> As a general rule, an amendment to a § 125 cafeteria plan to increase the carryover limit must be adopted on or before the last day of the plan year from which amounts may be carried over and may be effective retroactively to the first day of that plan year, provided that the § 125 cafeteria plan operates in accordance with the guidance under this notice and informs all employees eligible to participate in the plan of the carryover provision. Because § 125(d)(1) provides that a § 125 cafeteria plan must be a written plan, a § 125 cafeteria plan offering a health FSA may not utilize the increased carryover amount permitted under this notice for a plan year that begins in 2020 (or a later year) unless the plan is written in a manner that incorporates the increase by reference or the plan is timely amended to set forth the increased amount. Accordingly, a plan may be amended to adopt the increased carryover amount for a plan year that begins in 2021, for example, at any time on or before the last day of the plan year that begins in 2021; see section III.C. for a special amendment timing rule for the 2020 plan year. The ability to amend a plan to increase the carryover limit does not include the ability to allow employees to make new elections under the plan (but see relief for the 2020 plan year in section III.C.).

The special timing rule described above for 2020 reads as follows:

> With respect to the requirement to amend the written plan, Notice 2020-29 provides that an amendment under this notice for the 2020 plan year must be adopted on or before December 31, 2021, and may be effective retroactively to January 1, 2020, provided that the employer informs all individuals eligible to participate in the § 125 cafeteria plan of the changes to the plan.

A special rule found in Notice 2020-29, issued the same day, will allow employees whose employer's plans are amended in 2020 to increase the amount eligible for carryover to revise elections to defer to take advantage of this increase (although the relief in Notice 2020-29 isn't limited to this case):

> However, the Treasury Department and the IRS are simultaneously issuing a notice that, among other things, for the remainder of 2020, allows employers to permit mid-year elections under a § 125 cafeteria plan regarding a health FSA, including the ability to make an initial election to fund a health FSA, provided the changes are applied only prospectively. See Notice 2020-29, 2020-22 IRB __. Although Notice 2020-29 permits this flexibility temporarily in response to the public health emergency posed by the 2019 Novel Coronavirus, Notice 2020-29 does not limit

> the relief to individuals affected by the pandemic. Accordingly, individuals who, during 2020, wish to increase their health FSA contributions, or begin to make health FSA contributions, as a result of the increased carryover amount permitted under this notice may do so in accordance with Notice 2020-29. Although only future salary may be reduced under the revised election, amounts contributed to the health FSA after the revised election may be used for any medical care expense incurred during the first plan year that begins on or after January 1, 2020.

Reimbursement Timing for Individual Coverage HRA Plans

The Notice also contains a rule for reimbursing individual coverage aimed at making it administratively simpler to implement an individual coverage HRA. The new timing rule provides:

> As discussed in section II.B. of this notice, a health plan, including a premium reimbursement plan in a § 125 cafeteria plan or an individual coverage HRA, may not reimburse medical care expenses incurred before the beginning of the plan year and qualify for exclusion from income and wages under §§ 105 and 106. Medical care expenses are treated as incurred when the covered individual is provided the medical care that gives rise to the expense, and not when the amount is billed or paid. This notice provides that a plan is permitted to treat an expense for a premium for health insurance coverage as incurred on (1) the first day of each month of coverage on a pro rata basis, (2) the first day of the period of coverage, or (3) the date the premium is paid. Thus, for example, an individual coverage HRA with a calendar year plan year may immediately reimburse a substantiated premium for health insurance coverage that begins on January 1 of that plan year, even if the covered individual paid the premium for the coverage prior to the first day of the plan year.

COVID-19 RELIEF PROVIDED FOR §125 PLANS AND PARTICIPANTS

Notice 2020-29, 5/12/2020

The IRS has released guidance in Notice 2020-29 that allows for additional flexibility for §125 cafeteria plans given the COVID-19 national emergency that was declared on March 13.[542] The guidance deals with three general issues:

- Plans granting employees the right to make or modify elections mid-year in the §125 plan;
- Allowing participants to use unused amounts deferred to the plan remaining at the end of 2019 in 2020; and
- Allowing retroactive relief to January 1, 2020 for issues related to high deductible health plans and telepath services.

[542] Notice 2020-29, May 12, 2020, https://www.irs.gov/pub/irs-drop/n-20-29.pdf (retrieved May 12, 2020)

Changes in Elections Mid-Year

The IRS outlines the need for this relief in Section II.A. of the Notice:

> Due to the nature of the public health emergency posed by COVID-19 and unanticipated changes in the need for medical care, some employers have indicated a willingness to offer employees who initially declined to elect employer-sponsored health coverage an opportunity to elect health coverage or allow employees enrolled in employer-sponsored health coverage to enroll in different health coverage offered by the same employer or drop their existing employer-sponsored health coverage to enroll in other health coverage not offered by their employer (for example, coverage offered by their spouse's employer). In addition, some employees may have an increase or decrease in medical expenses due to unanticipated changes in the need for or availability of medical care and may wish to increase or decrease amounts in their health FSAs. Further, some employees may have an increase or decrease in the need for dependent care assistance due to the unanticipated closure of schools and child care providers and changes to the employee's work location or schedule. Depending on an employee's circumstances, the exceptions set forth in Treas. Reg. § 1.125-4 may not apply with respect to election changes that employees may wish to request for employer-sponsored health coverage, health FSAs, and dependent care assistance programs for reasons related to the COVID-19 public health emergency.

The IRS will allow employers to amend their §125 plans to allow for certain additional election options related to the COVID-19 emergency relief. The Notice states in Section III.A:

> This notice provides temporary flexibility for § 125 cafeteria plans to permit employees to make certain prospective mid-year election changes for employer-sponsored health coverage, health FSAs, and dependent care assistance programs during calendar year 2020 that the plan chooses to permit. Specifically, an employer, in its discretion, may amend one or more of its § 125 cafeteria plans (including limiting the period during which election changes may be made) to allow each employee who is eligible to make salary reduction contributions under the plan to make prospective election changes (including an initial election) during calendar year 2020 regarding employer-sponsored health coverage, a health FSA, or a dependent care assistance program, regardless of whether the basis for the election change satisfies the criteria set forth in Treas. Reg. § 1.125-4.

The Notice continues in Section III.A to allow the plan to be amended to provide for the following additional elections:

- Make a new election for employer-sponsored health coverage on a prospective basis, if the employee initially declined to elect employer-sponsored health coverage;
- Revoke an existing election for employer-sponsored health coverage and make a new election to enroll in different health coverage sponsored by the same employer on a prospective basis (including changing enrollment from self-only coverage to family coverage);

- Revoke an existing election for employer-sponsored health coverage on a prospective basis, provided that the employee attests in writing that the employee is enrolled, or immediately will enroll, in other health coverage not sponsored by the employer;
- Revoke an election, make a new election, or decrease or increase an existing election regarding a health FSA on a prospective basis; and
- Revoke an election, make a new election, or decrease or increase an existing election regarding a dependent care assistance program on a prospective basis.

Special rules apply if a plan allows an employee to revoke an existing election for employer-sponsored health coverage:

> To accept an employee's revocation of an existing election for employer-sponsored health coverage, the employer must receive from the employee an attestation in writing that the employee is enrolled, or immediately will enroll, in other comprehensive health coverage not sponsored by the employer. The employer may rely on the written attestation provided by the employee, unless the employer has actual knowledge that the employee is not, or will not be, enrolled in other comprehensive health coverage not sponsored by the employer.

An example of such a written attestation is provided as part of the notice:

> Name: ________________________ (and other identifying information requested by the employer for administrative purposes).
>
> I attest that I am enrolled in, or immediately will enroll in, one of the following types of coverage: (1) employer-sponsored health coverage through the employer of my spouse or parent; (2) individual health insurance coverage enrolled in through the Health Insurance Marketplace (also known as the Health Insurance Exchange); (3) Medicaid; (4) Medicare; (5) TRICARE; (6) Civilian Health and Medical Program of the Department of Veterans Affairs (CHAMPVA); or (7) other coverage that provides comprehensive health benefits (for example, health insurance purchased directly from an insurance company or health insurance provided through a student health plan).
>
> Signature: _______________________

The employer amending the plan to allow for changes is not required to allow unlimited changes by employees. The Notice provides:

> An employer utilizing this relief under § 125 is not required to provide unlimited election changes but may, in its discretion, determine the extent to which such election changes are permitted and applied, provided that any permitted election changes are applied on a prospective basis only, and the changes to the plan's election requirements do not result in failure to comply with the nondiscrimination rules applicable to § 125 cafeteria plans.

In particular, the notice allows the employer to implement provisions to prevent adverse selection in opting out of health coverage:

> In determining the extent to which election changes are permitted and applied, an employer may wish to consider the potential for adverse selection of health coverage by employees. To prevent adverse selection of health coverage, an employer may wish to limit elections to circumstances in which an employee's coverage will be increased or improved as a result of the election (for example, by electing to switch from self-only coverage to family coverage, or from a low option plan covering in-network expenses only to a high option plan covering expenses in or out of network).

The sponsor is also warned that such revisions may impact other laws, specifically citing the notice requirements under Title I of the Employee Income Retirement Security Act of 1974 (ERISA). The employer should insure that such laws are complied with—the notice does not provide relief for any issues arising from failing to comply with those provisions.

The Notice continues with the following issues related to this change:

> With respect to mid-year election changes for employer-sponsored coverage, this relief applies to both employers sponsoring self-insured plans and employers sponsoring insured plans. With respect to health FSAs, this relief applies to all health FSAs, including limited purpose health FSAs compatible with HSAs. In addition, with respect to health FSAs and dependent care assistance programs, employers are permitted to limit mid-year elections to amounts no less than amounts already reimbursed.

The Notice also provides relief for plans that may have implemented such options prior to the issuance of this notice:

> This relief may be applied retroactively to periods prior to the issuance of this notice and on or after January 1, 2020, to address a § 125 cafeteria plan that, prior to the issuance of this notice, permitted mid-year election changes for employer-sponsored health coverage, health FSAs, or dependent care assistance programs that otherwise are consistent with the requirements for the relief provided in this notice.

Revisions to Carryover Rules

As with the relief for mid-year elections, the IRS first outlines the reason carryover relief is being given in Section II.B of the Notice:

> Due to the nature of the public health emergency posed by COVID-19, in particular unanticipated changes in the availability of certain medical care and dependent care, employees may be more likely to have unused health FSA amounts or dependent care assistance program amounts (or have larger unused health FSA amounts or dependent care assistance program amounts) as of the end of plan years, or grace periods, ending in 2020 and may wish to have an extended period during

> which to apply their unused health FSA amounts or dependent care assistance program amounts to pay or reimburse medical care expenses or dependent care expenses.

The Notice provides for the following optional changes to carrying over unused amounts:

> This notice also provides flexibility for a § 125 cafeteria plan to provide an extended period to apply unused amounts remaining in a health FSA or dependent care assistance program to pay or reimburse medical care expenses or dependent care expenses. Specifically, an employer, in its discretion, may amend one or more of its § 125 cafeteria plans to permit employees to apply unused amounts remaining in a health FSA or a dependent care assistance program as of the end of a grace period ending in 2020 or a plan year ending in 2020 to pay or reimburse expenses incurred for the same qualified benefit through December 31, 2020. For example, if an employer sponsors a § 125 cafeteria plan with a health FSA that has a calendar year plan year and provides for a grace period ending on March 15 immediately following the end of each plan year, the employer may amend the plan to permit employees to apply unused amounts remaining in an employee's health FSA as of March 15, 2020, to reimburse the employee for medical care expenses incurred through December 31, 2020. This relief applies to all health FSAs, including limited purpose health FSAs compatible with HSAs. However, health FSA amounts may only be used for medical care expenses, and dependent care assistance program amounts may only be used for dependent care expenses. The extension of time for incurring claims is available both to § 125 cafeteria plans that have a grace period, and plans that provide for a carryover, notwithstanding Notice 2013-71, which otherwise continues in effect and provides that health FSAs can either adopt a grace period or provide for a carryover amount but cannot have both.

Via a footnote, the Notice provides that this relief would be unnecessary (as in, no benefit available) for those with fiscal years of October or later:

> Certain plans would not need the relief provided in this notice. For example, a plan with a plan year ending on or after October 31, 2020, continues to be able to provide a grace period of up to two months and 15 days, which would allow the reimbursement of claims incurred after December 31, 2020.

The Notice also clarifies how such a revision would interact with high deductible health plans (HDHPs) and health savings accounts (HSAs):

> The extension of the period for incurring claims that may be reimbursed by the health FSA is an extension of coverage by a health plan that is not an HDHP for purposes of determining whether an eligible individual qualifies to make contributions to an HSA (except in the case of an HSA-compatible health FSA, such as a limited purpose health FSA). See section II.C. of this notice. Thus, an individual who had unused amounts remaining at the end of a plan year or grace period ending in 2020 and who is allowed an extended period to incur expenses under a health FSA pursuant to a plan amended in accordance with this notice will

> not be eligible to contribute to an HSA during the extended period (except in the case of an HSA-compatible health FSA, including a health FSA that is amended to be HSA-compatible)

The Notice provides the time period that this relief applies to:

> The relief set forth in this notice may be applied on or after January 1, 2020 and on or before December 31, 2020, provided that any elections made in accordance with this notice apply only on a prospective basis.

The IRS provides two examples in the Notice of the applicability of this relief.

EXAMPLE 1.

Employer provides a health FSA under a § 125 cafeteria plan that allows a $500 carryover for the 2019 plan year (July 1, 2019 to June 30, 2020). Pursuant to this notice and Notice 2020-33, Employer amends the plan to adopt a $550 (indexed) carryover beginning with the 2020 plan year, and also amends the plan to adopt the temporary extended period for incurring claims with respect to the 2019 plan year, allowing for claims incurred prior to January 1, 2021, to be paid with respect to amounts from the 2019 plan year.

Employee A has a remaining balance in his health FSA for the 2019 plan year of $2,000 on June 30, 2020, because a scheduled non-emergency procedure was postponed. For the 2020 plan year beginning July 1, 2020, Employee A elects to contribute $2,000 to his health FSA. Employee A is able to reschedule the procedure before December 31, 2020 and, between July 1, 2020 and December 31, 2020, incurs $1,900 in medical care expenses. The health FSA may reimburse Employee A $1,900 from the $2,000 remaining in his health FSA at the end of the 2019 plan year, leaving $100 unused from the 2019 plan year. Under the plan terms that provide for a carryover, Employee A is allowed to use the remaining $100 in his health FSA until June 30, 2021, to reimburse claims incurred during the 2020 plan year. Employee A may be reimbursed for up to $2,100 ($2,000 contributed to the health FSA for the 2020 plan year plus $100 carryover from the 2019 plan year) for medical care expenses incurred between January 1, 2021 and June 30, 2021. In addition, Employee A may carry over to the 2021 plan year beginning July 1, 2021 up to $550 of any remaining portion of that $2,100 after claims are processed for the 2020 plan year that began July 1, 2020. A grace period is not available for the plan year ending June 30, 2021.

EXAMPLE 2.

Same facts as Example 1, except that Employee B has a remaining balance in his health FSA for the 2019 plan year of $1,250 on June 30, 2020. For the 2020 plan year beginning July 1, 2020, Employee B elects to contribute $1,200 to his health FSA. Between July 1, 2020 and December 31, 2020, Employee B incurs $600 in medical care expenses. The health FSA may reimburse Employee B $600 from the $1,250 remaining in his health FSA at the end of the 2019 plan year, leaving $650 unused from the 2019 plan year. Under the plan terms, Employee B is allowed to use $5004 of the $650 unused amount from the 2019 plan year to reimburse claims incurred during the 2020 plan year, and the remaining $150 will be forfeited. Employee B may be reimbursed for up to $1,700 ($1,200 contributed to the health FSA for the 2020 plan year plus $500 carryover from the 2019 plan year) for medical care expenses incurred between January 1, 2021 and June 30, 2021. In addition, Employee B may carry over to the 2021 plan year beginning July 1, 2021 up to $550 of any remaining unused portion of that $1,700 after claims are processed for the 2020 plan year that began July 1, 2020. A grace period is not available for the plan year ending June 30, 2021.

Relief for HDHP Health Plans and HSAs

Finally, the IRS provides the justification for relief related to high deductible health plans (HDHPs) and health savings accounts (HSAs):

> Coverage by a general purpose health FSA is coverage by a health plan that disqualifies an otherwise eligible individual from contributing to an HSA, although coverage by a limited purpose health FSA would not do so.2 See Rev. Rul. 2004-45, 2004-1 C.B. 971. Similarly, a telemedicine arrangement generally constitutes a health plan or insurance that provides coverage before the minimum annual deductible is met, and provides coverage that is not disregarded coverage or preventive care, which would generally disqualify an otherwise eligible individual from contributing to an HSA. However, section 3701 of the CARES Act amended § 223 of the Code to temporarily allow HSA-eligible HDHPs to cover telehealth and other remote care services. See section IV.B. of this notice for more details.

Clarification of Notice 2020-15 on COVID-19 Testing and Treatment

The Notice contains the following information to clarify COVID-19 testing and treatment and the impact of qualification of an insurance plan as an HDHP in Section IV.A.

> Notice 2020-15 provides that a health plan that otherwise satisfies the requirements to be an HDHP under § 223(c)(2)(A) will not fail to be an HDHP merely because the health plan provides medical care services and items purchased related to testing for and treatment of COVID-19 prior to the satisfaction of the applicable minimum deductible. This notice clarifies that the relief provided in Notice 2020-15 regarding HDHPs and expenses related to testing for and treatment of COVID-19 applies with respect to reimbursements of expenses incurred on or after January 1, 2020. This notice further clarifies that the panel of diagnostic testing for influenza A & B, norovirus and other coronaviruses, and respiratory syncytial virus (RSV) and any items or services required to be covered with zero cost sharing under section 6001 of the Families First Coronavirus Response Act (P.L. 116-127, 134 Stat. 178 (March 18, 2020)), as amended by the CARES Act, are part of testing and treatment for COVID-19 for purposes of Notice 2020-15.

FSA Reimbursement Issues With Regard to Eligibility to Contribute to an HSA

The Notice provides the following relief in Section IV.B:

> Section 3701 of the CARES Act amends § 223(c) of the Code to provide a temporary safe harbor for providing coverage for telehealth and other remote care services. As added by the CARES Act, § 223(c)(2)(E) of the Code allows HSA-eligible HDHPs to cover telehealth and other remote care services without a deductible or with a deductible below the minimum annual deductible otherwise required by § 223(c)(2)(A) of the Code. Section 3701 of the CARES Act also

> amends § 223(c)(1)(B)(ii) of the Code to include telehealth and other remote care services as categories of coverage that are disregarded for purposes of determining whether an individual who has other health plan coverage in addition to an HDHP is an eligible individual who may make tax-favored contributions to his or her HSA under § 223 of the Code. Thus, an otherwise eligible individual with coverage under an HDHP may also receive coverage for telehealth and other remote care services outside the HDHP and before satisfying the deductible of the HDHP and still contribute to an HSA. The amendments to § 223 of the Code under section 3701 of the CARES Act are effective March 27, 2020, and apply to plan years beginning on or before December 31, 2021. This notice provides that treatment of telehealth and other remote care services under section 3701 of the CARES Act applies with respect to services provided on or after January 1, 2020, with respect to plan years beginning on or before December 31, 2021. Therefore, for example, an otherwise eligible individual with coverage under an HDHP who also received coverage beginning February 15, 2020 for telehealth and other remote care services under an arrangement that is not an HDHP and before satisfying the deductible for the HDHP will not be disqualified from contributing to an HSA during 2020.

Plan Amendment Provisions

The Notice provides the following information regarding the timing and nature of amendments needed to take advantage of this relief in Section III.C:

> An employer that decides to amend one or more of its § 125 cafeteria plans to provide for mid-year election changes for employer-sponsored health coverage, health FSAs, or dependent care assistance programs in a manner consistent with this notice or to provide for an extended period to apply unused amounts remaining in a health FSA or a dependent care assistance program to pay or reimburse medical care expenses or dependent care expenses in a manner consistent with this notice must adopt a plan amendment. In addition, an employer that decides to amend its health FSA to provide for an increase in the carryover of unused amounts to the following year in a manner consistent with Notice 2020-33, for the 2020 plan year or plan years thereafter, must adopt a plan amendment.
>
> An amendment for the 2020 plan year must be adopted on or before December 31, 2021, and may be effective retroactively to January 1, 2020, provided that the § 125 cafeteria plan operates in accordance with this notice or Notice 2020-33 or both, as applicable, and the employer informs all employees eligible to participate in the § 125 cafeteria plan of the changes to the plan. Any amendment adopted pursuant to this notice must apply only to mid-year elections made during calendar year 2020, or to an extended period to apply unused health FSA amounts or dependent care assistance program amounts for the payment or reimbursement of medical care expenses or dependent care expenses incurred through December 31, 2020.

TAX TREATMENT FOR PROGRAMS FOR DONATION OF EMPLOYEE LEAVE TIME VALUE TO COVID-19 CHARITIES DESCRIBED IN IRS NOTICE

Notice 2020-46, 6/11/20

The IRS has released guidance for employers who have established programs that allow employees to donate the value of their vacation, sick, or personal leave to be paid by the employer to a §170(c) organization providing COVID-19 relief in Notice 2020-46.[543]

The Notice describes the programs as follows:

> Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in section 170(c) of the Code (section 170(c) organizations).

The Notice provides the following tax treatment for employees for these payments.

> Cash payments an employer makes to section 170(c) organizations in exchange for vacation, sick, or personal leave that its employees elect to forgo will not be treated as wages (or compensation, as applicable) to the employees or otherwise be included in the gross income of the employees if the payments are: (1) made to the section 170(c) organizations for the relief of victims of the COVID-19 pandemic in the affected geographic areas; and (2) paid to the section 170(c) organizations before January 1, 2021. Similarly, employees electing to forgo leave will not be treated as having constructively received gross income or wages (or compensation, as applicable). The amount of cash payments to which this guidance applies should not be included in Box 1, 3 (if applicable), or 5 of the Form W-2. Electing employees may not claim a charitable contribution deduction under section 170 with respect to the value of forgone leave.

Similarly, the Notice provides the following treatment for the employer.

> An employer may deduct these cash payments under the rules of section 170 or the rules of section 162 if the employer otherwise meets the respective requirements of either section.

[543] Notice 2020-46, June 11, 2020, https://www.irs.gov/pub/irs-drop/n-20-46.pdf (retrieved June 11, 2020)

IRS EXPANDS PRIOR GRANT OF COVID-19 QOF RELIEF AND ADDS MORE OPPORTUNITY ZONE RELIEF

Notice 2020-39, 6/4/20

The IRS has provided additional relief to certain taxpayers looking to reinvest proceeds in Qualified Opportunity Funds in Notice 2020-39.[544] As well, the Notice provides additional relief related to Opportunity Zones.

180-Day Reinvestment Period for QOF Investors

Generally, investors who wish to defer gains using the qualified opportunity fund provisions of IRC §1400Z-2 have 180 days to reinvest those gains. The IRS had previously granted an extension of time to make certain reinvestments in Notice 2020-23. This original relief is summarized in the new notice as follows:

> One of the time-sensitive acts postponed by Notice 2020-23 was the making of "an investment at the election of a taxpayer due to be made during the 180-day period described in section 1400Z-2(a)(1)(A) of the Code" (180-day investment period). See Notice 2020-23, Part III.A and C. Specifically, Notice 2020-23 postponed to July 15, 2020, any deadline for the 180-day investment requirement that otherwise would have occurred on or after April 1, 2020 and before July 15, 2020. See id., Part III.C. [545]

Notice 2020-39 extends this relief through December 31, 2020, providing:

> If the last day of the 180-day investment period within which a taxpayer must make an investment in a QOF in order to satisfy the 180-day investment requirement falls on or after April 1, 2020, and before December 31, 2020, the last day of that 180-day investment period is postponed to December 31, 2020. [546]

The IRS provides the following guidance in the Notice for taxpayers taking advantage of this relief:

> This relief is automatic; taxpayers do not have to call the IRS or send letters or other documents to the IRS to receive this relief. However, a taxpayer will still need to make a valid deferral election in accordance with the instructions to Form 8949, complete Form 8997, and file the completed Form 8949 and Form 8997 with a timely filed Federal income tax return (including extensions) or amended Federal income tax return for the taxable year in which the gain would be recognized if section 1400Z-2(a)(1) did not apply to defer recognition of the gain. For additional

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[544] Notice 2020-39, June 4, 2020, https://www.irs.gov/pub/irs-drop/n-20-39.pdf (retrieved June 5, 2020)

[545] Notice 2020-39, Section II.B

[546] Notice 2020-39, Section III.A

information, see https://www.irs.gov/form8949 and https://www.irs.gov/form8997. [547]

90-Percent Investment Standard for QOFs

The law provides a requirement that a minimum percentage of a fund's property must consist of qualified opportunity zone property. The Notice describes this requirement as follows:

> Section 1400Z-2(d)(1) defines a QOF as any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). This definition also requires a QOF to hold at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held by that QOF as measured (i) on the last day of the first 6-month period of the taxable year of the QOF, and (ii) on the last day of the taxable year of the QOF. See section 1400Z-2(d)(1). The requirement that the average percentages of the QOF's qualified opportunity zone property on these two dates (semi-annual testing dates) must equal at least 90 percent of the QOF's assets is referred to as the 90-percent investment standard. See section 1400Z-2(f). Section 1.1400Z2(d)-1 provides definitions and rules to implement the 90-percent investment standard.
>
> If the average of the percentages of the qualified opportunity zone property held by a QOF on these semi-annual testing dates fails to meet the 90-percent investment standard, section 1400Z-2(f)(1) provides a general rule that the QOF must pay a penalty for each month that the QOF fails to meet that standard. However, section 1400Z-2(f)(3) provides that no such penalty is imposed "with respect to any failure if it is shown that such failure is due to reasonable cause."[548]

Due to the economic disruption brought about by COVID-19, Notice 2020-39 provides the following blanket relief for certain violations of this provision:

> In the case of a QOF whose (i) last day of the first 6-month period of the taxable year or (ii) last day of the taxable year falls within the period beginning on April 1, 2020, and ending on December 31, 2020, any failure by that QOF to satisfy the 90-percent investment standard for that taxable year of the QOF is —
>
> > (1) due to reasonable cause under section 1400Z-2(f)(3); and
> >
> > (2) disregarded for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the requirements of section 1400Z-2 and the section 1400Z-2 regulations for any taxable year of the QOF.[549]

[547] Notice 2020-39, Section III.A

[548] Notice 2020-39, June 4, 2020, Section II.C

[549] Notice 2020-39, June 4, 2020, Section III.B

The steps to be undertaken by a QOF covered by this relief are outlined by the IRS in the Notice:

> This relief is automatic; QOFs do not have to call the IRS or send letters or other documents to the IRS to receive this relief. However, a QOF must accurately complete all lines on Form 8996 filed with respect to each affected taxable year EXCEPT that the QOF should place a "0" in Part IV, Line 8 (Penalty). The accurately completed Form 8996 must be filed with the QOF's timely filed Federal income tax return (including extensions) for the affected taxable year(s). For additional information, see https://www.irs.gov/form8996.[550]

Working Capital Safe Harbor for Qualified Opportunity Zone Businesses

Rules also apply to qualified opportunity zone businesses restricting the amount of holdings of "nonqualified financial property" by the business. However, a reasonable amount of working capital is allowed to be excluded from that category of asset. The regulations under IRC §1400Z-2 provide for a safe harbor calculation of such reasonable amounts of working capital. These rules are described in Notice 2020-23 as follows:

> An entity must meet certain requirements to be a qualified opportunity zone business, including the requirement of section 1397C(b)(8) that less than 5 percent of the average of the aggregate unadjusted bases of the entity's property be attributable to nonqualified financial property, as defined in section 1397C(e). Section 1397C(e) excludes from nonqualified financial property reasonable amounts of working capital that are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. See § 1.1400Z2(d)-1(d)(3)(iv).
>
> The section 1400Z-2 regulations provide qualified opportunity zone businesses with a safe harbor for treating an amount of working capital as reasonable for purposes of section 1397C(e) if certain requirements are satisfied (working capital safe harbor). See § 1.1400Z2(d)-1(d)(3)(v) (providing the scope of the working capital safe harbor and conditions for eligibility). One of those requirements is that there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets. See § 1.1400Z2(d)-1(d)(3)(v)(B). A qualified opportunity zone business may extend the working capital safe harbor period to a maximum 62-month period under § 1.1400Z2(d)-1(d)(3)(vi) if certain additional requirements are met.
>
> If such qualified opportunity zone business is located in a qualified opportunity zone within a Federally declared disaster (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may receive not more than an additional 24 months to expend its working capital assets, as long as the qualified opportunity zone business otherwise meets the requirements of the working capital safe harbor. See § 1.1400Z2(d)-1(d)(3)(v)(D). Therefore, a qualified opportunity zone business may, if each applicable requirement of § 1.1400Z2(d)-1(d)(3)(v) and (vi) is satisfied, have

[550] Notice 2020-39, June 4, 2020, Section III.B

> up to a maximum 86-months to expend working capital assets if the qualified opportunity zone business is located in a qualified opportunity zone within a Federally declared disaster.[551]

The Notice clarifies that the COVID-19 emergency will enable a qualified opportunity zone business to use the additional 24-month period:

> As a result of the Emergency Declaration (that is, the declaration of a Federally declared disaster for purposes of section 165(i)(5)(A)), all qualified opportunity zone businesses holding working capital assets intended to be covered by the working capital safe harbor before December 31, 2020, receive not more than an additional 24 months to expend the working capital assets of the qualified opportunity zone business, as long as the qualified opportunity zone business otherwise meets the requirements of § 1.1400Z2(d)-1(d)(3)(v) (that is, the requirements to qualify for the working capital safe harbor). See § 1.1400Z2(d)-1(d)(3)(v)(D) (providing such 24-month extension due to a Federally declared disaster).[552]

30-Month Substantial Improvement Period for QOFs

Another requirement imposed on QOFs is a 30-month limit on the time to substantially improve property that is not "original use investment" for the property to be considered qualified opportunity zone business property. Notice 2020-39 summarizes this rule as follows:

> Section 1400Z-2(d)(2)(D)(i) provides that tangible property is treated as qualified opportunity zone business property if the tangible property is used in a trade or business of the QOF and satisfies three general requirements. One of these requirements is that the original use of post-2017 acquired tangible property in the qualified opportunity zone must begin with the QOF (referred to as the "original use requirement"), or the QOF must substantially improve that property (substantial improvement requirement). See section 1400Z-2(d)(2)(D)(i)(II). The substantial improvement requirement is met only if, during any 30-month period beginning after the date of acquisition of the post-2017 acquired tangible property, there are "additions to basis with respect to such property" held by the QOF that, in the aggregate, exceed the QOF's adjusted basis of that property as of the beginning of that 30-month period (30-month substantial improvement period). See section 1400Z-2(d)(2)(D)(ii). Section 1.1400Z2(d)-2(b)(4) provides rules to implement the substantial improvement requirement.[553]

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[551] Notice 2020-39, June 4, 2020, Section II.D

[552] Notice 2020-39, June 4, 2020, Section IV.A

[553] Notice 2020-39, June 4, 2020, Section II.E

Notice 2020-39 gives relief by providing that the period from April 1, 2020 to December 31, 2020 will be disregarded for these purposes:

> For purposes of the substantial improvement requirement with respect to property held by a QOF or qualified opportunity zone business, the period beginning on April 1, 2020, and ending on December 31, 2020, is disregarded in determining any 30-month substantial improvement period (that is, the 30-month substantial improvement period is tolled during the period beginning on April 1, 2020, and ending on December 31, 2020).[554]

12-Month Reinvestment Period for QOFs

The regulations under IRC §1400Z-2 provided a special rule that allowed a QOF that sells or disposes of some or all of its qualified opportunity zone property or that receives a distribution that is treated as a return of capital from qualified opportunity zone stock can continue to count those proceeds as qualified opportunity zone property if the amounts are properly reinvested within 12 months.

Notice 2020-39 outlines this rule from the regulations:

> The section 1400Z-2 regulations provide generally that, if (i) a QOF sells or disposes of some or all of its qualified opportunity zone property or if a distribution with respect to the QOF's qualified opportunity zone stock is treated as a return of capital in the QOF's hands, and if (ii) the QOF reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90-percent investment standard. See § 1.1400Z2(f)-1(b)(1). This treatment is available to a QOF only to the extent that, prior to the reinvestment in qualified opportunity zone property, the reinvested proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. See *id*.
>
> If the QOF's plan to reinvest some or all of the above-described proceeds in qualified opportunity zone property is delayed due to a Federally declared disaster (as defined in section 165(i)(5)(A)), the QOF may receive not more than an additional 12 months to reinvest the proceeds, provided that the QOF invests the proceeds in the manner originally intended before the disaster. See § 1.1400Z2(f)-1(b)(2).[555]

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[554] Notice 2020-39, June 4, 2020, Section III.C

[555] Notice 2020-39, June 4, 2020, Section II.F

The Notice grants relief if the 12-month reinvestment period includes January 20, 2020, giving the QOF an additional 12 months to reinvest:

> If any QOF's 12-month reinvestment period includes January 20, 2020 (that is, the date of the disaster identified in the Major Disaster Declarations), that QOF receives up to an additional 12 months to reinvest in qualified opportunity zone property some or all of the proceeds received by the QOF from the return of capital or the sale or disposition of some or all of the QOF's qualified opportunity zone property, provided that the QOF satisfies the requirements of § 1.1400Z2(f)-1(b)(1) and invests the proceeds in the manner originally intended before January 20, 2020. See § 1.1400Z2(f)-1(b)(2) (providing such 12-month extension due to a Federally declared disaster).[556]

[556] Notice 2020-39, June 4, 2020, Section IV.B

Unit

12

CARES Act: Individual Tax Provisions

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Calculate the amount of the recovery rebate due to a taxpayer
- Explain to clients the special options available for retirement funds in 2020
- Understand the other modifications made to individual taxation by the CARES Act

Although the "checks to every taxpayer" (well, not really) got most of the headlines, there are a number of provisions directed at individuals in addition to the rebate payments found in this new law.

The provisions found in the individual tax section of the CARES Act are discussed below.

RECOVERY REBATES FOR INDIVIDUALS (CARES ACT §2201)

The payments to taxpayers are referred to as "2020 Recovery Rebates for Individuals" found at new IRC §6428. Technically the rebate is a credit to be claimed on the 2020 income tax return, though we'll quickly find out it's not quite as simple as that.

Basic Credit for 2020

The credit is equal to:

- $1,200 for individuals not filing a joint return and
- $2,400 for a couple filing a joint income tax return.[557]

[557] IRC §6428(a)(1)

The credit is then increased by $500 for each qualifying child as defined for the child tax credit. This means the credit applies to a qualifying child under the dependency rules who has not attained age 17 by the end of the taxable year.[558]

The credit is classified as a refundable credit,[559] so taxpayers will receive the full credit regardless of the amount of tax otherwise due for the year.

The big "gotcha" for the clients of many CPAs is found in the adjusted gross income limitation rules found at IRC §6428(c). The credit is reduced, but not below zero, by 5% of the amount the taxpayer's income exceeds:

- $150,000 for taxpayers filing a joint return;
- $112,500 for taxpayers filing as head of household; and
- $75,000 for all other taxpayers.[560]

Individuals who are eligible to qualify for the credit includes all individuals *other than*:

- Nonresident aliens;
- Individuals eligible to be treated as a dependent of another for tax purposes under IRC §151; and
- An estate or trust.[561]

No credit will be allowed unless the taxpayer provides a valid identification number on the tax return for:

- The taxpayer;
- The taxpayer's spouse for a joint return; and
- Each qualifying child.[562]

A valid identification number includes a social security number or an adoption taxpayer identification number (for a qualifying child who is adopted or placed for adoption).[563]

The requirement to have an adoption taxpayer identification number for a child does not apply if:

- At least one spouse is a member of the Armed Forces of the United States; and

[558] IRC §6428(a)(2); IRC §24(c)

[559] IRC §6428(b)

[560] IRC §6428(c)

[561] IRC §6482(d)

[562] IRC §6428(g)(1)

[563] IRC §6428(g)(2)

- At least one spouse has a valid identification number shown on the return.[564]

Reduction for Amounts of Advance Credit Received

But if this is a 2020 credit, what about those statements that checks were going to go out to Americans immediately? Those checks are the advance credit to be received under this program, with the 2020 credit reduced by the amount of advance credit received.

The 2020 credit is to be reduced (but not below zero) by the amount of the advance payment received by the taxpayer under advance payment rules found at IRC §6428(f).[565] If the taxpayers receive an advance payment by reference to a joint return, ½ of the refund shall be treated as paid to each taxpayer. This would become important if the taxpayers do not file a joint return for 2020.[566]

Note that since the credit is reduced *but not below zero*, if a taxpayer gets an advanced credit in excess of what it is determined the taxpayer actually qualifies for on the 2020 return, the taxpayer does not have to repay the excess. But if the taxpayer qualifies for more credit on the 2020 return than he/she received as an advance payment, the taxpayer will obtain that additional credit on the 2020 income tax return.

Advance Credit Amount

The basic advance credit computation looks at a taxpayer's 2019 income tax return, treating the taxpayer as if he/she/they had made a payment against 2019 taxes equal to the amount that would have been allowed under the 2020 credit calculation rules described earlier if they had applied in 2019.[567]

EXAMPLE

Harry filed his 2019 return in early February 2020 claiming head of household status. His adjusted gross income was $60,000 and he had one qualifying child. For purposes of the advance credit, Harry would receive the $1,200 basic individual credit plus a $500 additional credit for his one qualifying child.

If Harry's adjusted gross income for 2019 had instead been $200,000, he would receive no advance payment of credit, as his entire credit would have phased out under the rules that would apply to 2020. Harry will have to wait until he files his 2020 return to see if he qualifies for a credit in 2020 and receives any benefit then.

Treasury is directed to pay the advance payment amount as rapidly as possible, but in no event will an advance payment be made after December 31, 2020.[568] Treasury is allowed to pay these funds to any account that the payee authorized, on or after January 1, 2018, to receive the delivery of a refund

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[564] IRC §6482(g)(3)

[565] IRC §6428(e)(1)

[566] IRC §6428(e)(2)

[567] IRC §6428(f)(1), (2)

[568] IRC §6428(f)(3)(A)

of taxes or of a Federal payment (such as social security benefits).[569] The government is also authorized to modify such information for purposes of facilitating the accurate and efficient delivery of the payment.[570]

The government will not pay any interest on any overpayment attributable to the advance payment rules.[571]

All of this is well and good, but the 2019 tax returns now aren't even due without an extension until July 15, 2020, and taxpayers still have the option to file an extension and delay their filing until October 15, 2020. As well, with the various precautions in place for COVID-19 the IRS may not have gotten even all returns filed with the agency as of the date of enactment processed in their system.

To handle these returns, the law provides for an option to use an alternative source of information. For taxpayers whose 2019 returns has not yet been filed the agency can:

- Use the taxpayer's 2018 return as the basis for computing the advance payment and
- If the taxpayer did not file a 2018 income tax return, make use of information for the taxpayer found in:
  - Form 1099SSA filed for 2019 (Social Security Benefit Statement) or
  - Form RRB-1099 filed for 2019 (Social Security Equivalent Benefit Statement).[572]

Note that if a taxpayer was not required to file a 2018 income tax return and does not receive either social security or railroad retirement, there apparently will be no source the IRS will be authorized to use to compute the advance payment. At this point it's not clear whether such individual simply won't get a check, or if the IRS will require them to file a 2019 return, even if one is not otherwise due, and then pay the advance payment assuming it can be processed by December 31, 2020.

Treasury will send a notice to a taxpayer's last known address within 15 days of the date a payment is distributed indicating:

- The date the payment was made;
- The amount of the payment; and
- A phone number for a point of contact with the IRS to report a failure to receive the payment.[573]

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[569] IRC §6428(f)(3)(B)

[570] IRC §6428(f)(3)(C)

[571] IRC §6428(f)(4)

[572] IRC §6428(f)(5)

[573] IRC §6428(g)(1), (2)

SPECIAL RULES FOR USE OF RETIREMENT FUNDS (CARES ACT §2202)

Taxpayers who have access to most retirement accounts will be eligible for certain special treatments due to the CARES Act.

Withdrawals from Retirement Plans

The 10% early distribution tax found at IRC §72(t) will not apply to a "coronavirus-related distribution."[574]

A *coronavirus-related distribution* is any distribution from an eligible retirement plan made:

- On or after January 1, 2020 and before December 31, 2020;
- To an individual
  - Who is diagnosed with the virus SARS-CoV-2 or with coronavirus disease (COVID-19) by a test approved by the CDC;
  - Whose spouse or dependent is diagnosed with any of those viruses by such a test or
  - Who experiences adverse financial consequences as a result of being quarantined, furloughed or laid off, or having work hours reduced due to such virus or disease, being unable to work due to lack of child care due to such virus or disease, closing or reducing hours of a business owned or operated by the individual due to such virus or disease, or other factors as determined by Treasury.[575]

A plan administrator may rely upon an employee's certification that he/she meets these requirements.[576]

Eligible retirement plans from which these distributions can be taken are:

- An individual retirement account described in section 408(a),
- An individual retirement annuity described in section 408(b) (other than an endowment contract),
- A qualified trust (standard qualified employer retirement plan under IRC §401(a)),
- An annuity plan described in section 403(a),

[574] Act §2202(a)(1)

[575] Act §2202(a)(4)(A)

[576] Act §2202(a)(4)(B)

- An eligible deferred compensation plan described in section 457(b) which is maintained by an eligible employer described in section 457(e)(1)(A), and
- An annuity contract described in section 403(b).[577]

The maximum amount of such a distribution is $100,000 for the taxable year.[578]

The individual is allowed to repay the distribution and obtain rollover treatment for a period that runs for three years beginning on the day after the date such distribution is received.[579]

As well, the taxpayer, unless he/she elects otherwise, will include the distribution in income over three years, beginning with the year of the distribution.[580]

These distributions are exempted from the rules requiring withholding from eligible rollover distributions from plans that are not a trustee-to-trustee transfer.[581]

A coronavirus related distribution is treated as meeting the requirements of:

- IRC §401(k)(2)(B)(i) (cases where funds can be distributed from a §401(k) plan);
- IRC §403(b)(7)(A)(i) (cases where funds can be distributed from a §403(b) plan);
- IRC §403(b)(11) (cases where funds can be distributed from a §403(b) plan);
- IRC §457(d)(1)(a) (cases where funds can be distributed from a §457 plan); and
- Section 8433(h)(1) of title 5, United States Code (Thrift Saving Plan distributions).

Loans from Qualified Plans

The CARES Act, for the 180-day period beginning on March 27, 2020, increases the maximum plan loan amount allowed to $100,000 from $50,000, as well as raising the limit to full amount of the present value of the non-forfeitable accrued benefit under the plan.[582]

The law also allows for a one-year delay in the payment date for any payment beginning on March 27, 2020 and ending on December 31, 2020.[583] Subsequent payments' due dates shall be adjusted to

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[577] Act §2202(a)(4)(C); IRC §402(c)(8)(B)

[578] Act §2202(a)(2)(A)

[579] Act §2202(a)(3)(A)

[580] Act §2202(a)(5)(A)

[581] Act §2202(a)(6)(A)

[582] Act §2202(b)(1)

[583] Act §2202(b)(2)(A)

take into account the delay[584] and the period will be ignored for the 5-year limit on the terms of such loans.[585]

Plan Amendments

The CARES Act also allows plans to operate as if amended to take these provisions into account[586] so long as the plan is actually amended on or before the last day of the first plan year beginning on or after January 1, 2022 (or such later date as Treasury may prescribe).[587]

TEMPORARY WAIVER OF REQUIRED MINIMUM DISTRIBUTIONS FOR CERTAIN RETIREMENT PLANS AND ACCOUNTS (CARES ACT §2203)

With the rapid drop in the stock market as the COVID-19 crisis sped up, many retirees found that their required minimum distributions for 2020 now made up a much larger portion of their retirement fund than it had back at the beginning of the year. If such distributions were required to be made, a retiree might be forced to greatly or even, in the worst case, entirely deplete the retirement account.

The CARES Act removes the requirement to take required minimum distributions in 2020 for defined contribution plans and IRAs. Similar relief is granted for individuals who attained age 70 ½ in 2019, but had not taken their required minimum distribution in 2019.[588]

The law also restores a special rule that applied in 2009 to eliminate the potential problem of what will retroactively become an eligible rollover distribution that should have had taxes withheld. The rule, found at IRC §402(c)(4) provides:

> If all or any portion of a distribution during 2020 is treated as an eligible rollover distribution but would not be so treated if the minimum distribution requirements under section 401(a)(9) had applied during 2020, such distribution shall not be treated as an eligible rollover distribution for purposes of section 401(a)(31) or 3405(c) or subsection (f) of this section.

ALLOWANCE OF PARTIAL ABOVE THE LINE DEDUCTION FOR CHARITABLE CONTRIBUTIONS (CARES ACT §2204)

A special limited charitable deduction for non-itemizers is added by the CARES Act. IRC §62(a)(22) will now allow taxpayers that do not itemize their deductions to claim up to $300 of cash

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[584] Act §2202(b)(2)(B)

[585] Act §2202(b)(2)(C)

[586] Act §2202(c)(1)

[587] Act §2202(c)(2)

[588] Act §2203

charitable contributions in computing adjusted gross income. The new rule applies to tax years beginning in 2020 (that is, it appears it is only applicable in 2020).[589]

MODIFICATION OF LIMITATIONS ON CHARITABLE CONTRIBUTIONS (CARES ACT §2205)

While the above the line deduction is fine, it only works if a taxpayer doesn't itemize deductions. In this case, we are looking at those wanting to make charitable contributions in excess of the percentage limitations, the law provides for ignoring the percentage limitations on cash contributions of IRC §170(b) and the carryover limitations of IRC §170(d) for individuals.[590] Contributions in excess of 100% of adjusted gross income before any net operating loss deduction are available for carryover to the following year.[591]

For C corporations the limit will be set at 25% of taxable income, up from 10%, for qualified contributions.[592] Individual partners of a partnership and shareholders of an S corporation make their own election to use the higher limits.[593]

Qualifying contributions for this purpose are cash contributions made in 2020 to a charitable contribution described at IRC §170(b)(1)(A) (50% contribution category) if the taxpayer elects to make use of this special rule.[594] However, excluded from the category of qualifying contributions are contributions to:

- §509(a)(3) supporting organization private foundations or
- For the establishment of a new, or maintenance of an existing, donor advised fund as defined in IRC §4966(d)(2).[595]

The special limitations on the contribution of food inventory by a C corporation are increased to 25% from the 15% normally in place under the law.[596]

[589] Act §2204

[590] Act §2205(a)(1)

[591] Act §2205(a)(2)(A)

[592] Act §2205(a)(2)(B)

[593] Act §2205(a)(3)(C)

[594] Act §2205(a)(3)(A)

[595] Act §2205(a)(3)(B)

[596] Act §2205(b)

EXCLUSION FOR CERTAIN EMPLOYER PAYMENTS OF STUDENT LOANS (CARES ACT §2206)

The exclusion available for qualified employer paid tuition under IRC §127(c) is expanded to include payments by an employee of principal and interest on a qualified education loan (as defined in IRC §221(d)(1)).[597]

The employee will not be allowed to claim a deduction for interest for amounts paid by the employer under this program.[598]

Note that the standard limitations on providing this fringe benefit will still apply—it is not the case that every employer can pay student loan payments for every employee. For many small employers, these restrictions have made such a program unattractive due to very low limits on benefits available to owners of more than 5% of the business and their spouses or dependents.[599]

The exclusion covers payments made after the date of enactment and before January 1, 2021.[600]

HDHP TEMPORARY RULES FOR TELEHEALTH SERVICES (CARES ACT §3701)

High deductible health plans will be allowed to provide coverage for telehealth and other remote care prior to an employee meeting his/her deductible for the year. This rule is effective as of March 27, 2020 and applies to plan years beginning before December 31, 2021.[601]

INCLUSION OF CERTAIN OVER-THE-COUNTER MEDICAL PRODUCTS AS QUALIFIED MEDICAL EXPENSES (CARES ACT §3702)

The CARES Act expands the items that can paid for out of health savings accounts (HSAs), Archer medical savings accounts (MSAs) and health flexible spending arrangements (FSAs) to include *menstrual care products.*[602]

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[597] Act §2206(a)

[598] Act §2206(b)

[599] IRC §127(b)(3)

[600] Act §2206(a), (c)

[601] IRC §223(c)(1)(B)(ii); Act §3701(b)

[602] Act §3702

NOTES

Unit

13

CARES Act: Business Tax Provisions

LEARNING OBJECTIVES

After completing this unit, participants will be able to:

- Understand the revised net operating loss carryback provisions for 2018-2020, as well as the steps to be taken to waive the carryback and to file a claim for refund
- Apply the revisions found to various Tax Cuts and Jobs Act provisions, including technical corrections, found in the CARES Act

In addition to the worker retention credit and deferral of payroll payments discussed earlier, the CARES Act contained a number of additional special provisions for businesses, many of which temporarily reversed certain changes made in the Tax Cuts and Jobs Act (TCJA) or which applied technical corrections to the TCJA.

MODIFICATIONS FOR NET OPERATING LOSSES (CARES ACT §2303)

One of the key changes made in the Tax Cuts and Jobs Act was the elimination of net operating loss carrybacks for most taxpayers and limiting the use of net operation loss carryovers to only offset 80% of taxable income. The CARES Act temporarily removes these changes, and puts in place a default five year net operating loss carryback.

For years beginning after December 31, 2017 and before January 1, 2021 losses are carried back five years.[603] So that means that 2018, 2019 and 2020 losses will be available for five year carrybacks.

If a loss goes back to a year where §965(a) applies (the 965 tax), then the taxpayer will be treated as having made the election to ignore the net operating loss carryback under IRC §965(n) for the

[603] IRC §172(b)(1)(D)

affected years.[604] The taxpayer can also make an election to exclude §965 years in lieu of making the election to waive the entire carryback. That provision reads:

> (v) Special rules for elections under paragraph (3). --
>
> > (I) Special election to exclude section 965 years. -- If the 5-year carryback period under clause (i)(I) with respect to any net operating loss of a taxpayer includes 1 or 4 more taxable years in which an amount is includible in gross income by reason of section 965(a), the taxpayer may, in lieu of the election otherwise available under paragraph (3), elect under such paragraph to exclude all such taxable years from such carryback period.
> >
> > (II) Time of elections. -- An election under paragraph (3) (including an election described in subclause (I)) with respect to a net operating loss arising in a taxable year beginning in 2018 or 2019 shall be made by the due date (including extensions of time) for filing the taxpayer's return for the first taxable year ending after the date of the enactment of this subparagraph.[605]

The CARES Act also enacts a technical correction fixing a drafting error in the Tax Cuts and Jobs Act that impacted fiscal year taxpayers.[606]

PROCEDURES FOR ELECTING OPTIONS FOR NET OPERATING LOSS TREATMENTS ADDED BY CARES ACT RELEASED

Notice 2020-24, 4/9/20

The CARES Act restored the ability to carryback net operating losses temporarily. The loss carrybacks were restored for 2018, 2019 and 2020, with special provisions provided for electing to carry losses from 2018 and/or 2019 forward to take care of the problem that it was too late in many cases to timely elect to forego the carryback period. In Notice 2020-24[607] the IRS has provided procedures for actions related to these net operating losses.

Waiving the Entire Five-Year Carryback

A taxpayer that wishes to waive the five-year carryback period for 2018 and/or 2019 will take the following steps.

> <u>(1) Elections to waive carryback under § 172(b)(3) for NOLs arising in taxable years beginning in 2018 or 2019.</u> A taxpayer within the scope of this revenue procedure may elect under § 172(b)(3) to waive the carryback period for an NOL arising in a

[604] IRC §172(b)(1)(D)(iv)

[605] IRC §172(b)(1)(D)(v)

[606] Act §2303(c)

[607] Notice 2020-24, April 9, 2020, https://www.irs.gov/pub/irs-drop/rp-18-58.pdf, retrieved April 9, 2020

> taxable year beginning in 2018 or 2019. Such an election must be made no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the first taxable year ending after March 27, 2020. A taxpayer must make an election described in this section 4.01(1) by attaching to its Federal income tax return filed for the first taxable year ending after March 27, 2020, a separate statement for each of taxable years 2018 or 2019 for which the taxpayer intends to make the election. The election statement must state that the taxpayer is electing to apply § 172(b)(3) under Rev. Proc. 2020-24 and the taxable year for which the statement applies. Once made, the election is irrevocable.[608]

Bypass §965 Years in the Carryback Period

Taxpayers are allowed to elect to exclude only §965 years from the carryback period, avoiding the complications of dealing with that area. Such an election will have the following effect:

> An election under § 172(b)(1)(D)(v)(I) to exclude all section 965 years from the carryback period for an NOL allows a taxpayer to disregard those taxable years when applying an NOL to the carryback period and determining whether the taxpayer has an overpayment and can receive a refund or credit for any of the remaining years in the carryback period to which the NOL is applied.[609]

What this election does *not* do is allow the taxpayer to go back to even earlier years to replace the excluded years—rather, while no loss goes into the §965 years, they still count as one of the five years:

> A taxpayer who makes an election under § 172(b)(2)(D)(v)(I) for an NOL must include all section 965 years for purposes of counting the five taxable years in the carryback period for the NOL. [610]

The election is filed by taking the following steps:

> A taxpayer must make the election described in this section 74.01(2) by attaching an election statement to the earliest filed, after this revenue procedure is effective, of:
>
> > (1) The Federal income tax return for the taxable year in which the NOL arises;
> >
> > (2) The taxpayer's claim for tentative carryback adjustment (Form 1045, Application for Tentative Refund; or Form 1139, Corporation Application for Tentative Refund) applying the NOL to a taxable year in the carryback period; or

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[608] Notice 2020-24, Section 4.01(1)

[609] Notice 2020-24, Section 4.01(2)(d)

[610] Notice 2020-24, Section 4.01(2)(d)

> (3) The amended Federal income tax return applying the NOL to the earliest taxable year in the carryback period that is not a section 965 year.[611]

As well, information must be attached to each amended return when this election is made:

> A taxpayer making the election who claims a refund or credit as a result of the carryback of the NOL by filing amended Federal income tax returns for taxable years in the carryback period must also attach an election statement to each amended return. The election statement must state that the taxpayer is electing to apply §172(b)(1)(D)(v)(I) under Rev. Proc. 2020-24, the taxable year in which the NOL arose, and the taxpayer's section 965 years. Once made, the election is irrevocable.[612]

The Notice also provides for when this election must be filed:

> An election under this section 4.01(2) for an NOL arising in a taxable year beginning in 2018 or 2019 must be made no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the first taxable year ending after March 27, 2020. For an NOL arising in a taxable year beginning after December 31, 2019, and before January 1, 2021, an election under this section 4.01(2) must be made by no later than the due date, including extensions, for filing the taxpayer's Federal income tax return for the taxable year in which the NOL arises.[613]

Effect When a Loss is Carried to a §965 Year

If a taxpayer does not make the election to bypass the §965 years, the Notice explains what happens in those years.

> To the extent an NOL is carried back pursuant to § 172(b)(1)(D)(i) to a section 965 year, the deemed election under §965(n) pursuant to § 172(b)(1)(D)(iv) may not be waived for that section 965 year (including if a taxpayer previously revoked an election under § 965(n) for that section 965 year pursuant to §1.965-7(e)(2)(ii)(B)). If the deemed election under § 965(n) applies to a section 965 year for which a taxpayer previously revoked or did not previously make an election under § 965(n), the deemed election shall only apply for purposes of the carryback of an NOL to such section 965 year.[614]

Consolidated Groups

Details of the application of these provisions to consolidated groups of corporations are found in Section 4.03 of the Notice.

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[611] Notice 2020-24, Section 4.01(2)(b)

[612] Notice 2020-24, Section 4.01(2)(c)

[613] Notice 2020-24, Section 4.01(2)(a)

[614] Notice 2020-24, Section 4.02

FAXES WILL BE USED TEMPORARILY TO FILE CARES ACT RELATED TENTATIVE CLAIMS FOR REFUNDS

"Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," IRS Website, 4/13/20

The CARES Act added provisions allowing taxpayers to carry net operating losses from 2018 and 2019 back five years, potentially giving affected taxpayers access to much needed cash by filing a claim for refund. And the IRS has issued guidance allowing the Forms 1045 and 1139 to be used to claim the refunds under the tentative refund procedures.

But there is a problem—those forms cannot be filed electronically, and the IRS is not processing paper filed forms at this time, as all Service Centers have now been closed for an indefinite period of time. In order to address this issue, the IRS has released on its website temporary procedures for filing Forms 1045 and 1139 by fax.[615]

The guidance notes that *only* claims for refund under either §2303 or §2305 of the CARES Act will be processed under this procedure. The page describes those sections as follows:

- Section 2303 requires a taxpayer with a net operating loss arising in a 2018, 2019, or 2020 taxable year to carry that loss back to each of the five preceding years unless the taxpayer elects to waive or reduce the carryback; and
- Section 2305 modifies the credit for prior-year minimum tax liability of corporations, including to accelerate the recovery of remaining minimum tax credits of a corporation for its 2019 taxable year from its 2021 taxable year and to permit a corporation to elect instead to recover 100 percent of any of its remaining minimum tax credits in its 2018 taxable year.

The program, which begins on April 17, is described as follows:

> Starting on April 17, 2020 and until further notice, the IRS will accept eligible refund claims Form 1139 submitted via Fax to 844-249-6236 and eligible refund claims Form 1045 submitted via fax to 844-249-6237. Before then, these fax numbers will not be operational. We encourage taxpayers to wait until this procedure is available rather than mail their Forms 1139 and 1045 since mail processing is being impacted by the emergency.

The IRS is also imposing a 100-page limit on the claims submitted:

> A maximum of 100 pages can be initially faxed to either of the fax numbers listed above. If additional documentation is required to be attached or deemed to be

[615] "Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," IRS Website, April 13, 2020, https://www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19 , retrieved April 13, 2020

> necessary, taxpayers will be notified during the processing of the Form 1139 or Form 1045.

The IRS notes the following changes from the normal hard copy procedures:

> Previously, these forms could be filed only via hard copy delivered through the USPS or by a private delivery service. There are well-established procedures for processing the hard copy forms in order to provide quick tentative refunds to taxpayers. A temporary procedure to accept these forms via fax permits us to make the relief in the CARES Act available to taxpayers before IRS processing centers are able to reopen. The procedures to process claims will remain the same – the only difference is to allow an additional method to file eligible refund claims.

The FAQ also deals with cases where taxpayers may have already mailed in a paper Form 1045 or 1139:

> Yes, if you previously mailed a hard copy of either of these forms that is an eligible refund claim (because it contains changes permitted by the AMT and NOL provisions of the CARES Act identified above) after March 27, 2020, you can now submit that same claim to the fax numbers stated above starting on April 17.

If a taxpayer submits an ineligible claim (one not authorized under the CARES Act provisions mentioned), it will be held and processed once normal operations resume.

The IRS also notes that the instructions for Forms 1045 and 1139 have outdated information regarding §965 years in the carryback period, instructions that will be corrected to agree with the law:

> Yes, you may disregard the instructions for Form 1139 and Form 1045 which prohibit taxpayers from using these forms to apply for refunds for 965 years. The instructions to these forms will be updated to reflect this change. However, please be aware that because the CARES Act added section 172(b)(1)(D)(iv) to provide that a taxpayer who has a carryback to a section 965 year is deemed to have made a section 965(n) election that limits the amount of the loss that can be carried back to each such year, an NOL can be carried back only to reduce income in excess of the amount of the net section 965(a) inclusion. The IRS expects to issue additional instructions on filing requests for tentative refunds for taxpayers with outstanding section 965(h) net tax liabilities, so that these requests and liabilities can be identified, routed, and tracked appropriately, and so that payment schedules can be adjusted to avoid unintentional or erroneous acceleration of deferred section 965(h) installment payments, delays in refunds, or other processing complications.

The IRS will *not* be establishing a similar procedure for filing Form 4466 "Corporation Application for Quick Refund of Overpayment of Estimated Tax," instead requiring taxpayers to follow the existing form instructions.

And the IRS ends by making it clear that the fax system is not something that they plan to make a permanent way to file these claims:

> No, accepting faxed versions of these forms that are normally delivered through the USPS or by a private delivery service is meant as a short-term measure to assist taxpayers in receiving refunds provided under the CARES Act as quickly as possible.

IRS ADDS MORE C CORPORATION GUIDANCE TO TENATIVE REFUND FAX TEMPORARY PROCEDURES FAQ

"Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," IRS Website, 4/16/2020

The IRS has added additional information, primarily related to C corporation taxpayers, to the FAQ on the temporary procedures for filing Forms 1045 and 1139.[616]

The IRS first addresses whether a similar procedure will be set up for handling the amended corporate return form, Form 1120X. And the answer is simple—no.

> **8. Will the IRS be establishing a similar procedure for Form 1120X, Amended U.S. Corporation Income Tax Return?**
>
> No, the Form 1120X must be filed in accordance with existing form instructions. If a Form 1120X is faxed to the fax number noted above, it will not be accepted for processing.

Some taxpayers likely had a Form 1120X still under consideration by the IRS, or one they had mailed off before the Service Centers shut down. As well, taxpayers may discover issues that will need fixing when preparing the Form 1139 that would require using a Form 1120X. Those taxpayers are, essentially, out of luck until the IRS can start processing the paper Form 1120X.

> **9. What will happen if I filed a Form 1120X that has not been processed and I used those numbers in my Form 1139 filing?**
>
> Your Form 1139 must reflect your originally filed or previously processed amended return information. If your Form 1139 does not match your IRS account, the Form 1139 cannot be processed because the Form 1120X needs to be processed first. For example, if you gave a Form 1120X to your examination team, it has not been processed.

[616] "Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," IRS Website, April 16, 2020 revision, https://www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19 , retrieved April 17, 2020

> Do not attempt to file an amended return at time of filing Form1139. Amended returns will not be acted upon when filed with Form 1139 through the temporary fax procedures.

This problem will also get in the way of corporations who have changes to make to prior years due to items contained in the CARES Act, such as the fix for qualified investment property lives and qualification for bonus depreciation. If those either increase a net operating loss or are the items that will generate a new net operating loss once they are taken into account, the business will not be able to take advantage of the fax option to file their Form 1139.

The FAQ goes on to deal with the issue of attempting to claim the accelerated access to unused corporate minimum tax credits. While the law provides the credits can be claimed via the tentative refund procedures, the Form 1139 does not provide an option to claim a refund based on the credit. The IRS deals with this as follows:

> **10. The current version of Form 1139 (2018) does not provide for tentative refunds for refundable prior year minimum tax credits. How should I complete the Form 1139 if I am only claiming tentative refunds of prior year minimum tax credits? How should I complete the 2018 Form 8827?**
>
> The following instructions apply for the 2018 Forms 1139 and 8827 to allow for the changes per CARES Act Section 2305(b).
>
> **Form 1139**
>
> - Include at the top of Form 1139, "Electing to Take 100% Refundable Credit Amount in 2018 - per CARES Act Section 2305(b)".
> - You should complete Lines 1(d) and 29 of the Form 1139. Leave Lines 1a through 1c and 2 through 28 blank.
> - Enter on Line 1(d), the minimum tax credit carryforward to 2019, as reported on the original Form 8827 Line 9. Disregard the instructions for Form 1139, Line 1(d) "Other".
> - Enter on line 29, the difference between the amount reported on the original 2018 Form 8827 Line 8(c) and the amount reported on the revised 2018 Form 8827 Line 8(c) as described below. Disregard the instructions for Form 1139, Line 29 "Overpayment of tax due to a claim of right adjustment under section 1341(b)(1)."
>
> **Form 8827**
>
> - Include at the top of 2018 Form 8827, "Electing to Take 100% Refundable Credit Amount in 2018 - per CARES Act Section 2305(b)."

- When completing Line 6 of the Worksheet for Calculating the Refundable Minimum Tax Credit Amount on 2018 Form 8827 replace "50%" in the instructions on Line 6 with "100%."

- Complete the remainder of 2018 Form 8827 according to the instructions.

11. Should I file the application for a tentative refund and claim both the NOL carryback and 100% refundable minimum tax credit on the same 2018 Form 1139 and how?

Yes, you should use the same Form 1139 for both claims.

- Complete Lines 1a through 1c and 2 through 28 as appropriate, following the existing Form 1139 instructions to report your NOL carryback.

- Enter on Line 1(d), the minimum tax credit carryforward to 2019, as reported on the original Form 8827 Line 9. Disregard the instructions for Form 1139, Line 1(d) "Other".

- Enter on Line 29, the difference between the amount reported on the original 2018 Form 8827 Line 8(c) and the amount reported on the revised 2018 Form 8827 Line 8(c) as described below. Disregard the instructions for Form 1139, Line 29 "Overpayment of tax due to a claim of right adjustment under section 1341(b)(1)."

Complete the 2018 Form 8827 as follows:

- Include at the top of 2018 Form 8827, "Electing to Take 100% Refundable Credit Amount in 2018 - per CARES Act Section 2305(b)."

- When completing Line 6 of the Worksheet for Calculating the Refundable Minimum Tax Credit Amount of the 2018 Form 8827 replace "50%" in the instructions on Line 6 with "100%."

- Complete the remainder of 2018 Form 8827 according to the instructions.

If you have a carryback of a net operating loss for the taxable year and are applying for a tentative carryback refund and a 100% refundable minimum tax credit tentative refund, ordering rules apply. You must take into account any adjustments made in applying for the tentative carryback adjustment before determining the amount of the overpayment attributable to the 100% refundable minimum tax credit refund. (Treas. Reg. § 5.6411-1). Caution: adjustments to alternative minimum tax in the carryback years could affect the amount of the 100% refundable minimum tax credit allowed in 2018.

Finally, the FAQ adds a section on items to be included with a Form 1139 submitted via the fax program:

> **12. What documents should I attach to 2018 Form 1139 for a tentative refund for a 100% refundable minimum tax credit or the NOL carryback?**
>
> A. If you are only claiming a tentative refund for a net operating loss carryback, follow the existing instructions for Form 1139.
>
> B. If you are only claiming a refund for the minimum tax credit, you should attach (1) the first three pages of the originally filed or previously processed amended 2018 Form 1120, including Schedule J, (2) a copy of the originally filed 2018 Form 8827, (3) the first three pages of the revised 2018 Form 1120, reflecting the change with the 100% refundable minimum tax credit, and (4) the revised 2018 Form 8827.
>
> C. If you are claiming both a refund for the minimum tax credit and the NOL carryback, follow the existing instructions for Form 1139 for the NOL carryback and the instructions in (B) above for the 100% refundable minimum tax credit refund. Do not attempt to file an amended return at time of filing Form1139. Amended returns will not be acted upon when filed with Form 1139 through the temporary fax procedures.

GUIDANCE ISSUED ON ATNOL ISSUES WHEN CARRYING BACK CORPORATE NOLS UNDER CARES ACT

"Questions and Answers about NOL Carrybacks of C Corporations to Taxable Years in which the Alternative Minimum Tax Applies," IRS website, 5/27/20

Guidance has been posted on the IRS website in the form of questions and answers regarding the carryback of net operating losses for corporations under the CARES Act into years when the alternative minimum tax (AMT) was still in force.[617]

The Tax Cuts and Jobs Act (TCJA) repealed the corporate alternative minimum tax beginning in 2018 and removed the ability for taxpayers to carry losses from 2018 back into 2017 and earlier years. However, when the CARES Act added a provision allowing net operating losses from 2018-2020 to be carried back five years, these losses from years when the AMT no longer applied were being carried back to years when the AMT still applied to taxpayers. So what was the alternative tax net operating loss (ATNOL) for these years to carry back to those earlier years?

[617] "Questions and Answers about NOL Carrybacks of C Corporations to Taxable Years in which the Alternative Minimum Tax Applies," IRS website, May 27, 2020, https://www.irs.gov/newsroom/questions-and-answers-about-nol-carrybacks-of-c-corporations-to-taxable-years-in-which-the-alternative-minimum-tax-applies (retrieved May 29, 2020)

Nothing in the CARES Act explicitly addressed how taxpayers were to handle carrying these losses into years where the AMT applied. In the guidance, the IRS looked to provide an answer.

The first question provides a key answer—the ATNOL for any post-2017 year is zero:

> **Q1. A C corporation with an NOL arising in a taxable year beginning after December 31, 2017 (post-2017 year) is carrying back all or a portion of that NOL to a taxable year beginning before January 1, 2018 (pre-2018 year). Although the AMT does not apply to C corporations in post-2017 years, it does apply to such taxpayers in pre-2018 years. For purposes of determining the C corporation's alternative minimum taxable income in the pre-2018 year, what should be the amount of alternative tax net operating loss (ATNOL) arising in the post-2017 year?**
>
> A1. For Forms 1120X, Amended U.S. Corporation Income Tax Return, or 1139, Corporation Application for Tentative Refund, filed on or after June 1, 2020, treat the ATNOL amount arising in a post-2017 year as zero. The processing of the C corporation's refund may be delayed if it uses a different method to determine the amount of its ATNOL.

It is likely that many who had filed a Form 1139 or 1120X before this guidance was posted did not use zero as the ATNOL. But the IRS indicates that it does not want these taxpayers to take any action until and unless the IRS contacts the corporation.

> **Q2. A C corporation has already filed amended returns or a claim for tentative carryback adjustment carrying back an NOL from a post-2017 year to pre-2018 years, but did not treat the ATNOL for the post-2017 year as zero. Is the C corporation required to take any action, such as refiling, and follow this guidance?**
>
> A2. The C corporation does not need to take any action, or refile a Form 1120X or Form 1139 that was filed before June 1, 2020, unless contacted by the IRS.

Note that this change in AMT calculations will lead to an increase in minimum tax credit for years when the carryback leads to an increased minimum tax liability—a credit which likely will end up being refunded as described below. Under the TCJA these AMT NOLs would eventually be either absorbed in a later year or fully refunded, and the CARES Act accelerated those refunds, essentially allowing any unused AMT credit to be refunded in 2018 if the taxpayer elected to accelerate the refund. The remaining questions deal with these minimum tax credit issues.

The next two questions deal with the ability to net these changes and even recover the excess minimum tax credits on the Form 1139.

> **Q3. As a result of an NOL carryback, a C corporation either has an AMT liability in a pre-2018 carryback year or has released minimum tax credits (MTC) under section 53 in a pre-2018 carryback year because it no longer has enough regular tax liability to use them. The C corporation is not able to use**

> **the MTC generated or released by the NOL carryback in any taxable year prior to 2018. The C corporation made an election under section 53(e)(5) to recover 100% of its MTCs as refundable credits in its first taxable year beginning in 2018. May the C corporation claim both the NOL carryback and MTC refund for 2018 on the same Form 1139?**
>
> A3. Yes, the C corporation may file a single Form 1139, following the instructions in questions 11 and 12 of the temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19.
>
> **Q4. As a result of an NOL carryback, the C corporation either has an AMT liability in a pre-2018 carryback year or it has released MTCs under section 53 in a pre-2018 carryback year because it no longer has enough regular tax liability to use them. The C corporation is able to use the MTC generated or released by the NOL carryback in a subsequent year that is part of the five-year carryback period preceding the year in which the NOL arose (the carryback period). May the C corporation claim both the NOL carryback and the decrease in tax liability from the MTC on Form 1139?**
>
> A4. Yes, if the MTC generated or released by the NOL carryback in one year in the carryback period is used in a subsequent year in the carryback period to reduce the C corporation's tax liability (as opposed to resulting in a refundable MTC), then the C corporation may claim a refund for any decrease in tax resulting from that use of the MTC on Form 1139, noting the change in the MTC in the appropriate column of line 21 for the year in which the MTC is used.

A taxpayer is not required to elect to receive the unused minimum tax credit back in a single year. But the page cautions that if the election is not made, the Form 1139 cannot be used to claim any refundable credit:

> **Caution:** Form 1139 cannot be used to claim the refundable portion of the MTC (as opposed to a refund resulting from a reduction of the C corporation's tax liability due to the use of the MTC), except in the case of an election under section 53(e)(5). If a C corporation is entitled to a refundable MTC for a year in the carryback period for any reason other than an election under section 53(e)(5), it must separately file a Form 1120X to claim a refund of that portion of the MTC. For example, if a C corporation does not make an election under section 53(e)(5) to recover the full amount of its MTC in the first taxable year beginning in 2018, the C corporation may recover the portion of the MTC made refundable by section 53(e)(3) only by filing a Form 1120X.

Assuming the taxpayer has decided to make the election, the page goes on to give guidance on making the election:

> **Q5. A C corporation has refundable MTCs and wants to make the election under section 53(e)(5) to claim 100% of its refundable MTCs in its first**

taxable year beginning in 2018. How does the C corporation make this election?

A5. The election under section 53(e)(5) to claim 100% of a C corporation's refundable MTC in its first taxable year beginning in 2018 may be made by either filing a Form 1120X or a Form 1139. For either form used, the C corporation must include at the top of the form, "Electing to Take 100% Refundable Credit Amount in 2018 – per CARES Act Section 2305(b)". Instructions for completing the Form 1139 are available in questions 10, 11, and 12 of the temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19.

The guidance ends by providing details on the deadline for making the election under IRC §53(e)(5) to claim 100% of any refundable credit in the first taxable year beginning in 2018:

Q6. Is there a due date by which a C corporation must make the section 53(e)(5) election?

A6. Yes. An election on Form 1139 must be filed no later than December 30, 2020. If the Form 1139 includes both a claim for refundable MTC and an NOL carryback that arose in a taxable year that began during 2018 and ended on or before June 30, 2019, the Form 1139 must be filed by the earlier of the extended due date provided under Notice 2020-26, or December 30, 2020. An election on Form 1120X must be filed within the period described under section 6511(a) that applies to the C corporation's first taxable year beginning in 2018.

MODIFICATION OF LIMITATION ON LOSSES FOR TAXPAYERS OTHER THAN CORPORATIONS (CARES ACT §2304)

Another TCJA change that is temporarily removed from the law is the limitation on business losses for non-corporate taxpayers found at IRC §461(l). The effective date of the business loss limitations of §461(l) is retroactively moved back to years beginning after December 31, 2020.[618]

When the §461(l) business loss limitation does return to the law in 2021, it will be modified by two technical corrections.

One will remove wages from being included as business income, a treatment the Blue Book had indicated was Congress's intent but which was not the result of the original bill.[619]

[618] Act §2304(a)(1)(B)

[619] IRC §461(l)(3)(A)

As well, the following capital gains and losses will be excluded from business income:

- Losses from sales or exchanges of capital assets shall not be taken into account as business losses and
- Gains from sales or exchanges of capital assets taken into account for computing the net business loss shall not exceed the lesser of—
  - The capital gain net income determined by taking into account only gains and losses attributable to a trade or business, or
  - The capital gain net income.[620]

MODIFICATION OF CREDIT FOR PRIOR YEAR MINIMUM TAX LIABILITY OF CORPORATIONS (CARES ACT §2305)

The refund of excess corporate minimum tax credit carryover for a C corporation will be retroactively accelerated, with 50% of any excess credit refundable for a taxable year beginning in 2018 and 100% being refundable for a year beginning in 2019.[621]

As well, the taxpayer is allowed to elect to claim the entire excess credit on the 2018 return, generally via filing a claim for refund if the return has already been filed.[622]

MODIFICATIONS OF LIMITATION ON BUSINESS INTEREST (CARES ACT §2306)

Although we were still waiting for the final regulations under §163(j) to come out when the CARES Act was signed into law, the CARES Act modifies the §163(j) rules.

For taxable years beginning in 2019 and 2020, the business interest limit is increased from 30% to 50%.[623] A taxpayer can elect not to have this special rule apply for either or both taxable years.[624]

However, different rules apply in the case of a partnership. The above rules will not apply for any tax year beginning in 2019 but unless a partner elects not to have this rule apply, in the case of any excess

[620] IRC §461(l)(3)(B)

[621] IRC §53(e)(2)

[622] IRC §53(e)(5)

[623] IRC §163(j)(10)(A)(i)

[624] IRC §163(j)(10)(A)(iii)

business interest of the partnership for any taxable year beginning in 2019 which is allocated to the partner:

- 50 percent of such excess business interest shall be treated as business interest which is paid or accrued by the partner in the partner's first taxable year beginning in 2020 and which is not subject to the limits of §163(j)(1), and
- 50 percent of such excess business interest shall be subject to the excess business interest limitations in the same manner as any other excess business interest so allocated.[625]

Why this rule? Most likely because of the revision to the partnership audit rules that otherwise would have necessitated an administrative adjustment request to be prepared by all partnerships that didn't opt out of the BBA audit regime, were impacted by §163(j) limits and have filed their 2019 tax return.

However, even a 50% limitation may not be worth much if the business otherwise loses money or just has a poor year, something that will happen to a number of businesses for 2020. Thus, for tax years beginning in 2020, the taxpayer may elect to use the numbers from the tax year beginning in 2019 to compute the limit, with special rules to deal with short taxable years.[626]

OPTION TO CHANGE §163(J) ELECTIONS FOR REAL ESTATE AND FARMING BUSINESSES FOR CARES ACT CHANGES ISSUED BY IRS

Revenue Procedure 2020-22, 4/10/20

Some taxpayers who elected to be "electing real property trades or businesses" based on the provisions of §163(j) prior to amendment by the CARES Act likely regretted their decisions once the Act retroactively changed the limit from 30% of adjusted taxable income to 50% of adjusted taxable income temporarily. The IRS is now giving those taxpayers a chance to undo that election based on guidance in Revenue Procedure 2020-22.[627]

As well, the Procedure covers other new elections that are part of the CARES Act to deal with the changes made by that Act to §163(j).

Modifying §163(j)(7) Elections

The Procedure outlines its scope in Section 3. It begins by stating:

> Sections 4 and 5 of this revenue procedure apply to a taxpayer described in section 3.01(1) or (2) of this revenue procedure with respect to an election under section 163(j)(7)(B) to be an electing real property trade or business or under section

[625] IRC §163(j)(10)(A)(ii)

[626] IRC §163(j)(10)(B)

[627] Revenue Procedure 2020-22, April 10, 2020, https://www.irs.gov/pub/irs-drop/rp-20-22.pdf, retrieved April 10, 2020

> 163(j)(7)(C) to be an electing farming business (collectively, section 163(j)(7) election). The fact that a taxpayer satisfies the scope requirement of this section 3.01 is not a determination that the taxpayer is a real property trade or business under section 162, 212, or 469 of the Code, or a farming business under section 162, 199A, or 263A of the Code.[628]

Making a Late §163(j)(7) Election

First the IRS deals with the (seemingly less likely) decision that a qualified farming or real estate business would want to make a late election under §163(j)(7) to become an electing farming or real estate business, exempt from the §163(j) limits on business interest, but required to depreciate certain assets using ADS methods and lives.

Taxpayers who can make this late election are:

> A taxpayer is described in this section 3.01(1) if the taxpayer did not file a section 163(j)(7) election with its timely filed original Federal income tax return or Form 1065, including extensions, or withdrew an election under section 5 of this revenue procedure, for a taxable year beginning in 2018 (2018 taxable year), 2019 (2019 taxable year), or 2020 (2020 taxable year), was otherwise qualified to make an election when the return was filed, and now wants to make an election for one of those taxable years.[629]

The time for making the late §163(j) election is outlined in the procedure:

> A taxpayer within the scope of section 3.01(1) of this revenue procedure may make the section 163(j)(7) election for a 2018, 2019, or 2020 taxable year by filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable. Except as provided in Revenue Procedure 2020-23, 2020-18 I.R.B. 1 (April 27, 2020), released on www.irs.gov on April 8, 2020, regarding the time to file an amended return by a partnership subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 (BBA partnership) for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may make a late section 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under section 6235 for the reviewed year, as defined in § 301.6241-1(a)(8) of the Procedure and Administration Regulations (26 CFR Part 301).[630]

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[628] Revenue Procedure 2020-22, Section 3.01

[629] Revenue Procedure 2020-22, Section 3.01(1)

[630] Revenue Procedure 2020-22, Section 6.02

The taxpayer makes the late §163(j) election as follows:

> A taxpayer described in section 4.02 of this revenue procedure must make the election on a timely filed amended Federal income tax return, amended Form 1065, or an AAR, as applicable, with the election statement in accordance with the rules and procedures contained in proposed § 1.163(j)-9 of the 2018 proposed regulations and this section 4. The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the late section 163(j)(7) election and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, for any affected succeeding taxable year. An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the late election applies. The taxpayer is subject to all of the other rules and requirements in section 163(j), except as otherwise provided in this revenue procedure. The Treasury Department and the IRS have provided guidance under section 163(j) in the 2018 proposed regulations and will provide additional guidance in forthcoming final regulations and additional proposed regulations under section 163(j). The additional proposed regulations will address issues arising under the CARES Act as well as certain other issues.[631]

The late election statement's contents are outlined as follows:

> The election statement must be titled, "Revenue Procedure 2020-22 Late Section 163(j)(7) Election." The election statement must contain:
>
> (1) The taxpayer's name;
>
> (2) The taxpayer's address;
>
> (3) The taxpayer's social security number (SSN) or employer identification number (EIN);
>
> (4) A description of the taxpayer's electing trade or business, including the principal business activity code; and
>
> (5) A statement that the taxpayer is making an election under section 163(j)(7)(B) or 163(j)(7)(C), as applicable. [632]

This portion of the procedure concludes on issues related to depreciation when a late election is made:

> A taxpayer within the scope of section 3.01(1) of this revenue procedure that is making a section 163(j)(7) election must determine its depreciation on the amended

[631] Revenue Procedure 2020-22, Section 6.03

[632] Revenue Procedure 2020-22, Section 6.04

> Federal income tax returns, amended Forms 1065, or AARs, as applicable, for the property that is affected by the late election using the alternative depreciation system of section 168(g), pursuant to section 168(g)(1)(F) or (G). See also section 163(j)(11). Section 4.02 of Rev. Proc. 2019-8, 2019-3 I.R.B. 347, explains how to change to the alternative depreciation system for existing property that is affected by the late election.[633]

Withdrawing an Election Under §163(j)(7)

The more likely scenario is that a taxpayer will want to withdraw a prior election under §163(j). Under the provisions added by TCJA, an election under §163(j)(7) was an election that bound the taxpayer forever, with no opportunity to undo the election. But the IRS reasoned that taxpayers may have made a very different decision had the interest limit been set at 50% of adjusted taxable income rather than 30%.

Section 5 allows for just such a withdraw of the prior election. Those taxpayers eligible for it are:

> A taxpayer is described in this section 3.01(2) if the taxpayer filed a section 163(j)(7) election with its timely filed original Federal income tax return or Form 1065, including extensions, or made a late election under section 4 of this revenue procedure, for a 2018, 2019, or 2020 taxable year and now wants to withdraw the election.[634]

The time and manner for withdrawing an election under IRC §163(j)(7) are provided in the procedure:

> A taxpayer that wishes to withdraw an election as described in section 5.01 of this revenue procedure for a 2018, 2019, or 2020 taxable year must timely file an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the taxable year in which the election was made, with an election withdrawal statement. Except as provided in Revenue Procedure 2020-23, regarding the time to file amended returns by BBA partnerships for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may withdraw the section 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under section 6235 for the reviewed year, as defined in § 301.6241-1(a)(8). The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the withdrawn section 163(j)(7) election and any collateral adjustments to taxable income or to tax liability,

[633] Revenue Procedure 2020-22, Section 6.05

[634] Revenue Procedure 2020-22, Section 3.01(2)

> including any adjustments under section 481. A taxpayer also must file amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, including such collateral adjustments, for any affected succeeding taxable years. An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the withdrawn election applies.[635]

The election withdrawal statement contents are described as follows:

> The election withdrawal statement should be titled, "Revenue Procedure 2020-22 Section 163(j)(7) Election Withdrawal." The election withdrawal statement must contain the taxpayer's name, address, and SSN or EIN, and must state that, pursuant to Revenue Procedure 2020-22, the taxpayer is withdrawing its election under section 163(j)(7)(B) or 163(j)(7)(C), as applicable.[636]

As well, the procedure again discusses the issues that will arise with regard to depreciation when the original election is withdrawn:

> A taxpayer that is withdrawing a prior section 163(j)(7) election must determine its depreciation for the property that is affected by the withdrawn election in accordance with section 168 on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable.[637]

Making an Election Under New §163(j)(10)

The CARES Act added IRC §163(j)(10) that created some new elections to deal with the CARES Act changes to §163(j). This ruling also provides rules for these elections, and the scope is defined in the following paragraph:

> Section 6 of this revenue procedure provides the time and manner of making or revoking elections under new section 163(j)(10) applicable to a taxpayer that has timely filed, or will timely file, an original Federal income tax return or Form 1065 for a taxpayer's 2019 or 2020 taxable year. [638]

The CARES Act added a number of special purpose elections which are described below.

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[635] Revenue Procedure 2020-22, Section 5.02

[636] Revenue Procedure 2020-22, Section 5.03

[637] Revenue Procedure 2020-22, Section 5.04

[638] Revenue Procedure 2020-22, Section 3.02

Election Out of the 50 Percent ATI Limitation

Taxpayers have the option to not apply the 50% limitation for the 2019 and/or 2020 tax year, going back to the 30% limit.

> Except as otherwise provided in this section 6.01(1), a taxpayer may elect under section 163(j)(10)(A)(iii) not to apply the 50 percent ATI limitation for a 2019 or 2020 taxable year. A partnership can make this election only for a 2020 taxable year because partnerships cannot use the 50 percent ATI limitation for a 2019 taxable year.[639]

The time and manner of making the election is outlined as follows:

> A taxpayer permitted to make the election, as described in section 6.01 of this revenue procedure, makes the election not to apply the 50 percent ATI limitation for a 2019 or 2020 taxable year by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or AAR, as applicable, using the 30 percent ATI limitation. No formal statement is required to make the election.[640]

Effectively, this is a "Nike" election—the taxpayer just "does it" and applies the 30% limitation.

The procedure also provides an option for a taxpayer (who may have not been aware of the option to use the 50% limitation or just changes his/her mind) to revoke the election to continue to use the 30% limit:

> If a taxpayer made the election, as described in section 6.01(2) of this revenue procedure, not to apply the 50 percent ATI limitation, for a 2019 or 2020 taxable year, and the taxpayer wishes to revoke that election for such taxable year, the Commissioner grants the taxpayer consent to revoke that election, provided the taxpayer timely files an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the applicable tax year, using the 50 percent ATI limitation.[641]

This section of the procedure concludes:

> The election in section 6.01 of this revenue procedure must be made for each taxable year. For a consolidated group, the election is made by the agent for a consolidated group, within the meaning of § 1.1502-77, on behalf of members of the consolidated group. For partnerships, the election is made by the partnership, but only for a 2020 taxable year. For an applicable CFC, as defined in proposed §

[639] Revenue Procedure 2020-22, Section 6.01(1)

[640] Revenue Procedure 2020-22, Section 6.01(2)

[641] Revenue Procedure 2020-22, Section 6.01(3)

> 1.163(j)-7(f)(2), the election is not effective unless made for the applicable CFC by each controlling domestic shareholder, as defined in § 1.964-1(c)(5).[642]

Election to Use 2019 ATI in 2020 Taxable Year

Given that many taxpayers will have much lower income in 2020 than in 2019, the law allows the taxpayer to elect to use the taxpayer's 2019 ATI in lieu of using the ATI for 2020.

> Under section 163(j)(10)(B), a taxpayer may elect to use the taxpayer's ATI for the last taxable year beginning in 2019 (that is, the taxpayer's 2019 ATI) as the ATI for any taxable year beginning in 2020, subject to modifications for short taxable years.[643]

The time and manner of making the election is described in the Procedure:

> A taxpayer makes an election under this section 6.02 for a 2020 taxable year by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or AAR, as applicable, using the taxpayer's 2019 ATI. A taxpayer revokes an election under this section 6.02 for a 2020 taxable year by timely filing an amended Federal income tax return, amended Form 1065, or AAR by a BBA partnership, as applicable, not using the taxpayer's 2019 ATI. No formal statement is required to make or revoke the election.[644]

The procedure provides the following information for who makes the election:

> For a consolidated group, the election under section 6.02 of this revenue procedure is made by the agent for a consolidated group, within the meaning of § 1.1502-77, on behalf of itself and members of the group. For partnerships, the election is made by the partnership. For an applicable CFC, the election is not effective unless made for the applicable CFC by each controlling domestic shareholder. In the case of a CFC group, as defined in proposed § 1.163(j)-7(f)(6), the election is not effective for any CFC group member, as defined in proposed § 1.163(j)-7(f)(8), unless made for every taxable year of a CFC group member for which the election is available and for which the CFC group member is a CFC group member on the last day of the CFC group member's taxable year.[645]

The IRS also discusses issues that will arise with a short taxable year:

> If an election is made under section 6.02 of this revenue procedure for a 2020 taxable year that is a short taxable year, the ATI for the taxpayer's applicable taxable

[642] Revenue Procedure 2020-22, Section 6.01(4)

[643] Revenue Procedure 2020-22, Section 6.02(1)

[644] Revenue Procedure 2020-22, Section 6.02(2)

[645] Revenue Procedure 2020-22, Section 6.02(3)

> year beginning in 2020 is equal to the amount that bears the same ratio to such ATI as the number of months in the short taxable years bears to 12.[646]

Election Out of the 50 Percent EBIE (Excess Business Interest Expense) Rule

A taxpayer wishing to elect out of the 50 percent EBIE rule makes the election at the following time and in the following manner:

> A partner makes the election under section 6.03 of this revenue procedure by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, an amended Form 1065, or an AAR, as applicable, for the partner's first taxable year beginning in 2020, by not applying the 50 percent EBIE rule in determining the section 163(j) limitation. A partner revokes the election under this section 6.03 by timely filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the partner's first taxable year beginning in 2020, by applying the 50 percent EBIE rule in determining the section 163(j) limitation.[647]

TECHNICAL AMENDMENTS REGARDING QUALIFIED IMPROVEMENT PROPERTY (CARES ACT §2307)

The CARES Act also provided the vehicle to fix the "retail glitch" that caused qualified improvement property to be depreciated over 39 years, even though Congress meant to allow it to be depreciated over 15 years and subject to bonus depreciation.

Congress now adds the reference to IRC §168(e)(3)(E) to have such property treated as 15-year property, solving the problem of having the property treated as 39-year property.[648]

These changes take effect as if they had been part of the original TCJA—thus opening up refund opportunities for post-TCJA returns already filed that used the 39-year life.[649]

REVENUE PROCEDURE ISSUED EXPLAINING ACCOUNTING METHOD CHANGE OPTIONS FOR QUALIFIED IMPROVEMENT PROPERTY

Revenue Procedure 2020-25, 4/18/20

The IRS has released guidance on dealing with the change in depreciation for qualified improvement property in Revenue Procedure 2020-25.[650]

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[646] Revenue Procedure 2020-22, Section 6.02(4)

[647] Revenue Procedure 2020-22, Section 6.03(2)

[648] Act §2307(a)

[649] Act §2307(b)

[650] Revenue Procedure 2020-25, April 17, 2020, https://www.irs.gov/pub/irs-drop/rp-20-25.pdf, retrieved April 17, 2020

Qualified Improvement Property Accounting Method Change

The procedure generally applies to qualified improvement property placed in service after December 31, 2017, in the taxpayer's 2018, 2019 or 2020 taxable. But it does not apply in the following situations:

- Qualified improvement property placed in service after December 31, 2017, by a taxpayer that made a late election, or withdrew an election, under § 163(j)(7)(B) (electing real property trade or business) or § 163(j)(7)(C) (electing farming business) for the taxable year in which the qualified improvement property is placed in service by the taxpayer, in accordance with Rev. Proc. 2020-22, 2020-18 I.R.B. 745 (April 27, 2020), released on www.irs.gov on April 10, 2020. Any changes to depreciation for such qualified improvement property, or other depreciable property, affected by the late election or withdrawn election under § 163(j)(7)(B) or 163(j)(7)(C) are made in accordance with sections 4.02 and 4.03, or 5.02 of Rev. Proc. 2020-22, as applicable; or

- Qualified improvement property for which the taxpayer deducted or deducts the cost or other basis of such property as an expense.[651]

The ruling views this a change in accounting method from a now impermissible method of accounting to a permissible one. As the ruling notes:

> A taxpayer changing the depreciation of qualified improvement property within the scope of this section 3 to the depreciation method, recovery period, and convention described in section 2.01(3) of this revenue procedure is changing from an impermissible method of accounting to a permissible method of accounting. Similarly, a change from not claiming to claiming the additional first year depreciation deduction under § 168(k) for qualified improvement property that is within the scope of this section 3 and is eligible for the additional first year depreciation deduction is a change from an impermissible method of accounting to a permissible method of accounting.[652]

If the qualified improvement property was placed in service in the taxable year immediately preceding the year of change (1-Year QIP), the procedure offers up the following options to accomplish the change:

- The taxpayer may change from the impermissible method of determining depreciation to the permissible method of determining depreciation for the 1-year QIP by filing a Form 3115 for this change in accordance with section 3.02(3)(b) of this revenue procedure, provided the § 481(a) adjustment reported on the Form 3115 includes the amount of any adjustment attributable to all property, including the 1-year QIP, subject to the Form 3115; or

[651] Revenue Procedure 2020-25, Section 3.01

[652] Revenue Procedure 2020-25, Section 3.02(1)

- The taxpayer may change from the impermissible method of determining depreciation to the permissible method of determining depreciation for the 1-year QIP by filing an amended return or AAR in accordance with section 3.02(3)(a) of this revenue procedure.[653]

If the taxpayer decides to go the Form 3115/IRC §481(a) adjustment route for the 1-Year QIP property to accomplish the change or is looking to change methods on property outside the one year window, the taxpayer takes the following steps:

> A Form 3115 with the taxpayer's timely filed Federal income tax return or Form 1065 under the automatic change procedures in Rev. Proc. 2015-13. See section 6.03(1) of this revenue procedure for the procedures for making this change in method of accounting.

Alternatively, if a taxpayer goes the amended return route to correct the depreciation claimed on 1-Year QIP property, the following steps are taken:

> Except as provided in Rev. Proc. 2020-23, 2020-18 I.R.B. 749, (April 27, 2020), released on www.irs.gov on April 8, 2020, regarding the time to file amended returns by a partnership subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 (BBA partnership) for taxable years beginning in 2018 and 2019, a Federal amended income tax return or amended Form 1065 for the placed-in-service year of the qualified improvement property on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23 or that cannot file an amended Form 1065 because the placed-in-service year of the qualified improvement property is a taxable year that is not within the scope of Rev. Proc. 2020-23, the BBA partnership may file an AAR for the placed-in-service year of the qualified improvement property on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under § 6235 for the reviewed year as defined in § 301.6241-1(a)(8). This amended return or AAR must include the adjustment to taxable income for the change in determining depreciation of the qualified improvement property and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on original or amended Federal returns or AARs for any affected succeeding taxable years…[654]

Note that a taxpayer has until October 15, 2021 to make this decision to amend the 2018 return or go for the accounting method change and file Form 3115 with a §481(a) adjustment in 2019. Taxpayers will need to determine which year is the preferable year to make the change—and the decision may rest on how quickly the IRS could be expected to process a paper amended 2018 return. One advantage to an accounting method change for 2019 is that the return could be filed electronically and have an immediate effect either by reducing tax due with the return or leading to a tax refund being issued.

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[653] Revenue Procedure 2020-25, Section 3.02(2)

[654] Revenue Procedure 2020-25, Section 3.02(3)(a)

Elections Under IRC §168

The next section deals with elections under IRC §168(g)(7) and (k). These elections are generally permanent in nature, as described in the procedure:

> Section 1.168(k)-2(f)(5) provides that, in general, the § 168(k)(5) election, § 168(k)(7) election, and § 168(k)(10) election, once made, may be revoked only by filing a request for a private letter ruling and obtaining the written consent of the Commissioner of Internal Revenue (Commissioner) to revoke the election. Further, if a taxpayer timely filed its Federal income tax return or Form 1065 for the taxpayer's taxable year beginning in 2017 and ending on or after September 28, 2017, sections 4.03, 5.04, and 6.05 of Rev. Proc. 2019-33 provide special procedures to allow the taxpayer to revoke its § 168(k)(5) election, § 168(k)(7) election, and § 168(k)(10) election, respectively, made for such taxable year. As noted in section 2.02(1) of this revenue procedure, section 168(g)(7)(B) provides that the § 168(g)(7) election, once made, is irrevocable.

The election under IRC §168(g)(7) is described as follows:

> Section 168(g)(7) allows a taxpayer to make an election to depreciate under the ADS any class of property placed in service by the taxpayer during the taxable year (§ 168(g)(7) election). If the § 168(g)(7) election is made, the election applies to all property that is in the same class of property and placed in service in the same taxable year. However, for nonresidential real property and residential rental property, the election may be made separately for each property. Once made, the § 168(g)(7) election is irrevocable. See § 168(g)(7)(B). Section 301.9100-7T(a)(2) and (3) of the Procedure and Administration Regulations provide the time and manner of making the § 168(g)(7) election. Such election is made by the due date, including extensions, of the Federal income tax return or Form 1065, U.S. Return of Partnership Income, for the taxable year in which the property is placed in service by the taxpayer, and is made by attaching a statement to such return. The instructions to Form 4562, Depreciation and Amortization, provide that the § 168(g)(7) election is made by completing line 20 of Form 4562.[655]

The election under IRC §168(k)(5)(A) is described as follows:

> Section 168(k)(5)(A) allows a taxpayer to make an election to apply the special rules of § 168(k)(5) to one or more specified plants that are planted, or grafted to a plant that has already been planted, by the taxpayer in the ordinary course of its farming business, as defined in § 263A(e)(4) (§ 168(k)(5) election). The rules and procedures for making the § 168(k)(5) election are set forth in § 1.168(k)-2(f)(2). Pursuant to § 1.168(k)-2(f)(2)(ii), the § 168(k)(5) election is made by the due date, including extensions, of the Federal income tax return or Form 1065 for the taxable year in which the taxpayer planted or grafted the specified plant to which the § 168(k)(5) election applies, and is made in the manner prescribed on Form 4562 and

[655] Revenue Procedure 2020-25, Section 2.02(1)

> its instructions. For specified plants planted, or grafted to a plant that was previously planted, by the taxpayer before the applicability date set forth in § 1.168(k)-2(h) for § 1.168(k)-2, section 4.05 of Rev. Proc. 2017-33, 2017-19 I.R.B. 1236, provides the time and manner for making the § 168(k)(5) election and such procedures are the same as in § 1.168(k)-2(f)(2)(ii). Further, if a taxpayer timely filed its Federal income tax return or Form 1065 for the taxpayer's taxable year beginning in 2017 and ending on or after September 28, 2017, sections 4.01(2) and 4.02 of Rev. Proc. 2019-33, 2019-34 I.R.B. 662, provide special procedures to allow the taxpayer to make a deemed § 168(k)(5) election or a late § 168(k)(5) election for a specified plant planted, or grafted to a plant that was previously planted, by the taxpayer after September 27, 2017.[656]

The election under IRC §168(k)(7) is described as:

> Section 168(k)(7) allows a taxpayer to make an election not to deduct the additional first year depreciation for any class of property that is qualified property placed in service during the taxable year (§ 168(k)(7) election). The rules and procedures for making the § 168(k)(7) election are set forth in § 1.168(k)-2(f)(1). Section 1.168(k)-2(f)(1)(ii) defines "class of property" for purposes of the § 168(k)(7) election. Under § 1.168(k)-2(f)(1)(ii), qualified improvement property is included in the 15-year property class and is not a separate class of property. However, qualified improvement property, as defined in § 168(k)(3) as in effect prior to amendment by the TCJA, acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer before January 1, 2018, is a separate class of property under § 1.168(k)- 2(f)(1)(ii)(D). Pursuant to § 1.168(k)-2(f)(1)(iii), the § 168(k)(7) election is made by the due date, including extensions, of the Federal income tax return or Form 1065 for the taxable year in which the qualified property is placed in service by the taxpayer, and is made in the manner prescribed on Form 4562 and its instructions. For qualified property placed in service by the taxpayer before the applicability date set forth in § 1.168(k)-2(h) for § 1.168(k)-2, section 4.04 of Rev. Proc. 2017-33 provides the time and manner for making the § 168(k)(7) election and such procedures are the same as in § 1.168(k)-2(f)(1)(iii). Further, if a taxpayer timely filed its Federal income tax return or Form 1065 for the taxpayer's taxable year beginning in 2017 and ending on or after September 28, 2017, sections 5.02(2) and 5.03 of Rev. Proc. 2019-33 provide special procedures to allow the taxpayer to make a deemed § 168(k)(7) election or a late § 168(k)(7) election for a class of property that is qualified property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during such taxable year.[657]

[656] Revenue Procedure 2020-25, Section 2.02(2)

[657] Revenue Procedure 2020-25, Section 2.02(3)

The election under §168(k)(10) is described as follows:

> Section 168(k)(10) allows a taxpayer to make an election to deduct 50 percent, instead of 100 percent, additional first year depreciation for: (a) all qualified property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during its taxable year that includes September 28, 2017; and (b) all specified plants that are planted, or grafted to a plant that has already been planted, after September 27, 2017, by the taxpayer in the ordinary course of the taxpayer's farming business during its taxable year that includes September 28, 2017, if the taxpayer makes the § 168(k)(5) election for that taxable year (§ 168(k)(10) election). The rules and procedures for making the § 168(k)(10) election are set forth in § 1.168(k)-2(f)(3). Pursuant to § 1.168(k)-2(f)(3)(ii), the § 168(k)(10) election is made by the due date, including extensions, of the Federal income tax return or Form 1065 for the taxpayer's taxable year that includes September 28, 2017, and is made in the manner prescribed on the 2017 Form 4562 and its instructions. For qualified property placed in service, and specified plants planted, or grafted to a plant that was previously planted, by the taxpayer before the applicability date set forth in § 1.168(k)-2(h) for § 1.168(k)-2, section 6.02 of Rev. Proc. 2019-33 provides the time and manner for making the § 168(k)(10) election and such procedures are the same as in § 1.168(k)-2(f)(3)(ii). Further, if a taxpayer timely filed its Federal income tax return or Form 1065 for the taxpayer's taxable year beginning in 2017 and ending on or after September 28, 2017, sections 6.03(2) and 6.04 of Rev. Proc. 2019-33 provide special procedures to allow the taxpayer to make a deemed § 168(k)(10) election or a late § 168(k)(10) election for all qualified property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during such taxable year, or for all specified plants planted, or grafted to a plant that was previously planted, by the taxpayer after September 27, 2017.[658]

Time and manner of making a late § 168(g)(7), (k)(5), (k)(7), or (k)(10) election

This section applies to:

- A taxpayer that (a) placed in service depreciable property during its 2018, 2019, or 2020 taxable year, (b) timely filed its Federal income tax return or Form 1065 for the placed-in-service year of such depreciable property and such return was filed on or before April 17, 2020, (c) wants to make a § 168(g)(7) election, § 168(k)(5) election, or § 168(k)(7) election for such depreciable property, and (d) did not previously revoke or withdraw such election(s) in accordance with section 5.02 of this revenue procedure. The taxpayer makes the § 168(g)(7) election, § 168(k)(5) election, or § 168(k)(7) election in accordance with section 2.02(1), (2), or (3), respectively, of this revenue procedure or under section 4.02 of this revenue procedure; or

- A taxpayer that (a) timely filed its Federal income tax return or Form 1065 for the taxpayer's taxable year that includes September 28, 2017, (b) wants to make a § 168(k)(10) election for

[658] Revenue Procedure 2020-25, Section 2.02(4)

such taxable year, and (c) did not previously revoke a § 168(k)(10) election for such taxable year in accordance with section 5.02 of this revenue procedure. The taxpayer makes the § 168(k)(10) in accordance with section 2.02(4) of this revenue procedure or under section 4.02 of this revenue procedure.[659]

A taxpayer covered by this procedure may make a late election under IRC § 168(g)(7), (k)(5), (k)(7), or (k)(10) election in one of two manners:

- Except as provided in Rev. Proc. 2020-23 regarding the time to file amended returns by BBA partnerships for taxable years beginning in 2018 and 2019, a Federal amended income tax return or amended Form 1065 for the placed-in-service year of the property on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23 or that cannot file an amended Form 1065 because the placed-in-service year of the property is a taxable year that is not within the scope of Rev. Proc. 2020-23, the BBA partnership may file an AAR for the placed-in-service year of the property on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under § 6235 for the reviewed year as defined in § 301.6241-1(a)(8). This amended return or AAR must include the adjustment to taxable income for the late election and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on original or amended Federal returns or AARs for any affected succeeding taxable years; or

- A Form 3115 with the taxpayer's timely filed original Federal income tax return or Form 1065 (a) for the taxpayer's first or second taxable year succeeding the taxable year in which the taxpayer placed in service the property, or (b) that is filed on or after April 17, 2020, and on or before October 15, 2021. The late § 168(g)(7), (k)(5), (k)(7), or (k)(10) election under this section 4.02(2) will be treated as a change in method of accounting with a § 481(a) adjustment only during this limited period of time. The time and manner of making this late election are described in section 6.03(2) of this revenue procedure.[660]

Revoking or Withdrawing Certain Elections Under §168

This section applies to:

- A taxpayer that (a) placed in service depreciable property during its 2018, 2019, or 2020 taxable year, (b) made a § 168(k)(5) election or § 168(k)(7) election on its timely filed original Federal income tax return or Form 1065 for the placed-in-service year of such depreciable property and such return was filed on or before April 17, 2020, or made a § 168(k)(5) election or § 168(k)(7) election in accordance with section 4 or 5 of Rev. Proc. 2019-33, respectively, for the placed-in-service year of such depreciable property on or before April 17, 2020, and (c) wants to revoke such election. If the taxpayer revokes the § 168(k)(7) election in accordance with section 5.02(2)

[659] Revenue Procedure 2020-25, Section 4.01

[660] Revenue Procedure 2020-25, Section 4.02

of this revenue procedure, the revocation applies to all property included in the class of property and placed in service during the same taxable year;

- A taxpayer that made a § 168(k)(10) election on its timely filed original Federal income tax return or Form 1065 for the taxpayer's taxable year that includes September 28, 2017, and such return was filed on or before April 17, 2020, or made a § 168(k)(10) election in accordance with section 6 of Rev. Proc. 2019-33 for the taxpayer's taxable year that includes September 28, 2017, on or before April 17, 2020, and that wants to revoke the § 168(k)(10) election. If the taxpayer revokes the § 168(k)(10) election in accordance with section 5.02(2) of this revenue procedure, the revocation applies to (a) all qualified property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during its taxable year that includes September 28, 2017, and (b) all specified plants that are planted, or grafted to a plant that has already been planted, after September 27, 2017, by the taxpayer in the ordinary course of the taxpayer's farming business during its taxable year that includes September 28, 2017, if the taxpayer made the § 168(k)(5) election for that taxable year; or

- A taxpayer that (a) placed in service depreciable property during its 2018, 2019, or 2020 taxable year, (b) made a § 168(g)(7) election on its timely filed original Federal income tax return or Form 1065 for the placed-in-service year of such depreciable property and such return was filed on or before April 17, 2020, and (c) wants to withdraw such election. If the taxpayer withdraws the § 168(g)(7) election in accordance with section 5.02(3) of this revenue procedure, the taxpayer will be treated as if the election was never made for all property included in the class of property and placed in service during the same taxable year. However, if the taxpayer withdraws the § 168(g)(7) election for an item of nonresidential real property or residential rental property in accordance with section 5.02(3) of this revenue procedure, the taxpayer will be treated as if the election was not made for that specific item of nonresidential real property or residential rental property.[661]

A taxpayer covered by this section of the ruling is given consent revoke its §168(k)(5) election, §168(k)(7) election, or §168(k)(10) election, or consent to withdraw its §168(g)(7) election if the follows the procedures outlined.[662]

If a taxpayer who wishes to revoke a §168(k)(5), (7), or (10) election can do so by following either of the following procedures:

- Except as provided in Rev. Proc. 2020-23 regarding the time to file amended returns by BBA partnerships for taxable years beginning in 2018 and 2019, a Federal amended income tax return or amended Form 1065 for the placed-in-service year of the property on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23 or that cannot file an amended Form 1065 because the placed-in-service year of the property is a taxable year that is not within the scope of Rev. Proc. 2020-23, the BBA partnership may file an AAR for the placed-in-service year of the property on or before October 15, 2021, but in no event later than

[661] Revenue Procedure 2020-25, Section 5.01

[662] Revenue Procedure 2020-25, Section 5.02(1)

the applicable period of limitations on making adjustments under §6235 for the reviewed year as defined in § 301.6241-1(a)(8). This amended return or AAR must include the adjustment to taxable income for the revocation of the §168(k)(5), (k)(7), or (k)(10) election and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on original or amended Federal returns or AARs for any affected succeeding taxable years; or

- A Form 3115 with the taxpayer's timely filed original Federal income tax return or Form 1065 (i) for the taxpayer's first or second taxable year succeeding the taxable year in which the taxpayer placed in service the property, or (ii) that is filed on or after April 17, 2020, and on or before October 15, 2021. The revocation of the § 168(k)(5), (k)(7), or (k)(10) election under this section 5.02(2)(b) will be treated as a change in method of accounting with a § 481(a) adjustment only during this limited period of time. The time and manner of making this revocation are described in section 6.03(2) of this revenue procedure.[663]

A withdrawal of §168(7) election is accomplished as follows:

> A taxpayer within the scope of this section 5 may withdraw a § 168(g)(7) election by filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable. Except as provided in Rev. Proc. 2020-23 regarding the time to file amended returns by BBA partnerships for taxable years beginning in 2018 and 2019, the Federal amended income tax return or amended Form 1065 for the placed-in-service year of the property must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23 or that cannot file an amended Form 1065 because the placed-in-service year of the property is a taxable year that is not within the scope of Rev. Proc. 2020-23, the BBA partnership may file an AAR for the placed-in-service year of the property on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under § 6235 for the reviewed year as defined in § 301.6241-1(a)(8). This amended return or AAR must include the adjustment to taxable income for the withdrawal of the § 168(g)(7) election and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on original or amended Federal returns or AARs for any affected succeeding taxable years.[664]

Section 6 of the procedure has the detailed procedures for filing the necessary accounting method changes for this procedure.

The procedure also contains a modification to Revenue Procedure 2015-56 that details a safe harbor method accounting for determining whether expenditures paid or incurred to remodel or refresh a qualified building are deductible under § 162(a) of the Internal Revenue Code (Code), must be capitalized as improvements under § 263(a), or must be capitalized as the costs of property produced by the taxpayer for use in its trade or business under § 263A in Section 7 of the procedure.

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663 Revenue Procedure 2020-25, Section 5.02(2)

664 Revenue Procedure 2020-25, Section 5.02(3)

RELIEF GRANTED FOR SOME WHOSE ABILITY TO CLAIM §911 EXCLUSIONS ARE IMPACTED BY THE COVID-19 EMERGENCY

Revenue Procedure 2020-27, 4/21/20

In a procedure issued at the same time as one giving relief for individuals trapped in the United States due to travel restrictions who might inadvertently become U.S. residents for tax purposes (Revenue Procedure 2020-20), the IRS released a similar relief procedure for taxpayers who will be unable to meet the tests to qualify for the foreign earned income exclusion due to the COVID-19 emergency in Revenue Procedure 2020-27.[665]

The procedure outlines the general rules under §911(a) for being a "qualified individual" for purposes of qualifying for the foreign earned income exclusion and housing cost amount:

> .01 Section 911(a) allows a "qualified individual," as defined in section 911(d)(1), to elect to exclude from gross income the individual's foreign earned income and the housing cost amount.
>
> .02 Section 911(d)(1) defines the term "qualified individual" as an individual whose tax home is in a foreign country and who is (A) a citizen of the United States and establishes to the satisfaction of the Secretary that the individual has been a *bona fide* resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (B) a citizen or resident of the United States who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days.
>
> .03 In addition, section 911(d)(4) provides that an individual will be treated as a qualified individual with respect to a period in which the individual was a *bona fide* resident of, or was present in, a foreign country if the individual left the country during a period for which the Secretary of the Treasury, after consultation with the Secretary of State, determines that individuals were required to leave because of war, civil unrest, or similar adverse conditions that precluded the normal conduct of business. An individual must establish that but for those conditions the individual could reasonably have been expected to meet the eligibility requirements.[666]

The ruling provides the following relief, finding the adverse conditions noted above, applied as follows for 2019 and 2020:

> .01 For 2019 and 2020, the Secretary of the Treasury, after consultation with the Secretary of State, has determined that, for purposes of section 911(d)(4), the

[665] Revenue Procedure 2020-27, April 21, 2020, https://www.irs.gov/pub/irs-drop/rp-20-27.pdf, retrieved April 22, 2020

[666] Revenue Procedure 2020-27, Section 2.01-.03

COVID-19 Emergency is an adverse condition that precluded the normal conduct of business as follows:

- in the People's Republic of China, excluding the Special Administrative Regions of Hong Kong and Macau (China), as of December 1, 2019; and

- globally, as of February 1, 2020.

The period covered by this revenue procedure ends on July 15, 2020, unless an extension is announced by the Treasury Department and IRS. Thus, for purposes of section 911, an individual who left China on or after December 1, 2019, or another foreign country on or after February 1, 2020, but on or before July 15, 2020, will be treated as a qualified individual with respect to the period during which that individual was present in, or was a bona fide resident of, that foreign country if the individual establishes a reasonable expectation that he or she would have met the requirements of section 911(d)(1) but for the COVID-19 Emergency.

.02 To qualify for relief under section 911(d)(4), an individual must have established residency, or have been physically present, in the foreign country on or before the applicable date specified in section 3.01 of this revenue procedure. Therefore, an individual who was first physically present or established residency in China after December 1, 2020, or another foreign country after February 1, 2020, would not be eligible to use this revenue procedure.[667]

The procedure outlines how this relief will apply to a 12-month period:

.03 Individuals seeking to qualify for the section 911 foreign earned income exclusion because they could reasonably have been expected to have been present in a foreign country for 330 days but for the COVID-19 Emergency and have met the other requirements for qualification may use any 12-month period to meet the qualified individual requirement.[668]

The procedure concludes with two examples of applying the 12-month period:

For example, under this revenue procedure, an individual who arrived in China on September 1, 2019, and establishes that he or she reasonably expected to work in China until September 1, 2020, but departed China on January 10, 2020, due to the COVID-19 Emergency would be a qualified individual for the period from September 1 through December 31, 2019, and for the period from January 1 through January 9, 2020, assuming the individual has met the other requirements for qualification under section 911. As another example, under this revenue procedure, an individual who was present in the United Kingdom on January 1 through March 1, 2020, establishes that he or she reasonably expected to work in the United Kingdom for the entire calendar year, but departed the United Kingdom

[667] Revenue Procedure 2020-20, Section 3.01-.02

[668] Revenue Procedure 2020-20, Section 3.03

on March 2, 2020, due to the COVID-19 Emergency, and returns to the United Kingdom on August 25, 2020, for the remainder of the calendar year, would be a qualified individual for 2020 with respect to the period between January 1 through March 1, 2020, and August 25 through December 31, 2020, assuming the individual has met the other requirements for qualification under section 911.[669]

RELIEF ISSUED FOR INDIVIDUALS WHO WILL INADVERTENTLY MEET SUBSTANTIAL PRESENCE TEST DUE TO INTERNATIONAL COVID-19 TRAVEL RESTRICTIONS

Revenue Procedure 2020-20, 4/22/20

The IRS has introduced relief for individuals who, due to travel restrictions imposed during the COVID-19 crisis, will now end up meeting the "substantial presence test" and would otherwise be treated as U.S. residents under IRC §7701(b)(3). The relief is found in Revenue Procedure 2020-20.[670]

As the procedure notes:

> Travel and related disruptions resulting from the global outbreak of the COVID-19 virus may cause certain Eligible Individuals, as defined in section 3.04 of this revenue procedure, who did not anticipate meeting the "substantial presence test" under section 7701(b)(3) of the Internal Revenue Code (the Code) to become residents of the United States for federal income tax purposes during 2020 and may impact an individual's qualifications for certain treaty benefits. This revenue procedure provides procedures for Eligible Individuals to claim the COVID-19 Medical Condition Travel Exception, as described in section 4.01 of this revenue procedure. Similar relief applies in determining whether an individual (whether or not an Eligible Individual) qualifies for benefits under a U.S. income tax treaty with respect to income from dependent personal services performed in the United States.[671]

The procedure explains the justification for its issuance, explaining something that most everyone who has not been away from civilization since the end of 2019 is likely aware of:

> The COVID-19 Emergency, as defined in section 3.01 of this revenue procedure, may have affected the travel plans of foreign travelers who intended to leave the United States. Regardless of whether they were infected with the COVID-19 virus, individuals may have become severely restricted in their movements, including by order of government authorities. Individuals who do not have the COVID-19 virus

[669] Revenue Procedure 2020-20, Section 3.03

[670] Revenue Procedure 2020-20, April 21, 2020, https://www.irs.gov/pub/irs-drop/rp-20-20.pdf, retrieved April 21, 2020

[671] Revenue Procedure 2020-20, Section 1

and attempt to leave the United States may also face canceled flights and disruptions in other forms of transportation, shelter-in-place orders, quarantines, and border closures. Additionally, even those who can travel may feel unsafe doing so during the COVID-19 Emergency due to recommendations to implement social distancing and limit exposure to public spaces.[672]

Certain terms are defined to be used later in the procedure:

.01 *COVID-19 Emergency.* The term COVID-19 Emergency means the global outbreak of the COVID-19 virus.

.02 *COVID-19 Emergency Period.* The term COVID-19 Emergency Period is a single period of up to 60 consecutive calendar days selected by an individual starting on or after February 1, 2020 and on or before April 1, 2020 during which the individual is physically present in the United States on each day.

.03 C*OVID-19 Emergency Travel Disruptions.* The term COVID-19 Emergency Travel Disruptions means the travel disruptions described in section 2.01 of this revenue procedure.

.04 *Eligible Individual.* The term Eligible Individual means any individual (1) who was not a U.S. resident at the close of the 2019 tax year, (2) who is not a lawful permanent resident at any point in 2020, (3) who is present in the United States (without regard to this revenue procedure) on each of the days of the individual's COVID-19 Emergency Period, and (4) who does not become a U.S. resident in 2020 due to days of presence in the United States outside of the individual's COVID-19 Emergency Period.

.05 *Medical Condition Exception.* The term Medical Condition Exception means the exception from the substantial presence test provided under section 7701(b)(3)(D)(ii) and section 301.7701(b)-3(c).[673]

The procedure applies a special COVID-19 Medical Condition Travel Exception to an individual's days of presence as described below:

.01 *COVID-19 Medical Condition Travel Exception to days of presence*. An Eligible Individual who intended to leave the United States during the individual's COVID-19 Emergency Period, but was unable to do so due to COVID-19 Emergency Travel Disruptions, may exclude the individual's COVID-19 Emergency Period (up to 60 calendar days of presence in the United States, as explained in section 3.02 of this revenue procedure) for purposes of applying the substantial presence test. The COVID-19 Emergency will be considered a medical condition, as described in section 301.7701(b)-3(c), that prevented the Eligible Individual from leaving the United States on each day during the individual's COVID-19 Emergency Period

[672] Revenue Procedure 2020-20, Section 2.01

[673] Revenue Procedure 2020-20, Section 3

> and, as generally required by the Medical Condition Exception, will not be treated as a pre-existing medical condition, as described in section 301.7701(b)-3(c)(3). Also, in determining an individual's eligibility for treaty benefits with respect to income from employment or the performance of other dependent personal services within the United States, any days of presence during the individual's COVID-19 Emergency Period on which the individual was unable to leave the United States due to COVID-19 Emergency Travel Disruptions will not be counted.[674]

The procedure also provides a presumption of intent and inability to leave the United States:

> .02 *Presumption of intent and inability to leave the United States.* For purposes of this revenue procedure, an Eligible Individual will be presumed to have intended to leave the United States on any day during the individual's COVID-19 Emergency Period, unless that individual has applied, or otherwise taken steps, to become a lawful permanent resident of the United States. An Eligible Individual will be presumed unable to leave the United States for purposes of the substantial presence test on any day during the individual's COVID-19 Emergency Period. Similarly, an individual claiming benefits under an applicable U.S. income tax treaty with respect to income from employment or other dependent personal services performed in the United States will be presumed unable to leave the United States on any day during the individual's COVID-19 Emergency Period.[675]

Section 5 provides the detailed procedures for claiming the COVID-19 medical condition travel exception. The procedures begin with the following general comments:

> Eligible Individuals who have a requirement to file a Form 1040- NR for 2020 (taking into account the application of this revenue procedure) must claim the COVID-19 Medical Condition Travel Exception by attaching Form 8843, *Statement for Exempt Individuals and Individuals with a Medical Condition*, to their Form 1040-NR, by the form's due date (with extensions), and mailing the forms to the address shown in the Form 1040-NR return instructions. Eligible Individuals who are not required to file a 2020 Form 1040-NR are not required to file Form 8843 to claim the COVID-19 Medical Condition Travel Exception under this revenue procedure, but those individuals should retain all relevant records to support reliance on this revenue procedure and be prepared to produce these records and complete a Form 8843 if requested by the IRS.[676]

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[674] Revenue Procedure 2020-20, Section 4.01

[675] Revenue Procedure 2020-20, Section 4.02

[676] Revenue Procedure 2020-20, Section 5.01

Special instructions are provided for completing a Form 8843:

> Subject to section 5.01 of this revenue procedure, to claim the COVID-19 Medical Condition Travel Exception, Eligible Individuals should complete Form 8843 as follows:
>
> - Part I and the general identifying information sections should be completed pursuant to the form instructions;
> - Parts II, III, and IV, if applicable, should be completed pursuant to the form instructions;
> - Part V should be completed by writing the following in each respective space:
>   - for line 17a, "COVID-19 MEDICAL CONDITION TRAVEL EXCEPTION."
>   - for line 17b, the start date of the Eligible Individual's COVID-19 Emergency Period.
>   - for line 17c, the end date of the Eligible Individual's COVID-19 Emergency Period.
>   - line 18 should be left blank. There is no need for a physician's statement when claiming the COVID-19 Medical Condition Travel Exception.
> - The individual should sign and date the form consistent with the form instructions.
> - The individual should retain a copy of the completed Form 8843 and be prepared to produce the copy if requested by the IRS, as well as documentation demonstrating that the individual was physically present in the United States during all of the individual's COVID-19 Emergency Period.[677]

The procedure also provides information for those who fail to file the form:

> Eligible Individuals who are required under section 5.01 of this revenue procedure to file Form 8843 with their Form 1040-NR to claim the COVID-19 Medical Condition Travel Exception, but who fail to do so, may be eligible for the procedural relief under section 301.7701(b)-8(d)(2) or the relief under section 301.7701(b)-8(e). Eligible Individuals who are not required to file a Form 8843 under section 5.01 may submit the completed Form 8843 at a later date as needed,

[677] Revenue Procedure 2020-20, Section 5.02

> including if the individual's nonresident status for 2020, 2021, or 2022 is later challenged under examination or otherwise.[678]

The ruling also explains the interaction with other exceptions to the substantial presence test:

> An Eligible Individual may claim the COVID-19 Medical Condition Travel Exception in addition to, or instead of, claiming other exceptions from the substantial presence test for which the individual is eligible. Specifically, relief provided under this revenue procedure does not change the application of other applicable exceptions to the substantial presence test: (i) exclusion of days of presence for exempt individuals described under section 7701(b)(3)(D)(i) and section 301.7701(b)-3(b), (ii) exclusion of days of presence under the Medical Condition Exception for medical problems or medical conditions other than those related to the COVID-19 Medical Condition Travel Exception, as addressed in section 5.05 of this revenue procedure, (iii) the closer connection exception under section 301.7701(b)-2, and (iv) relief pursuant to treaty provisions applicable to dual residents under section 301.7701(b)-7. Individuals who qualify for other exceptions to the substantial presence test do not need to claim the COVID-19 Medical Condition Travel Exception in order to claim other available exceptions, or they may choose to claim all exceptions for which they are eligible. For example, an alien individual who would be a U.S. resident due to days spent in the United States even after excluding eligible days under the COVID-19 Medical Condition Travel Exception may still be considered a nonresident alien if the individual is eligible to claim the closer connection exception under section 301.7701(b)-2.[679]

The procedure also provides that the medical condition exception is also available along with this special exception:

> An Eligible Individual who claims the COVID-19 Medical Condition Travel Exception may also claim the Medical Condition Exception, including for medical conditions or medical problems related to the COVID19 virus, with respect to any period during 2020 in which the individual satisfies the requirements to do so. Individuals claiming the Medical Condition Exception for any period outside of the individual's COVID-19 Emergency Period should file Form 8843 consistent with the applicable regulations and form instructions.[680]

Finally, the procedure discusses claiming a treaty benefit for services income:

> To claim an exemption from withholding on income from dependent personal services pursuant to a U.S. income tax treaty in accordance with this revenue procedure, an individual should provide the employer or other withholding agent a Form 8233, *Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual*, certifying that

[678] Revenue Procedure 2020-20, Section 5.03

[679] Revenue Procedure 2020-20, Section 5.04

[680] Revenue Procedure 2020-20, Section 5.05

the income is exempt. However, if the withholding agent currently treats the income as exempt based on a previously submitted Form 8233, it is not necessary to provide an additional Form 8233. Form 8233 should be completed pursuant to the form instructions. On line 14 of Form 8233, write "COVID-19 MEDICAL CONDITION TRAVEL EXCEPTION" and specify the individual's COVID-19 Emergency Period. If a new Form 8233 is not provided to a withholding agent, or if the withholding agent already has withheld income tax that would be exempt from withholding in accordance with this revenue procedure, the nonresident individual should file Form 1040-NR and attach a statement including the same information requested on the Form 8233 (including the phrase "COVID-19 MEDICAL CONDITION TRAVEL EXCEPTION," the individual's COVID-19 Emergency Period, the applicable tax treaty, and the tax treaty article).[681]

[681] Revenue Procedure 2020-20, Section 5.06

Unit 14

Individual Tax Developments

SECTION: 61
INCOME WILL BE REALIZED BY PARTICIPANTS PAID IN CONVERTIBLE VIRTUAL CURRENCIES FOR COMPLETING MICROTASKS VIA A CROWDSOURCING PLATFORM

Citation: CCA 202035011, 8/28/2020

The IRS has returned to the virtual currency taxation subject area, this time in a Chief Counsel Advice ruling on the tax consequences for individuals who receive convertible virtual currency in exchange for performing microtasks through a crowdsourcing or similar platform.[682]

The IRS looks at the tax consequences for individuals using a crowdsourcing platform to provide services in this memorandum. A crowdsourcing arrangement is described in the memorandum as follows:

> A variety of digital platforms now enable individuals or entities to "crowdsource" jobs by using the Internet to outsource assignments to an undefined and often large group of other individuals or entities. A crowdsourcing arrangement may involve three parties referred to in this memorandum as vendors, firms, and workers. Vendors develop a platform upon which firms can broadcast their tasks and workers can accept, perform and/or submit the work.[683]

The memorandum then goes on to describe microtasking and microtasks:

> Certain crowdsourcing platforms specifically facilitate the practice of microtasking, which may involve subdividing larger tasks into smaller tasks and distributing the tasks via online crowdwork platforms. In general, microtasks are simple, menial

[682] CCA 202035011, August 28, 2020 https://www.irs.gov/pub/irs-wd/202035011.pdf (retrieved August 28, 2020)

[683] CCA 202035011, pp. 1-2

> activities that still require some degree of human interaction beyond the current ability of artificial intelligence.[684]

In the case the IRS is looking at, those performing microtasks are paid in a convertible virtual currency, such as Bitcoin:

> Certain microtasking platforms allow those who perform microtasks to receive payments in consideration for completing each microtask in the form of convertible virtual currency. For example, a firm may offer to pay workers in units of Bitcoin or other convertible virtual currency if the worker processes data or reviews images. Other examples include an offer of convertible virtual currency in exchange for downloading a particular app from an app store and leaving a positive review including a comment, downloading games and reaching certain milestones, completing online quizzes and surveys, or registering accounts with various online services. These types of microtasks may provide individuals with "rewards" in the form of convertible virtual currency. The value of convertible virtual currency paid in exchange for a single microtask often is a small amount that may be less than $1.[685]

The IRS had previously ruled that general tax principles apply to the taxation of transactions involving convertible virtual currencies.[686] So, normally, if a taxpayer receives a convertible virtual currency, such as Bitcoin, in exchange for performing services, the taxpayer would have taxable income equal to the value of the convertible virtual currency received. But does the answer change when the payment for the service is very small, including below $1?

The IRS concludes that the fact that the payment is small and is paid out in a convertible virtual currency does not change the result. Compensation received for services is taxable under IRC §61(a)(1) and performing a microtask is a service.

> Because the term "service," for purposes of § 61, is not defined in the Code, the term should be construed "in accord with its ordinary or natural meaning." *Smith v. United States*, 508 U.S. 223, 228 (1993). A taxpayer who performs a task through a crowdsourcing platform, including a microtask, has performed a service for the party that requested the task with the expectation that he or she will receive compensation. If the taxpayer receives convertible virtual currency for performing the task, regardless of the value and the manner in which it is received, then the taxpayer has been compensated with property. See Notice 2014-21. The convertible virtual currency received must be reported on the taxpayer's income tax return as ordinary income and may be subject to self-employment tax. See §§ 61, 83, and 1401.[687]

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[684] CCA 202035011, p. 2

[685] CCA 202035011, p. 2

[686] See Notice 2014-21 and Revenue Ruling 2019-24

[687] CCA 202035011, p. 3

SECTION: 62
TAX STATUS OF PAYMENTS RECEIVED FOR PYRRHOTITE DAMAGE CLARIFIED BY IRS ANNOUNCEMENT

Citation: Announcement 2020-5, 4/22/20

The IRS has issued additional guidance related to a problem Connecticut homeowners had with deteriorating concrete foundations due to pyrrhotite in the concrete mixture in Announcement 2020-5.[688]

The Announcement describes the problem as follows:

> Pyrrhotite is a mineral that oxidizes in the presence of water and oxygen, leading to the formation of expansive mineral products. Pyrrhotite is naturally found in certain stone aggregates used to produce concrete and can cause concrete to deteriorate prematurely in certain cases.
>
> In August 2015, agencies of the State of Connecticut began investigating numerous complaints by homeowners concerning the premature deterioration of the concrete foundations of their homes. These agencies concluded that the premature deterioration of the concrete foundations was due to the presence of pyrrhotite in the concrete mixture used to pour the foundations (deteriorating concrete foundations).

The issue involves the tax status of payments made by an insurance company formed by the state of Connecticut to homeowners who had foundation damage related to pyrrhotite. The IRS describes the program as follows:

> In 2017, the State of Connecticut mandated the establishment and funding of an entity, the Connecticut Foundation Solutions Indemnity Company, Inc. (CFSIC), to assist homeowners with the expeditious repair of the most severe cases of deteriorating concrete foundations. In addition to establishing the CFSIC, the State of Connecticut authorized the CFSIC to raise funds and augment the monies bonded by the state to remedy the issue of deteriorating concrete foundations.
>
> In January 2019, the CFSIC began accepting applications from homeowners seeking financial assistance to repair their deteriorating concrete foundations. All claims require a contract between the homeowner and a contractor for repair or replacement of the foundation. The contract must set forth the total cost of repair. The CFSIC pays the lesser of: (1) the expenses pertaining to the repair of the crumbling foundation to a structurally safe level, or (2) $175,000, per residential building. There are two types of claims that homeowners can make. The first type of claim requests that the CFSIC pay the contractor directly, on behalf of the

688 Announcement 2020-5, April 22, 2020, https://www.irs.gov/pub/irs-drop/a-20-05.pdf, retrieved April 22, 2020

> homeowner, for eligible expenses before and during the performance of the repair work. The second type of claim requests that the CFSIC reimburse the homeowner directly for eligible expenses previously paid to the contractor. Payments under both types of claims commenced in 2019.

In Revenue Procedures 2017-60 and 2018-14, the IRS released guidance that allowed taxpayers who incurred expenses to repair these foundations to claim a casualty loss under IRC §165.

This newly released guidance looks at what happens to taxpayers who receive payments from the CFSIC. If a taxpayer had previously claimed a deduction for payments that later were reimbursed by the CFSIC, IRC §111 governs the tax treatment as described below:

> If a Connecticut homeowner who paid amounts to repair damage to a personal residence with a deteriorating concrete foundation has claimed a deduction under the safe harbor or otherwise on an original or amended Federal income tax return for an earlier taxable year, then payments received by the homeowner from the CFSIC in a subsequent taxable year must be included in the homeowner's gross income in the Federal income tax return for the subsequent taxable year to the extent the deduction claimed for the earlier taxable year resulted in a Federal income tax benefit. See section 111 of the Code. For example, if a homeowner claimed a deduction of $125,000 for such amounts in an earlier taxable year and the entire deduction resulted in a reduction in Federal income tax from the tax that would apply without the deduction, a $125,000 recovery must be included as gross income in the homeowner's Federal income tax return for the subsequent taxable year.

However, what was not so clear is what should happen if a taxpayer who had not previously claimed a loss deduction or did not receive a benefit from claiming the deduction receives a payment (either directly or to a contractor on the taxpayer's behalf) from the CFSIC.

> If a Connecticut homeowner has not claimed a Federal income tax deduction for amounts paid to repair damage to a principal residence under the safe harbor or otherwise, or to the extent such a deduction did not result in a Federal income tax benefit, payments from the CFSIC to contractors (on behalf of the homeowner) or reimbursements paid to the homeowner will not be treated as includible in gross income of the homeowner in the year the payment or reimbursement is paid. Reimbursed repair costs cannot be deducted or included in the basis of a home.

The announcement relieves concerns that it was possible this CFSIC payment might have been viewed as an accession to wealth under IRC §61, and therefore includible in gross income. The IRS has made clear that the agency does not see this as part of gross income.

SECTION: 108
DEBT CANCELLED BY LENDER WAS NOT QUALIFIED PRINCIPAL RESIDENCE DEBT, ENTIRE CANCELLATION AMOUNT TAXABLE

Citation: Weiderman v. Commissioner, T.C. Memo. 2020-109, 7/15/20

In the case of *Weiderman v. Commissioner*, T.C. Memo. 2020-109,[689] the taxpayer found that simply using a loan to purchase a residence is not sufficient to make it into qualified principal residence indebtedness. The taxpayer was looking to claim an exclusion from cancellation of indebtedness income under IRC §108(a)(1)(E).

Qualified Principal Residence Indebtedness Exclusion of Cancellation of Indebtedness Income

A provision that was originally "temporarily" added as part of the economic relief packages that were enacted as a reaction to the 2008 real estate crash, the exclusion from income for cancellation of indebtedness on qualified principal residence debt has been extended multiple times, most recently as part of the 2019 end of year tax package.

The provision reads:

> (a)Exclusion from gross income
>
> (1) In general
>
> Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—
>
> > …
> >
> > (E) the indebtedness discharged is qualified principal residence indebtedness which is discharged—
> >
> > > (i) before January 1, 2021, or
> > >
> > > (ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2021.

[689] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, July 15, 2020, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12289 (retrieved July 16, 2020)

Qualified principal residence indebtedness is defined at IRC §108(h)(2) as:

> (2) Qualified principal residence indebtedness
>
> For purposes of this section, the term "qualified principal residence indebtedness" means acquisition indebtedness (within the meaning of section 163(h)(3)(B), applied by substituting "$2,000,000 ($1,000,000" for "$1,000,000 ($500,000" in clause (ii) thereof and determined without regard to the substitution described in section 163(h)(3)(F)(i)(II)) with respect to the principal residence of the taxpayer.

The cross reference to IRC §163(h)(3)(B) ties the definition to the one used for home mortgage interest that is deductible on Schedule A, but with a $2 million rather than $750,000 limit on the amount of such debt—acquisition indebtedness.

Two key tests must be met for debt to be treated as acquisition indebtedness, and thus potentially eligible for special treatment under §108(a)(1)(E)'s debt forgiveness exclusion:

- The debt is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and
- The debt is secured by such residence.

Debt Used to Acquire Residence

In this case, the Tax Court provides us with the following information regarding the debt in question:

> Following negotiations, by letter dated December 11, 2006, K-Swiss offered Mrs. Weiderman employment as vice president — marketing, directly reporting to the chief executive officer of K-Swiss, and a salary of $25,000 monthly (December 11, 2006, letter). Mrs. Weiderman was required to move to Southern California where K-Swiss was located, and as outlined in the December 11, 2006, letter K-Swiss would (among other things) grant her an interest-free loan of $500,000 to help finance the purchase of a home in that area, provide her up to 180 days of temporary housing in a furnished executive apartment, reimburse her travel expenses for three three-day trips for her and Mr. Weiderman, and pay her moving expenses from Massachusetts to California.
>
> …
>
> Meanwhile, petitioners offered to purchase a home in Agoura Hills, California (Agoura Hills property), and this purchase was consummated in February 2007. They paid $1,950,000 for the Agoura Hills property (plus settlement charges and prorated county taxes and homeowner association dues) by (1) providing a deposit or earnest money of $50,000, (2) obtaining a $1,450,000 mortgage and a $75,000 bridge loan from Wells Fargo, and (3) providing an additional deposit of $385,993, which was wired into the escrow account established for the purchase from

> petitioners' Wells Fargo checking account six days after their receipt of the $500,000 loan proceeds via wire transfer. [690]

Under the tracing rules applicable to interest, the taxpayer was allowed to trace $385,993 of the employer loan as being used to acquire the residence. But merely using the debt to acquire the residence is not enough to qualify the debt as acquisition indebtedness.

Security Requirement

The new job did not work out and, under terms of the note, the taxpayers had to repay the note due to the loss of the position. The Court describes what happened as follows:

> On December 1, 2008, K-Swiss terminated Mrs. Weiderman's employment. Because her employment was terminated and in accordance with the February 15, 2007, promissory note, K-Swiss demanded that petitioners repay the $500,000 loan. Knowing that the only way they could pay back this loan was to sell the Agoura Hills property and thus concerned about their repayment ability, petitioners listed (with the assistance of a real estate agent) the Agoura Hills property for sale and hired Mary Lee Wegner, a Sherman Oaks, California, employment attorney, to negotiate a settlement with K-Swiss. Initially, K-Swiss offered to cancel $250,000 of the $500,000 loan in lieu of a cash severance payment. Ultimately petitioners agreed to having K-Swiss cancel $220,000 of the loan and pay them $30,000.
>
> The details of their agreement were memorialized by a separation agreement and general release executed by Mrs. Weiderman and K-Swiss in January and February 2009, respectively (2009 separation agreement), along with a promissory note secured by a deed of trust executed by petitioners on January 29, 2009, in favor of K-Swiss (January 29, 2009, promissory note). As stated in appendix A of the 2009 separation agreement, K-Swiss was obligated to pay Mrs. Weiderman $30,000 in one lump sum without payroll or other deductions on the eighth calendar day after she delivered a signed copy of the 2009 separation agreement to K-Swiss. Additionally, as stated therein, with respect to the $500,000 loan memorialized by the February 15, 2007, promissory note, K-Swiss forgave $220,000 of that debt (leaving a balance owing of $280,000) and would mark that note "Cancelled", and petitioners were obligated to sign (1) a new promissory note for $280,000 in favor of K-Swiss, replacing the February 15, 2007, promissory note and (2) a deed of trust also in favor of K-Swiss and recordable against the Agoura Hills property to secure payment of the $280,000. The January 29, 2009, promissory note reiterated K-Swiss' agreement to cancel the February 15, 2007, promissory note. It also set forth the conditions for repayment of the $280,000; to wit, that the amount would be due and payable in full upon the sale of the Agoura Hills property or, if the net proceeds from that sale were insufficient to pay this amount, then the amount would be due on January 31, 2010.

[690] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 3-5

> On January 29, 2009, in accordance with appendix A of the 2009 separation agreement, petitioners signed a deed of trust in favor of K-Swiss, securing the $280,000 loan with the Agoura Hills property. Petitioners delivered the signed deed of trust to K-Swiss and K-Swiss recorded it with the Los Angeles County, California, Registrar-Recorder. On February 6, 2009, in accordance with appendix A of the 2009 separation agreement, K-Swiss wired the $30,000 into petitioners' checking account with Bank of America.3 An unnamed representative of K-Swiss wrote "CANCELLED" across the February 15, 2007, promissory note.
>
> On May 20, 2009, the Agoura Hills property sold for $1,665,000. Shortly before the sale Mrs. Weiderman and K-Swiss agreed to amend the 2009 separation agreement to reflect an additional forgiveness of petitioners' outstanding debt this time, $35,000 of the $280,000 loan.
>
> The details of this agreement were memorialized in a May 12, 2009, letter from K-Swiss to Mrs. Weiderman that she countersigned on May 15, 2009 (May 12, 2009, letter). As stated in the May 12, 2009, letter, Mrs. Weiderman's indebtedness to K-Swiss was reduced from $280,000 to $245,000, with repayment of the $245,000 to occur as follows: (1) $200,000 to be paid upon the sale of the Agoura Hills property and (2) the balance to be paid in two equal installments on January 31, 2010 and 2011, respectively. Additionally, as stated therein, petitioners were obligated to sign a new promissory note to reflect the $245,000 debt.
>
> In accordance with the May 12, 2009, letter petitioners executed an "[a]mended and [r]estated" promissory note for $245,000 in favor of K-Swiss and K-Swiss was paid the $200,000 upon the sale of the Agoura Hills property. Petitioners, however, failed to make the January 31, 2010, installment payment of $22,500. After letters dated February 12 and April 6, 2010, were sent by K-Swiss to Mrs. Weiderman regarding this failure, petitioners retained Carl D. Hasting, an attorney and a certified public accountant (C.P.A.) at CDH Associates, Inc., in Westlake Village, California, as legal counsel to explore settling the outstanding $45,000 debt. In June 2010, as a result of settlement discussions, petitioners and K-Swiss executed a settlement and release agreement whereby petitioners would pay K-Swiss $15,000 and K-Swiss would forgive the remaining $30,000 of outstanding debt (June 2010 settlement agreement). At times not established by the record petitioners and K-Swiss met the terms of this agreement.[691]

Eventually the taxpayer reported $255,000 as excludable cancellation of indebtedness income from qualified principal residence indebtedness.

[691] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 5-8

The Tax Court looked at the issue of whether the debt in question was secured by a qualified principal residence. The Court noted the following definition of what constitutes a debt being secured for these purposes:

> For these purposes, secured debt is any debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract) that makes the debtor's interest in the qualified residence specific security for the payment of the debt (1) under which, in the event of default, the residence could be subjected to the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated and (2) is recorded or otherwise perfected in accordance with the applicable State law. Sec. 1.163-10T(o)(1), Temporary Income Tax Regs., 52 Fed. Reg. 48417 (Dec. 22, 1987). In California, the State in which the Agoura Hills property was situated, a mortgage or deed of trust is perfected by recordation of the document at the office of the county recorder. Cal. Civ. Code secs. 1213 and 1214 (West 1989).[692]

The Court notes that the initial loan, which was used for acquiring the residence, was not secured in accordance with this definition:

> In accordance with the December 11, 2006, letter K-Swiss granted Mrs. Weiderman a $500,000 loan to help finance the purchase of a home in Southern California, and petitioners used most of the loan proceeds to purchase the Agoura Hills property. Although the loan was memorialized by the February 15, 2007, promissory note, this note did not provide that the indebtedness was secured by the Agoura Hills property. Additionally, the February 15, 2007, promissory note was not recorded with the Los Angeles County, California, Registrar-Recorder.14 The $500,000 loan was therefore unsecured debt. Since it was unsecured debt, it was not acquisition indebtedness within the meaning of section 163(h)(3)(B)(i), and thus K-Swiss' cancellation of $220,000 of that indebtedness as memorialized by appendix A of the 2009 separation agreement was not cancellation of qualified principal residence indebtedness within the meaning of section 108.[693]

But a later loan that refinanced this loan did have such a deed of trust recorded to perfect the lien—didn't that fix the problem? Unfortunately for the taxpayer, recording that loan did not solve the problem since this new debt now failed the first test—it was not used in acquiring, constructing or substantially improving the property. As the opinion continues:

> In accordance with appendix A of the 2009 separation agreement petitioners signed the January 29, 2009, promissory note which created an indebtedness of $280,000 in favor of K-Swiss, together with a deed of trust also in favor of K-Swiss and recordable against the Agoura Hills property to secure payment of that new indebtedness. Although K-Swiss recorded the deed of trust with the Los Angeles County, California, Registrar-Recorder, the $280,000 debt was not "incurred in acquiring, constructing, or substantially improving" the Agoura Hills property.

[692] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, p. 25

[693] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 25-26

> Indeed, the January 29, 2009, promissory note conditioned repayment of the $280,000 upon the sale of the Agoura Hills property. Like the indebtedness of $500,000, the indebtedness of $280,000 was therefore not acquisition indebtedness, and thus K-Swiss' cancellation of $35,000 of that indebtedness as memorialized by the May 12, 2009, letter shortly before the sale of the Agoura Hills property was not cancellation of qualified principal residence indebtedness.
>
> Finally, in accordance with the May 12, 2009, letter, petitioners executed an "[a]mended and [r]estated" promissory note for $245,000 in favor of K-Swiss. Like the February 15, 2007, promissory note, the note for $245,000 did not provide that the indebtedness was secured by the Agoura Hills property. Additionally, like the $280,000 debt, the $245,000 debt was not "incurred in acquiring, constructing, or substantially improving" the Agoura Hills property; indeed, similar to the repayment of the $280,000, repayment of ($200,000 of) the $245,000 was conditioned upon the sale of the Agoura Hills property. The indebtedness of $245,000 was therefore no different from the indebtedness of $500,000 and $280,000 — it was not acquisition indebtedness, and thus K-Swiss' cancellation of $30,000 of the outstanding indebtedness to it of $45,000 in accordance with the June 2010 settlement agreement was not cancellation of qualified principal residence indebtedness.[694]

Note that under IRC §163(h)(3)(B) a refinancing of debt that is *already* qualified principal residence debt will not cause a problem. The resulting new debt will inherit the status of the old. But. in this case, the debt being refinanced was not qualified debt, thus the refinancing did not fall under the special rule found at the end of IRC §163(h)(3)(B).

SECTION 164
PASSTHROUGH TAXES CREATED BY STATES AS SALT WORKAROUNDS WILL BE ALLOWED AS DEDUCTION WITHOUT REGARD TO ANY SALT LIMITATIONS

Notice 2020-75, 11/9/20

The IRS has now released guidance that proposed regulations will be released that will allow partnerships and S corporations to deduct state and local income taxes imposed on the entity.[695] This development resolves an issue that has been around since Connecticut enacted the first passthrough tax following the passage of the Tax Cuts and Jobs Act.

[694] *Weiderman v. Commissioner*, T.C. Memo. 2020-109, pp. 26-28

[695] Notice 2020-75, November 9, 2020, https://www.irs.gov/pub/irs-drop/n-20-75.pdf (retrieved November 9, 2020)

The IRS notes the following:

> Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. The Treasury Department and the IRS are aware that there is uncertainty as to whether entity-level payments made under these laws to jurisdictions described in section 164(b)(2) other than U.S. territories must be taken into account in applying the SALT deduction limitation at the owner level.[696]

The IRS begins by announcing that they will be issuing proposed regulations to allow this deduction:

> .01 Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.[697]

The Notice provides the following with regard to the deduction of such payments:

> (2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.[698]

The term *Specified Income Tax Payment* is defined as follows:

> For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions.[699]

One area of concern that some had with regard to the entity level passthrough taxes imposed by states was that some were imposed at the election of the entity. Would the fact that an entity has elected to

[696] Notice 2020-75, Section 2.02(3)

[697] Notice 2020-75, Section 3.01

[698] Notice 2020-75, Section 3.02(2)

[699] Notice 2020-75, Section 3.02(1)

pay the tax eliminate the treatment as a tax imposed on the entity? The IRS has decided that is not an issue. Similarly, the fact that a partner ends up with a benefit against his/her tax liability also is not a problem for such taxes.

> For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.[700]

The tax will *not* be a separately stated item, but rather will be part of the non-separately stated income or loss from the partnership or S corporation:

> Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).[701]

As well, the amounts paid will not be taken into account for the individual SALT limitation:

> Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.[702]

The applicability date allows taxpayers to deduct taxes paid on such taxes generally for years ending after December 31, 2017:

> The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to

[700] Notice 2020-75, Section 3.02(1)

[701] Notice 2020-75, Section 3.02(3)

[702] Notice 2020-75, Section 3.02(4)

satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.[703]

SECTION 164
IRS LETTER TO CONGRESSIONAL OFFICE INDICATES THAT $10,000 CAP APPLIES TO DEDUCTION OF REAL ESTATE TAXES ON REAL ESTATE COOPERATIVE UNIT UNDER §216

Information Letter 2020-0010, 9/25/20

In an information letter,[704] the IRS has informally addressed an issue that has existed since the passage of the Tax Cuts and Jobs Act—does the $10,000 state and local tax deduction cap apply to the special deduction under IRC §216 to a shareholder's portion of taxes paid by a housing cooperative?

In February 2019,[705] we published an article looking at the interaction of the limitation on personal state and local taxes found at IRC §164(b)(6) and the deduction allowed for owners of shares in a real estate cooperative under IRC §216. A real estate cooperative is an alternative to the use of a condominium structure to have an individual purchase a segment (or unit) in a particular building. The cooperative is a corporation that owns the building, with each shareholder normally having the right to occupy a particular unit.

Since the property tax would be imposed on the corporation as owner of the building rather than the shareholder, IRC §216 provides a method for the shareholder to claim his/her share of the taxes paid by the corporation.

As was described in the article, it appeared the language of the Tax Cuts and Jobs Act added at §164(b)(6) to limit itemized deductions for state and local taxes other than for business or investment properties failed to specifically limit taxes for which the deduction was allowed under IRC §216. As was noted, the Blue Book indicated that it was Congress's intent to have the limit applied, but the Blue Book text also contained the footnote reference that a technical correction might be necessary to achieve that result—that is, the text of the law might not be drafted properly to achieve the intended result.

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703 Notice 2020-75, Section 4

704 Information Letter 2020-0010, September 25, 2020, https://www.irs.gov/pub/irs-wd/20-0010.pdf (retrieved October 28, 2020)

705 Edward Zollars, "Owners of Shares in Housing Cooperatives May Escape $10,000 Limit on Tax Deduction Due to Drafting Error in TCJA," *Current Federal Tax Developments* website, February 22, 2020, https://www.currentfederaltaxdevelopments.com/blog/2019/2/22/owners-of-shares-in-housing-cooperatives-may-escape-10000-limit-on-tax-deduction-due-to-drafting-error-in-tcja (retrieved October 28, 2020)

Congressman Jerrold Nadler's office made an inquiry to the IRS about whether, in fact, this limitation applied and, in a letter dated July 29, 2020 but formally released on the IRS website later, the IRS addressed the issue.

The IRS letter takes the position that the limitation does apply to these taxes under IRC §216:

> The SALT limitation under section 164(b)(6) applies to the deduction taken into account by a tenant-stockholder under section 216 for the tenant-stockholder's proportionate share of the real estate taxes paid or incurred by a cooperative housing corporation.[706]

The letter provides the following analysis in support of this position:

> Section 164 generally allows an itemized deduction for certain taxes, including state and local real property tax, state and local personal property tax, and state and local income tax or state and local sales tax, for the taxable year in which paid Section 164(b)(6), which was added by the Tax Cut and Jobs Act of 2017, limits an individual's deduction for the taxable year to an aggregate amount of the state and local taxes taken into account during the taxable year to $10,000 (or $5,000 in the case of a married individual filing a separate return) for taxable years beginning after December 31, 2017, and before January 1, 2026.
>
> Section 216(a) allows a deduction by a tenant-stockholder for the tenant-stockholder's proportionate share of the real estate taxes allowable as a deduction to the cooperative housing corporation under section 164. The legislative history to section 216 states that "[t]he general purpose of this provision is to place the tenant stockholders of a cooperative apartment in the same position as the owner of a dwelling house so far as deductions for interest and taxes is concerned." S. Rep. No. 1621, 77th Cong., 2d Sess. 51 (1942). Further, regarding the SALT limitation, the Joint Committee on Taxation states that "[i]t is intended that the limitation apply to the deduction for amounts paid or accrued to a cooperative housing corporation by a tenant-stockholder under section 216(a)(1) (relating to real estate taxes) in the same manner as the limitation applies to real estate taxes under section 164." Joint Committee on Taxation Staff, *General Explanation of Public Law 115-97*, JCS-1-18 p. 68 (December 2018).[707]

The analysis is interesting in that it relies entirely on statements of Congressional intent and steers clear of analyzing the actual text of the section in question. As well, while quoting the Blue Book (the *General Explanation of Public Law 115-97*), the letter avoids mentioning the footnote that was tied to the passage quoted that indicates a law change might be necessary to achieve this result.

So where does this leave taxpayers and advisers? First, advisers should include the fact that, as informal as these letters are, the IRS is on record as deciding the limit applies when advising taxpayers on the matter. Even if the IRS position is improper, there would be costs incurred to defend the

[706] Information Letter 2020-0010, p.2

[707] Information Letter 2020-0010, pp. 1-2

position if it is challenged on exam, costs that would be avoided if the taxpayer simply applies the cap. That is, the full deduction might be justified, but the costs of carrying the issue could be greater ultimately than the taxes saved.

But, as well, it is important to note that the IRS is issuing this guidance in a format that carries little or no authority beyond the persuasive nature of the legal analysis—and analysis that, conveniently, ignores the language found in the relevant provisions. Generally, Congressional intent only matters when attempting to resolve ambiguity in the law—but the IRS does not attempt to first show the existence of such ambiguity in the positions in question. If the law itself can only reasonably be read to lead to one result, that is the result that matters regardless of intent.

And, frankly, the IRS has applied that very standard to other TCJA provisions. Although clearly Congress intended for qualified improvement property to have a 15-year life and be eligible for bonus depreciation treatment when the TCJA was passed, the IRS took the position that the law itself did not support that treatment. Eventually Congress passed a technical correction in the CARES Act to modify the law to agree with the intent.

At this point, it would appear that taking the position that a deduction in full is allowed under §216 is at the very least a reasonable interpretation of the law. For that reason, an adviser should be able to sign a return taking that position if the taxpayer wishes to risk an IRS challenge. The adviser may decide the position lacks substantial authority, or that it might be viewed as doing so, and decide that disclosure of the position on a Form 8275 may be appropriate.

But, fundamentally, aside from the IRS going on the record in a rather obscure manner indicating the limit should apply, nothing much has changed regarding this issue. Only time will tell if this is merely IRS saber rattling to scare taxpayers away from doing this (and thus, actual challenges would be rare) or if the agency seriously plans to pursue these positions. And, in the latter case, it will likely take a few more years before any such case ends up before the courts for a ruling on the matter.

SECTION: 164
FINAL REGULATIONS ISSUED ON TREATMENT OF CERTAIN CHARITABLE CONTRIBUTIONS AS BUSINESS EXPENSES AND STATE TAX CREDIT ISSUES RELATED TO CHARITABLE CONTRIBUTIONS

Citation: TD 9907, 8/7/20

The IRS has released final regulations updating guidance on cases when a payment to a charity will be treated as a payment of an ordinary and necessary business expense under IRC §162 in TD 9907.[708] The regulations also contain provisions that clarify situations when a donation to a charity that results in a credit against state and local taxes can be deducted as an additional payment of those taxes.

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[708] TD 9907, August 7, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-17393.pdf?utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov&utm_medium=email

Payments Treated as Trade or Business Expenses under IRC §162

The final regulations retain the provision found in the proposed regulations, updating Reg. §1.162-15(a) that provides a test to determine if a payment to a charitable organization qualifies as a trade or business expense under IRC §162. The regulation provides:

> A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see §1.170A-1(h).[709]

Why is it important if the payment is a charitable contribution vs. a business expense? Normally a business expense deduction gets a more favorable tax treatment than a charitable contribution. Some of the benefits to having the payment reclassified can include:

- No percentage of adjusted gross income (for individuals) or taxable income (for a C corporation) limitation on the annual deduction exists for §162 expenses, while charitable contributions are subject to such restrictions;
- No need for an individual to itemize deductions to obtain a tax benefit if the deduction is under IRC §162 for a business (other than as an employee) conducted by the taxpayer or which has income flow through to the taxpayer; and
- The deduction reduces a taxpayer's adjusted gross income rather than taxable income, potentially allowing a taxpayer to receive a tax benefit that would not be available or would be reduced if the taxpayer's adjusted gross income was higher.

But note that for the payment to be treated as a trade or business expense, the business must show two things:

- A direct relationship of the payment to the taxpayer's trade or business and
- The payment was made with a reasonable expectation of a financial return commensurate with the amount of the payment or transfer.[710]

[709] Reg. §1.162-15(a)

[710] Reg. §1.162-15(a)

As the IRS did when the proposed regulations were issued, the IRS directs taxpayers to review the analysis in the case of *Marquis v. Commissioner*, 49 T.C. 695 (1968) to understand how to meet the tests.

We discussed the *Marquis* case when the proposed regulations were issued in January[711] and the issue remains the same—in *Marquis,* the taxpayer had clearly calculated her likely additional business related to her "contributions" and stopped contributing to organizations when it became clear they would not use her services.

The regulation provides the following example of applying this rule:

EXAMPLE 1, REG. §1.162-15(A)(2)(I)

A, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. A makes a $1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert supporters, including A. A's advertisement includes the URL for the website through which A sells its instruments. A reasonably expects that the advertisement will attract new customers to A's website and will help A to sell more musical instruments. A may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

In response to our article on the proposed regulations, we received a number of inquiries from advisers who had been told by charities (primarily what the IRS will refer to in the preamble as scholarship granting organizations, or SGOs) that the above regulation allowed a full deduction anytime a passthrough organization made a donation to such an entity and even that there was no requirement to show either the connection to the trade or business or demonstrate an expectation of a return in excess of the amount contributed. Such organizations often openly marketed such contributions to their organizations as work-arounds for the $10,000 limit on deductions on non-business state and local taxes under IRC §164.

Some of that was driven by an example, also contained in the final regulations, that applied this rule to a passthrough entity.

EXAMPLE 2, REG. §1.162-15(A)(2)(II)

P, a partnership, operates a chain of supermarkets, some of which are located in State N. P operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. P makes the final determination on which charities receive payments. P advertises the program. P reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, P makes a $1,000 payment to a charity described in section 170(c). P may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. *This result is unchanged if, under State N's tax credit program, P expects to receive a $1,000 income tax credit on account of P's payment, and under State N law, the credit can be passed through to P's partners*. *(emphasis added)*

[711] Edward Zollars, "IRS Example Suggests Possible State Tax Workaround for Certain Passthrough Credits," *Current Federal Tax Developments* website, January 15, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/1/15/irs-example-suggests-possible-state-tax-workaround-for-certain-passthrough-credits (retrieved August 7, 2020)

It continues to be the author's position that the organizations are claiming, or at least strongly implying, more than the regulation allows by its clear language—and that the example is consistent with that position. While the last paragraph indicate the deduction could be allowed even if it resulted in an income tax credit passed out to the equity holders (as is the case in some of these programs), it also provided that the partnership found a reasonable expectation that the contribution would increase goodwill and revenue significantly, a point I've not found emphasized in much of the marketing material.

As well, the IRS noted in the preamble that one commentator had "requested clarification regarding whether a business entity may deduct payments to SGOs under section 162 as ordinary and necessary business expenses incurred in carrying on a trade or business." The IRS did not provide that sort of specific clarification, rather it provided in the preamble:

> While the Treasury Department and the IRS acknowledge these concerns, the regulations retain the clarifications to §1.162-15(a)(1) and (a)(2) regarding section 162 deductions for business payments to section 170(c) entities, as well as examples illustrating the rule. Section 1.162-15(a)(1) mirrors the language of §1.170A-1(c)(5), which has been in effect since 1970. Section 1.170A-1(c)(5) provided that if the taxpayer's payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of commensurate financial return, the payment or transfer may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170. See also Marquis v. Commissioner, 49 T.C. 695 (1968). Section 1.162-15(a)(1) applies the same standard. *Thus, a passthrough entity may deduct a payment under §1.162- 15(a)(1) only if the entity can demonstrate that the payment satisfies these requirements, which limits the possibility of abuse. (emphasis added)*

Some have objected that, in a case where a credit equal to 100% of the amount contributed is allowed for a contribution (something the state of Arizona, for one, does allow), the contribution would always meet the requirement of a benefit beyond the amount paid by the business. However, that view ignores the fact the regulation requires that the *taxpayer* (in this case the passthrough) have a reasonable expectation of a financial return. When the credit is passed out to the equity holders, it is they and not the passthrough taxpayer, who would receive any return.

As well, that analysis also ignores the requirement that payment bear a *direct* relationship to the taxpayer's trade or business. Without a substantial benefit aside from the indirect payment of personal income taxes of the equity holder(s), it would appear very difficult to articulate a reasonable direct relationship. Such a transaction appears also to pose issues of lacking economic substance as that term is defined at IRC §7701(o).

Safe Harbor for Certain Payments to Charities in Exchange for State or Local Credits

The final regulations retain, without any significant changes, the safe harbor rules for certain charitable contributions for which a business receives a state or local tax credit.

The preamble provides the following justification for these safe harbor provisions:

> To the extent that a C corporation or specified passthrough entity receives or expects to receive a State or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit and a reasonable expectation of commensurate financial return to the C corporation's or specified passthrough entity's business in the form of a reduction in the State or local taxes that the entity would otherwise be required to pay. Thus, the final regulations provide safe harbors that allow a C corporation or specified passthrough entity engaged in a trade or business to treat the portion of the payment that is equal to the amount of the credit received or expected to be received as meeting the requirements of an ordinary and necessary business expense under section 162. The safe harbors for C corporations and specified passthrough entities apply only to payments of cash and cash equivalents.

But the preamble notes one key caveat to this analysis: "The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a State or local income tax."

Safe Harbor for C Corporations

The regulations provide the following safe harbor rule applicable to C corporations:

> Safe harbor for C corporations. If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a State or local tax credit that reduces a State or local tax imposed on the C corporation, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received.[712]

This safe harbor is shorter and simpler than the one for passthrough entities discussed next. A key reason for its simplicity is that virtually all of the taxes paid by C corporation are allowed as a deduction under IRC §164 without limitation.

Safe Harbor for Specified Passthrough Entities

A more involved safe harbor exists for certain passthrough entities, referred to as *specified passthrough entities*. To be a *specified passthrough entity* eligible to use the safe harbor, all of the following requirements must be satisfied:

- The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under §301.7701-3 of this chapter 9 (that is, it *cannot* be a disregarded entity, such as a single member LLC or a grantor trust);

[712] Reg. §1.162-15(a)(3)(i)

- The entity operates a trade or business within the meaning of section 162 (thus, investment partnerships would not qualify);

- The entity is subject to a State or local tax incurred in carrying on its trade or business that is imposed directly on the entity (note that a state income tax imposed on the equity holder for income reported from the entity would *not* qualify); and

- In return for a payment to a qualified charity, the passthrough entity receives or expects to receive a State or local tax credit that the entity applies or expects to apply to offset a State or local tax described in the previous bullet point.[713]

If an entity meets the above requirements, it is eligible to make use of the following safe harbor to enable a deduction for the amount paid as a §162 trade or business expense:

> Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a State or local tax credit that reduces a State or local tax described in paragraph (a)(3)(ii)(A)(3) of this section, the specified passthrough entity may treat such payment as an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.[714]

But note the "except as provided" language in the safe harbor. That exception is a fairly significant one for the passthrough entity:

> The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a State or local income tax.[715]

Quid Pro Quo Benefits from a Party Other Than the Charity

The IRS also rejected comments that claimed that a *quid pro quo* benefit that comes from a party other than the charity should not reduce a claimed charitable deduction. Such a ruling would enable many of the state tax credit qualified contributions to continue to be deducted in full without a reduction to take into account a personal income tax or real estate tax reduction received when such a contribution is made.

The IRS declined to issue regulations providing for such a distinction. As the preamble states:

> The Treasury Department and the IRS considered these comments, but did not adopt the suggested changes because the established tax law does not support them. As discussed in the preamble to the proposed regulations, both the courts and the IRS have concluded that the quid pro quo principle is equally applicable, regardless of whether the donor expects to receive the benefit from the donee or from a third

[713] Reg. §1.162-15(a)(3)(ii)(A)

[714] Reg. §1.162-15(a)(3)(ii)(B)

[715] Reg. §1.162-15(a)(3)(ii)(C)

party. See, e.g., *Singer v. United States*, 449 F.2d 413 (Ct. Cl. 1971) (rejecting the taxpayer's argument that an expected benefit should be ignored because it would be received from a third party); Rev. Rul. 67-246, 1967-2 C.B. 104 (concluding that the donor's charitable contribution deduction must be reduced by the value of a transistor radio provided by a local store). Moreover, the courts have concluded that a taxpayer's expectation of a substantial benefit in return, from any source, reflects a lack of requisite charitable intent on the part of the donor. See, e.g., *Ottawa Silica Co. v. United States*, 699 F.2d 1124 (Fed. Cir. 1983) (denying a charitable contribution deduction for the value of land donated for the construction of a school, where the taxpayer had reason to believe such construction would ultimately increase the value of its land). Thus, the source of the consideration is immaterial in determining whether a donor has received or expects to receive a return benefit that reduces its charitable contribution deduction.

Safe Harbor for Payments by an Individual in Exchange for State or Local Tax Credits

The final regulations retain the safe harbor allowing a deduction for individuals as a payment of state or local taxes for certain payments made to charities that qualify a taxpayer for a credit against state or local taxes. Of course, since the payment is treated as a payment of taxes under §164, it will only give a benefit to the extent payments for other taxes subject to the general $10,000 limit on individual state and local taxes deducted on Schedule A not related to a §212 activity fall short of that limit. Just in case that wasn't clear, the regulations provide:

> Nothing in this paragraph (j) may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitation of section 164(b)(6)[716] for any amount paid as a tax or treated under this paragraph (j) as a payment of tax.[717]

The safe harbor only allows a deduction in the year in which the credit actually reduces the state and local tax of the taxpayer:

> To the extent that a State or local tax credit described in paragraph (j)(1) of this section is not applied to offset the individual's applicable State or local tax liability for the taxable year of the payment or the preceding taxable year, any excess State or local tax credit permitted to be carried forward may be treated as a payment of State or local tax under section 164(a) in the taxable year or years for which the carryover credit is applied in accordance with State or local law.[718]

The safe harbor provides:

> An individual who itemizes deductions and who makes a payment to or for the use of an entity described in section 170(c) in consideration for a State or local tax credit

[716] The $10,000 limit.

[717] Reg. §1.164-3(j)(3)

[718] Reg. §1.164-3(j)(2)

> may treat as a payment of State or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is disallowed under §1.170A-1(h)(3). This treatment as payment of a State or local tax is allowed in the taxable year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable State or local law, to offset the individual's State or local tax liability for such taxable year or the preceding taxable year.[719]

The safe harbor only applies to cash contributions, not those of property.[720] As well, a payment cannot be deducted under this safe harbor and under another provision of the IRC.[721]

SECTION: 170
TAX COURT DENIES IRS ATTEMPT TO ARGUE CONTRIBUTION OF STOCK WAS A DISGUISED TAXABLE REDEMPTION FOLLOWED BY A CASH CONTRIBUTION

Citation: Dickinson v. Commissioner, TC Memo 2020-128, 9/3/20

In the case of *Dickinson v. Commissioner,*[722] the IRS was attempting to treat a taxpayer's contribution of shares of stock directly to a charity as being rather a redemption of the stock, creating taxable capital gain, followed by a deductible charitable contribution.

In this case, the taxpayers donated shares in a privately held company in which the husband was the CFO to Fidelity Investments Charitable Gift Fund. The case notes:

> The GCI board of directors (Board) authorized shareholders to donate GCI shares to Fidelity Investments Charitable Gift Fund (Fidelity), an organization tax exempt under section 501(c)(3), through written consent actions in 2013 and 2014. In both consent actions the Board stated that Fidelity "has a donor advised fund program which incorporates procedures requiring * * * [Fidelity] to immediately liquidate the donated stock" and "seeks an imminent exit strategy and, therefore promptly tenders the donated stock to the issuer for cash". The Board approved a third round of donations at a Board meeting by unanimous vote in 2015; the Board members signed the written minutes of the meeting. After each Board authorization, petitioner husband donated appreciated GCI shares to Fidelity. Petitioner husband remained a full-time GCI employee following each donation.[723]

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[719] Reg. §1.164-3(j)(1)

[720] Reg. §1.164-3(j)(4)

[721] Reg. §1.164-3(j)(5)

[722] *Dickinson v. Commissioner*, TC Memo 2020-128, September 3, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12323 (retrieved September 3, 2020)

[723] *Dickinson v. Commissioner*, pp. 2-3

A taxpayer is allowed to deduct the fair market value of appreciated property donated to a charity that would have generated long term capital gain income if sold, but without having to recognize the long term capital gain income.[724] This creates a larger net deduction than would be achieved had the taxpayer sold the asset (triggering recognition of the gain) and then donated the cash proceeds to charity.

But the IRS objected that, in this case, the taxpayer knew when the donation was made that Fidelity would immediately sell the shares, so the transaction should be more properly viewed as a taxable redemption of the shares donated, followed by a donation of the cash proceeds.

The Tax Court did not agree with the IRS's view of the transaction. The Court, citing *Humacid v. Commissioner*, 42 TC 894, 913 (1964) found that the form of the transaction as a contribution of the shares to Fidelity had to be respected if:

- The taxpayer has given away the property absolutely and parts with the title to the property and
- That gift takes place prior to when the property would give rise to income by way of a sale.[725]

The Court first looks to see if the taxpayer truly donated all of his rights in the stock to the charity. The Court finds that, despite the IRS's arguments, there was no question that the property was truly transferred to the charity:

> GCI's letters to Fidelity confirming ownership transfer, Fidelity's letters to petitioners explaining that Fidelity had "exclusive legal control" over the donated stock, and the LOUs to the same effect all support petitioners' claim that petitioner husband transferred all his rights in the shares. Respondent makes much of the fact that Fidelity regularly redeemed the GCI shares shortly after each donation, according to what the Board understood to be Fidelity's internal procedures. Respondent argues that these facts suggest petitioner husband, GCI, and Fidelity could have arranged the redemptions in advance of the gifts, but a preexisting understanding among the parties that the donee would redeem donated stock does not convert a postdonation redemption into a predonation redemption. *See Behrend*, 1972 WL 2627, at *3. Furthermore, neither a pattern of stock donations followed by donee redemptions, a stock donation closely followed by a donee redemption, nor selection of a donee on the basis of the donee's internal policy of redeeming donated stock suggests that the donor failed to transfer all his rights in the donated stock. *See, e.g., Grove v. Commissioner*, 490 F.2d at 242- 245 (respecting form of transaction where donee needed to fundraise to support its operations, and over a decade consistently redeemed annual donations of stock for which donor remained entitled to dividends); *Carrington v. Commissioner*, 476 F.2d at 705-706 (respecting form of transaction where donee redeemed stock eight days after it was donated); *Palmer v. Commissioner*, 62 T.C. 684, 692-693 (1974), (respecting form of transaction where, pursuant to a single plan, the taxpayer donated stock to a foundation and then caused the corporation to redeem the stock from the

[724] See IRC §§170 and 61(3) and Reg. §1.170A-1(c)(1)

[725] *Dickinson v. Commissioner*, pp. 5-6

> foundation the day after the donation), *aff'd*, 523 F.2d 1308 (8th Cir. 1975). Petitioners' contemporaneous documentary evidence of an absolute gift, and respondent's failure to assert facts indicating any genuine controversy on this point, lead us to conclude that petitioner husband's donations satisfy the first *Humacid* requirement.[726]

But even if there was an actual transfer of ownership, the transfer could still fail if the sale was already a *fait accompli*. That would serve as an impermissible assignment of income, violating the second requirement under *Humacid*. As the Court notes, "*Humacid* prong two ensures that if stock is about to be acquired by the issuing corporation via redemption, the shareholder cannot avoid tax on the transaction by donating the stock before he receives the proceeds."[727]

For that to be the case, the Court finds the following has to be true:

> Where a donee redeems shares shortly after a donation, the assignment of income doctrine applies only if the redemption was practically certain to occur at the time of the gift, and would have occurred whether the shareholder made the gift or not. *See Palmer v. Commissioner*, 62 T.C. at 694-695; *see also Ferguson v. Commissioner*, 174 F.3d 997, 1003-1004 (9th Cir. 1999) (finding that the shareholder recognizes income from a stock sale where acquisition is "practically certain to occur", rather than the subject of "a mere anticipation or expectation", before the shareholder donates stock), aff'g 108 T.C. 244 (1997). In *Hudspeth v. United States*, 471 F.2d 275, 276 (8th Cir. 1972), for example, the court recast a stock donation as a taxable stock sale and donation of the sale proceeds where the taxpayer donated stock after the issuing corporation's directors and shareholders had adopted a plan of complete liquidation. *See also Jones v. United States*, 531 F.2d 1343, 1343-1344 (6th Cir. 1976); *Allen v. Commissioner*, 66 T.C. 340, 347 (1976).[728]

The Tax Court notes that the Ninth Circuit has gone further in its analysis of similar cases in a footnote to the above analysis:

> The Court of Appeals for the Ninth Circuit has gone a step further, asserting in dicta that stock sale proceeds are taxable to a shareholder who donates stock absent a binding obligation to sell if the facts and circumstances indicate that a tender offer and merger are "practically certain to proceed" in the immediate future. *See Ferguson v. Commissioner*, 174 F.3d 997, 1004 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997).[729]

But the Tax Court found this case was not of that sort, noting:

> By contrast, there was no assignment of income in *Palmer v. Commissioner*, 62 T.C. at 687-688, 695, even though all parties were related and anticipated the redemption before the donation, because "no vote for the redemption had yet been

[726] *Dickinson v. Commissioner*, pp. 6-8

[727] *Dickinson v. Commissioner,* p. 8

[728] *Dickinson v. Commissioner,* p. 9

[729] *Dickinson v. Commissioner,* Footnote 2, p. 9

> taken" when the shareholder donated the stock. As in Palmer, the redemption in this case was not a fait accompli at the time of the gift. As noted above, respondent argues that the parties may have prearranged for Fidelity to redeem the stock. Even if that was the case, it would not affect the analysis under the second *Humacid* requirement. Rather, we respect the form of the transaction because petitioner husband did not avoid receipt of redemption proceeds by donating the GCI shares.[730]

Basically, there was no income to assign—absent the contribution, the taxpayer was not going to receive cash in exchange for a portion of his shares. No buyer was sitting in the wings who was going to buy the shares in the near future regardless of the owner.

Of interest is the fact that the Court declined to follow the holding in Revenue Ruling 78-197 to decide the case, even though both parties referred the Court to it. In that ruling, the IRS, in announcing it would follow the *Palmer* decision noted earlier, held:

> The Service will treat the proceeds of a redemption of stock under facts similar to those in Palmer as income to the donor only if the donee is legally bound, or can be compelled by the corporation, to surrender the shares for redemption.[731]

The Court notes:

> This Court has not adopted Rev. Rul. 78-197, supra, as the test for resolving anticipatory assignment of income issues, *see Rauenhorst v. Commissioner*, 119 T.C. at 166, and does not do so today. The ultimate question, as noted in *Palmer*, is whether the redemption and the shareholder's corresponding right to income had already crystallized at the time of the gift. See Palmer v. Commissioner, 62 T.C. at 694-695. Regardless of whether the donee's obligation to redeem the stock may suggest the donor had a fixed right to redemption income at the time of the donation, *see Rauenhorst v. Commissioner*, 119 T.C. at 166-167, respondent does not allege that petitioner husband had any such right in this case. Accordingly, respondent's resort to Rev. Rul. 78-197, supra, is unavailing.

Thus, the Court concludes:

> As required by *Humacid* and its progeny, petitioner husband made an absolute gift of the GCI shares in each taxable year before the stock gave rise to income by way of a sale.[732]

Therefore, the taxpayer was not required to recognize as income a gain that would have resulted from a redemption of the donated shares immediately prior to the donation.

[730] *Dickinson v. Commissioner,* p. 9

[731] Rev. Rul. 78-197; 1978-1 C.B. 83

[732] *Dickinson v. Commissioner,* pp. 10-11

SECTION: 170
IRS ANNOUNCES ENFORCEMENT ACTIONS AGAINST CERTAIN SYNDICATED CONSERVATION EASEMENTS, THREATENS ACTION AGAINST PREPARERS OF AFFECTED RETURNS

Citation: "IRS increases enforcement action on Syndicated Conservation Easements," IRS News Release IR-2019-182, 11/12/19

In News Release IR-2019-182, the IRS announced that it was going to increase enforcement actions against syndicated conservation easements.[733]

The IRS had put certain syndicated conservation easements on the listed transaction list in 2016. The IRS news release describes the targeted structures:

> In December 2016, the IRS issued Notice 2017-10[734], which designated certain syndicated conservation easements as listed transactions. Specifically, the Notice listed transactions where investors in pass-through entities receive promotional material offering the possibility of a charitable contribution deduction worth at least two and half times their investment. In many transactions, the deduction taken is significantly higher than 250 percent of the investment. Syndicated conservation easements are included on the IRS's 2019 "Dirty Dozen" list of tax scams to avoid.
>
> …In addition to grossly overstating the value of the easement that is purportedly donated to charity, these transactions often fail to comply with the basic requirements for claiming a charitable deduction for a donated easement. The IRS has prevailed in many cases involving these basic requirements and has now established a body of law that the IRS believes supports disallowance of the deduction in a significant number of pending conservation easement cases. Where it hasn't done so already, the IRS will soon be moving the Tax Court to invalidate the claimed deductions in all cases where the transactions fail to comply with the basic requirements, leaving only the final penalty amount to be determined.[735]

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[733] "IRS increases enforcement action on Syndicated Conservation Easements," IRS News Release IR-2019-182, November 12, 2019, https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements, retrieved November 13, 2019

[734] Notice 2017-10, https://www.irs.gov/pub/irs-drop/n-17-10.pdf, retrieved November 13, 2019

[735] IR-2019-182, https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements, retrieved November 13, 2019

The IRS in the release encourages taxpayers to avoid penalties and interest by acting now to remove any tax benefits from such transactions from their returns. But see the discussion later in this article about why this action does not necessarily solve the problem.

> Taxpayers may avoid the imposition of penalties relating to improper contribution deductions if they fully remove the improper contribution and related tax benefits from their returns by timely filing a qualified amended return or timely administrative adjustment request.
>
> The IRS's comprehensive compliance efforts are focused on the abusive syndicated conservation easement transactions described in Notice 2017-10, recognizing that there are many legitimate conservation easement transactions.[736]

The IRS also notes that it is not just participants who may face actions from the agency, noting:

> In addition to auditing participants, the IRS is pursuing investigations of promoters, appraisers, tax return preparers and others. Further, the IRS is evaluating numerous referrals of practitioners to the IRS Office of Professional Responsibility. The IRS will develop and assert all appropriate penalties, including penalties for participants (40 percent accuracy-related penalty), appraisers (penalty for substantial and gross valuation misstatements attributable to incorrect appraisals), promoters, material advisors, and accommodating entities (penalty for promoting abusive tax shelters and penalty for aiding and abetting understatement of tax liability), as well as return preparers (penalty for understatement of taxpayer's liability by a tax return preparer).[737]

Advisers who have clients that have invested in conservation easement programs should review Notice 2017-10 and consider if the program appears to be one covered by the Notice. The taxpayer is especially at risk if the taxpayer failed to timely file the disclosure forms for affected returns (Form 8886, *Reportable Transaction Disclosure Statement*). Note that a failure to file the form both keeps the statute for assessment open and subjects the taxpayer to very substantial penalties.

Even if a return was filed before Notice 2017-10 was issued, if the statute had not yet closed on the assessment of tax for the return by the date the transaction was put on the list, the statute will remain open if the form was not filed shortly after the publication date.[738]

If the adviser was involved with the preparation of that return, the adviser likely should suggest the taxpayer seek alternative counsel on the issue. Since there may be conflict of interest issues under Circular 230,[739] the AICPA Code of Professional Conduct and state accountancy board regulations

[736] IR-2019-182, https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements, retrieved November 13, 2019

[737] IR-2019-182, https://www.irs.gov/newsroom/irs-increases-enforcement-action-on-syndicated-conservation-easements, retrieved November 13, 2019

[738] IRC §6501(c)(10)

[739] Circular 230, §10.29

are at play if the disclosure was missed and the professional that originally prepared the return attempts to provide representation. The potential conflict issue is heightened by the IRS's explicit threat to take action against preparers as part of this initiative.

As well, while the IRS suggests amending the return to solve the penalty problem, such an amended return will not solve the failure to properly disclose listed transaction problems. The taxpayer could be in a similar situation to that of the taxpayer in *Yari v. Commissioner*, 143 TC No. 7, aff'd CA9 that we discussed in 2016 on the Current Federal Tax Developments website.[740]

SECTION: 223
HDHP AND HSA INFLATION ADJUSTED NUMBERS RELEASED FOR 2021

Citation: Revenue Procedure 2020-32, 5/20/20

The inflation adjusted numbers for health savings accounts (HSAs) and high deductible health plans (HDHPs) for 2021 have been released by the IRS in Revenue Procedure 2020-32.[741]

For 2021 the limits on contributions to an HSA will be:

- $3,600 for an individual with self-only coverage under an HDHP and
- $7,200 for an individual with family coverage under an HDHP.

For 2021 a high deductible health plan is defined as a health plan with an annual deductible that is not less than:

- $1,400 for self-only coverage or
- $2,800 for family coverage.

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[740] Ed Zollars, "Tax Shown on Original Return, Not Amount Computed on Amended Return, Used to Compute Limitation on §6707A Disclosure Penalty," *Current Federal Tax Developments* website, October 17, 2016, https://www.currentfederaltaxdevelopments.com/blog/2016/10/17/tax-shown-on-original-return-not-amount-computed-on-amended-return-used-to-compute-limitation-on-6707a-disclosure-penalty, retrieved November 13, 2019

[741] Revenue Procedure 2020-32, May 20, 2021, https://www.irs.gov/pub/irs-drop/rp-20-32.pdf (retrieved May 21, 2020)

SECTION 401
FINAL REGULATIONS MODIFY TABLES FOR COMPUTING RMDS, EFFECTIVE BEGINNING IN 2022

TD 9930, 11/5/20

The various tables used to compute required minimum distributions from retirement plans have been updated, taking effect beginning in 2022, as the IRS has issued revised regulations under IRC §401(a)(9).[742]

In August 2018, Executive Order 13847, 83 FR 45321, directed the IRS to review the life expectancy and distribution tables to determine if they should be updated to reflect current mortality data, and how often such tables should be updated. In November 2019 the IRS released proposed regulations containing proposed updated tables.

Longer Life Expectancy Tables

In the preamble to the final regulations, the IRS provides the following description of the changes that were made:

> The life expectancy tables and applicable distribution period tables in these regulations generally reflect longer life expectancies than the tables in formerly applicable §1.401(a)(9)-9. For example, a 72-year-old IRA owner who applied the Uniform Lifetime Table under formerly applicable §1.401(a)(9)-9 to calculate required minimum distributions used a life expectancy of 25.6 years. Applying the Uniform Lifetime Table set forth in these regulations, a 72-year-old IRA owner will use a life expectancy of 27.4 years to calculate required minimum distributions. As another example, a 75-year-old surviving spouse who is the employee's sole beneficiary and applied the Single Life Table under formerly applicable §1.401(a)(9)-9 to compute required minimum distributions used a life expectancy of 13.4 years. Under these regulations, a 75-year-old surviving spouse will use a life expectancy of 14.8 years. The effect of these changes is to reduce required minimum distributions generally, which will allow participants to retain larger amounts in their retirement plans to account for the possibility they may live longer.[743]

The updated Uniform Lifetime Table,[744] used to calculate the required minimum distributions, is provided below:

Age of employee	Distribution period
72	27.4
73	26.5
74	25.5

[742] TD 9930, November 5, 2020, https://public-inspection.federalregister.gov/2020-24723.pdf (retrieved November 6, 2020)

[743] TD 9930, Summary of Comments and Explanation of Provisions, I. Overview

[744] Reg. §1.401(a)(9)-9(c)

Age of employee	Distribution period
75	24.6
76	23.7
77	22.9
78	22.0
79	21.1
80	20.2
81	19.4
82	18.5
83	17.7
84	16.8
85	16.0
86	15.2
87	14.4
88	13.7
89	12.9
90	12.2
91	11.5
92	10.8
93	10.1
94	9.5
95	8.9
96	8.4
97	7.8
98	7.3
99	6.8
100	6.4
101	6.0
102	5.6
103	5.2
104	4.9
105	4.6
106	4.3
107	4.1
108	3.9
109	3.7
110	3.5
111	3.4
112	3.3
113	3.1
114	3.0
115	2.9
116	2.8

Age of employee	Distribution period
117	2.7
118	2.5
119	2.3
120	2.0

This table is described by the IRS as follows in the preamble to the regulations:

> The Uniform Lifetime Table in these regulations sets forth joint and last survivor life expectancies for each age beginning with age 72, based on a hypothetical beneficiary. Pursuant to §1.401(a)(9)-5, Q&A-4(a), the Uniform Lifetime Table is used for determining the distribution period for lifetime distributions to an employee in situations in which the employee's surviving spouse either is not the sole designated beneficiary or is the sole designated beneficiary but is not more than 10 years younger than the employee. The joint and last survivor life expectancy of an employee is taken from the Joint and Last Survivor Table using a hypothetical beneficiary who is assumed to be 10 years younger than the employee.[745]

In a footnote, the IRS reminds readers why the revised table starts at age 72 rather than 70:

> The proposed regulations included Uniform Lifetime Table entries beginning with age 70. These regulations do not include Uniform Lifetime Table entries for ages 70 and 71 because section 114 of the SECURE Act changed the minimum age for receiving required minimum distributions from age 70½ to age 72.[746]

The regulation also provides updates to the following tables:

- Single life table;[747]
- Joint and last survivor life table;[748] and
- Mortality rates table.[749]

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[745] TD 9930, Summary of Comments and Explanation of Provisions, III. Updated Life Expectancy and Distribution Period Tables

[746] TD 9930, Summary of Comments and Explanation of Provisions, III. Updated Life Expectancy and Distribution Period Tables, Footnote 14

[747] Reg. §1.409(a)(9)-9(b)

[748] Reg. §1.409(a)(9)-9(d)

[749] Reg. §1.409(a)(9)-9(e)

Upcoming Ruling on Substantially Equal Periodic Payments

The preamble notes that the agency will be issuing a ruling on applying these new provisions to substantially equal periodic payments:

> The Treasury Department and the IRS anticipate issuing guidance that would update Rev. Rul. 2002-62. This update would apply the life expectancy, distribution period, and mortality tables set forth in these regulations for purposes of determining substantially equal periodic payments once these regulations become effective.[750]

Applicability Dates

The regulations provide details on how and when the new regulations will apply to distributions:

> The life expectancy tables and Uniform Lifetime Table set forth in this section apply for distribution calendar years beginning on or after January 1, 2022. For life expectancy tables and the Uniform Lifetime Table applicable for earlier distribution calendar years, see §1.401(a)(9)-9, as set forth in 26 CFR part 1 revised as of April 1, 2020 (formerly applicable §1.401(a)(9)-9).[751]

The regulations contain additional guidance on the use of these tables for life expectancies that may be recalculated:

> If an employee died before January 1, 2022, and, under the rules of §1.401(a)(9)-5, the distribution period that applies for a calendar year following the calendar year of the employee's death is equal to a single life expectancy calculated as of the calendar year of the employee's death (or, if applicable, the following calendar year), reduced by 1 for each subsequent year, then that life expectancy is reset as provided in paragraph (f)(2)(ii) of this section.[752]

The redetermination under this provision is to be handled via these rules

> With respect to a life expectancy described in paragraph (f)(2)(i) of this section, the distribution period that applies for a distribution calendar year beginning on or after January 1, 2022, is determined by using the Single Life Table in paragraph (b) of this section to determine the initial life expectancy for the age of the relevant individual in the relevant calendar year and then reducing the resulting distribution period by 1 for each subsequent year. However, see section 401(a)(9)(H)(ii) and (iii) for rules limiting the availability of a life expectancy distribution period.[753]

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[750] [750] TD 9930, Summary of Comments and Explanation of Provisions, V. Use of Revised Tables to Determine Substantially Equal Periodic Payments

[751] Reg. §1.409(a)(9)-9(f)(1)

[752] Reg. §1.409(a)(9)-9(f)(2)(i)

[753] Reg. §1.409(a)(9)-9(f)(2)(ii)(A)

The regulation provides the following example of applying this rule:

EXAMPLE, REG. §1.409(A)(9)-9(F)(2)(II)(B), REDETERMINATION

Assume that an employee died at age 80 in 2019 and the employee's designated beneficiary (who was not the employee's spouse) was age 75 in the year of the employee's death. For 2020, the distribution period that would have applied for the beneficiary was 12.7 years (the period applicable for a 76- year-old under the Single Life Table in formerly applicable §1.401(a)(9)-9), and for 2021, it would have been 11.7 years (the original distribution period, reduced by 1 year). For 2022, if the designated beneficiary is still alive, then the applicable distribution period would be 12.1 years (the 14.1-year life expectancy for a 76-year-old under the Single Life Table in paragraph (b) of this section, reduced by 2 years). However, see section 401(a)(9)(H)(iii) for rules regarding how to apply the required distribution rules to defined contribution plans if the eligible designated beneficiary dies prior to distribution of the employee's entire interest.

The regulation provides for the following if the employee's sole beneficiary was the employee's surviving spouse:

> Similarly, if an employee's sole beneficiary is the employee's surviving spouse, and the spouse dies before January 1, 2022, then the spouse's life expectancy for the calendar year of the spouse's death (which is used to determine the applicable distribution period for later years) is reset as provided in paragraph (f)(2)(ii) of this section.[754]

The proposed regulations originally would have had these regulations apply for 2021—so why do the final regulations push this liberalization back to 2022? The IRS explains this change in the effective date in the preamble:

> A number of commenters also requested that the effective date of the final regulations be delayed to 2022 (instead of 2021). They noted that plan sponsors and IRA providers are currently working to update their systems for the SECURE Act changes to section 401(a)(9) and recommended that the effective date of these regulations be delayed in order to allow administrators sufficient additional time to update systems for these regulations. As described in the Effective/Applicability Date section of this preamble, these regulations will apply to distribution calendar years beginning on or after January 1, 2022.[755]

[754] Reg. §1.409(a)(9)-9(f)(2)(i)

[755] TD 9930, SUPPLEMENTARY INFORMATION, Background, II. Regulations under Section 401(a)(9)

SECTION: 408
TAXPAYER THAT TOOK IRA FUNDS TO MAKE CASH OFFER ON RESIDENCE DENIED LATE ROLLOVER RELIEF

Citation: PLR 2020033008, 8/15/20

While the IRS has issued numerous private letter rulings over the years granting taxpayers relief for late IRA rollovers, far fewer rulings have been issued denying relief. But in PLR 2020033008,[756] the IRS did just that for a taxpayer's request for permission to make a late rollover, as the taxpayer had effectively attempted to borrow the funds from the IRA to make a cash offer on a residence.

Most advisers have heard it claimed that taxpayers can use the rollover rules to allow that taxpayer to borrow funds from the IRA and then roll the funds back in. This "loan" provision referred to is found at IRC §408(d)(3)(A):

> (A) In general Paragraph (1) does not apply to any amount paid or distributed out of an individual retirement account or individual retirement annuity to the individual for whose benefit the account or annuity is maintained if—
>
>> (i) the entire amount received (including money and any other property) is paid into an individual retirement account or individual retirement annuity (other than an endowment contract) for the benefit of such individual not later than the 60th day after the day on which he receives the payment or distribution; or
>>
>> (ii) the entire amount received (including money and any other property) is paid into an eligible retirement plan for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to this paragraph).
>
> For purposes of clause (ii), the term "eligible retirement plan" means an eligible retirement plan described in clause (iii), (iv), (v), or (vi) of section 402(c)(8)(B).

The IRS has conceded that, if the requirements are strictly followed, the taxpayer can do what he/she wishes to do with the funds, a key requirement being returning the funds within 60 days.

While IRC §408(d)(3)(I) does grant the IRS the authority to waive a late rollover "where the failure to waive such requirement would be against equity or good conscience," the agency has stated clearly that returning a "loan" late will not meet that criteria. The agency's view is that while the "borrowing" noted above is permitted since nothing in the IRC bars it, that was not the purpose of the rollover provision. That provision was meant to allow taxpayers to move funds from one account

[756] PLR 2020033008, August 15, 2020 https://www.irs.gov/pub/irs-wd/202033008.pdf (retrieved August 15, 2020)

to another and, in the view of the agency, it is not against "equity or good conscience" to deny relief when a taxpayer was using the provision for other purposes.

But this taxpayer was hopeful that the situation the taxpayer faced was different enough to allow for such relief:

> In Year 1, Taxpayer A and his spouse worked with a real estate agent in selling their existing home and purchasing a new one. The real estate agent advised Taxpayer A to make a cash offer for the purchase of a new residence using funds from IRA B. The real estate agent assured Taxpayer A that he could repay the amount back into his IRA at a later time, after the sale of his current residence, and made no mention of the 60-day rollover period.
>
> Lacking other available funds and acting on the advice of the real estate agent, Taxpayer A completed a distribution request form provided by Financial Institution C. Taxpayer A indicated on the form that the purpose for the distribution was to purchase a new home. Financial Institution C's distribution request form stated that the individual requesting a distribution and signing the form understands that a 10 percent tax penalty and ordinary income taxes may apply to the distribution, and the individual agrees to obtain legal and tax advice to make this determination. Although the form provided a rollover option, it made no mention of the 60-day rollover period.
>
> On Date 2, Taxpayer A withdrew Amount 1 from IRA B to purchase the new residence. On Date 3, Taxpayer A used the distribution of Amount 1 for the purchase of his new house. On Date 4, after the expiration of the 60-day rollover period, Taxpayer A's prior residence was sold. After this sale, Taxpayer A contacted Financial Institution C to try to repay Amount 2 (a portion of total distribution Amount 1), back into IRA B. However, Financial Institution C informed him that it could not accept the repayment of Amount 2 because the 60-day rollover period had passed.[757]

The taxpayer argued that since the financial institution had not informed the taxpayer about the 60-day rollover rule, the IRS should grant relief based on what the taxpayer saw as an error of the financial institution.

However, the IRS pointed out the following:

> However, unlike a plan qualified under section 401(a), the Code does not impose a requirement on an IRA custodian to inform individuals of the rollover rules, and the failure of the realtor and the financial institution to provide this information does not rise to the level of financial institution error.[758]

[757] PLR 2020033008, August 15, 2020, p. 2

[758] PLR 2020033008, August 15, 2020, pp. 3-4

Thus, the IRS goes on to deny the taxpayer's request for relief:

> In this case, the information and documentation submitted show that Taxpayer A withdrew Amount 1 from IRA B for use as a short-term, interest-free loan to purchase a new home. One of the factors in Rev. Proc. 2003-16 is the use of the amount distributed, for example, whether the amount was cashed. The Committee Report describing legislative intent indicates that Congress enacted the rollover provisions to allow portability between eligible plans including IRAs. Using a distribution as a short-term loan to cover personal expenses is not consistent with the intent of Congress to allow portability between eligible plans. Therefore, under the facts and circumstances presented in this case, the Service declines to waive the 60-day rollover requirement with respect to the distribution of Amount 2 from IRA B.[759]

SECTION: 664
IRS MEMORANDUM ADDRESSES ISSUES WITH MARKETED CRAT PROGRAM

Citation: Memorandum AM 2020-006, 6/26/20

In Memorandum AM 2020-006,[760] the IRS looked at a marketed charitable remainder annuity trust structure which claimed to allow a taxpayer to completely avoid paying tax on large capital gains. The IRS was not impressed with the marketing materials they reviewed, finding the program failed to accomplish the goal implied by the materials.

The Plan

The IRS describes the structure as follows:

> Taxpayer creates and funds a trust which is purported to qualify as a CRAT. The trust is funded with interests in a closely-held business, with farmland, and/or with the crops produced by farmland. The trust resembles the model CRAT described in the appropriate revenue procedure (for an inter vivos CRAT for one measuring life, this would be Rev. Proc. 2003-53, 2003-2 C.B. 230, which is cited in the promotional materials), with the following significant modifications:
>
> Article 5B provides that the trustee may provide for the annuity amount by purchasing one or more annuities (including without limitation one or more single premium immediate annuities (SPIAs)), with the total cost of such annuity or annuities to be less than 90% of the initial fair market value (FMV) of the trust property, which will guarantee to pay to the beneficiaries or beneficiaries' children as applicable, the annual annuity amount during the five year annuity period.

[759] PLR 2020033008, August 15, 2020, p. 4

[760] Memorandum AM 2020-006, June 26, 2020, https://www.irs.gov/pub/lanoa/am-2020-006.pdf (retrieved July 2, 2020)

> Article 5F provides that in each taxable year of the trust, the trustee shall pay "to the beneficiary for during the [annuity period], during their lifetime for a period of five years," an annuity amount equal to the greater of (1) 10% of the initial FMV of all property transferred to the trust; or (2) the payments received by the trustee from one or more SPIAs purchased by the trustee as provided in Article 5B, provided however, that such annuity payments cannot exceed 49% of the initial FMV of the trust property valued as described above. Upon the death of the last surviving initial beneficiary prior to the end of the annuity period, the annuity amount shall be paid in equal shares, per stirpes and not per capita to the grantor's children for the remainder of the annuity period.
>
> Article 5L provides that in lieu of the remainder distribution to the charitable organization, the trustee, upon the availability of adequate funding in cash, may pay to the charitable organization a cash sum equal to 10% of the initial FMV of the trust property plus $100. The trustee shall not make a distribution in kind to satisfy this cash distribution.[761]

The marketing materials provided a series of descriptions of the tax implications of various transactions that were part of the marketed program:

- A single premium immediate annuity (SPIA) creates a stream of payments that are only partially taxable under the tax law, with each payment consisting of a portion that is a return of original investment and a portion that is income;[762]
- A charitable remainder annuity trust (CRAT) does not pay capital gain taxes when it sells the appreciated property initially transferred to fund the CRAT;[763]
- The CRAT's basis in an annuity it purchases is based on the funds it invests into the SPIA, not the grantor's basis in the donated asset;[764]
- In Revenue Procedure 2020-53, the IRS allowed for an early distribution to charity from a CRAT;[765] and
- CRATs are allowed to purchase SPIAs in lieu of purchasing other, more traditional investments.[766]

[761] Memorandum AM 2020-006, pp. 2-3

[762] Memorandum AM 2020-006, p. 3

[763] Memorandum AM 2020-006, pp. 2-3

[764] Memorandum AM 2020-006, p. 3

[765] Memorandum AM 2020-006, p. 5

[766] Memorandum AM 2020-006, pp. 5-7

The memorandum does not take the position that any of those statements are incorrect. However, the promoter's materials go on to state or imply the following tax results based on those items.

- The beneficiary each year will pay tax only on the ordinary income portion of the annuity, with the portion allocated to investment in the contract becoming a wholly nontaxable distribution to the beneficiary;
- The capital gain will never be taxable to the beneficiary in any amount; and
- The structure qualifies as a CRAT, giving the taxpayer the immediate deduction benefit of a CRAT.

The memorandum does take the position that every one of those statements is false.

Arrangement is Not a Charitable Remainder Annuity Trust

The memorandum finds that two key flaws cause this arrangement to fail to qualify for treatment as a charitable remainder annuity trust. If the arrangement is not a charitable remainder annuity trust, then there is not a tax exempt entity that would not initially pay tax on the gain on the sale of the capital asset and the grantor would not get a charitable contribution deduction for the partial interest gift.

The first objection is that the provision that calculates the payment as 10% of the original trust principal *or* the amount of the SPAI annual distribution (capped at 49% of the initial fair market value) means this does not qualify as a charitable remainder *annuity* trust as the payment stream is not the required sum certain annuity:

> Excessive authorized payments/Payment not a sum certain: Article 5F of the trust agreement described above provides that in each taxable year of the trust, the trustee shall pay to the beneficiary "during their lifetime for a period of five years" an annuity amount equal to the greater of (1) 10% of the initial FMV of all property transferred to the trust or (2) the payments received by the trustee from one or more SPIAs purchased by the trustee. Even if the trust was being correctly administered, this provision allowing a payment to the income beneficiary in excess of the amount determined at the funding of the trust based on a percentage of the initial FMV of the trust assets causes the trust to fail to qualify under § 664(d)(1)(B) since such excess payments are not described in § 664(d)(1)(A). This determination is not dependent on whether any excess payments are ever actually made. Additionally, Article 5F does not satisfy the "sum certain" requirement of § 1.664-2(a)(1)(i), as the amount payable could change if the trust purchases an SPIA.[767]

While a charitable remainder *unitrust* is allowed to have a provision that provides for payment of the greater of the unitrust amount or trust income, such an income provision is not allowed in an annuity trust which must have a sum certain payout.

[767] Memorandum AM 2020-006, p. 11

The arrangement also violates the CRAT requirements in the view of the memorandum by the method it uses to implement a prepayment of the charitable contribution:

> Prepayment: Article 5L provides that in lieu of the remainder distribution to the charitable organization, the trustee may pay to the charitable organization a cash sum equal to 10% of the initial FMV of the trust property plus $100. This provision and the description of the structure in the promotional materials indicate that after a payment of 10% of the initial FMV of the trust assets to charity, the charity has no further rights under the trust and will not receive the remainder at the end of the trust term. Under § 664(d)(1)(C), the payment of the remainder to charity is a mandatory definitional requirement for a CRAT. A trust which does not require such payment is disqualified without regard to any actual distributions which it may make to charity during or at the end of its term. Section 664(d)(1)(D) provides that the value of the remainder calculated at the creation of the trust must be at least 10% of FMV; it neither states nor implies that a current payment of that amount to charity vitiates the requirement to also pay the remainder at the end of the term. The cited publications, such as Rev. Proc. 2003-53 and PLR 200124010, do not support the promoters' contentions, as the provisions described therein clearly authorize payments to charity in addition to, not in lieu of, the payment of the remainder, such additional payments being consistent with § 664(d)(1)(B) and explicitly authorized by § 1.664-2(a)(4).[768]

Clearly, the promoter's idea in most cases would be to immediately give the 10% plus $100 to the charity, and then have a trust that had no additional obligation to pay the charity, allowing the entire proceeds of the annuity to go to the beneficiary. But, as the memorandum notes, that structure would appear to invalidate the CRAT.

Annuity Distributions and the §644 Layers

The IRS memorandum, noting that the above failures would remove the arrangement's tax benefits, goes on to note that even if, for the sake of argument, you assume the trust does qualify as a CRAT, the claimed tax treatment misapplies the rules of §72 for taxation of annuities and §644 for taxation of charitable remainder trust distributions to beneficiaries.

The memorandum begins by citing the proper tax treatment of such a CRT that sells an asset, purchases a SPIA, and then makes distributions while receiving payments from the SPIA:

> Amounts received under an immediate annuity that meets certain requirements and is described under § 72(u)(3)(E), which the annuities purchased as part of this structure appear to be, are taxed under the general rules of §§ 72(a)(1) and 72(b)(1). That is, each payment under the annuity will consist of an ordinary income portion and an excluded portion representing return of investment, until such time as the entire investment has been recovered. See, generally, § 1.72-1. A CRT is exempt from ordinary income taxation itself, but its distributions to the annuity or unitrust recipients, as the case may be, are taxable to the extent that those distributions are

[768] Memorandum AM 2020-006, pp. 11-12

> treated as coming from the potentially taxable tiers in § 664(b): current and accumulated ordinary income and current and accumulated capital gain. Note that the promoters' paraphrase of § 664(b) quoted above omits the "accumulated" element of each of these tiers.
>
> Applying the rules of § 664 and § 72 together to the standard facts described in the promoters' materials, in which the appreciated asset is contributed to the CRAT, sold shortly thereafter, and the proceeds used to purchase the SPIA, would result in annual ordinary income being added to the § 664(b)(1) tier each year from the annuity, and a large one-time amount being added to the § 664(b)(2) tier from the sale of the asset (assuming the asset is of a kind to produce capital gain). Assuming no other activity, the annual annuity distributions would take out current and any accumulated ordinary income from the annuity and then accumulated capital gain from the sale, only reaching non-taxable corpus to the extent these two accounts have been exhausted.[769]

The IRS notes the misleading implications created by the promoter's materials regarding Notice 2008-99 and PLR 9237030 in a footnote, stating:

> The promoters' citation to Notice 2008-99 is simply misleading in that they quote it for the correct statement that a CRT is exempt from ordinary income taxation and has a cost basis in purchased assets, without noting that the gain on assets sold will be added to the § 664 tiers and thus preserved for taxation to the income beneficiaries as distributions are made. Similarly, they draw a false implication from the accurate summary of the § 72 rules regarding immediate annuities in PLR 9237030, that those rules somehow override the § 664 tier structure in cases where a CRT holds such an annuity.[770]

That is, the promotional materials left out significant details (like the tier structure), thus inviting the reader to "fill in" conclusions that are erroneous without a memorandum ever actually making the statements in question. So technically, there's no actual falsehood in the statements—but that does not mean the materials are not misleading.

Specifically, the memorandum goes on to say:

> Instead, the promoters are treating the capital gains as being trapped in the CRAT, with the income beneficiaries only taxed on the ordinary annuity income each year as if they were themselves the owners of the SPIA, rather than it being an asset of the CRAT funding their annuity payments from the trust. To reach this result, they are misinterpreting the cited TAM and PLRs. In those documents discussing a CRT holding an annuity contract, it is clear that the annuity income is included in the income of the trust, thus entering the § 664(b) tiers, not bypassing the trust and appearing directly on the income beneficiaries' returns. Put differently, the annuity

[769] Memorandum AM 2020-006, pp. 12-13

[770] Memorandum AM 2020-006, p. 12

> is a funding mechanism for the CRT's required payments to the income beneficiaries, not an income stream of the beneficiaries in lieu of such payments.[771]
>
> … Promoters cite two of these rulings for the indisputable proposition that a CRT may purchase an annuity, but then do not explain that the trust will be the owner of the annuity contract and the income therefrom. Moreover, none of these rulings address the taxation of any distributions from the CRAT to the individual beneficiaries. Thus, none of cited authorities in the promotional materials support taxing the payments under the annuity contract solely under § 72 without running them through the § 664(b) tier system. Rather, the taxable portions of the annuity payments are income to the trust, which would mechanically fall into the first tier as ordinary income, with distributions from the trust first coming from ordinary income before dipping into the other tiers, including capital gain, until the entire distribution is accounted for.[772]

The IRS then posits two potential alternative treatments for imposing tax on a taxpayer who is taking an incorrect reporting position based on the implications of the promotional materials. First, the annuities could be treated as distributed to the beneficiaries by the CRAT upon purchase:

> The first alternative is to treat the CRAT as actually having distributed the entire annuity contract to the individual beneficiaries. CRTs may make in-kind distributions to satisfy their income distribution requirements, but the value of the policy would far exceed the beneficiaries' required annuity payment for the year and thus would violate the prohibition of § 1.664-2(a)(4) that no amount other than the annuity amount may be paid to or for the use of any person other than charity. This and any subsequent failure to make annuity payments would be operational failures disqualifying the CRAT retroactively under the rule of *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd* 309 F.3d 1290 (11th Cir. 2002).[773]

The IRS notes that some of the structures attempt to block this result by having the CRAT listed as the owner of the annuity, with the beneficiaries listed as the annuitants receiving the benefits. But the memorandum finds this just changes the problems that the CRAT faces:

> To the extent that the trusts argue that their record ownership of the annuity contracts prevents the Service from asserting that the CRATs made in-kind distributions of the annuity contracts to the income beneficiaries, we note that it could create a new set of hazards for them. If the trusts have retained a right to change the recipient of the annuity, then the CRTs will be disqualified for not meeting the requirements of §§ 1.664-2(a)(3)(i) and (ii). Under § 1.664-2(a)(3)(i), individual beneficiaries must be living at the time of trust creation, but the trust's retained power to substitute annuitants would allow it to direct the annuity payments to beneficiaries who were born after the creation of the trust. Under §

[771] Memorandum AM 2020-006, p. 13

[772] Memorandum AM 2020-006, p. 14

[773] Memorandum AM 2020-006, p. 14

> 1.664- 2(a)(3)(ii), no person can retain a power which would cause the trust to be a grantor trust; the retained power to change the annuity recipient would generally create a grantor trust as a power to control "beneficial enjoyment" of the trust under § 674(a) and none of the exceptions provided in §§ 674(b), (c), and (d) appear to apply. Additionally, distributions of trust assets to individuals other than those named in the trust instrument would be another *Atkinson* operational failure.[774]

Alternatively, the IRS could argue to treat it as if it was a valid CRAT and tax the distributions under those rules:

> The second alternative is simply to treat the payments under the annuity contract as if they had been correctly routed through the CRAT, taking out the tiers. Assuming that in any given case, the contributed assets are highly appreciated and are sold shortly after contribution, this would result in the distributions consisting of a thin layer of ordinary income with the balance being current or (in years after the year of sale) accumulated capital gain. We understand that some examinations have conceded the validity of the CRAT under § 664, in which cases this alternative would become the primary argument. Even if the CRATs are valid, this does not validate the attempt to trap the capital gains at the entity level.[775]

Memorandum's Recommendation to Agents

The IRS memorandum concludes with the following recommendation to agents when they encounter one of these structures:

> In all cases using this structure, the validity of the CRAT should be challenged both on the basis of disqualifying terms in the instrument and subsequent operational failures, with the result under both theories being (1) the disallowance of any charitable deductions claimed for the value of the remainder and (2) the treatment of the trust as a taxable entity from its creation, causing the sale of any appreciated donated assets to be currently taxable to the trust (or its beneficiaries, if the gain is included in DNI) in the year of sale. In appropriate cases, an assignment of income argument should be made to tax the gain of the sale of assets by the trust to the grantors or to assert SECA tax liability against the trust grantors. A whipsaw argument should also be included that if the trust is a qualified CRAT, the beneficiaries have reported incorrectly by only including the § 72 ordinary income on the annuity contract and not current or accumulated capital gain on the sale of the assets as part of their § 664(b) distribution.[776]

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[774] Memorandum AM 2020-006, p. 15

[775] Memorandum AM 2020-006, p. 15

[776] Memorandum AM 2020-006, p. 17

SECTION: 1402
IRS MEMORANDUM ARGUES THAT LOSS LIMITS APPLY IN COMPUTING SELF-EMPLOYMENT INCOME OF A TAXPAYER

Citation: Chief Counsel Advice 202009024, 2/27/20

In Chief Counsel Advice 202009024,[777] the IRS looked into the issue of whether passive activity loss, basis, and at-risk limits impact the ability to use a self-employment loss from a partnership against other self-employment income of a taxpayer for the year in question.

The question posed in the advice is:

> Whether the basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 apply to determining a general partner's net earnings from self-employment (NESE) under § 1402 for Self-Employment Contributions Act (SECA) tax purposes.

The fact pattern presented was the following:

> LLC ("LLC") elected to be treated as a partnership for federal tax purposes. The LLC has three (3) individual members: Member A, Member B, and Member C. All three members are general partners of the LLC. The LLC is involved in the single activity of contracting for the production of widgets for customers.
>
> During the tax year X, the LLC had a current year operating loss. Net operating loss carrybacks and carryovers are not at issue. All LLC members received guaranteed payments in the tax year. To determine the amount of NESE subject to SECA tax for the tax year: Member A reduced his guaranteed payment by his individual share of the partnership's losses without applying the basis loss limitation under § 704(d); Member B reduced his guaranteed payment by his individual share of the partnership's losses without applying the at-risk loss limitation under § 465; and Member C had sufficient basis and at-risk amounts to apply his share of the partnership loss against his guaranteed payment. In addition, Member C's share of partnership loss was not limited by the passive activity loss limitation under § 469 because Member C materially participated in the LLC.
>
> All the members agree that the loss limitations apply in determining their income subject to federal income taxes. However, Member A and Member B argue that the basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 do not apply in determining their NESE subject to SECA tax, respectively. Member C's share of the partnership loss was not limited by any of the loss limitations.

The IRS notes in Footnote 2 to the memorandum that it has heard some taxpayers arguing that Revenue Ruling 56-675 allows such losses to be offset against self-employment income even if

[777] CCA 202009024, February 28, 2020, https://www.irs.gov/pub/irs-wd/202009024.pdf (retrieved March 5, 2020)

blocked by another limit in the IRC. But the IRS notes that the ruling never says that the limits do not apply, and the agency takes the position that silence does not mean they don't matter.

> Some taxpayers have erroneously cited to Revenue Ruling 56-675, 1956-2 C.B. 459, as authority that NESE is not affected by the loss limitations under § § 704(d), 465, and 469. It is our position that this ruling is not an authority on the application of the various loss limitations for SECA tax purposes. Rev. Rul. 56-675 stated that under § 1.1402(a)-1(a)(2) of the regulations, guaranteed payments are treated as gross income subject to SECA tax. However, where a partner's distributive share includes a loss resulting from the operation of the partnership business, including the deduction for guaranteed payments treated as a business expense under section 162, the self-employment income is the net amount computed by applying to the guaranteed payment received by that partner the distributive share of loss. Rev. Rul. 56-675 did not address the application of loss limitations for SECA tax purposes. Since basis cannot be negative, the facts implied taxpayer had sufficient basis, so the loss limitation of § 704(d) would not apply. Also, loss limitations under § § 465 and 469 did not exist in 1956. Consequently, Rev. Rul. 56-675 is not applicable to whether and how the loss limitation rules apply in determining NESE under § 1402.

The memorandum points out the following definition of net earnings from self-employment found in the IRC:

> Section 1402(a) of the Code defines the term "net earnings from self-employment" as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by subtitle A which are attributable to such trade or business, plus the individual's distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member, with certain enumerated exceptions.

The memorandum first looks at the passive activity loss limitations under §469 and concludes that if a loss deduction for income tax purposes is barred by the passive activity rules, it also will not be able to offset self-employment income for the year in question. The memorandum cites an example from Reg. §1.469-1T(d)(3) that specifically provides that the loss is barred:

> Example. An individual has a $5,000 passive activity loss for a taxable year, all of which is disallowed under § 1.469-1T(a)(1). All of the disallowed loss is allocated under § 1.469-1T(f) to activities that are trades or businesses (within the meaning of section 1402(c)). Such loss is not taken into account for the taxable year in computing the taxpayer's taxable income subject to tax under section 1. <u>*In addition, such loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401.*</u> (Emphasis added).

The memorandum continues to note that the regulation text supports that position with regard to passive losses:

> Treas. Reg. § 1.469-1T(d)(3) provides that a deduction under § 469 or the regulation is not taken into account for any subtitle A tax, which includes SECA tax imposed under § § 1401 through 1403. Furthermore, the example under that regulation specifically articulates that "[passive activity] loss is not taken into account for the taxable year in computing the taxpayer's net earnings from self-employment subject to tax under section 1401" when the loss is not taken into account in computing a taxpayer's taxable income subject to tax under section 1. Although the example does not expressly involve a passive activity loss from a partnership, the regulation provision it illustrates makes no distinction between individuals conducting the trade or business directly and partners in a partnership conducting the trade or business.

With regard to the basis loss limitations of §704(d), the memorandum observes that:

> Stating, in part, that "[a]n individual's distributive share of such income or loss of a partnership shall be determined as provided in section 704," Treas. Reg. § 1.1402(a)-2(d) pulls in the basis loss limitation under § 704(d) into the computation of NESE.

That is, the basis limitation rules are contained in IRC §704, and the regulations under IRC §1402 specifically look to §704 for a taxpayer to compute his/her income from self-employment.

Finally, the memorandum looks at the at-risk limits found in IRC §465 and concludes that any losses suspended by those rules also will not impact the current year's self-employment income:

> Furthermore, § 465 applies in determining NESE of individuals carrying on a trade or business because § 1402(a) expressly takes into account deductions that are allowed by subtitle A (which is inclusive of the loss limitation rule of § 465) with regard to any trade or business carried on by the individual. While there is no similar guidance under § 1402 or § 465 that expressly states that the at-risk loss limitation under § 465 also applies for purposes of calculating NESE of general partners for SECA tax purposes, applying this loss limitation rule in determining a general partner's NESE under § 1402 for SECA tax purposes is consistent with considering the basis loss limitation under § 704(d) and the passive activity loss limitation under § 469 in computing NESE for a general partner. Like the application of § 469, § 465 determines the extent to which the partner's distributive share of the losses from the partnership carrying on the trade or business is taken into account in determining the partner's taxable income for the taxable year, and its effect is not limited to chapter 1 of the Code. Section 465 generally applies for purposes of the Code, including chapter 2

The conclusion of the memorandum provides:

> The basis loss limitation under § 704(d) and the at-risk loss limitation under § 465 apply in determining a general partner's NESE under § 1402 for SECA tax purposes, to the same extent these loss limitation rules apply for income tax purposes, unless a specific exclusion applies under § 1402(a). In the Example, under that general fact pattern, no specific exclusion applies under § 1402(a). Therefore, the individual share of the partnership loss of Member A and Member B must be disallowed for both SECA tax and income tax purposes because Member A had insufficient basis and Member B had an insufficient at-risk amount.

SECTION: 6011 IRS NOW ACCEPTING ELECTRONICALLY FILED INDIVIDUAL AMENDED RETURNS FOR 2019 TAX YEAR

Citation: "Now available: IRS Form 1040-X electronic filing," IR-2020-182, 8/17/20

After announcing earlier in the year a plan to begin accepting a limited number of amended returns electronically later in the summer,[778] the IRS has now announced the beginning of this program.[779]

The program initially will only allow the electronic filing of the following amended forms for tax year 2019:

- Form 1040 and
- Form 1040-SR.

The news release notes that taxpayers may still file these returns on paper, using the Where's My Amended Return?[780] online tool to check the status of either type of return.

The IRS notes the following advantages for filing amended returns electronically:

> Currently, taxpayers must mail a completed Form 1040-X to the IRS for processing. The new electronic option allows the IRS to receive amended returns faster while minimizing errors normally associated with manually completing the form.

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[778] Ed Zollars, CPA, "Forms 1040-X for 2019 Will Be Available for Electronic Filing Later in the Summer of 2020," *Current Federal Tax Developments* website, May 28, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/5/28/njscarmoal24kg613zo6ltsrgwlqvm (retrieved August 18, 2020)

[779] "Now available: IRS Form 1040-X electronic filing," IR-2020-182, August 17, 2020 https://www.irs.gov/newsroom/now-available-irs-form-1040-x-electronic-filing (retrieved August 18, 2020)

[780] https://www.irs.gov/filing/wheres-my-amended-return (retrieved August 18, 2020)

> Since the tax-filing software allows users to input their data in a question-answer format, it simplifies the process for them. It also makes it easier for IRS employees to answer taxpayer questions since the data is entered electronically and submitted to the agency almost simultaneously.
>
> "Adding the 1040-X to the e-filing portfolio provides a better experience for the taxpayer, all around. It makes submitting an amended return easier and it allows our employees to process it in a more efficient way," said Ken Corbin, the IRS Wage and Investment commissioner and head of the division responsible for processing these returns.

What is not mentioned, but what practitioners are very aware of at this date, is that the IRS is also far behind in dealing with processing paper forms. The hope is that using this system will allow the taxpayer looking to claim a refund on an amended 2019 return to have their claim processed faster, and thus receive the refund faster as well.

The release notes that the IRS receives about 3 million Forms 1040-X each year.

Note that since only 2019 returns can be amended electronically, it is likely that a large number of amended returns filed for the remainder of the year will still need to be filed on paper. As well, it will likely take some time before all states will also accept electronically filed amended returns.

SECTION: 6501
TAXPAYER'S FAILURE TO INCLUDE IP PIN ON RETURN, TRIGGERING E-FILE REJECTION, DID NOT DELAY THE BEGINNING OF THE RUNNING OF THE STATUTE OF LIMITATIONS

Citation: Fowler v. Commissioner, 155 TC No. 7, 9/9/20

The Tax Court considered the question in the case of *Fowler v. Commissioner*,[781] 155 TC No. 7 of the impact of a taxpayer electronically filing a tax return without a required IP PIN on the running of the statute of limitations on the time for the IRS to assess tax.

The taxpayer in this case had his identity compromised in 2013 and the IRS claims the agency sent the taxpayer an IP PIN in late December 2013. However, the taxpayer claims that he did not receive the IP PIN by the October 15, 2014 date on which he timely attempted to file his 2013 income tax return.[782]

[781] *Fowler v. Commissioner*, 155 TC No. 7, September 9, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12321 (retrieved September 9, 2020)

[782] *Fowler v. Commissioner*, 155 TC No. 7, p. 4 Footnote 4

The Court describes the taxpayer's first attempt to file his 2013 return as follows:

> Petitioner efiled the 2013 Form 1040 on October 15, 2014 (October 15 submission). Petitioner electronically signed (e-signed) Form 8879, IRS e-file Signature Authorization, to authorize Bennett Thrasher, LLP, a certified public accountancy firm, to file a return on his behalf in its capacity as an electronic return originator (ERO). Jeffrey J. Call, a partner at Bennett Thrasher, e-signed the 2013 Form 1040 with a Practitioner Personal Identification Number (PIN) and transmitted it directly to respondent on October 15, 2014. Mr. Call received a Submission ID, a "globally unique 20 digit number assigned to electronically filed tax returns". Pub. 1345, at 56. Respondent's software received the October 15 submission that same day and sent Mr. Call a rejection notice, citing code "IND181" for failure to provide a valid Identity Protection Personal Identification Number (IP PIN) with the efiled return.[783]

The taxpayer and preparer attempted to solve the issue by sending in a paper copy of the return less than two weeks after the rejection:

> Petitioner again submitted a 2013 Form 1040 on October 28, 2014 (October 28 submission). Mr. Call prepared a paper 2013 Form 1040 with the same information as the October 15 submission, and petitioner used DocuSign to sign the jurat. On October 28, 2014, Bennett Thrasher mailed the 2013 Form 1040 with petitioner's DocuSign signature stamp to the IRS Service Center in Austin, Texas, via U.S. Postal Service (USPS) Certified Mail with Return Receipt. The USPS delivered the October 28 submission to the IRS on October 30, 2014. The return receipt confirms that an IRS employee, Sandra Douds, signed for the package. Petitioner received a letter in December 2014 notifying him that the IRS had not received his 2013 return.[784]

Finally, in 2015 the taxpayer, having obtained a new IP PIN, did manage to electronically file his 2013 tax return with the IRS in April of 2015:

> Mr. Call efiled a 2013 Form 1040 on behalf of petitioner a third time on April 30, 2015 (April 30 submission). Petitioner obtained an IP PIN from the IRS on or before April 30, 2015, and it was included in the April 30 submission. With the exception of the IP PIN, the tax information in the April 30 submission was identical to the information in the first and second submissions. The IRS' software reviewed and accepted the April 30 submission on the same day.[785]

The IRS issued a notice of deficiency to the taxpayer on April 5, 2018, less than three years after the date of the successful electronic filing, but more than three years after the date the taxpayer had first

[783] *Fowler v. Commissioner*, 155 TC No. 7, pp. 3-4

[784] *Fowler v. Commissioner*, 155 TC No. 7, pp. 4-5

[785] *Fowler v. Commissioner*, 155 TC No. 7, p. 5

attempted to electronically file the return and after the taxpayer had followed up with a paper tax return containing the same information.[786]

The taxpayer argued that the IRS was too late—the statute of limitations for the agency to assess tax against the taxpayer expired three years after the return had been filed and thus the assessment after that date was not valid under IRC §6501. The taxpayer argued that either the statute began on October 15, 2014 when the first electronically filed return was submitted or, at the worst, on October 30, 2014 when the agency received the paper return filed in response to the rejection of the electronically filed return.

The IRS argued that the rejected return did not count as a return for starting the tolling of the statute as the IP PIN is a required part of the signature[787] and that the second return, being signed by an unauthorized means, was not a valid return[788]—thus, the statute did not begin to run until April 30, 2015 when an electronic return was submitted with the IP PIN.

The Tax Court noted that a taxpayer's delivery of a document purporting to be a return starts the statute of limitations under IRC §6501 if:

- The document filed purports to be a return and provides sufficient data to calculate the tax liability;
- The taxpayer made an honest and reasonable attempt to satisfy the requirements of the tax law; and
- The taxpayer executes the document under penalty of perjury.[789]

The Tax Court quickly concludes that the taxpayer had met the first two standards—the taxpayer had submitted a return with sufficient information to calculate the tax and had made an honest and reasonable attempt to satisfy the requirements of the law.[790]

The true dispute arose under the third standard—did the taxpayer properly execute the document under penalties of perjury. The IRS asserted that only on the third attempt did the agency receive a return that was properly signed, since a proper signature for an electronic return requires an IP PIN if the taxpayer has had one issued.

The Tax Court disagreed that the IP PIN makes up part of the signature:

> Respondent argues that the October 15 submission failed to satisfy the signature requirement because it did not include an IP PIN. This argument does not persuade

[786] *Fowler v. Commissioner*, 155 TC No. 7,pp. 5-6

[787] *Fowler v. Commissioner*, 155 TC No. 7, p. 11

[788] *Fowler v. Commissioner*, 155 TC No. 7, p. 8, Footnote 8

[789] *Fowler v. Commissioner*, 155 TC No. 7, p. 9, citing *Beard v. Commissioner*, 82 T.C. 766, 777 (1984), *aff'd* 793 F.2d 139 (6th Cir. 1986)

[790] *Fowler v. Commissioner*, 155 TC No. 7, pp. 10-11

us because the IP PIN is separate from the signature guidance the Secretary has issued.[791]

The Tax Court looks to IRS guidance and finds nowhere does the agency inform taxpayers or EROs that the IP PIN is part of the signature:

> Despite the authority delegated in section 6061, there is little regulatory guidance as to what constitutes a valid signature. Section 1.6061-1(a), Income Tax Regs., provides only that each individual "shall sign" his income tax return. Section 1.6695-1(b)(2), Income Tax Regs., directs a signing tax return preparer to "electronically sign the return in the manner prescribed by the Commissioner in forms, instructions, or other appropriate guidance." We therefore look to the instructions to the 2013 Form 1040 itself. Under the heading "IRS e-file: Electronic Return Signatures!", the instructions state that the taxpayer "must sign the return electronically using a personal identification number (PIN)", either a Self-Select PIN or a Practitioner PIN. 2013 Form 1040 Instructions, at 73 (emphasis added). Here, Mr. Call included a Practitioner PIN on petitioner's efiled return in accordance with the instructions.[792]

The Court goes on to note:

> In this case, whereas the 2013 Form 1040 Instructions definitively identify the Self-Select PIN and the Practitioner PIN as the means of signing an electronic return, they provide no explicit indication that the IP PIN is part of the signature. See 2013 Form 1040 Instructions, at 73; see also IRS Publication 4164, *Modernized e-File (MeF) Guide for Software Developers and Transmitters: Processing Year 2014* (Rev. 12-2013), at 16-17, 177-187 (hereinafter Pub. 4164) (addressing signature method and IP PIN in different sections and giving no indication that IP PIN is part of signature requirement); IRS Publication 17, *Your Federal Income Tax for Individuals* (Nov. 26, 2013), at 8-9 (same).[793]

Some may be concerned because the IP PIN box does appear near the signature line on the printed version of the Form 1040, but the Court didn't find that clearly indicated the IP PIN was a required part of the signature:

> The IP PIN appears within the "Sign Here" section of the 2013 Form 1040 itself, but so do other elements of the return that are not fundamental to a *Beard* signature. See, e.g., *Hulett v. Commissioner*, 150 T.C. at 68 (finding a return validly executed even though it omits taxpayers' daytime phone number, which is requested in the "Sign Here" section); *Estate of Temple v. Commissioner*, 67 T.C. 143, 164 (1976) (finding the absence of one spouse's signature on 1966 Form 1040 does not itself prevent return from being joint return, even though the 1966 Form 1040, like the

[791] *Fowler v. Commissioner*, 155 TC No. 7, p. 11

[792] *Fowler v. Commissioner*, 155 TC No. 7, p. 12

[793] *Fowler v. Commissioner*, 155 TC No. 7, pp. 12-13

2013 Form 1040, provides in the "Sign Here" section that both spouses must sign a joint return).[794]

The Court concludes the taxpayer justifiably relied on the IRS instructions in signing the form, and that the IRS cannot now claim reliance on its own documents wasn't justified.[795]

The IRS did refer to the Internal Revenue Manual to justify its position, noting that it provides that if an electronic return is filed with a missing or incorrect IP PIN the return will be rejected, but the Court states "[a]n IP PIN does not become part of the signature requirement simply because respondent's software will reject an efiled return without it." The Court goes on to note that the Modernized e-File (MeF) system rejects returns for a number of errors that won't cause the return to fail to meet the three pronged test for beginning the running of the statute.[796]

The Court also rejects the IRS position that the IP PIN is needed to authenticate the return—that is, be sure the person claiming to sign the return is really the taxpayer. The Court notes the IRS's own internal guidance states that an e-signature may not itself be sufficient to authenticate a return. As well, since the taxpayer filed via an ERO, the ERO is directed to verify the taxpayer's identity, causing the Court to observe that "[i]t is not obvious to us why this requirement does not make the IP PIN superfluous in petitioner's case.'[797]

The court notes that a return must also be "properly filed" to start the running of the statute—did the taxpayer's method of filing comply with the IRS's prescribed filing requirements.[798] But the Court did not agree with the IRS's view that failing to include the IP PIN violated this requirement, finding a return is filed when it is physically delivered to the proper IRS office—and that delivery can be by electronic filing.[799]

> We find there is no genuine dispute that petitioner delivered the October 15 submission to respondent. Petitioner submitted with his motion an affidavit signed by Jeffrey Call, who stated that he submitted a 2013 Form 1040 to respondent on behalf of petitioner. See *Caulkins v. Commissioner*, T.C. Memo. 1984-504, 48 T.C.M. (CCH) 1182, 1186 (1984) ("[F]undamental agency law provides that the actions of the tax preparer (agent) are imputed to the taxpayer (principal)."). Petitioner also provided Bennett Thrasher's transmission log, which included the 20-digit Submission ID given to an efiler after submitting a return. Most significantly, respondent acknowledges that petitioner submitted a return on October 15, 2014, when he states in his response to petitioner's cross-motion for summary judgment that petitioner "first attempted to e-file his 2013 income tax

[794] *Fowler v. Commissioner*, 155 TC No. 7, p. 13

[795] *Fowler v. Commissioner*, 155 TC No. 7, p. 13

[796] *Fowler v. Commissioner*, 155 TC No. 7, p. 14

[797] *Fowler v. Commissioner*, 155 TC No. 7, p. 15

[798] *Fowler v. Commissioner*, 155 TC No. 7, p. 15

[799] *Fowler v. Commissioner*, 155 TC No. 7, p. 17

> return on October 15, 2014, but his e-filing attempt was unsuccessful because he failed to include his IP PIN on the return."[800]

The Court concludes:

> Where a taxpayer properly files a required return, the taxpayer has satisfied all his duties to trigger the statute of limitations. Respondent has many tools to determine the appropriate liability, but he must use these tools within the prescribed limitations period. We simply see no reason to allow respondent to toll the statute of limitations where petitioner properly filed a return.[801]

Because the Court decided the first filing attempt began the running of the statute, the Court did not move on to decide what some might have been more interested in—would the use of DocuSign to sign the paper return have been deemed an acceptable method of signing in this case.[802]

While this case is favorable to the taxpayer, one area of concern is that, in the end, the Tax Court based the decision on IRS instructions, something that the IRS can much more easily revise than regulations. It's not clear if the IRS had stated that an IP PIN was part of the required signature in the instructions to Form 1040 if the result would still have been in favor of the taxpayer, so advisers should take care to note if the IRS revises those instructions in the future.

SECTION: STATE TAX
TAXPAYER'S DOMICILE REMAINED IN CALIFORNIA DESPITE TAKING A POSITION IN MALAYSIA

Citation: In the Matter of the Appeal of Mazur, California OTA Case No. 19064883, 2020-OTA-263P, Pending Precedential, 7/23/20

A state level decision in the case of *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883[803] has a discussion of the concept of *domicile*, a key concept used by many states as either the single or one of the tests available to determine if an individual must file an income tax return as a resident of the state.

In states with an income tax, residents generally are required to pay tax to the state on all income for the year, whether or not it is sourced to the state, while nonresidents generally only pay tax on income that can trace its source to the state. But whether someone is or is not a resident isn't necessarily a simple item to determine.

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800 *Fowler v. Commissioner*, 155 TC No. 7, pp. 17-18

801 *Fowler v. Commissioner*, 155 TC No. 7, p. 19

802 *Fowler v. Commissioner*, 155 TC No. 7, p. 8

803 *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, Pending Precedential, July 23, 2020

A concept often used by a state to determine who is a resident is *domicile*. The concept is one that has developed over centuries[804] but roughly looks at a person's "permanent home" which remains in place until the individual clearly establishes a new permanent home. The state of New Jersey, in its instructions to its resident tax form, has the following definition:

> A domicile is the place you consider your permanent home – the place where you intend to return after a period of absence (e.g., vacation, business assignment, educational leave). You have only one domicile, although you may have more than one place to live. Your domicile does not change until you move to a new location with the intent to establish your permanent home there and to abandon your New Jersey domicile. Moving to a new location, even for a long time, does not change your domicile if you intend to return to New Jersey. Your home, whether inside or outside New Jersey, is not permanent if you maintain it only for a temporary period to accomplish a particular purpose (e.g., temporary job assignment).[805]

In this case California is the state in question, and having a California domicile is one of the ways a taxpayer may end up being treated as a California resident. As the opinion notes:

> Thus, the statutory definition of "resident" contains two alternative tests, the satisfaction of either one leads to a conclusion that the individual is a resident of this state. In determining residency for an individual not domiciled in California, the inquiry is whether the individual is in California "for other than a temporary or transitory purpose." (R&TC, § 17014(a)(1).) But for an individual domiciled in California, the inquiry is whether the individual "is outside [California] for a temporary or transitory purpose." (R&TC, § 17014(a)(2).) "The key question under either [test] is whether the taxpayer's purpose in entering or leaving California was temporary or transitory in character." (*Appeal of Berner* (2001-SBE-006-A) 2002 WL 1884256.)[806]

Thus, if the taxpayer is not domiciled in California, he could not be a resident since he was no longer in California, one of the requirements for a person not domiciled in California to be treated as a California resident for tax purposes.

A taxpayer has only a single domicile at a time, though that doesn't mean different states won't interpret the concept differently enough to avoid having two states both find an individual is domiciled in that state. For California the opinion describes a view that is very similar to that found in the New Jersey instructions cited earlier, as well as the view of many states:

> Domicile is defined as the one location where an individual has the most settled and permanent connection, and the place to which an individual intends to return when

[804] You can find a long discussion and citations to various sources on the topic at the Wikipedia page on Domicile (law) at https://en.wikipedia.org/wiki/Domicile_(law)

[805] *New Jersey Resident Return (NJ-1040) Booklet*, 2019, p. 4, https://www.state.nj.us/treasury/taxation/pdf/current/1040i.pdf (retrieved September 11, 2020)

[806] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, pp. 3-4

> absent.5 (*Appeal of Bragg*, *supra*; Cal. Code Regs., tit. 18, § 17014(c).) An individual who is domiciled in California and leaves the state retains his or her California domicile as long as there is a definite intention of returning to California, regardless of the length of time or the reasons for the absence. (Cal. Code Regs., tit. 18, § 17014(c).)[807]

In a footnote, the opinion expands a bit more on this concept.

> Defined another way, domicile refers to the place where individuals have their "true, fixed, permanent home and principal establishment, and to which place [they have], whenever [they are] absent, the intention of returning." (Cal. Code Regs., tit. 18, § 17014(c).) Domicile "is the place in which [individuals have] voluntarily fixed the habitation of [themselves and their] family, not for a mere special or limited purpose, but with the present intention of making a permanent home, until some unexpected event shall occur to induce [individuals] to adopt some other permanent home." (*Ibid*.)[808]

Changing a domicile involves more than simply leaving the state. As the opinion continues:

> In order to change domicile, a taxpayer must: (1) actually move to a new residence; and (2) intend to remain there permanently or indefinitely. (*Appeal of Bragg*, *supra*; see also *Noble v. Franchise Tax Bd.* (2004) 118 Cal.App.4th 560, 568 [noting these two elements as indispensable to accomplishing a change of domicile].)

It is also not sufficient for a taxpayer to merely claim he/she had the required intent to change domicile—objective evidence will be considered to either bolster or call into question such an assertion.

> Intent is not determined merely from unsubstantiated statements; the individual's acts and declarations will also be considered. (*Appeal of Bragg, supra*; see also *Noble v. Franchise Tax Bd.*, supra, 118 Cal.App.4th at pp. 567-568.)[809]

The burden is on the taxpayer asserting a change in domicile to clearly show such a change has taken place:

> A domicile once acquired is presumed to continue until it is shown to have been changed. (*Appeal of Bailey* (76-SBE-016) 1976 WL 4032.) The burden of proof as to a change of domicile is on the party asserting such change. (*Appeal of Bragg, supra.*) If there is doubt on the question of domicile after presentation of the facts and circumstances, then domicile must be found to have not changed. (*Ibid*.)[810]

[807] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 4

[808] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 4 Footnote 5

[809] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 4

[810] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 5

In this case the taxpayer certainly left the state, ending up in Malaysia. As the opinion notes:

> In February 2013, appellant-husband moved from California to Malaysia for the purpose of employment as a Product Marketing/Business Development Manager for Symmid Corporation SDN BHD (Symmid).
>
> M. Mazer (appellant-wife) did not accompany appellant-husband to live in Malaysia and continued to live at appellants' home in California during 2013. She remained a domiciliary and resident of California during the 2013 tax year. Appellants also have an adult daughter who remained in California.
>
> In March 2014, appellant-husband ceased his employment with Symmid and returned to the home that he shared with appellant-wife in California. In total, appellant-husband was in Malaysia for 13 months.[811]

The taxpayers' position was that while M. Mazer was a California resident, L. Mazer was not a California resident. Thus, the Mazers subtracted ½ of Mr. Mazer's wages from Malaysia (his community share of the income—California is a community property state).

The opinion, looking at the facts of the case, determined that L. Mazer was still domiciled in California. The opinion notes:

> It is undisputed that appellant-husband's domicile prior to leaving for Malaysia in February 2013, was California. Accordingly, his place of domicile for 2013 will be presumed to be California unless he can show that it has changed. (*Appeal of Bailey*, *supra*.) Appellants, on their part, contend that appellant-husband abandoned his California domicile and intended to make Malaysia his permanent home. While appellant-husband's physical presence was in Malaysia, we must examine whether he intended to remain there permanently or indefinitely. (See *Appeal of Bragg*, *supra*.) Thus, we will examine appellant-husband's acts to determine whether they show that he intended to abandon his old California domicile and establish a new one in Malaysia. (See *Appeal of Berner*, *supra*.)
>
> While appellant-husband lived and worked in Malaysia, appellant-husband's actions do not indicate he intended to abandon his old domicile and establish a new one. Appellant-wife remained in California at their marital abode that was maintained in his absence, the address of which was used on their 2013 California tax return. The maintenance of a marital abode is a significant factor in resolving the question of domicile. (*Appeal of Bailey*, *supra*.) Appellants contend that appellant-wife was in California merely to facilitate the transition to Malaysia. However, appellants provide no evidence to indicate any steps taken to move appellant-wife to a new permanent home in Malaysia. In addition, after his employment in Malaysia concluded, appellant-husband returned to the home that was retained in California. An expectation of returning to one's former place of abode defeats the acquisition of a new domicile. (*Appeal of Addington* (82-SBE-001) 1982 WL 11679.)

[811] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, pp. 1-2

> To summarize, appellant-husband was domiciled in California prior to leaving the state for an employment-related contract expected to last two years and during that period of employment, appellant-wife continued to maintain a home in California, which appellant-husband returned to at the conclusion of his out-of-state employment. These facts indicate that appellant-husband's domicile did not change from California to Malaysia. (See *Appeal of Addington*, *supra*; Cal. Code Regs., tit. 18, § 17014(c).)[812]

Under California law the taxpayer could still avoid being a California resident, despite being domiciled in California, if he was in Malaysia for other than a temporary or transitory purpose. The opinion notes the tests for being out of state for a temporary or transitory purpose:

> Whether an individual is outside California for a temporary or transitory purpose is a question of fact to be determined by examining all the circumstances of each particular case. (Cal. Code Regs., tit. 18, § 17014(b); see *Appeal of Addington, supra*.) The determination cannot be based solely on the individual's subjective intent but instead must be based on objective facts. (*Appeal of Berner, supra*.)
>
> An absence for a specified duration of two years or less, and not indefinitely, has been held to be only temporary and transitory. (*Appeal of Crozier* (92-SBE-005) 1992 WL 92339.) However, a stay of less than two years will not automatically indicate a temporary or transitory purpose if the reason for the shortened stay is not inconsistent with an intent that the stay be long, permanent, or indefinite. (*Ibid*.) An absence for employment or business purposes which would require a long or indefinite period to complete is not temporary or transitory. (*Ibid*.) An "indefinite period," however, is not one of weeks or months but one of "substantial duration" involving a period of years. (*Ibid*.)[813]

The opinion, in making this decision, looks to the level of connection the taxpayer has with the area where he/she is residing vs. connections to California. As the opinion continues:

> For one thing, such contacts constitute an important measure of the benefits and protections the taxpayer has received from the laws and government of California. (*Ibid*.) Further, such contacts provide objective indicia of whether the taxpayer entered or left this state for temporary or transitory purposes. (*Ibid*.) Where a California domiciliary leaves the state for employment purposes, it is particularly relevant to determine whether, upon departure, the taxpayer substantially severed his or her California connections and then took steps to establish significant connections with his or her new place of abode, or whether the California connections were maintained in readiness for his or her return. (*Appeal of Harrison* (85-SBE-059) 1985 WL 15838.)[814]

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[812] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 6

[813] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 6

[814] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 7

Citing the case of *Appeal of Bragg* (2003-SBE-002) 2003 WL 21403264, the opinion provides the following criteria to be used to determine where a taxpayer has the closest connection:

Registrations and filings with a state or other agency, including:

- Homeowner's property tax exemption
- Automobile registration
- Driver's license
- Voter registration/participation history
- Address used and state of residence claimed on federal/state tax returns

Personal and professional associations, including the state of the taxpayer's:

- Employment
- Children's school
- Bank and savings accounts
- Memberships in social, religious, and professional organizations
- Use of professional services, such as doctors, dentists, accountants, and attorneys
- Maintenance/ownership of business interests
- Professional license(s)
- Ownership of investment real property
- Presence/connections/residency as indicated by third-party affidavits/declarations

Physical presence and property, including:

- Location and approximate sizes and values of residential real property
- Where the taxpayer's spouse and children reside
- Taxpayer's telephone records (i.e., the origination point of taxpayer's telephone calls)
- Origination point of the taxpayer's checking account/credit card transactions

- Number/general purpose (vacation, business, etc.) of days the taxpayer spends in California versus other states[815]

In this case the administrative law judge (ALJ) concludes that the factors indicate clearly that far too many close connections remained with California.

The ALJ notes that the nature of his employment doesn't suggest that the assignment was necessarily intended to be permanent, based on the evidence submitted:

> In addition, appellant-husband's optionally renewable contract does not necessarily indicate that his employment was for a permanent or indefinite term. (See *Appeal of Purkins* (84-SBE-081) 1984 WL 16160; see also *Appeal of Milos* (84-SBE-042) 1984 WL 16121 [taxpayer held to be California resident based on connections after accepting six-month extensions repeatedly over four years].) Appellants provide no evidence indicating that appellant-husband's employment in Malaysia was expected to last indefinitely and, as the Bragg factor discussion below illustrates, the evidence indicates that his employment and stay in Malaysia was for a temporary and transitory purpose. (See *Appeal of Milos, supra*.) Without further evidence in support, we cannot find the contract term providing that it "may be renewable" is sufficient on its own to establish that appellant-husband's employment was for an indefinite period of substantial duration. Given the above, we find that appellant-husband's two-year employment contract indicates that his absence from California was for a temporary and transitory purpose. (*Appeal of Crozier, supra*.)[816]

While the opinion states that the mere fact the taxpayer only remained in Malaysia for 13 months before returning to California is not necessarily clear evidence of a lack of a permanent or indefinite term when the work commenced, it is a practical problem. Agents are more likely to press the issue of residency when the taxpayer's stay in the new location is of short duration with a return to the original state afterward, as it is reasonable to expect that it's far more likely the underlying facts will continue to show close ties to the old home state.

The taxpayer's connections outside of work also were more closely tied to California. The opinion notes:

> During the time period appellant-husband was in Malaysia for purposes of employment, he did establish connections there, including his apartment lease, vehicle, vehicle registration, and had bills mailed to his Malaysian address. However, these connections were contingent on his employment with Symmid and paid for by his employer. While he had a vehicle provided by Symmid, he did not obtain a Malaysian driver's license, and although he changed his mailing address to Malaysia, the apartment was in the name of Symmid, and the bills sent to his apartment were paid for by Symmid. It has been held that housing, meals, and vehicles provided by an employer as a "matter of job convenience" are not necessarily significant connections. (*Appeal of Stephens* (85-SBE-083) 1985 WL 15861; see also *Appeal of*

[815] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, pp. 7-8

[816] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, p. 8

Keeling (85-SBE-124) 1985 WL 15895.) Similarly, appellant-husband's connections to Malaysia based on his employment existed only so long as he could fulfill his contractual obligations. We find this tends to show that the connections were, like his contract, of limited duration, and not significant, particularly given that no other evidence was provided indicative of a permanent move.

In addition, appellants do not provide evidence that appellant-husband substantially severed his California connections. Appellant-wife lived in California and they continued to maintain their ownership of a house and vehicle in California. Appellants provide no evidence showing steps taken by appellant-wife to move to Malaysia or to move their permanent home from California. Furthermore, once his employment ended in Malaysia, appellant-husband immediately went back to his home in California, which was maintained in readiness for his return. Because appellant-husband's connections with Malaysia were only those provided by his employer as a matter of job convenience and not significant, and he made no attempt to sever his substantial connections with California, we find that his presence in Malaysia was for a temporary or transitory purpose. (See *Appeal of Milos, supra*.) Therefore, we find that appellant-husband was a resident of California in 2013 and subject to tax on his entire taxable income, including his income earned in Malaysia.[817]

[817] *In the Matter of the Appeal of Mazur*, California OTA Case No. 19064883, 2020-OTA-263P, pp. 9-10

NOTES

Unit 15

Business Tax Developments

SECTION: 61 FINAL REGULATIONS ISSUED INCREASING MAXIMUM VALUE FOR VEHICLES ELIGIBLE FOR THE FAVR AND CENTS-PER-MILE VALUATION METHODS

Citation: TD 9893, 2/5/20

The IRS has released final regulations modifying the dollar limits for vehicles subject to a fleet average valuation rule or having personal use valued using the cents-per-mile valuation method found in Reg. §1.61-21.[818]

The preamble to the final regulations describes these special rules as follows:

> The amount that must be included in the employee's income and wages for the personal use of an employer-provided vehicle generally is determined by reference to the vehicle's fair market value (FMV). However, for many years, §1.61-21 has provided special valuation rules for employer-provided vehicles (the prior final regulations).1 If an employer chooses to use a special valuation rule, the special value is treated as the FMV of the benefit for income tax and employment tax purposes. §1.61-21(b)(4). As discussed further in this Background section of this preamble, two such special valuation rules, the fleet-average valuation rule and the vehicle cents-per-mile valuation rule, are set forth in §1.61-21(d)(5)(v) and §1.61-21(e), respectively. These two special valuation rules are subject to limitations, including that they may be used only in connection with vehicles having values that do not exceed a maximum amount set forth in the regulations.[819]

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[818] TD 9893, February 5, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-02158.pdf?utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov&utm_medium=email (retrieved February 4, 2020)

[819] TD 9893, p. 2

The prior final regulations limited the cost of such vehicles to $12,800 for the cents-per-mile valuation method and $16,500 for a vehicle valued under the fleet-average valuation rule, subject to adjustment for inflation

The preamble to the proposed regulations provides the following description of the allowed use of a fleet-average valuation rule:

> The fleet-average valuation rule is an optional component of a special valuation rule called the automobile lease valuation rule set forth in §1.61-21(d). Under the automobile lease valuation rule, the value of the personal use of an employer-provided automobile available to an employee for an entire year is the portion of the annual lease value determined under the regulations (Annual Lease Value) relating to the availability of the automobile for personal use. Furthermore, provided the FMV of the automobile does not exceed the maximum value permitted under §1.61-21(d)(5)(v), an employer with a fleet of 20 or more automobiles may use a fleet-average value for purposes of calculating the Annual Lease Value of any automobile in the fleet.
>
> The fleet-average value is the average of the fair market values of all the automobiles in the fleet. However, §1.61-21(d)(5)(v)(D) of the prior final regulations provided that the value of an employee's personal use of an automobile could not be determined under the fleet-average valuation rule for a calendar year if the FMV of the automobile on the first date the automobile was made available to the employee exceeded the base value of $16,500, as adjusted annually pursuant to section 280F(d)(7). Section 1.61-21(d)(5)(v)(D) provided that the first such adjustment would be for calendar year 1989, subject to minor modifications to the section 280F(d)(7) formula specified in the regulations. In other words, under the prior final regulations, the maximum value for use of the fleet-average valuation rule was the base value of $16,500, as adjusted annually under section 280F(d)(7) every year since 1989.
>
> …Section 1.61-21(d)(5)(v)(B) provides that the fleet-average valuation rule may be used by an employer as of January 1 of any calendar year following the calendar year in which the employer acquires a sufficient number of automobiles to total a fleet of 20 or more, each one satisfying the maximum value requirement of §1.61-21(d)(5)(v)(D). The Annual Lease Value calculated for automobiles in the fleet, based on the fleet-average value, must remain in effect for the period that begins with the first January 1 the fleet-average valuation rule is applied by the employer to the automobiles in the fleet and ends on December 31 of the subsequent calendar year. The Annual Lease Value for each subsequent two-year period is calculated by determining the fleet average value of the automobiles in the fleet as of the first January 1 of such period. An employer may cease using the fleet-average valuation rule as of any January 1.[820]

[820] TD 9893, pp. 3-5

As well, it goes on to describe the cents-per-mile valuation method:

> Another special valuation rule is the vehicle cents-per-mile rule in §1.61-21(e). Under §1.61-21(e), if an employer provides an employee with the use of a vehicle that the employer reasonably expects will be regularly used in the employer's trade or business throughout the calendar year (or such shorter period as the vehicle may be owned or leased by the employer), or that satisfies the requirements of §1.61-21(e)(1)(ii) (i.e., the vehicle is actually driven at least 10,000 miles in the year and use of the vehicle during the year is primarily by employees), the value of the personal use may be determined based on the applicable standard mileage rate multiplied by the total number of miles the vehicle is driven by the employee for personal purposes.
>
> Section 1.61-21(e)(1)(iii)(A) provides that the value of the personal use may not be determined under the vehicle cents-per-mile valuation rule for a calendar year if the fair market value of the vehicle on the first date the vehicle is made available to the employee exceeds the sum of the maximum recovery deductions allowable under section 280F(a) for a five-year period for an automobile first placed in service during that calendar year (whether or not the automobile is actually placed in service during that year), as adjusted by section 280F(d)(7). The prior final regulations provided that, under this rule, with respect to a vehicle placed in service in or after 1989, the limitation on value was $12,800, as adjusted under section 280F(d)(7). In other words, under the prior final regulations, the maximum value of a vehicle for use of the vehicle cents-per-mile valuation rule was the base value of $12,800, as adjusted annually under section 280F(d)(7) since 1989. As with the fleet-average valuation rule, beginning in 2005, the IRS calculated the price inflation adjustment for trucks and vans separately from cars. See Rev. Proc. 2005-48. For 2017, the maximum value for use of the vehicle cents-per-mile valuation rule was $15,900 for a passenger automobile and $17,800 for a truck or van. See Notice 2017-03.
>
> Section 1.61-21(e)(5)(i) states that an employer must adopt the vehicle cents-per-mile valuation rule for a vehicle to take effect by the first day on which the vehicle is used by an employee of the employer for personal use (or, if another special valuation rule called the commuting valuation rule of §1.61-21(f) is used when the vehicle is first used by an employee of the employer for personal use, the first day on which the commuting valuation rule is not used). Section 1.61-21(e)(5)(ii) also provides, in part, that once the vehicle cents-per-mile valuation rule has been adopted for a vehicle by an employer, the rule must be used by the employer for all subsequent years in which the vehicle qualifies for use of the rule, except that the employer may, for any year during which use of the vehicle qualifies for the commuting valuation rule of §1.61-21(f), use the commuting valuation rule with respect to the vehicle.[821]

[821] TD 9893, pp. 5-6

The preamble notes that the Tax Cuts and Jobs Act (TCJA) substantially increased the cap on the maximum deductible depreciation for automobiles and revised the cost of living adjustment to be computed using both the CPI auto component and the Chained Consumer Price Index for All Urban Consumers (C-CPI-U) automobile component.[822]

Those changes have led to the need to revise the dollar limits upward substantially for these two valuation methods. The IRS announced their intent to revise the regulations to accomplish this and provided 2018 values in Notice 2019-08. This notice was followed up with 2019 numbers found in Notice 2019-34.[823]

On August 29, 2019 the proposed regulations to implement these changes were published in the *Federal Register* by the Treasury Department.[824] No comments were received, so the final regulations were adopted without substantive changes.[825]

Thus, Reg. §1.61-21(d)(5)(v)(D) related to the use of the fleet-average valuation rule is modified to read as follows:

> (D) <u>Limitations on use of fleet-average rule.</u> The rule provided in this paragraph (d)(5)(v) may not be used for any automobile the fair market value of which (determined pursuant to paragraphs (d)(5)(i) through (iv) of this section as of the first date on which the automobile is made available to any employee of the employer for personal use) exceeds $50,000, as adjusted by section 280F(d)(7). The first such adjustment shall be for calendar year 2019. In addition, the rule provided in this paragraph (d)(5)(v) may only be used for automobiles that the employer reasonably expects will regularly be used in the employer's trade or business. For rules concerning when an automobile is regularly used in the employer's business, see paragraph (e)(1)(iv) of this section.[826]

The revised regulation applies to tax years beginning on or after February 5, 2020, but taxpayers can apply the changes for tax years beginning on or after January 1, 2018.[827]

A special transition rule is also in place for 2018 and 2019. The provision provides:

> (G) <u>Transition rule for 2018 and 2019.</u> Notwithstanding paragraph (d)(5)(v)(B) of this section, an employer that did not qualify to use the fleet-average valuation rule prior to January 1, 2018, with respect to any automobile (including a truck or van) because the fair market value of the vehicle exceeded the inflation-adjusted maximum value requirement of paragraph (d)(5)(v)(D) of this section, as published by the Service in a notice or revenue procedure applicable to the year the vehicle was

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[822] TD 9893, p. 7

[823] TD 9893, pp. 7-8

[824] *Federal Register*, 84 FR 44258, August 23, 2019

[825] TD 9893, p. 12

[826] Reg. §1.61-21(d)(5)(v)(D)

[827] Reg. §1.61-21(d)(5)(v)(H)

first made available to any employee of the employer, may adopt the fleet-average valuation rule for 2018 or 2019 with respect to the vehicle, provided the fair market value of the vehicle does not exceed $50,000 on January 1, 2018, or $50,400 on January 1, 2019, respectively.[828]

For the cents-per-mile valuation method, the regulations are first changed at Reg. §1.61-21(e)(1)(iii)(A) to say:

> (A) In general. The value of the use of an automobile (as defined in paragraph (d)(1)(ii) of this section) may not be determined under the vehicle cents-per-mile valuation rule of this paragraph (e) for a calendar year if the fair market value of the automobile (determined pursuant to paragraphs (d)(5)(i) through (iv) of this section as of the first date on which the automobile is made available to any employee of the employer for personal use) exceeds $50,000, as adjusted by section 280F(d)(7). The first such adjustment shall be for calendar year 2019.[829]

As well, Reg. §1.61-21(e)(5)(i) is revised to read:

> (i) Use of the vehicle cents-per-mile valuation rule by an employer. An employer must adopt the vehicle cents-per-mile valuation rule of this paragraph (e) for a vehicle to take effect by the first day on which the vehicle is used by an employee of the employer for personal use (or, if the commuting valuation rule of paragraph (f) of this section is used when the vehicle is first used by an employee of the employer for personal use, the first day on which the commuting valuation rule is not used).[830]

As with the FAVR rule, these regulation changes are effective for taxable years beginning on or after February 5, 2020, with taxpayers being given the option to apply these rules to tax years beginning on or after January 1, 2018.[831]

Similarly, a special transition rule for the cents-per-mile valuation method is provided for 2018 and 2019:

> (vi) Transition rule for 2018 and 2019. For a vehicle first made available to any employee of an employer for personal use before calendar year 2018, an employer that did not qualify under this paragraph (e)(5) to adopt the vehicle cents-per-mile valuation rule on the first day on which the vehicle is used by the employee for personal use because the fair market value of the vehicle exceeded the inflation-adjusted limitation of paragraph (e)(1)(iii) of this section, as published by the Service in a notice or revenue procedure applicable to the year the vehicle was first used by the employee for personal use, may first adopt the vehicle cents-per-mile valuation rule for the 2018 or 2019 taxable year, provided the fair market value of the vehicle does not exceed $50,000 on January 1, 2018, or $50,400 on January 1,

[828] Reg. §1.61-21(d)(5)(v)(G)

[829] Reg. §1.61-21(e)(1)(iii)(A)

[830] Reg. §1.61-21(e)(5)(i)

[831] Reg. §1.61-21(e)(6)

> 2019, respectively. Similarly, for a vehicle first made available to any employee of the employer for personal use before calendar year 2018, if the commuting valuation rule of paragraph (f) of this section was used when the vehicle was first used by the employee for personal use, and the employer did not qualify to switch to the vehicle cents-per-mile valuation rule of this paragraph (e) on the first day on which the commuting valuation rule of paragraph (f) of this section was not used because the vehicle had a fair market value in excess of the inflation-adjusted limitation of paragraph (e)(1)(iii) of this section, as published by the Service in a notice or revenue procedure applicable to the year the commuting valuation rule was first not used, the employer may adopt the vehicle cents-per-mile valuation rule for the 2018 or 2019 taxable year, provided the fair market value of the vehicle does not exceed $50,000 on January 1, 2018, or $50,400 on January 1, 2019, respectively. However, in accordance with paragraph (e)(5)(ii) of this section, an employer that adopts the vehicle cents-per-mile valuation rule pursuant to this paragraph (e)(5)(vi) must continue to use the rule for all subsequent years in which the vehicle qualifies for use of the rule, except that the employer may, for any year during which use of the vehicle qualifies for the commuting valuation rule of paragraph (f) of this section, use the commuting valuation rule with regard to the vehicle.[832]

SECTION: 139
FAQ ADDRESSES TAX TREATMENT OF CARES PROVIDER RELIEF PAYMENTS

Citation: "Frequently Asked Questions about Taxation of Provider Relief Payments," IRS Website, 7/6/2020

The IRS released a very short FAQ to provide two answers related to the taxation of provider relief payments from the Provider Relief Fund created by the CARES Act.[833]

The web page describes the program as follows:

> The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), enacted on March 27, 2020, appropriated $100 billion for the Public Health and Social Services Emergency Fund (Provider Relief Fund). The Paycheck Protection Program and Health Care Enhancement Act, enacted on April 24, 2020, appropriated an additional $75 billion to the Provider Relief Fund. This funding will be used to reimburse eligible health care providers for health care-related expenses or lost revenues that are attributable to the COVID-19 pandemic. See https://www.hhs.gov/provider-relief/index.html for more information about the Provider Relief Fund.

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[832] Reg. §1.61-21(e)(5)(vi)

[833] "Frequently Asked Questions about Taxation of Provider Relief Payments," IRS Website, July 6, 2020, https://www.irs.gov/newsroom/frequently-asked-questions-about-taxation-of-provider-relief-payments (retrieved July 10, 2020)

Taxpayers who receive these funds may wonder about their tax status—are these payments taxable income or not?

Section 139 Does Not Apply

Following the declaration of the national emergency, a number of commentators have pointed out the special exclusion from income for certain payments related to emergency relief found at IRC §139. Some providers have posited that these payments seem "like" a relief payment related to COVID-19 and thus should be non-taxable. But the FAQ points out an issue with that view in Question 1:

> **Q1: May a health care provider that receives a payment from the Provider Relief Fund exclude this payment from gross income as a qualified disaster relief payment under section 139 of the Internal Revenue Code (Code)?**
>
> A: No. A payment to a business, even if the business is a sole proprietorship, does not qualify as a qualified disaster relief payment under section 139. The payment from the Provider Relief Fund is includible in gross income under section 61 of the Code.

Tax Exempt Health Care Provider

The IRS also provides guidance to tax exempt health care providers who receive such payments, indicating that generally such payments will not subject the entity to tax—but with an exception for entities with unrelated businesses:

> **Q: Is a tax-exempt health care provider subject to tax on a payment it receives from the Provider Relief Fund?**
>
> A: Generally, no. A health care provider that is described in section 501(c) of the Code generally is exempt from federal income taxation under section 501(a). Nonetheless, a payment received by a tax-exempt health care provider from the Provider Relief Fund may be subject to tax under section 511 if the payment reimburses the provider for expenses or lost revenue attributable to an unrelated trade or business as defined in section 513.

SECTION: 163
PROPOSED REVENUE PROCEDURE ISSUED TO ALLOW QUALIFIED RESIDENTIAL LIVING FACILITIES TO BE §163(J) ELECTING REAL PROPERTY TRADE OR BUSINESS

Citation: Notice 2020-59, 7/28/20

At the same time the IRS issued final regulations on the business interest deduction limitations under IRC §163(j), the agency issued a proposed Revenue Procedure in Notice 2020-59 to provide a safe harbor for a trade or business that manages or operates a qualified residential living facility to be treated as a real property trade or business solely for the purposes of qualifying as an electing real property trade or business under IRC §163(j)(7)(B).[834]

An electing real property or business is exempted from the business interest limitations under IRC §163(j) but is required to use the alternative depreciation system (ADS) methods to depreciate any real property.

The IRS explains the reason why they are proposing this safe harbor in Notice 2020-59:

> The Treasury Department and the IRS are aware that taxpayers have uncertainty about whether residential living facilities that include the provision of supplemental assistive, nursing, or routine medical services qualify as electing real property trades or businesses under section 163(j)(7)(B).
>
> To mitigate this uncertainty, the proposed revenue procedure in section 6 of this notice provides a safe harbor under which a qualified residential living facility, as defined in section 3.01 of the proposed revenue procedure, is treated as eligible to be an electing real property trade or business under section 163(j)(7)(B).[835]

Although the procedure is issued as a draft, the IRS provides that taxpayers may rely on the procedure until the date a final revenue procedure is published:

> Until the date on which the proposed revenue procedure is published as a revenue procedure in the Internal Revenue Bulletin, taxpayers may rely on the safe harbor described in the proposed revenue procedure for purposes of determining whether a qualified residential living facility, as defined in section 3.01 of the proposed revenue procedure, is eligible to be an electing real property trade or business solely for purposes of section 163(j).[836]

The proposed Revenue Procedure defines a *qualified residential living facility* as a facility that:

- Consists of multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences on a permanent or semi-permanent basis to individual customers or patients;
- Includes the provision of supplemental assistive, nursing, or other routine medical services; and
- Has an average period of customer or patient use of the individual rental dwelling units that is 90 days or more.[837]

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[834] Notice 2020-59, July 28, 2020 https://www.irs.gov/pub/irs-drop/n-20-59.pdf (retrieved August 6, 2020)

[835] Notice 2020-59, Section 2

[836] Notice 2020-59, Section 4

[837] Notice 2020-59, Proposed Revenue Procedure Section 3.01

The proposed revenue procedure provides the following guidance on determining the average period of customer use:

> The average period of customer or patient use is determined by dividing (i) the sum of the total number of days in the taxable year that each customer or patient resides in a rental dwelling unit of the residential living facility (which may be determined by reference to a rental contract or other formal written lease agreement); by (ii) the total number of individual residential customers or patients that reside in all of the rental dwelling units of the facility for the taxable year. For this purpose, a married couple residing in a single rental dwelling unit of the residential living facility will be counted as one individual customer or patient, unless each spouse is separately properly treated as an individual customer or patient of the residential living facility that receives supplemental assistive, nursing, or other routine medical services from or on behalf of the residential living facility.[838]

The proposed procedure provides the following example:

EXAMPLE, PROPOSED REVENUE PROCEDURE, NOTICE 2020-59

Facility has 100 rental dwelling units. Of the 100 units, 60 units are occupied by the same customer or patient for the entire year, 25 units are occupied by each customer or patient for three months (90 days) of the year, and 15 units are occupied for only 10 months (300 days) of the year (for a total of 100 customers for the year). Of the 15 units occupied for only 10 months of the year, 10 units are occupied by customers or patients for 5 months (150 days) each (for a total of 20 customers for the 10-month period). For the remaining 5 of 15 units that are occupied for only 10 months of the year, 5 customers or patients occupy the units for 8 months (240 days) of the year, and 5 other customers or patients occupy the units for 2 months (60 days) of the year. The average period of customer or patient use is determined by dividing the sum of the total number of days in the taxable year that each customer resides in a rental dwelling unit, by the total number of individual residential customers or patients that reside in all of the rental dwelling units for the taxable year. The total number of days in the taxable year that the customers or patients reside in the rental dwelling unit is 35,400 days [21,900 days (60 units that are occupied for the entire year x 365 days per year) + 9,000 days (25 units that are occupied for 90 days each x 90 days x 4 90-day periods in a year) + 4,500 days (15 units that are occupied for only 10 months x 300 days)]. The total number of individual residential customers or patients is 190 [60 customers or patients occupying a unit for the entire year + 100 (25 customers or patients occupying units for 90 days each x 4 90-day periods in a year) + 20 customers or patients that occupy a unit for a 5-month period + 5 customers or patients that occupy a unit for a 8-month period + 5 customers or patients that occupy a unit for a 2-month period]. Accordingly, the average period of customer or patient use is approximately 186 days (35,400/190).

The proposed revenue procedure defines *supplemental assistive, nursing or other routine medical services* as:

> Supplemental assistive, nursing, or other routine medical services are personal and professional services that are customarily and routinely provided to individual residential customers or patients of nursing homes, assisted living facilities, memory care residences, continuing care retirement communities, skilled nursing facilities, or similar facilities, as needed, on a day-to-day basis. Such services generally do not

[838] Notice 2020-59, Proposed Revenue Procedure Section 3.02(1)

> include surgical, radiological, or other intensive or specialized medical services that are usually only provided in emergency or short-term in-patient or out-patient hospital or surgical settings.[839]

The proposed revenue procedure defines *permanent or semi-permanent basis* as:

> The rental dwelling units of a residential living facility serve as primary residences on a permanent or semi-permanent basis to customers or patients whose use of the units is generally long-term (more than 90 days) in nature, even though some customers or patients may arrive at the residential living facility with significantly shortened life expectancies due to advanced age or terminal medical conditions, and some customers or patients otherwise may be expected to periodically reside away from the residential living facility (such as at the primary residence of a spouse or other relative) for short periods or durations of time.[840]

Under the proposed revenue procedure, a taxpayer that manages or operates a qualified residential living facility may, solely for the purpose of the election to be treated as an electing real property business under IRC §163(j), treat the operation as a real property trade or business. Meeting the tests to qualify under the safe harbor does not establish that the business is engaged in a real property trade or business for the passive activity rules found at IRC §469.[841]

The proposed revenue procedure provides the following information on the effect of the election and how it should be made:

> If a taxpayer makes the election pursuant to this safe harbor, the provisions in § 1.163(j)-9 of the regulations apply, and the taxpayer must use the alternative depreciation system of section 168(g) of the Code to depreciate the property described in section 168(g)(8). The taxpayer makes the election at the time, and in the manner prescribed by § 1.163(j)-9(d). See also Rev. Proc. 2020-22.[842]

The proposed revenue procedure imposes the following requirements for keeping books and records:

> A trade or business that manages or operates a residential living facility to which this revenue procedure applies must retain books and records to substantiate that all the requirements of this section 4 have been met in accordance with section 6001 of the Code.[843]

The proposed revenue procedure also contains the following broad anti-abuse rule applicable to this procedure:

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[839] Notice 2020-59, Proposed Revenue Procedure Section 3.03

[840] Notice 2020-59, Proposed Revenue Procedure Section 3.04

[841] Notice 2020-59, Proposed Revenue Procedure Section 4.01

[842] Notice 2020-59, Proposed Revenue Procedure Section 4.02

[843] Notice 2020-59, Proposed Revenue Procedure Section 4.03

> Arrangements entered into with a principal purpose of avoiding the rules of section 163(j) of the Code or the regulations under section 163(j) may be disregarded or recharacterized by the Commissioner of Internal Revenue to the extent necessary to carry out the purposes of section 163(j). See § 1.163(j)-2(j).[844]

The proposed revenue procedure applies to tax years beginning after December 31, 2017.[845]

SECTION: 163
OPTION TO CHANGE §163(J) ELECTIONS FOR REAL ESTATE AND FARMING BUSINESSES FOR CARES ACT CHANGES ISSUED BY IRS

Citation: Revenue Procedure 2020-22, 4/10/20

Some taxpayers who elected to be "electing real property trades or businesses" based on the provisions of §163(j) prior to amendment by the CARES Act likely regretted their decisions once the Act retroactively changed the limit from 30% of adjusted taxable income to 50% of adjusted taxable income temporarily. The IRS is now giving those taxpayers a chance to undo that election based on guidance in Revenue Procedure 2020-22.[846]

As well, the Procedure covers other new elections that are part of the CARES Act to deal with the changes made by that Act to §163(j).

Modifying §163(j)(7) Elections

The Procedure outlines its scope in Section 3. It begins by stating:

> Sections 4 and 5 of this revenue procedure apply to a taxpayer described in section 3.01(1) or (2) of this revenue procedure with respect to an election under section 163(j)(7)(B) to be an electing real property trade or business or under section 163(j)(7)(C) to be an electing farming business (collectively, section 163(j)(7) election). The fact that a taxpayer satisfies the scope requirement of this section 3.01 is not a determination that the taxpayer is a real property trade or business under section 162, 212, or 469 of the Code, or a farming business under section 162, 199A, or 263A of the Code.[847]

Making a Late §163(j)(7) Election

First the IRS deals with the (seemingly less likely) decision that a qualified farming or real estate business would want to make a late election under §163(j)(7) to become an electing farming or real

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[844] Notice 2020-59, Proposed Revenue Procedure Section 4.04

[845] Notice 2020-59, Proposed Revenue Procedure Section 5

[846] Revenue Procedure 2020-22, April 10, 2020, https://www.irs.gov/pub/irs-drop/rp-20-22.pdf, retrieved April 10, 2020

[847] Revenue Procedure 2020-22, Section 3.01

estate business, exempt from the §163(j) limits on business interest, but required to depreciate certain assets using ADS methods and lives.

Taxpayers who can make this late election are:

> A taxpayer is described in this section 3.01(1) if the taxpayer did not file a section 163(j)(7) election with its timely filed original Federal income tax return or Form 1065, including extensions, or withdrew an election under section 5 of this revenue procedure, for a taxable year beginning in 2018 (2018 taxable year), 2019 (2019 taxable year), or 2020 (2020 taxable year), was otherwise qualified to make an election when the return was filed, and now wants to make an election for one of those taxable years.[848]

The time for making the late §163(j) election is outlined in the procedure:

> A taxpayer within the scope of section 3.01(1) of this revenue procedure may make the section 163(j)(7) election for a 2018, 2019, or 2020 taxable year by filing an amended Federal income tax return, amended Form 1065, or AAR, as applicable. Except as provided in Revenue Procedure 2020-23, 2020-18 I.R.B. 1 (April 27, 2020), released on www.irs.gov on April 8, 2020, regarding the time to file an amended return by a partnership subject to the centralized partnership audit regime enacted as part of the Bipartisan Budget Act of 2015 (BBA partnership) for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may make a late section 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under section 6235 for the reviewed year, as defined in § 301.6241-1(a)(8) of the Procedure and Administration Regulations (26 CFR Part 301).[849]

The taxpayer makes the late §163(j) election as follows:

> A taxpayer described in section 4.02 of this revenue procedure must make the election on a timely filed amended Federal income tax return, amended Form 1065, or an AAR, as applicable, with the election statement in accordance with the rules and procedures contained in proposed § 1.163(j)-9 of the 2018 proposed regulations and this section 4. The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the late section 163(j)(7) election and any collateral adjustments to taxable income or to tax liability. Such collateral adjustments also must be made on amended Federal income tax returns, amended Forms 1065, or AARs, as applicable,

[848] Revenue Procedure 2020-22, Section 3.01(1)

[849] Revenue Procedure 2020-22, Section 6.02

> for any affected succeeding taxable year. An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the late election applies. The taxpayer is subject to all of the other rules and requirements in section 163(j), except as otherwise provided in this revenue procedure. The Treasury Department and the IRS have provided guidance under section 163(j) in the 2018 proposed regulations and will provide additional guidance in forthcoming final regulations and additional proposed regulations under section 163(j). The additional proposed regulations will address issues arising under the CARES Act as well as certain other issues.[850]

The late election statement's contents are outlined as follows:

> The election statement must be titled, "Revenue Procedure 2020-22 Late Section 163(j)(7) Election." The election statement must contain:
>
> (1) The taxpayer's name;
>
> (2) The taxpayer's address;
>
> (3) The taxpayer's social security number (SSN) or employer identification number (EIN);
>
> (4) A description of the taxpayer's electing trade or business, including the principal business activity code; and
>
> (5) A statement that the taxpayer is making an election under section 163(j)(7)(B) or 163(j)(7)(C), as applicable. [851]

This portion of the procedure concludes on issues related to depreciation when a late election is made:

> A taxpayer within the scope of section 3.01(1) of this revenue procedure that is making a section 163(j)(7) election must determine its depreciation on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, for the property that is affected by the late election using the alternative depreciation system of section 168(g), pursuant to section 168(g)(1)(F) or (G). See also section 163(j)(11). Section 4.02 of Rev. Proc. 2019-8, 2019-3 I.R.B. 347, explains how to change to the alternative depreciation system for existing property that is affected by the late election.[852]

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[850] Revenue Procedure 2020-22, Section 6.03

[851] Revenue Procedure 2020-22, Section 6.04

[852] Revenue Procedure 2020-22, Section 6.05

Withdrawing an Election Under §163(j)(7)

The more likely scenario is that a taxpayer will want to withdraw a prior election under §163(j). Under the provisions added by TCJA, an election under §163(j)(7) was an election that bound the taxpayer forever, with no opportunity to undo the election. But the IRS reasoned that taxpayers may have made a very different decision had the interest limit been set at 50% of adjusted taxable income rather than 30%.

Section 5 allows for just such a withdraw of the prior election. Those taxpayers eligible for it are:

> A taxpayer is described in this section 3.01(2) if the taxpayer filed a section 163(j)(7) election with its timely filed original Federal income tax return or Form 1065, including extensions, or made a late election under section 4 of this revenue procedure, for a 2018, 2019, or 2020 taxable year and now wants to withdraw the election.[853]

The time and manner for withdrawing an election under IRC §163(j)(7) are provided in the procedure:

> A taxpayer that wishes to withdraw an election as described in section 5.01 of this revenue procedure for a 2018, 2019, or 2020 taxable year must timely file an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the taxable year in which the election was made, with an election withdrawal statement. Except as provided in Revenue Procedure 2020-23, regarding the time to file amended returns by BBA partnerships for 2018 and 2019 taxable years, the amended Federal income tax return or amended Form 1065 must be filed on or before October 15, 2021, but in no event later than the applicable period of limitations on assessment for the taxable year for which the amended return is being filed. In the case of a BBA partnership that chooses not to file an amended Form 1065 as permitted under Rev. Proc. 2020-23, the BBA partnership may withdraw the section 163(j)(7) election by filing an AAR on or before October 15, 2021, but in no event later than the applicable period of limitations on making adjustments under section 6235 for the reviewed year, as defined in § 301.6241-1(a)(8). The amended Federal income tax return, amended Form 1065, or AAR, as applicable, must include the adjustment to taxable income for the withdrawn section 163(j)(7) election and any collateral adjustments to taxable income or to tax liability, including any adjustments under section 481. A taxpayer also must file amended Federal income tax returns, amended Forms 1065, or AARs, as applicable, including such collateral adjustments, for any affected succeeding taxable years. An example of such collateral adjustments is the amount of depreciation allowed or allowable in the applicable taxable year for the property to which the withdrawn election applies.[854]

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[853] Revenue Procedure 2020-22, Section 3.01(2)

[854] Revenue Procedure 2020-22, Section 5.02

The election withdrawal statement contents are described as follows:

> The election withdrawal statement should be titled, "Revenue Procedure 2020-22 Section 163(j)(7) Election Withdrawal." The election withdrawal statement must contain the taxpayer's name, address, and SSN or EIN, and must state that, pursuant to Revenue Procedure 2020-22, the taxpayer is withdrawing its election under section 163(j)(7)(B) or 163(j)(7)(C), as applicable.[855]

As well, the procedure again discusses the issues that will arise with regard to depreciation when the original election is withdrawn:

> A taxpayer that is withdrawing a prior section 163(j)(7) election must determine its depreciation for the property that is affected by the withdrawn election in accordance with section 168 on the amended Federal income tax returns, amended Forms 1065, or AARs, as applicable.[856]

Making an Election Under New §163(j)(10)

The CARES Act added IRC §163(j)(10) that created some new elections to deal with the CARES Act changes to §163(j). This ruling also provides rules for these elections, and the scope is defined in the following paragraph:

> Section 6 of this revenue procedure provides the time and manner of making or revoking elections under new section 163(j)(10) applicable to a taxpayer that has timely filed, or will timely file, an original Federal income tax return or Form 1065 for a taxpayer's 2019 or 2020 taxable year. [857]

The CARES Act added a number of special purpose elections which are described below.

Election Out of the 50 Percent ATI Limitation

Taxpayers have the option to not apply the 50% limitation for the 2019 and/or 2020 tax year, going back to the 30% limit.

> Except as otherwise provided in this section 6.01(1), a taxpayer may elect under section 163(j)(10)(A)(iii) not to apply the 50 percent ATI limitation for a 2019 or 2020 taxable year. A partnership can make this election only for a 2020 taxable year because partnerships cannot use the 50 percent ATI limitation for a 2019 taxable year.[858]

The time and manner of making the election is outlined as follows:

[855] Revenue Procedure 2020-22, Section 5.03

[856] Revenue Procedure 2020-22, Section 5.04

[857] Revenue Procedure 2020-22, Section 3.02

[858] Revenue Procedure 2020-22, Section 6.01(1)

> A taxpayer permitted to make the election, as described in section 6.01 of this revenue procedure, makes the election not to apply the 50 percent ATI limitation for a 2019 or 2020 taxable year by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or AAR, as applicable, using the 30 percent ATI limitation. No formal statement is required to make the election.[859]

Effectively, this is a "Nike" election—the taxpayer just "does it" and applies the 30% limitation.

The procedure also provides an option for a taxpayer (who may have not been aware of the option to use the 50% limitation or just changes his/her mind) to revoke the election to continue to use the 30% limit:

> If a taxpayer made the election, as described in section 6.01(2) of this revenue procedure, not to apply the 50 percent ATI limitation, for a 2019 or 2020 taxable year, and the taxpayer wishes to revoke that election for such taxable year, the Commissioner grants the taxpayer consent to revoke that election, provided the taxpayer timely files an amended Federal income tax return, amended Form 1065, or AAR, as applicable, for the applicable tax year, using the 50 percent ATI limitation.[860]

This section of the procedure concludes:

> The election in section 6.01 of this revenue procedure must be made for each taxable year. For a consolidated group, the election is made by the agent for a consolidated group, within the meaning of § 1.1502-77, on behalf of members of the consolidated group. For partnerships, the election is made by the partnership, but only for a 2020 taxable year. For an applicable CFC, as defined in proposed § 1.163(j)-7(f)(2), the election is not effective unless made for the applicable CFC by each controlling domestic shareholder, as defined in § 1.964-1(c)(5).[861]

Election to Use 2019 ATI in 2020 Taxable Year

Given that many taxpayers will have much lower income in 2020 than in 2019, the law allows the taxpayer to elect to use the taxpayer's 2019 ATI in lieu of using the ATI for 2020.

> Under section 163(j)(10)(B), a taxpayer may elect to use the taxpayer's ATI for the last taxable year beginning in 2019 (that is, the taxpayer's 2019 ATI) as the ATI for any taxable year beginning in 2020, subject to modifications for short taxable years.[862]

[859] Revenue Procedure 2020-22, Section 6.01(2)

[860] Revenue Procedure 2020-22, Section 6.01(3)

[861] Revenue Procedure 2020-22, Section 6.01(4)

[862] Revenue Procedure 2020-22, Section 6.02(1)

The time and manner of making the election is described in the Procedure:

> A taxpayer makes an election under this section 6.02 for a 2020 taxable year by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or AAR, as applicable, using the taxpayer's 2019 ATI. A taxpayer revokes an election under this section 6.02 for a 2020 taxable year by timely filing an amended Federal income tax return, amended Form 1065, or AAR by a BBA partnership, as applicable, not using the taxpayer's 2019 ATI. No formal statement is required to make or revoke the election.[863]

The procedure provides the following information for who makes the election:

> For a consolidated group, the election under section 6.02 of this revenue procedure is made by the agent for a consolidated group, within the meaning of § 1.1502-77, on behalf of itself and members of the group. For partnerships, the election is made by the partnership. For an applicable CFC, the election is not effective unless made for the applicable CFC by each controlling domestic shareholder. In the case of a CFC group, as defined in proposed § 1.163(j)-7(f)(6), the election is not effective for any CFC group member, as defined in proposed § 1.163(j)-7(f)(8), unless made for every taxable year of a CFC group member for which the election is available and for which the CFC group member is a CFC group member on the last day of the CFC group member's taxable year.[864]

The IRS also discusses issues that will arise with a short taxable year:

> If an election is made under section 6.02 of this revenue procedure for a 2020 taxable year that is a short taxable year, the ATI for the taxpayer's applicable taxable year beginning in 2020 is equal to the amount that bears the same ratio to such ATI as the number of months in the short taxable years bears to 12.[865]

Election Out of the 50 Percent EBIE (Excess Business Interest Expense) Rule

A taxpayer wishing to elect out of the 50 percent EBIE rule makes the election at the following time and in the following manner:

> A partner makes the election under section 6.03 of this revenue procedure by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, an amended Form 1065, or an AAR, as applicable, for the partner's first taxable year beginning in 2020, by not applying the 50 percent EBIE rule in determining the section 163(j) limitation. A partner revokes the election under this section 6.03 by timely filing an amended Federal income tax

[863] Revenue Procedure 2020-22, Section 6.02(2)

[864] Revenue Procedure 2020-22, Section 6.02(3)

[865] Revenue Procedure 2020-22, Section 6.02(4)

return, amended Form 1065, or AAR, as applicable, for the partner's first taxable year beginning in 2020, by applying the 50 percent EBIE rule in determining the section 163(j) limitation.[866]

SECTION: 168
ADDITIONAL SET OF FINAL REGULATIONS ON BONUS DEPRECIATION RELEASED BY IRS

Citation: TD 9916, 9/21/2020

Another set of final regulations[867] have been issued by the IRS on bonus depreciation under the Tax Cuts and Jobs Act (TCJA). These regulations make final, with revisions, proposed regulations issued in 2019 (REG-106808-19).

Selected items highlighted by the IRS in the preamble related to areas that received comments from the proposed regulations or were revised from what was in those regulations are discussed below.

Floor Plan Financing Interest Impact on Bonus Depreciation

The IRS provides that the bar on claiming bonus depreciation related to floor plan financing interest only applies if the taxpayer is actually subject to the business interest limitation found at IRC §163(j) for the year in question. Reg. §1.168(k)-2(b)(2)(ii)(G) provides that bonus depreciation is not allowed for property acquired during the year:

> (G) Used in a trade or business that has had floor plan financing indebtedness, as defined in section 163(j)(9)(B) and §1.163(j)-1(b)(18), if the floor plan financing interest expense, as defined in section 163(j)(9)(A) and §1.163(j)-1(b)(19), related to such indebtedness is taken into account under section 163(j)(1)(C) for the taxable year. Such property also must be placed in service by the taxpayer in any taxable year beginning after December 31, 2017. Solely for purposes of section 168(k)(9)(B) and this paragraph (b)(2)(ii)(G), floor plan financing interest expense is taken into account for the taxable year by a trade or business that has had floor plan financing indebtedness only if the business interest expense, as defined in section 163(j)(5) and §1.163(j)-1(b)(3), of the trade or business for the taxable year (which includes floor plan financing interest expense) exceeds the sum of the amounts calculated under section 163(j)(1)(A) and (B) for the trade or business for the taxable year. If the trade or business has taken floor plan financing interest expense into account pursuant to this paragraph (b)(2)(ii)(G) for a taxable year, this paragraph (b)(2)(ii)(G) applies to any property placed in service by that trade or business in that taxable year. This paragraph (b)(2)(ii)(G) does not apply to property that is

[866] Revenue Procedure 2020-22, Section 6.03(2)

[867] TD 9916, September 21, 2020 (date released by the IRS. The publication date of the regulations in *Federal Register* is the date the regulations are treated as issued)

> leased to a lessee's trade or business that has had floor plan financing indebtedness, by a lessor's trade or business that has not had floor plan financing indebtedness during the taxable year or that has had floor plan financing indebtedness but did not take into account floor plan financing interest expense for the taxable year pursuant to this paragraph (b)(2)(ii)(G).[868]

However, in the preamble to the final regulations, the IRS declined to allow a business with floor plan financing to opt out of being able to claim floor plan financing interest as a deduction in addition to business interest in order to obtain bonus depreciation for the assets acquired in the year:

> A commenter on the 2019 Proposed Regulations requested that these final regulations allow a trade or business that has business interest expense, including floor plan financing interest expense, that exceeds the sum of the amounts calculated under deduction to the sum of the amounts under section 163(j)(1)(A) and (B), and not be precluded by section 168(k)(9)(B) from claiming the additional first year depreciation deduction. The Treasury Department and the IRS do not interpret section 163(j)(1) as allowing such an option. Consistent with the plain language of section 163(j)(1), §1.163(j)-2(b)(1) provides that the amount allowed as a deduction for business interest expense for the taxable year generally cannot exceed the sum of (1) the taxpayer's business interest income for the taxable year, (2) 30 percent of the taxpayer's adjusted taxable income for the taxable year, and (3) the taxpayer's floor plan financing interest expense for the taxable year. Pursuant to section 2306(a) of the CARES Act, the adjusted taxable income percentage is increased from 30 to 50 percent for any taxable year beginning in 2019 or 2020, subject to certain exceptions. Because neither section 163(j)(1) nor §1.163(j)-2(b) provide an option for a trade or business with floor plan financing indebtedness to include or exclude its floor plan financing interest expense in determining the amount allowed as a deduction for business interest expense for the taxable year, the Treasury Department and the IRS decline to adopt this comment.[869]

But the IRS did commit to providing guidance to taxpayers who had taken such a position on their 2018 Federal income tax return:

> The commenter also requested that the Treasury Department and the IRS provide transition relief for taxpayers that treated, on their 2018 Federal income tax returns, section 163(j)(1) as providing an option for a trade or business with floor plan financing indebtedness to include or exclude its floor plan financing interest expense in determining the amount allowed as a deduction for business interest expense for the taxable year. Further, the commenter requested transition relief for taxpayers with a trade or business with floor plan financing indebtedness that want to revoke their elections not to claim the additional first year depreciation for property placed in service during 2018 in order to rely on the 2019 Proposed Regulations. The

[868] Reg. §1.168(k)-2(b)(2)(ii)(F)

[869] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, A. Property described in section 168(k)(9)(B)

> Treasury Department and the IRS intend to issue published guidance that will address these requests.[870]

Five Year Lookback Rule for Prior Depreciable Interest

The IRS also discusses some clarifications made to the five year lookback rule. The preamble describes this rule found in the Proposed Regulations:

> Section 1.168(k)-2(b)(3)(iii)(B)(1) of the 2019 Final Regulations provides that property is treated as used by the taxpayer or a predecessor at any time prior to acquisition by the taxpayer or predecessor if the taxpayer or the predecessor had a depreciable interest in the property at any time prior to such acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property. To determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to acquisition, the 2019 Final Regulations also provide that only the five calendar years immediately prior to the taxpayer's current placed-in-service year of the property are taken into account (Five-Year Safe Harbor). If the taxpayer and a predecessor have not been in existence for this entire five-year period, the 2019 Final Regulations provide that only the number of calendar years the taxpayer and the predecessor have been in existence are taken into account.[871]

Based on comments, the IRS noted that some clarifications were found to be required for this provision:

> In connection with comments received on the Five-Year Safe Harbor and the Partnership Lookthrough Rule, the Treasury Department and the IRS reviewed the Five-Year Safe Harbor and determined that clarification of this safe harbor would be beneficial. One commenter requested clarification of the Five-Year Safe Harbor as to: (1) whether the "placed-in-service year" is the taxable year or the calendar year; and (2) whether the portion of the calendar year covering the period up to the placed-in-service date of the property is taken into account. The commenter also requested clarification regarding the application of the Five-Year Safe Harbor to situations where the taxpayer or a predecessor was not in existence during the entire 5-year lookback period. Specifically, the commenter pointed out that the safe harbor in the 2019 Final Regulations could be read to apply only to those periods in the 5-year lookback period that both the taxpayer and a predecessor are in existence, and not to those periods in the 5-year lookback period during which the taxpayer or a predecessor, or both, were in existence and had a depreciable interest in the property later acquired and placed in service by the taxpayer. The commenter suggested that the Five-Year Safe Harbor be clarified to say that the taxpayer and each predecessor

[870] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, A. Property described in section 168(k)(9)(B)

[871] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, a. Five-year safe harbor

> is subject to a separate lookback period that begins no earlier than the date such person came into existence.
>
> The Treasury Department and the IRS intended the "placed-in-service year" to be the current calendar year in which the property is placed in service by the taxpayer. Also, the Treasury Department and the IRS intended the portion of that calendar year covering the period up to the placed-in-service date of the property to be considered in determining whether the taxpayer or a predecessor previously had a depreciable interest. This approach is consistent with an exception to the de minimis use rule in §1.168(k)-2(b)(3)(iii)(B)(4) of the 2019 Proposed Regulations, which is discussed in greater detail in part I.B.1.b of this Summary of Comments and Explanation of Revisions section. Pursuant to that exception, when a taxpayer places in service eligible property in Year 1, disposes of that property to an unrelated party in Year 1 within 90 calendar days of that placed-in-service date, and then reacquires the same property later in Year 1, the taxpayer is treated as having a prior depreciable interest in the property upon the taxpayer's reacquisition of the property in Year 1. This rule would be superfluous if the Five-Year Safe Harbor did not consider the portion of the calendar year covering the period up to the placed-in-service date of the property.
>
> Accordingly, §1.168(k)-2(b)(3)(iii)(B)(1) is amended to clarify that the five calendar years immediately prior to the current calendar year in which the property is placed in service by the taxpayer, and the portion of such current calendar year before the placed-in-service date of the property determined without taking into account the applicable convention, are taken into account to determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to acquisition (lookback period). Section 1.168(k)-2(b)(3)(iii)(B)(1) also is amended to adopt the suggestion of the commenter that each of the taxpayer and the predecessor be subject to a separate lookback period. These final regulations clarify that if the taxpayer or a predecessor, or both, have not been in existence during the entire lookback period, then only the portion of the lookback period during which the taxpayer or a predecessor, or both, have been in existence is taken into account to determine if the taxpayer or the predecessor had a depreciable interest in the property. More examples have been added to clarify the application of the Five-Year Safe Harbor.[872]

The revised portion of Reg. §1.168(k)-2(b)(3)(iii)(B)(1) reads as follows:

> … To determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to the acquisition, only the five calendar years immediately prior to the current calendar year in which the property is placed in service by the taxpayer, and the portion of such current calendar year before the placed-in-service date of the property without taking into account the applicable convention, are taken into account (lookback period). If either the taxpayer or a

[872] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, a. Five-year safe harbor

> predecessor, or both, have not been in existence for the entire lookback period, only the portion of the lookback period during which the taxpayer or a predecessor, or both, as applicable, have been in existence is taken into account to determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to the acquisition. …[873]

De Minimis Use

The Proposed Regulations provided a *de minimis* use exception to the prior use rule which is described as follows:

> Section 1.168(k)-2(b)(3)(iii)(B)(4) of the 2019 Proposed Regulations provides an exception to the prior depreciable interest rule in the 2019 Final Regulations when the taxpayer disposes of property to an unrelated party within 90 calendar days after the taxpayer originally placed such property in service (De Minimis Use Rule). The 2019 Proposed Regulations also provide that the De Minimis Use Rule does not apply if the taxpayer reacquires and again places in service the property during the same taxable year the taxpayer disposed of the property.[874]

The IRS notes that a commenter requested clarification on three situations regarding the *de minimis* use provision:

> A commenter on the 2019 Proposed Regulations asked for clarification regarding the application of the De Minimis Use Rule in the following situations:
>
> > (1) The taxpayer places in service property in Year 1, disposes of that property to an unrelated party in Year 1 within 90 calendar days of that original placed-in-service date, and then reacquires and again places in service the same property later in Year 1 and does not dispose of the property again in Year 1;
> >
> > (2) The taxpayer places in service property in Year 1, disposes of that property to an unrelated party in Year 2 within 90 calendar days of that original placed-in-service date, and then reacquires and again places in service the same property in Year 2 or later; and
> >
> > (3) The taxpayer places in service property in Year 1 and disposes of that property to an unrelated party in Year 1 within 90 calendar days of that original placed- in-service date, then the taxpayer reacquires and again places in service the same property later in Year 1 and disposes of that property to an unrelated party in Year 2 within 90 calendar days of the

[873] Reg. §1.168(k)-2(b)(3)(iii)(B)(1)

[874] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, b. De minimis use

> subsequent placed-in-service date in Year 1, and the taxpayer reacquires and again places in service the same property in Year 4.[875]

The IRS first addresses the disposition to an unrelated party and reacquisition in the same year, agreeing with the commenter's view of the proper treatment only if the property was initially acquired after September 27, 2017:

> In situation 1, the additional first year depreciation deduction is not allowable for the property when it was initially placed in service in Year 1 by the taxpayer pursuant to §1.168(k)-2(g)(1)(i) of the 2019 Final Regulations. The additional first year depreciation deduction also is not allowable when the same property is subsequently placed in service in Year 1 by the same taxpayer under the De Minimis Use Rule in the 2019 Proposed Regulations. The commenter asserted that the additional first year depreciation deduction should be allowable for the property when it is placed in service again in Year 1 and is not disposed of again in Year 1, because the additional first year depreciation deduction is not allowable for the property when it initially was placed in service in Year 1 by the taxpayer. The Treasury Department and the IRS agree with this comment if the property is originally acquired by the taxpayer after September 27, 2017. The Treasury Department and the IRS decline to adopt this comment with respect to property that was originally acquired by the taxpayer before September 28, 2017, as the exception to the De Minimis Use Rule was intended to prevent certain churning transactions involving such property. The Treasury Department and the IRS believe that property that is placed in service, disposed of, and reacquired in the same taxable year is more likely to be part of a predetermined churning plan.[876]

Next, the IRS looks into the situation where the property is still disposed of within 90 days, but the disposition is in the tax year following acquisition:

> In situation 2, the additional first year depreciation deduction is allowable for the same property by the same taxpayer twice (in Year 1 when the property is initially placed in service, and in Year 2 when the property is placed in service again). This result is consistent with the De Minimis Use Rule in the 2019 Proposed Regulations, and this result is not changed in these final regulations.[877]

[875] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, b. De minimis use

[876] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, b. De minimis use

[877] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, b. De minimis use

Finally, the IRS looks at the situation involving multiple dispositions of the same property, each within 90 days of an acquisition:

> In situation 3, the De Minimis Use Rule provides only one 90-day period that is disregarded in determining whether the taxpayer had a depreciable interest in the property prior to its reacquisition. That 90-day period is measured from the original placed-in-service date of the property by the taxpayer. As a result, the second 90-day period in situation 3 (during which the taxpayer reacquired the property in Year 1, again placed it in service in Year 1, and then disposed of it in Year 2) is taken into account in determining whether the taxpayer previously used the property when the taxpayer again places in service the property in Year 4.[878]

The IRS modified the *de minimis* use provision found at Reg. §1.168(k)-2(b)(3)(B)(4) to read as follows:

> (4) De minimis use of property. If a taxpayer acquires and places in service property, the taxpayer or a predecessor did not previously have a depreciable interest in the property, the taxpayer disposes of the property to an unrelated party within 90 calendar days after the date the property was originally placed in service by the taxpayer, without taking into account the applicable convention, and the taxpayer reacquires and again places in service the property, then the taxpayer's depreciable interest in the property during that 90-day period is not taken into account for determining whether the property was used by the taxpayer or a predecessor at any time prior to its reacquisition by the taxpayer under paragraphs (b)(3)(iii)(A)(1) and (b)(3)(iii)(B)(1) of this section. If the taxpayer originally acquired the property before September 28, 2017, as determined under §1.168(k)-1(b)(4), and the taxpayer reacquires and again places in service the property during the same taxable year the taxpayer disposed of the property to the unrelated party, then this paragraph (b)(3)(iii)(B)(4) does not apply. For purposes of this paragraph (b)(3)(iii)(B)(4), an unrelated party is a person not described in section 179(d)(2)(A) or (B), and §1.179-4(c)(1)(ii) or (iii), or (c)(2).[879]

Partnership Lookthrough Rule Withdrawn

The IRS has decided to withdraw the partnership lookthrough rule related to used property found in the Proposed Regulations. The IRS describes the now withdrawn rule as follows:

> The Partnership Lookthrough Rule provides that a person is treated as having a depreciable interest in a portion of property prior to the person's acquisition of the property if the person was a partner in a partnership at any time the partnership owned the property. The Partnership Lookthrough Rule further provides that the

[878] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used property, 1. Depreciable Interest, b. De minimis use

[879] Reg. §1.168(k)-2(b)(3)(iii)(B)(4)

> portion of property in which a partner is treated as having a depreciable interest is equal to the total share of depreciation deductions with respect to the property allocated to the partner as a percentage of the total depreciation deductions allocated to all partners during the current calendar year and the five calendar years immediately prior to the partnership's current year.[880]

The IRS then notes that a commenter pointed out that the rule would create significant complexity since even a minor interest in a partnership required a partner to look through the entity:

> One commenter requested that the Treasury Department and the IRS withdraw the Partnership Lookthrough Rule and replace it with a rule that treats a taxpayer as having a depreciable interest in an item of property only if the taxpayer was a controlling partner in a partnership at any time the partnership owned the property during the applicable lookback period.

The IRS determined this comment was appropriate and decided to withdraw the regulation.

> The Treasury Department and the IRS agree with the commenter that the Partnership Lookthrough Rule should be withdrawn. The Treasury Department and the IRS have determined that the complexity of applying the Partnership Lookthrough Rule would place a significant administrative burden on both taxpayers and the IRS. For this reason, these final regulations withdraw the Partnership Lookthrough Rule. Therefore, under these final regulations, a partner will not be treated as having a depreciable interest in partnership property solely by virtue of being a partner in the partnership. The Treasury Department and the IRS have determined that a replacement rule that applies only to controlling partners is not necessary because the related party rule in section 179(d)(2)(A) applies to a direct purchase of partnership property by a current majority partner, and the series of related transactions rules in §1.168(k)-2(b)(3)(iii)(C) prevents avoidance of the related party rule through the use of intermediary parties.[881]

Series of Related Transactions

The Proposed Regulations contained the following provision for a series of related transactions when dealing with the used property issue:

> Section 1.168(k)-2(b)(3)(iii)(C) of the 2019 Proposed Regulations provides special rules for a series of related transactions (Proposed Related Transactions Rule). The Proposed Related Transactions Rule generally provides that the relationship between the parties under section 179(d)(2)(A) or (B) in a series of related transactions is tested immediately after each step in the series, and between the original transferor and the ultimate transferee immediately after the last transaction in the series. The

[880] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, 2. Application to Partnerships

[881] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, 2. Application to Partnerships

> Proposed Related Transactions Rule also provides that the relationship between the parties in a series of related transactions is not tested in certain situations. For example, a party in the series that is neither the original transferor nor the ultimate transferee is disregarded in applying the relatedness test if the party placed in service and disposed of the property in the party's same taxable year or did not place the property in service. The relationship between the parties also is not tested if the step is a transaction described in §1.168(k)-2(g)(1)(iii) (that is, a transfer of property in a transaction described in section 168(i)(7) in the same taxable year that the property is placed in service by the transferor). Finally, the 2019 Proposed Regulations provide that the Proposed Related Transactions Rule does not apply to syndication transactions or when all transactions in the series are described in §1.168(k)-2(g)(1)(iii).[882]

While the IRS rejected some suggestions to modify the rule, it did agree that some modifications were necessary. The preamble provides:

> …[T]he Treasury Department and the IRS agree that the Proposed Related Transactions Rule should be simplified. The Treasury Department and the IRS also agree that this rule should be modified to take into account changes in the relationship between the parties, including a party ceasing to exist, over the course of a series of related transactions. For example, assume that, pursuant to a series of related transactions, A transfers property to B, B transfers property to C, and C transfers property to D. Under the Proposed Related Transactions Rule, relatedness is tested after each step and between D and A. Assume further that, at the beginning of the series, C was related to A but, prior to acquiring the property, C ceases to be related to A, or A ceases to exist. The Proposed Related Transactions Rule does not address how to treat such changes.[883]

Thus, the IRS makes the following three changes to the rule in the final regulations:

> Accordingly, these final regulations provide that each transferee in a series of related transactions tests its relationship under section 179(d)(2)(A) or (B) with the transferor from which the transferee directly acquires the depreciable property (immediate transferor) and with the original transferor of the depreciable property in the series. The transferee is treated as related to the immediate transferor or the original transferor if the relationship exists either immediately before the first transfer of the depreciable property in the series or when the transferee acquires the property. Any transferor in a series of related transactions that ceases to exist during the series is deemed to continue to exist for purposes of testing relatedness.
>
> These final regulations also provide a special rule that disregards certain transitory relationships created pursuant to a series of related transactions. More specifically, if

[882] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, 3. Series of Related Transactions

[883] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, 3. Series of Related Transactions

a party acquires depreciable property in a series of related transactions in which the acquiring party acquires stock, meeting the requirements of section 1504(a)(2), of a corporation in a fully taxable transaction, followed by a liquidation of the acquired corporation under section 331, any relationship created as part of such series of transactions is disregarded in determining whether any party is related to such acquired corporation for purposes of testing relatedness. This rule is similar to §1.197-2(h)(6)(iii) and properly reflects the change in ownership of depreciable property in a series of related transactions without taking into account certain transitory relationships the purpose of which is unrelated to the additional first year depreciation deduction.

> Finally, these final regulations provide that, if a transferee in a series of related transactions acquires depreciable property from a transferor that was not in existence immediately prior to the first transfer of the property in the series (new transferor), the transferee tests its relationship with the party from which the new transferor acquired the depreciable property. Examples illustrating these revised rules are provided in these final regulations.[884]

Qualified Improvement Property

Between the time the Proposed Regulations were issued in 2019 and the final regulations were issued in September of 2020 Congress passed the CARES Act. The CARES Act corrected a drafting error in the TCJA, making qualified improvement property eligible for bonus depreciation. This affects the definition of bonus property provided for in the regulations:

> Section 1.168(b)-1(a)(5) of the 2019 Final Regulations defines the term "qualified improvement property" for purposes of section 168. Section 168(e)(6), as amended by section 13204 of the TCJA, and §§1.168(b)-1(a)(5)(i)(A) and (ii) provide the definition of that term for improvements placed in service after December 31, 2017. Section 2307 of the CARES Act amended section 168(e)(3)(E), (e)(6), and (g)(3)(B). Section 2307(a)(1)(A) of the CARES Act added a new clause (vii) to the end of section 168(e)(3)(E) to provide that qualified improvement property is classified as 15-year property. Section 2307(a)(1)(B) of the CARES Act amended the definition of qualified improvement property in section 168(e)(6) by providing that the improvement must be "made by the taxpayer." In addition, section 2307(a)(2) of the CARES Act amended the table in section 168(g)(3)(B) to provide a recovery period of 20 years for qualified improvement property for purposes of the alternative depreciation system under section 168(g). These amendments to section 168(e) and (g) are effective as if included in section 13204 of the TCJA and, therefore, apply to property placed in service after December 31, 2017.[885]

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[884] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, I. Operational Rules, B. Used Property, 3. Series of Related Transactions

[885] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, B. Qualified Improvement Property

The IRS describes the changes made to the regulations as follows:

> As a result of these changes by section 2307 of the CARES Act, these final regulations amend §1.168(b)-1(a)(5)(i)(A) to provide that the improvement must be made by the taxpayer.[886]

The language of the final regulation provides:

> (A) For purposes of section 168(e)(6), the improvement is made by the taxpayer and is placed in service by the taxpayer after December 31, 2017;[887]

The preamble goes on to discuss what is meant by *made by the taxpayer*:

> The Treasury Department and the IRS are aware of questions regarding the meaning of "made by the taxpayer" with respect to third-party construction of the improvement and the acquisition of a building in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions) that includes an improvement previously made by, and placed in service by, the transferor or distributor of the building. In this regard, the Treasury Department and the IRS believe that an improvement is made by the taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract. In contrast, if a taxpayer acquires nonresidential real property in a taxable transaction and such nonresidential real property includes an improvement previously placed in service by the seller of such nonresidential real property, the improvement is not made by the taxpayer.[888]

The preamble also discusses how this rule impacts property acquired in a transaction described in a IRC §168(i)(7) described nonrecognition transaction (such as an incorporation subject to IRC §351 or a contribution to a partnership under IRC §721):

> Consistent with section 168(i)(7) (pertaining to treatment of transferees in certain nonrecognition transactions), the Treasury Department and the IRS also believe that if a transferee taxpayer acquires nonresidential real property in a transaction described in section 168(i)(7)(B) (for example, section 351 or 721), any improvement that was previously made by, and placed in service by, the transferor or distributor of such nonresidential real property and that is qualified improvement property in the hands of the transferor or distributor is treated as being made by the transferee taxpayer, and thus is qualified improvement property in the hands of the transferee taxpayer, but only for the portion of its basis in such property that does

[886] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, B. Qualified Improvement Property

[887] §1.168(b)-1(a)(5)(i)(A)

[888] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, B. Qualified Improvement Property

> not exceed the transferor's or distributor's adjusted depreciable basis of this property. However, because the basis is determined by reference to the transferor's or distributor's adjusted basis in the improvement, the transferee taxpayer's acquisition does not satisfy section 179(d)(2)(C) and §1.179-4(c)(1)(iv) and thus, does not satisfy the used property acquisition requirements of §1.168(k)-2(b)(3)(iii). Accordingly, the qualified improvement property is not eligible for the additional first year depreciation deduction in the hands of the transferee taxpayer.[889]

The following example was added to the final regulations to illustrate the treatment for qualified improvement property:

REG. §1.168(K)-2(B)(2)(III)(I), EXAMPLE 9

(1) G, a calendar-year taxpayer, owns an office building for use in its trade or business and G placed in service such building in 2000. In November 2018, G made and placed in service an improvement to the inside of such building at a cost of $100,000. In January 2019, G entered into a written contract with H for H to construct an improvement to the inside of the building. In March 2019, H completed construction of the improvement at a cost of $750,000 and G placed in service such improvement. Both improvements to the building are section 1250 property and are not described in §1.168(b)-1(a)(5)(ii).

(2) Both the improvement to the office building made by G in November 2018 and the improvement to the office building that was constructed by H for G in 2019 are improvements made by G under §1.168(b)-1(a)(5)(i)(A). Further, each improvement is made to the inside of the office building, is section 1250 property, and is not described in §1.168(b)-1(a)(5)(ii). As a result, each improvement meets the definition of qualified improvement property in section 168(e)(6) and §1.168(b)-1(a)(5)(i)(A) and (a)(5)(ii). Accordingly, each improvement is 15-year property under section 168(e)(3) and is described in §1.168(k)-2(b)(2)(i)(A). Assuming all other requirements of this section are met, each improvement made by G qualifies for the additional first year depreciation deduction for G under this section.[890]

Clarification of the Breadth of the Transferor/Predecessor Rule

In response to a comment, the IRS has revised the regulations to clarify limits on the application of the term "predecessor" for a transferor of an asset to another party. The preamble notes:

> Section 1.168(k)-2(a)(2)(iv)(B) of the 2019 Final Regulations defines a predecessor as including a transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor. A commenter requested clarification of whether this definition was intended to apply only with respect to the specific property transferred or more broadly. The Treasury Department and the IRS intended the definition of a "predecessor" in §1.168(k)-2(a)(2)(iv)(B) of the 2019 Final Regulations to be property-specific. Similarly, the Treasury Department and the IRS intended the definition of a "class of property" in §1.168(k)-2(f)(1)(ii)(G)

[889] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, B. Qualified Improvement Property

[890] REG. §1.168(K)-2(B)(2)(iii)(I)

of the 2019 Final Regulations (regarding basis adjustments in partnership assets under section 743(b)) to be partner-specific.[891]

To clarify the issue, the IRS made the following minor modifications to the regulations:

> Accordingly, these final regulations amend §1.168(k)-2(a)(2)(iv)(B) of the 2019 Final Regulations to substitute "the" for "an", and these final regulations amend §1.168(k)-2(f)(1)((ii)(G) of the 2019 Final Regulations to substitute "Each" for "A".[892]

The IRS also removed a predecessor provision involving trusts, determining it was duplicative:

> Pursuant to §1.168(k)-2(a)(2)(iv)(E) of the 2019 Final Regulations, a transferor of an asset to a trust is a predecessor with respect to the trust. The Treasury Department and the IRS intended that this provision apply only to transfers involving carryover basis. Because §1.168(k)-2(a)(2)(iv)(B) of the 2019 Final Regulations applies to such transfers, these final regulations remove §1.168(k)-2(a)(2)(iv)(E) of the 2019 Final Regulations.[893]

SECTION: 195
TAXPAYER'S BUSINESS HAD NOT YET COMMENCED, ALL EXPENSES CAPITALIZED

Citation: Provitola v. Commissioner, US Tax Court Bench Opinion, Nos. 12357-16 and 16168-17, 1/24/2020

The good news for the taxpayer in the case of *Provitola v. Commissioner*, US Tax Court Bench Opinion, Nos. 12357-16 and 16168-17 (2019)[894] was that the Court rejected the IRS arguments that their business related to a product to enhance television viewing was a sham. But that was more than offset by the bad news when the Court also found that the business had not yet commenced in the years in question, meaning all expenses were capitalized pursuant to IRC §195 until the year the business actually begins operations.

Mr. Provitola is an attorney who also holds a B.S. in physics. His law practice specializes in patent law and he is sole owner of the S corporation in which he practices. Around 2003 he had an idea to

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[891] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, C. Predecessor and class of property

[892] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, C. Predecessor and class of property

[893] TD 9916, Preamble, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, II. Definitions, C. Predecessor and class of property

[894] *Provitola v. Commissioner*, US Tax Court Bench Opinion, Nos. 12357-16 and 16168-17, January 24, 2020 (released January 27, 2020), https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=313587&Todays=Y (retrieved January 28, 2020)

enhance television viewing and began developing a product. Between 2005 and 2016 he was awarded seven patents that related to this product he was developing. [895]

The couple formed Viovision Ventures, LLC with Kathleen Provitola as the sole owner of the LLC in 2007. The LLC was formed to market any product that Mr. Provilota might end up developing based on his concept. The LLC sat dormant until 2013 when it was billed for five years of services by Mr. Provitola's law firm, such services including management, product development and product design. In late 2013, the couple wrote a check for $36,000 to capitalize the LLC and the LLC wrote a check to the law firm to pay that portion of the $60,000 in fees that had been billed. A similar set of transactions took place at the end of 2014. [896]

The payments were reported as income by the law firm, which had sufficient business expenses to offset almost all of the expenses. As well, they claimed current deductions on Schedule C for the payments made by the LLC. During this time period, and right up through the day the case was heard, the LLC had not received any revenue related to the product it hoped to develop. [897]

As the Court described the activities of the LLC to date:

> As of 2015, indeed, as of the time of trial, Viovision had not attempted to sell any products and has not generated any revenue or any profit. Approximately 1,000 product units were manufactured after the years in issue, but there has been no attempt to sell them. Viovision never had any employees, never had an office apart from the Provitolas' home, and never did any advertising or marketing. Viovision has developed a website, but that website has not been made public.[898]

The IRS initially argued that the payments were not actually made in the notice of deficiency, but at trial no longer pushed that position. As well, the notice of deficiency claimed the payments were not ordinary and necessary expenses under IRC §162.[899]

But at trial the IRS advanced two different arguments:

- The LLC was a sham and not a real business, only using the expenses to offset the couple's other income and
- If it is not a sham, then the business has not yet commenced operations and, as such, all expenses would have to be capitalized as start-up expenses under IRC §195.

While the opinion rejects the IRS's first position, it does find merit in the second.

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[895] *Provitola v. Commissioner*, pp. 3-4

[896] *Provitola v. Commissioner*, pp. 4-5

[897] *Provitola v. Commissioner*, pp. 5-6

[898] *Provitola v. Commissioner*, pp. 6-7

[899] *Provitola v. Commissioner*, pp. 8-9

The Court found that there was more than enough evidence that the LLC was not merely a legal fiction:

> The Commissioner argued at trial that Viovision, the Provitolas' LLC, is "merely a legal fiction". However, we will respect Viovision's form because it is engaged in activities with a business purpose. Mr. Provitola is currently working on inventing and bringing to market his television viewing product through Viovision. He has developed the product and obtained several patents in the process. Although it is unclear at this time whether the product will be commercially viable, approximately 1,000 units of the product have been manufactured with the hope of eventual sale. A website has been created for that purpose, although that website is not yet public. The Provitolas treated Viovision as a discrete entity; for example, Viovision maintains a separate bank account. Viovision is not a "sham or unreal" nor is it "a bald and mischievous fiction." Viovision exists to develop an bring to market Mr. Provitola's invention, and we will respect its existence. [900]

As well, if the LLC was a fiction, then so was the income that the law firm had reported on the S return—but the Court noted the IRS did not argue that this should be reversed:

> We note that the Commissioner's substance over form argument is inconsistent with the notice of deficiency. In the notice, the Commissioner disallowed the expenses taken by Viovision for the payment of legal and professional fees paid to APPA for lack of substantiation and because the expenses were not ordinary and necessary. Notably, the Commissioner did not make a corresponding adjustment to APPA to remove the income from the legal and professional fees. If the payments made by Viovision were mere circular payments without any substance, then the income to APPA would be disregarded along with the deduction by Viovision. This is not the position set forth in the notice of deficiency and it is not supported by the record. We will give due regard to the separate entities. [901]

However, the Court did find far more compelling the second argument the IRS made—that the expenses incurred by the LLC were start-up expenses that had to be capitalized under IRC §195.

IRC §195(a) requires a taxpayer to capitalize start-up expenditures. Such expenditures are defined by IRC §195(c)(1) as:

> (1) Start-up expenditures
>
> The term "start-up expenditure" means any amount—
>
> > (A) paid or incurred in connection with—
> >
> > > (i) investigating the creation or acquisition of an active trade or business, or

[900] *Provitola v. Commissioner*, pp. 11-12

[901] *Provitola v. Commissioner*, p. 12

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

The term "start-up expenditure" does not include any amount with respect to which a deduction is allowable under section 163(a), 164, or 174.

IRC §195(b) provides options to recover these costs, but commencing in "the taxable year in which the active trade or business begins" through amortization and/or expensing depending on the amounts incurred. Prior to that year, the amounts are capitalized and held for possible future deduction.

The Court looked at whether the LLC was in the start-up phase of the business or if it had actually begun as an active trade or business. The Court found a case it felt was relevant in the case of *McKelvey v. Commissioner*, TC Memo 2002-63:

> In *McKelvey v. Commissioner*, T.C. Memo. 2002-63, 83 T.C.M. (CCH) 1339, the petitioner decided to start a tree farm. In preparation for his business, the Petitioner studied the commercial viability of land, forest health, entomology, and risk control issues. After buying the land for his tree farming business, the Petitioner paid for a forest management plan and planted pine trees as a pilot test for his farm. At the time of filing his tax return claiming deductions, the petitioner had not yet commercially harvested the trees. *McKelvey v. Commissioner*, T.C. Memo. 2002-63, 83 T.C.M. (CCH) 1339, 1340. This Court held that petitioner "had not actually commenced the business activity of tree farming". *McKelvey v. Commissioner*, T.C. Memo. 2002-63, 83 T.C.M. (CCH) 1339, 1341.[902]

Like the tree farm in *McKelvey*, the opinion finds that the LLC's business had also not yet commenced:

> Viovision has not yet commenced an active trade or business. Like the petitioner in *McKelvey*, Viovision has taken significant steps to prepare for the business of selling Mr. Provitola's invention. Viovision has not yet attempted to market or sell a product. It has not made any sales, made its website public, or attempted to market a product. As in *McKelvey* where this Court did not consider the petitioner to be engaged in a trade or business before commercially harvesting his trees, Viovision

[902] *Provitola v. Commissioner*, pp.14-15

> has not yet engaged in a trade or business before attempting to market and sell a product.[903]

Interestingly, this leads to a less favorable result for the years before the Court for the taxpayers than if the Court had found the entire transaction to be a sham and ignored the entire set of transactions (both the expense on the Schedule C and the income on the S corporation return), as the opinion notes:

> Because Viovision's expenses are start-up expenses, the Provitolas may not deduct those expenses under section 162. However, they may capitalize these expenses under section 165(a) in the future. Because we respect the payments made by Viovision, the payments are still income to APPA.[904]

The taxpayers have to recognize the income currently for payments to the law firm on their return, but only get the possibility of a deduction at some point in the future for the expenses.

But what about the fact that the IRS had not argued this position in the notice of deficiency and only raised the issue at trial. The Court found that this was not a major problem in this case:

> We note that this outcome is consistent with the position set forth in the Commissioner's notice of deficiency, which disallowed the expenses claimed by Viovision but did not adjust the income to APPA. To the extent the Commissioner's start-up expenditures argument is a new matter, he would bear the burden of proof. Rule 142(a)(1). That burden, however, is easily satisfied; it is clear that Viovision is still in the start-up phase and not yet an active trade or business.[905]

SECTION 199A
2020 DRAFT INSTRUCTIONS REMOVE REFERENCE TO REDUCING QBI BY CHARITABLE CONTRIBUTIONS

Draft 2020 Form 8895 Instructions, 10/9/20

The IRS has issued a draft of the instructions[906] for Form 8995, *Qualified Business Income Deduction Simplified Computation*, for 2020, something that may not initially seem noteworthy. But it turns out that what is no longer found in the instructions may indicate an IRS change of view on the impact of charitable contributions on the calculation of qualified business income under IRC §199A.

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[903] *Provitola v. Commissioner*, p. 15

[904] *Provitola v. Commissioner*, p. 15

[905] *Provitola v. Commissioner*, p. 15

[906] Draft 2020 Form 8895 Instructions, October 9, 2020, IRS website, https://www.irs.gov/pub/irs-dft/i8995--dft.pdf (retrieved October 14, 2020)

Eric Yauch noted in an article published in *Tax Notes Today Federal* on October 14, 2020[907] that the revised instructions no longer contain a reference to, in at least some cases, reducing qualified business income (QBI) by charitable contributions.

The 2019 Form 8995 instructions provided, in part:

> Your QBI includes items of income, gain, deduction, and loss from your trades or businesses that are effectively connected with the conduct of a trade or business in the United States. This includes income from partnerships (other than PTPs), S corporations, sole proprietorships, certain estates and trusts that are included or allowed in figuring your taxable income for the year. To figure the total amount of QBI, you must consider all items that are related to the trade or business. This includes, but isn't limited to, *charitable contributions*, unreimbursed partnership expenses, business interest expense, deductible part of self-employment tax, self-employment health insurance deduction, and contributions to qualified retirement plans.[908] (emphasis added)

In the 2020 draft PDF of the instructions, the last sentence of that paragraph now reads:

> This includes, but isn't limited to, unreimbursed partnership expenses, business interest expense, deductible part of self-employment tax, self-employment health insurance deduction, and contributions to qualified retirement plans.[909]

Note that the reference to charitable contributions is now absent from this sentence.

As the *Tax Notes Today Federal* article notes in quotes from a number of tax professionals, many had been surprised when the reference to charitable contributions being used in computing QBI cropped up in various 2019 IRS instructions and had questioned whether, in fact, the implied position of the IRS could be supported under the law.

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[907] Eric Yauch, "Practitioners Rejoice at Subtle IRS Change on 199A Calculation," *Tax Notes Today Federal*, October 13, 2020, https://www.taxnotes.com/tax-notes-today-federal/exemptions-and-deductions/practitioners-rejoice-subtle-irs-change-199a-calculation/2020/10/14/2d26d (retrieved October 14, 2020, subscription required)

[908] 2019 Form 8995 Instructions, IRS website, https://www.irs.gov/instructions/i8995 (retrieved October 14, 2020)

[909] Draft 2020 Form 8895 Instructions, October 9, 2020, p. 2

SECTION: 274
FINAL REGULATIONS PUBLISHED FOR MEALS AND ENTERTAINMENT EXPENSES

Citation: TD 9925, 9/30/20

The Treasury Department has released final regulations[910] relating to the changes to IRC §274 made as part of the Tax Cuts and Jobs Act.[911]

The Tax Cuts and Jobs Act (TCJA) repealed the rule that allowed a deduction for entertainment expenses if the taxpayer established that:

- The entertainment was directly related to the active conduct of the taxpayer's trade or business (*directly related exception*), or
- In the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the item was associated with the active conduct of the taxpayer's trade or business (*business discussion exception*).

Thus, following the TCJA, no deductions are allowed for entertainment expenses unless they meet one of the exceptions found at IRC §274(e).

Initially many were concerned it was not clear that meals had not been included as part of entertainment, since in prior acts Congress had treated meals as a subset of entertainment. But the IRS indicated in the preliminary guidance given in Notice 2018-76 that the agency did not believe the law barred deductions for most meals. The preamble to the proposed regulations confirm this treatment, stating:

> While the TCJA eliminated the deduction for entertainment expenses, Congress did not amend the provisions relating to the deductibility of business meals. Thus, taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business, including meals consumed by employees on work travel. See H.R. Rep. No. 115-466, at 407 (2017) (Conf. Rep.). However, as before the TCJA, no deduction is allowed for the expense of any food or beverages unless (a) the expense is not lavish or extravagant under the circumstances, and (b) the taxpayer (or an employee of the taxpayer) is present at the furnishing of the food or beverages. See section 274(k).[912]

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[910] TD 9925, September 30, 2020, https://www.irs.gov/pub/irs-drop/td-9925.pdf (retrieved September 30, 2020)

[911] REG-100814-19, February 21, 2020, https://docs.google.com/document/d/1G5BQic54VUc4zqPqjYcvj-cqYzftVvvkIB0tkHnqPFQ/edit (retrieved February 21, 2020)

[912] REG-100814-19, February 21, 2020, p. 5

As well, the preamble to the proposed regulations confirmed what many had noticed—there was no longer anything left in §274 that required the strict substantiation provisions for meals other than those related to travel. As the preamble continues:

> Prior to amendment by the TCJA, section 274(d) provided substantiation requirements for deductions under section 162 or 212 for any traveling expense (including meals and lodging while away from home), and for any item with respect to an activity of a type considered to constitute entertainment, amusement, or recreation or with respect to a facility used in connection with such activity. Section 13304(a)(2)(A) of the TCJA repealed the substantiation requirements for entertainment expenditures. Traveling expenses (including meals and lodging while away from home), however, remain subject to the section 274(d) substantiation requirements. Food and beverage expenses are subject to the substantiation requirements under section 162 and the requirement to maintain books and records under section 6001.[913]

Note that this doesn't mean there is no substantiation required, but rather that the anti-*Cohan* rules of old IRC §274(d) no longer apply. So a taxpayer can now attempt to use the *Cohan* case to argue for a deduction for meals not related to travel even if there is minimal substantiation—but it is important to note that such attempts most often fail, due to a lack of evidence to enable a reasonable estimate for expenses in the past that have been eligible for the *Cohan* treatment.

The preamble to the proposed regulations also discussed the removal of the ability of employers to claim 100% of the amount paid for *de minimis* food and beverage fringes, instead subjecting them to the 50% disallowance rule of IRC §274(n)(2)(B). The preamble states:

> Prior to amendment by the TCJA, section 274(n)(1) generally limited the deduction for food or beverage expenses to 50 percent of the amount that otherwise would have been allowable, subject to an exception in section 274(n)(2)(B) in the case of an expense for food or beverages that is excludable from the gross income of the recipient under section 132 by reason of section 132(e), relating to de minimis fringes. Section 132(e)(1) defines "*de minimis* fringe" as any property or service the value of which is, after taking into account the frequency with which similar fringes are provided by the employer to its employees, so small as to make accounting for it unreasonable or administratively impracticable. Section 132(e)(2) provides that the operation by an employer of any eating facility for employees is treated as a *de minimis* fringe if (1) the facility is located on or near the business premises of the employer, and (2) revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. Thus, under prior law, employers generally were allowed to fully deduct an expense for food or beverages provided to their employees if the amount was excludable from the gross income of the employee as a de minimis fringe. However, the TCJA repealed section 274(n)(2)(B), meaning that expenses for food or beverages that are *de minimis fringes* under section 132(e) are no longer

[913] REG-100814-19, February 21, 2020, p. 5

> excepted from section 274(n)(1). As a result, these expenses, like other food or beverage expenses generally, are subject to the 50 percent limitation unless one of the six exceptions to section 274(n) in section 274(e) applies.[914]

Some meals are allowed in full based on the exceptions found in IRC §274(e). Specifically, the preamble notes the following exceptions to the 50% disallowance of amounts paid for meals:

- Expenses for goods, services, and facilities to the extent that the expenses are treated as compensation to the recipient.[915]
- Expenses incurred by a taxpayer in connection with the performance of services for an employer or other person under a reimbursement or other expense allowance arrangement.[916]
- Expenses for recreational, social, or similar activities for employees.[917]
- Expenses for goods, services, and facilities made available to the general public.[918]
- Expenses for goods or services that are sold by the taxpayer in a bona fide transaction for adequate and full consideration in money or money's worth.[919]
- Expenses for goods, services, and facilities to the extent that the expenses are treated as income to a person other than an employee.[920]

The final regulations add two new regulations under IRC §274. Those regulations would be:

- Reg. §1.274-11: Dealing with entertainment expenditures paid or incurred after December 31, 2017 and
- Reg. §1.274-12: Dealing with food or beverage expenses under IRC §274(k) and §274(n) paid or incurred after December 31, 2017, including the application of the various exceptions under IRC §274(e) and business meals described in Notice 2018-76, as well as other meals including travel meals and employer provided meals.[921]

Entertainment Expenditures (Reg. §1.274-11)

The basic issue here is simple—no deduction is allowed, except as provided for in IRC §274(e), for

[914] REG-100814-19, February 21, 2020, pp. 7-8
[915] IRC §274(e)(2)
[916] IRC §274(e)(3)
[917] IRC §247(e)(4)
[918] IRC §274(e)(7)
[919] IRC §274(e)(8)
[920] IRC §274(e)(9)
[921] TD 9925, September 30, 2020

- Any entertainment expenditure,
- Expenditures related to a facility used in connection with an entertainment activity (including dues or fees paid to any social, athletic or sporting club or organization); or
- Amounts paid or incurred for membership in any club organized for business, pleasure, recreation or other social purpose.[922]

But the question is what exactly do those terms mean? Reg. §1.274-11(b) provides specific definitions for various terms.

Entertainment

Obviously, a key term to define is that of *entertainment*. The regulation defines entertainment generally as:

> …any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family.[923]

The proposed regulation then goes on to describe three specific modifications to this definition:

- The described activities are treated as entertainment under this section, subject to the objective test, regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. Basically, you can't get around this rule by arguing the expenditure is otherwise an ordinary and necessary business expense, the broad rule applicable to most business expenses found at IRC §162. IRC §274 is a specific set of exceptions to the general rule found at IRC §162.
- The term *entertainment* may include an activity, the cost of which otherwise is a business expense of the taxpayer, which satisfies the personal, living, or family needs of any individual, such as a hotel suite or an automobile to a business customer or the customer's family. Thus, context is extremely important when evaluating an expenditure, not just the specific expenditure itself.
- Finally, the regulation limits the reach of *entertainment* by excluding activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as a hotel room maintained by an employer for lodging of employees while in business travel status or an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work.

[922] Reg. §1.274-11(a)

[923] Reg. §1.274-11(b)(1)(i)

But the regulation notes that the providing of a hotel room or an automobile by an employer to an employee who is on vacation would constitute entertainment of the employee.[924]

Food and Beverages

Food and beverages are not considered entertainment unless they are provided during or at an entertainment activity.[925] But even food provided during or at an entertainment activity may escape classification as entertainment. The regulation provides:

> …[I]n the case of food or beverages provided during or at an entertainment activity, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.[926]

The "separate billing" rule first appeared in Notice 2018-76 and that basic rule is repeated in the proposed regulation. To meet the separate billing requirement the regulation provides:

> The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue's usual selling cost for those items if they were to be purchased separately from the entertainment, or must approximate the reasonable value of those items. Unless the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation can be made and the entire amount is a nondeductible entertainment expenditure.[927]

Objective Test

Knowing that taxpayers and advisers would look long and hard for ways to claim their expenditure is different the IRS issues what the agency refers to as an *objective test*. Note that, in fact, the test is a subjective test, but one that the IRS is presumed to be correct in applying during an exam. The objective test provides:

> An objective test is used to determine whether an activity is of a type generally considered to be entertainment. Thus, if an activity is generally considered to be entertainment, it will be treated as entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments that entertainment means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer's trade or business is considered. Thus, although attending a theatrical performance generally

[924] Reg. §1.274-11(b)(1)(i)

[925] Reg. §1.274-11(b)(1)(ii)

[926] Reg. §1.274-11(b)(1)(ii)

[927] Reg. §1.274-11(b)(1)(ii)

would be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in a professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce its products to a group of store buyers, the show generally would not be considered entertainment. However, if an appliance distributor sponsors a fashion show, the fashion show generally would be considered to be entertainment.[928]

The regulation reminds the reader that the exceptions under IRC §274(e) override the bar on the deduction of entertainment expenses.

Examples

As with most regulations, the language of the regulation text only provides some clues about how the IRS is likely to approach specific situations. The examples that often accompany the regulations are important for the adviser to study to gain an insight in how the IRS expects to apply the specifics discussed in the regulations.

The four examples below apply the entertainment provisions of Reg. §1.274-11 to some situations encountered by taxpayers. In each of the examples neither the taxpayer nor the business associate is engaged in a trade or business that relates to the entertainment activity

EXAMPLE 1, REG. §1.274-11(D)(1) – A BASEBALL GAME

Taxpayer A invites, B, a business associate, to a baseball game to discuss a proposed business deal. A purchases tickets for A and B to attend the game. The baseball game is entertainment as defined in paragraph (b)(1) of this section and thus, the cost of the game tickets is an entertainment expenditure and is not deductible by A.

Now we modify the example to consider the case where the taxpayer buys hot dogs and drinks for himself and the associate once they are at the game:

EXAMPLE 2, REG. §1.274-11(D)(2) – THE HOT DOGS AND DRINKS

Assume the same facts as in paragraph (d)(1) of this section (Example 1), except that A also buys hot dogs and drinks for A and B from a concession stand. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expenditure and is not subject to the section 274(a)(1) disallowance. Therefore, A may deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game if they meet the requirements of section 162 and §1.274-12.

Now we look at the case where the taxpayer has access to a luxury suite for a basketball game where food and beverages are provided in a bundle covered by a single fee:

EXAMPLE 3, REG. §1.274-11(D)(3)-HOT DOGS AND DRINKS AT THE SUITE

Taxpayer C invites D, a business associate, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food or beverages. The basketball game is entertainment as defined in paragraph (b)(1) of this section and, thus, the cost of the game tickets is an entertainment expenditure

[928] Reg. §1.274-11(b)(1)(iii)

and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages is an entertainment expenditure that is subject to the section 274(a)(1) disallowance. Therefore, C may not deduct the cost of the tickets or the food and beverages associated with the basketball game.

The answer changes when the food and beverage are separately stated on the invoice.

EXAMPLE 4, REG. §1.274-11(D)(4), FOOD AND DRINKS SEPARATELY STATED ON INVOICE

Assume the same facts as in paragraph (d)(3) of this section (Example 3), except that the invoice for the basketball game tickets separately states the cost of the food and beverages and reflects the venue's usual selling price if purchased separately. As in paragraph (d)(3) (Example 3), the basketball game is entertainment as defined in paragraph (b)(1) of this section and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expenditure and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expenditure and is not subject to the section 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game if they meet the requirements of section 162 and §1.274-12.

Note that these four examples are essentially the same examples, with the same results, as were found in Notice 2018-76.

Food or Beverages (Reg. §1.274-12)

The existing regulations under §274 did not always clearly differentiate between entertainment and meals. Now that the IRS has determined that the law Congress enacted does actually treat meals differently than entertainment, a comprehensive regulation on food and beverages is required, found at Reg. §1.274-12.

This regulation also contains the explanations of the exceptions found at IRC §274(e) that impact food and beverages.

The regulation begins with three rules that must be met in order for any deduction to be allowed for the provision of food and beverages as part of a business meal:

- The expense is not lavish or extravagant under the circumstances;
- The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
- The food or beverages are provided to the taxpayer or a business associate.[929]

Unless a specific exception applies, only 50% of the amount expended for food and beverages will be allowed as a deduction.[930]

[929] Reg. §1.274-12(a)(1)

[930] Reg. §1.274-12(a)(2)

In the preamble to the final regulations, the IRS provides the following response to a commenter who asked if a sole proprietor can deduct the cost of meals when working throughout the day:

> As explained in the Background section of this preamble, section 274 limits or disallows deductions for certain meal and entertainment expenditures that otherwise would be allowable under chapter 1, primarily under section 162(a), which allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The requirements imposed by section 274 are in addition to the requirements for deductibility imposed by other provisions of the Code. If a taxpayer intends to claim a deduction for an expenditure for meals or entertainment, the taxpayer must first establish that the expenditure is otherwise allowable as a deduction under chapter 1 before the provisions of section 274 become applicable. Therefore, the sole proprietor must first establish that the food or beverage expense is deductible under chapter 1 before section 274 would apply. For example, if the sole proprietor can establish that the food or beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business, the sole proprietor may deduct 50 percent of the food or beverage expenses under section 274(k) and (n) and §1.274-12(a) of the final regulations if: (1) the expenses are not lavish or extravagant; (2) the sole proprietor, or an employee of the sole proprietor, is present at the furnishing of the food or beverages; and (3) the food or beverages are provided to the sole proprietor or a business associate (as defined in §1.274-12(b)(3)).[931]

The IRS provides four examples to illustrate these rules. In neither case were the expenditures lavish or extravagant under the circumstances and are otherwise assumed to be ordinary and necessary expenses under IRC §162.

The first example is the traditional lunch with a client or customer.

EXAMPLE 1, REG. §1.274-12(A)(3)(I), TAKING A CLIENT TO LUNCH

Taxpayer A takes client B out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, A may deduct 50 percent of the food or beverage expenses.

Similarly, a lunch with an employee for a business purpose is also fine.

EXAMPLE 2, REG. §1.274-12(A)(3)(II), EMPLOYEE' PERFORMANCE REVIEW

Taxpayer C takes employee D out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, C may deduct 50 percent of the food or beverage expenses..

[931] TD 9925, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, 2. Food or Beverage Expenses, A. Business Meal Expenses

The final two examples deal with the treatment of expenses for food and beverages provided to attendees at a business meeting.

EXAMPLE 3, REG. §1.274-12(A)(3)(II), BUSINESS MEETING WITH FOOD AND BEVERAGES PROVIDED

Taxpayer E holds a business meeting at a hotel during which food and beverages are provided to attendees. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses.

EXAMPLE 4, REG. §1.274-12(A)(3)(II), BUSINESS MEETING WITH FOOD AND BEVERAGES PROVIDED TO EMPLOYEES

The facts are the same as in Example 3, except that all the attendees of the meeting are employees of E. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses. The exception in section 274(e)(5) does not apply to food and beverage expenses under section 274(k) and (n).

Meals incurred while on travel will remain subject to the substantiation rules of IRC §274(d).[932] Since §274(d) applies, the taxpayer must have the following in order to claim a deduction for meals incurred while traveling:

- The amount of such expense or other item,
- The time and place of the travel or the date and description of the gift,
- The business purpose of the expense or other item, and
- The business relationship to the taxpayer of the person receiving the benefit.[933]

Travel meal expenses of a spouse, dependent or other individual accompanying the taxpayer are not allowed unless the following criteria are met:

- The spouse, dependent, or other individual is an employee of the taxpayer;
- The travel of the spouse, dependent, or other individual is for a bona fide business purpose of the taxpayer; and
- The expenses would otherwise be deductible by the spouse, dependent or other individual.[934]

Although not officially labeled as an example, the IRS provides the following illustration of the application of the accompanying individual provision.

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[932] Reg. §1.274-12(a)(4)

[933] IRC §274(d)

[934] Reg. §1.274-12(a)(4)(a)(iii)

ILLUSTRATION, REG. §1.274-12(A)(4)(III)(D), TRAVEL WITH SPOUSE

Taxpayer E and Taxpayer E's spouse travel from New York to Boston to attend a series of business meetings. E's spouse is not an employee of E, does not travel to Boston for a bona fide business purpose of E, and the expenses would not otherwise be deductible. While in Boston, E and E's spouse go out to dinner. Under section 274(m)(3) and paragraph (a)(4)(iii) of this section, the expenses associated with the food and beverages consumed by E's spouse are not deductible. Therefore, the cost of E's spouse's dinner is not deductible. E may deduct 50 percent of the expense associated with the food and beverages E consumed while on business travel if E meets the requirements in sections 162 and 274, including section 274(k) and (d).

Food or Beverage

The regulations provide the following definition of a food or beverage:

> Food or beverages means all food and beverage items, regardless of whether characterized as meals, snacks, or other types of food and beverages, and regardless of whether the food and beverages are treated as de minimis fringes under section 132(e).[935]

Food or beverage expenditures are also defined in the regulation:

> Food or beverage expenses mean the full cost of food or beverages, including any delivery fees, tips, and sales tax. In the case of employer-provided meals furnished at an eating facility on the employer's business premises, food or beverage expenses do not include expenses for the operation of the eating facility such as salaries of employees preparing and serving meals, and other overhead costs.[936]

People at the Meal or for the Exceptions

The proposed regulation also looks at definitions for those who need to be at the meal to be deductible or to qualify for one of the exceptions under IRC §274(e).

The first definition is that of a *business associate*:

> Business associate means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.[937]

[935] Reg. §1.274-12(b)(1)

[936] Reg. §1.274-12(b)(2)

[937] Reg. §1.274-12(b)(3)

Next up is the definition of an *independent contractor*:

> For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, independent contractor means a person who is not an employee of the payor.[938]

The definition of a *client or customer* is as follows:

> For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, client or customer means a person who receives services from an independent contractor and enters into a reimbursement or other expense allowance arrangement with the independent contractor.[939]

The *payor* is defined as:

> For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, payor means a person that enters into a reimbursement or other expense allowance arrangement with an employee and may include an employer, its agent, or a third party.[940]

The *general public* is defined as:

> For purposes of paragraph (c)(2)(iv) of this section, the general public includes, but is not limited to, customers, clients, and visitors. The general public does not include employees, partners or independent contractors of the taxpayer. Also, an exclusive list of guests is not the general public.

Reimbursement Arrangement

For some of the exceptions, a reimbursement arrangement is involved. The IRS defines a reimbursement arrangement as follows:

- An arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (the employer, its agent, or a third party) for expenses the employee pays or incurs; and

[938] Reg. §1.274-12(b)(4)

[939] Reg. §1.274-12(b)(5)

[940] Reg. §1.274-12(b)(6)

- An arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs if either--

  – A written agreement between the parties expressly states that the client or customer will reimburse the independent contractor for expenses that are subject to the limitations on deductions in paragraph (a) of this section; or

  – A written agreement between the parties expressly identifies the party subject to the limitations.[941]

§274(e) Exceptions for Food and Beverages

The regulation concludes with guidance on the various exceptions to the general rules found in IRC §274(e).

Expenses Treated as Compensation

One option to avoid the 50% limit is to treat food and beverage as compensation to the employee. This includes items that involve the special requirements for meals while traveling. This exception is available if the expense is treated by the taxpayer:

- On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and

- As wages to the employee for purposes of withholding under chapter 24 of the Code, relating to collection of income tax at source on wages.[942]

The compensation rule can apply to independent contractors in addition to employees, but an additional restriction applies. The amount in question must be included in a Form 1099 issued to the contractor if the contractor is one to whom a 1099 would be required to issued. For this purpose, the Form 1099 must be issued even if the Form 1099 wouldn't be required to be issued because the amounts are less than $600. However, if other rules eliminate the need to file it (such as the payee is a corporation), then not issuing a Form 1099 is not fatal to the deduction.[943]

In the preamble to the proposed regulations the IRS indicated that they were providing examples to deal with specific fact patterns that some commentators had raised concerns about.[944] Thus, advisers who have situations such as those addressed in the regulation's examples need to pay close attention to these examples.

The first pair of examples are found in this area where the amounts are included as compensation.

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[941] Reg. §1.274-12(b)(7)

[942] Reg. §1.274-12(c)(2)

[943] Reg. §1.274-12(c)(2)(ii)(B)

[944] REG-100814-19, February 21, 2020, p. 15

The first example deals with the provision of food to employees at a company cafeteria where the employer treats the meals as compensation and thus preserves a full deduction for the expense.

EXAMPLE 1, REG. §1.274-12(C)(2)(D)(1), CAFETERIA FOOD IN THE PAYCHECK

Employer F provides food and beverages to its employees without charge at a company cafeteria on its premises. The food and beverages do not meet the definition of a *de minimis fringe* under section 132(e). F treats the food and beverage expenses as compensation and wages, and determines the amount of the inclusion under §1.61-21. Under section 274(e)(2) and paragraph (c)(2)(i) of this section, the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitations in paragraph (a) of this section. Thus, F may deduct 100 percent of the food and beverage expenses.

But the next example notes that if the meals are excluded from the employee's wages under IRC §119 because they are provided for the convenience of the employer, the employer will have to reduce the deduction by 50% of the expense incurred.

EXAMPLE 2, REG. §1.274-12(C)(2)(D)(2), MEALS EXCLUDED FROM WAGES

Employer G provides meals to its employees without charge. The meals are properly excluded from the employees' income under section 119 as meals provided for the convenience of the employer. Under §1.61-21(b)(1), an employee must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount, if any, paid for the benefit by or on behalf of the recipient, and the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Code. Because the entire value of the employees' meals is excluded from the employees' income under section 119, the fair market value of the fringe benefit does not exceed the amount excluded from gross income under subtitle A of the Code, so there is nothing to be included in the employees' income under §1.61-21. Thus, the exception in section 274(e)(2) and paragraph (c)(2)(i) of this section does not apply and G may only deduct 50 percent of the expenses for the food and beverages provided to employees.

Reimbursed Expenses

If the service recipient is reimbursing the business related meals expenses of the service provider, one or the other party (but not both) is going to have to bear the burden of the 50% deduction disallowance.[945]

If the reimbursement arrangement involves an employee, the regulation provides:

- The disallowance applies to the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid to the employee and treats the amount as wages subject to withholding. Note that due to the disallowance of deductions for miscellaneous itemized deductions found in IRC §67(g) that was added by TCJA, in reality the employee will most often get no deduction for the meals expense.

[945] Reg. §1.274-12(c)(2)(ii)(A)

- The disallowance applies to the payor if the amount is not treated as wages by the payor. However, if the payor itself is reimbursed by a customer for those meals, then we look to the rules for reimbursing persons that are not employees discussed next.[946]

If the reimbursement occurs to a nonemployee, such as in the case of a payment to an independent contractor, the limits apply to the party specified in the agreement as bearing the burden of the loss of the deduction, assuming such a designation is made in the contract or other arrangement.[947] If the agreement does not provide a designation, the deduction limit applies to:

- The independent contractor if the contractor does not account to the client or customer the amounts paid as such accounting is defined under the anti-*Cohan* rules of IRC §274(d).

- The client or customer if such an accounting is provided by the independent contractor. Such accounting will generally occur by separately stating the billing for the food and providing documentation of the same.[948]

The IRS provides four examples dealing with the reimbursement rules.

EXAMPLE 1, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT

Employee I performs services under an arrangement in which J, an employee leasing company, pays I a per diem allowance of $10x for each day that I performs services for J's client, K, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food or beverages that I pays in performing services as an employee. J enters into a written agreement with K under which K agrees to reimburse J for any substantiated reimbursements for travel expenses, including meal expenses, that J pays to I. The agreement does not expressly identify the party that is subject to the limitations on deductions in paragraph (a) of this section. I performs services for K while traveling away from home for 10 days and provides J with substantiation that satisfies the requirements of section 274(d) of $100x of meal expenses incurred by I while traveling away from home. J pays I $100x to reimburse those expenses pursuant to their arrangement. J delivers a copy of I's substantiation to K. K pays J $300x, which includes $200x compensation for services and $100x as reimbursement of J's payment of I's travel expenses for meals. Neither J nor K treats the $100x paid to I as compensation or wages.

Under paragraph (b)(7)(i) of this section, I and J have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(B)(1) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Instead, under paragraph (c)(2)(ii)(B)(2) of this section, J, the payor, is subject to limitations on deductions in paragraph (a) of this section unless J can meet the requirements of section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section.

Because the agreement between J and K expressly states that K will reimburse J for substantiated reimbursements for travel expenses that J pays to I, under paragraph (b)(7)(ii)(A) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. J accounts to K for K's reimbursement in the manner required by section 274(d) by delivering to K a copy of the substantiation J received from I. Therefore, under section 274(e)(3)(B) and

[946] Reg. §1.274-12(c)(2)(ii)(B)

[947] Reg. §1.274-12(c)(2)(ii)(C)

[948] Reg. §1.274-12(c)(2)(ii)(C) and (D)

paragraph (c)(2)(ii)(C)(2) of this section, K and not J is subject to the deduction limitations in paragraph (a) of this section.

The IRS then changes this employee leasing example slightly. The employee now accounts for the meals expense to the customer of the leasing company, and that customer then pays the reimbursement.

EXAMPLE 2, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT BY CUSTOMER DIRECTLY TO EMPLOYEE

The facts are the same as Example 1 except that, under the arrangements between I and J and between J and K, I provides the substantiation of the expenses directly to K, and K pays the per diem directly to I.

Under paragraph (b)(7)(i) of this section, I and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because I substantiates directly to K and the reimbursement payment was not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(C)(1) of this section I is not subject to the limitations on deductions in paragraph (a) of this section. Under paragraph (c)(2)(ii)(C)(2) of this section, K, the payor, is subject to the limitations on deductions in paragraph (a) of this section.

Now the IRS modifies the example to provide that limits apply to the employee leasing company.

EXAMPLE 3, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT COVERED BY AGREEMENT

The facts are the same as in Example 1 except that the written agreement between J and K expressly provides that the limitations of this section will apply to K.

Under paragraph (b)(7)(ii)(B) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because the agreement provides that the 274 deduction limitations apply to K, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section, K and not J is subject to the limitations on deductions in paragraph (a) of this section.

The final example looks at the case where there is no agreement to reimburse expenses.

EXAMPLE 4, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT COVERED BY AGREEMENT

The facts are the same as in Example 1 except that the agreement between J and K does not provide that K will reimburse J for travel expenses.

The arrangement between J and K is not a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3)(B) and paragraph (b)(7)(ii) of this section. Therefore, even though J accounts to K for the expenses, J is subject to the limitations on deductions in paragraph (a) of this section.

Note that without an agreement that the contractor will be reimbursed for covered expenses, even with an accounting the contractor will be stuck with the 50% disallowance.

Recreational Expenses for Employees

Expenses paid for food or beverages by a taxpayer for recreational, social or similar activities primarily for the benefit of employees is not subject to the 50% disallowance. However, special rules apply to the extent that some of the employees being provided the food are highly compensated employees.[949]

The regulation provides that it applies to "expenses paid or incurred for events such as holiday parties, annual picnics, or summer outings."[950] However, it cannot be used to cover expenses that are excluded from the employees' wages because they actually represent meals paid for the convenience of the employer per IRC §119. [951]

The exclusion only applies to food or beverages made primarily for the benefit of employees other than the following highly compensated employees:

- Officers;
- Shareholders or other owners who own a 10% or greater interest in the business (counting interests owned by members of the family within the meaning of IRC §267(c)(4) as owned by that person); or
- Other highly compensated employees.[952]

This does not mean this "tainted group" cannot attend the function in question, but rather that the function must be primarily for the benefit of the rank and file. As the proposed regulation notes:

> An expense for food or beverages is not to be considered outside of the exception of this paragraph (c)(2)(iii) merely because, due to the large number of employees involved, the provision of food or beverages is intended to benefit only a limited number of employees at one time, provided the provision of food or beverages does not discriminate in favor of officers, shareholders, other owners, or highly compensated employees. [953]

The IRS gives five examples of the recreational expense exception.

EXAMPLE 1, REG. §1.274-13(C)(2)(III)(C), HOLIDAY PARTY AT A HOTEL

Employer L invites all employees to a holiday party in a hotel ballroom that includes a buffet dinner and an open bar. Under section 274(e)(4), this paragraph (c)(2)(iii), and §1.274-11(c), the cost of the party, including food and beverage expenses, is not subject to the deduction limitations in paragraph (a) of this section because the holiday party is a recreational, social, or similar activity primarily for the benefit of non-highly compensated employees. Thus, L may deduct 100 percent of the cost of the party.

[949] Reg. §1.274-13(c)(2)(iii)(A)

[950] Reg. §1.274-13(c)(2)(iii)(A)

[951] Reg. §1.274-13(c)(2)(iii)(A)

[952] Reg. §1.274-13(c)(2)(iii)(B)

[953] Reg. §1.274-13(c)(2)(iii)(B)

The fact that the party did not discriminate in favor of the highly compensated employees was key in having this program qualify for a full deduction. Contrast the result with that in the second IRS example.

EXAMPLE 2, REG. §1.274-13(C)(2)(III)(C), HOLDING PARTY FOR HIGHLY COMPENSATED EMPLOYEES ONLY WITH FOOD SEPARATELY INVOICED

The facts are the same as in Example 1 except that Employer L invites only highly-compensated employees to the holiday party, and the invoice provided by the hotel lists the costs for food and beverages separately from the cost of the rental of the ballroom. The costs reflect the venue's usual selling price for food or beverages. The exception in this paragraph (c)(2)(iii) does not apply because L invited only highly-compensated employees to the holiday party. However, under §1.274-11(b)(1)(ii), the food and beverage expenses are not treated as entertainment. L may deduct 50 percent of the food and beverage costs that are separately stated on the invoice under paragraph (a)(2) of this section.

The IRS next moves on to snacks in the break room—and the IRS decides those foods will be subject to the 50% limitation.

EXAMPLE 3, REG. §1.274-13(C)(2)(III)(C), SNACKS IN THE BREAK ROOM

Employer M provides free coffee, soda, bottled water, chips, donuts, and other snacks in a break room available to all employees. The expenses associated with the food and beverages are subject to the deduction limitations in paragraph (a) of this section because the break room is not a recreational, social, or similar activity primarily for the benefit of the employees. Thus, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply and M may only deduct 50 percent of the expenses for food and beverages provided in the break room.

As well, if there is a job related reason to provide the food and drink for the convenience of the employer, the full 50% disallowance will apply.

EXAMPLE 4, REG. §1.274-13(C)(2)(III)(C), MEALS FURNISHED TO KEEP EMPLOYEES ON SITE

Employer N has a written policy that employees in a certain medical services-related position must be available for emergency calls due to the nature of the position that requires frequent emergency response. Because these emergencies can and do occur during meal periods, N furnishes food and beverages to employees in this position without charge in a cafeteria on N's premises. N excludes food and beverage expenses from the employees' income as meals provided for the convenience of the employer excludable under section 119. Because these food and beverages are furnished for the employer's convenience, and therefore are not primarily for the benefit of the employees, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even if some socializing related to the food and beverages provided occurs. Thus, N may only deduct 50 percent of the expenses for food and beverages provided to employees in the cafeteria.

Similarly, the IRS decides that this exception can't be combined with a business meal even if a social celebration takes place with the employee during that meal.

EXAMPLE 5, REG. §1.274-13(C)(2)(III)(C), BIRTHDAY DESERT AT A BUSINESS MEAL

Employer O invites an employee and a client to dinner at a restaurant. Because it is the birthday of the employee, O orders a special dessert in celebration. Because the meal is a business meal, and therefore not primarily for the benefit of the employee, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even though an employee social activity in the form of a birthday celebration occurred during the meal. Thus, O may only deduct 50 percent of the meal expenses.

The last two examples likely were added to make clear the IRS is not inclined to be very tolerant about "creative" attempts to expand the recreational rule to cover other situations as taxpayers attempt to get a full deduction. The event must be purely recreational in nature, not "maybe" recreational (if there was no medical emergency during the meal) or partially recreational (the birthday cake at the end of the business meal).

Food or Beverage Made Available to the Public

If the food or beverage is made available to the general public, then the 50% disallowance of the deduction does not apply to the expenditure. This is true even if that food or beverage is also available to employees of the employer, so long as the same types of food or beverages are provided to and primarily consumed by the general public.[954]

The IRS provides four examples of what constitutes such items available to the general public.

EXAMPLE 1, REG. §1.274-12(C)(2)(IV)(B), OPEN HOUSE OF REAL ESTATE AGENT

Employer P is a real estate agent and provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by P's employees, potential buyers of the property, and other real estate agents. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations in paragraph (a) of this section if over 50 percent of the food and beverages are primarily consumed by potential buyers and other real estate agents. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

The last sentence of the example is a key one—the taxpayer must show the food and beverages were primarily consumed by the general public (in this case, other real estate agents and potential buyers), rather than by the employees of the employer.

The same caveat is repeated in the second example, this one involving an automotive service center waiting room.

EXAMPLE 2, REG. §1.274-12(C)(2)(IV)(B), AUTO REPAIR WAITING AREA

Employer Q is an automobile service center and provides refreshments in its waiting area. The refreshments are consumed by Q's employees and customers. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations provided for in paragraph (a) of this section if over 50 percent of the food and beverages are primarily consumed by customers. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

[954] Reg. §1.274-12(c)(2)(iv)(A)

The next example deals with meals provided at a summer camp.

EXAMPLE 3, REG. §1.274-12(C)(2)(IV)(B), SUMMER CAMP

Employer R operates a summer camp open to the general public for children and provides breakfast and lunch, as part of the fee to attend camp, both to camp counselors, who are employees, and to camp attendees, who are customers. There are 20 camp counselors and 100 camp attendees. The same type of meal is available to each counselor and attendee, and attendees consume more than 50 percent of the food and beverages. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the food and beverages are not subject to the deduction limitations in paragraph (a) of this section, because over 50 percent of the food and beverages are primarily consumed by camp attendees. Thus, R may deduct 100 percent of the food and beverage expenses.

Note that the customers are treated as the general public in this case, though with the caveat that the camp is open to the general public. That suggests that there might be a point where restrictions on who could be a customer might lead to not treating customers as the general public.

As well, the example explicitly provides for a greater than 50% consumption test to determine if the food and beverages are primarily consumed by the general public. The next example emphasizes that the opposite is true—if more than 50% is consumed by employees, this exception won't work.

EXAMPLE 4, REG. §1.274-12(C)(2)(IV)(B), COMPANY CAFETERIA

Employer S provides food and beverages to its employees without charge at a company cafeteria on its premises. Occasionally, customers or other visitors also eat without charge in the cafeteria. The occasional consumption of food and beverages at the company cafeteria by customers and visitors is less than 50 percent of the total amount of food and beverages consumed at the cafeteria. Therefore, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

Goods or Services Sold to Customers

Food and beverages purchased for eventual sale to customers generally are also exempted from the 50% disallowance of a deduction. But the transaction must be one for adequate and full consideration in money or money's worth.[955]

The regulation provides that if a transaction fails that test, it will not qualify, stating:

> However, money or money's worth does not include payment through services provided. Under this paragraph (c)(2)(v), a restaurant or catering business may deduct 100 percent of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are also consumed at the worksite by employees who work in the employer's restaurant or catering business. In addition, for purposes of this paragraph (c)(2)(v), the term customer includes anyone, including an employee of the taxpayer, who is sold food

[955] Reg. §1.274-12(c)

or beverages in a bona fide transaction for an adequate and full consideration in money or money's worth. [956]

The IRS provides the following single example for this provision.

EXAMPLE, REG. §1.274-12(C)(2)(V)(B), RESTAURANT

Employer T operates a restaurant. T provides food and beverages to its food service employees before, during, and after their shifts for no consideration. Under section 274(e)(8) and this paragraph (c)(2)(v), the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitation in paragraph (a) of this section because the restaurant sells food and beverages to customers in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, T may deduct 100 percent of the food and beverage expenses.

Effective Date

These regulations are proposed to apply to taxable years that begin on or after the date of their publication as final regulations. However, prior to the issuance of the final regulations, taxpayers can rely on these regulations for expenses incurred after December 31, 2017. As well, until the regulations are finalized, taxpayers can continue to rely on Notice 2018-76.[957]

SECTION: 274
REMEMBER THE PARKING LOT TAX? IRS ISSUES PROPOSED REGULATIONS ON POST-TCJA QUALIFIED TRANSPORTATION EXPENSES

Citation: REG-119307-19, 6/19/20

The IRS has returned to the issue of qualified transportation fringes, including more detailed guidance on the implementation of the "parking lot tax," in proposed regulations.[958] The parking lot tax portion of the regulations build on the safe harbor calculation the IRS provided in Notice 2018-99, adding two additional simplified computations for disallowed parking costs.

The regulations cover any *qualified transportation fringe* which is defined as any of the following:

- Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment (as described in sections 132(f)(1)(A) and 132(f)(5)(B));

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[956] Reg. §1.274-12(c)

[957] REG-100814-19, February 21, 2020, p. 22

[958] REG-119307-19, June 19, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-13506.pdf?utm_medium=email&utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov (retrieved June 19, 2020)

- Any transit pass (as described in sections 132(f)(1)(B) and 132(f)(5)(A)); or
- Qualified parking (as described in sections 132(f)(1)(C) and 132(f)(5)(C))[959]

Under §274(a)(4), enacted as part of the Tax Cuts and Jobs Act, no income tax deduction is allowed "for the expense of any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer."

Determining the amount of the denied expense deduction is the purpose of these proposed regulations. Proposed Reg. §1.274-13 deals primarily with qualified parking expenses, while Proposed Reg. §1.274-14 deals with other transportation and commuting expenses.

Effective Date

Although these regulations would only mandatorily apply to taxable years beginning on or after the date the rules are published as final in the *Federal Register*, the preamble provides that, pending issuance of final regulations:

> … a taxpayer may rely on these proposed regulations for QTF expenses and transportation and commuting expenses, as applicable, that are paid or incurred in taxable years beginning after December 31, 2017. Alternatively, a taxpayer may choose to rely on the guidance in Notice 2018-99 until these proposed regulations are finalized.[960]

Definitions

The proposed regulations start with the following key definitions that apply generally for parking QTFs, with key portions highlighted:

- **Employee** - The term employee means a common law employee or other statutory employee, such as an officer of a corporation, who is currently employed by the taxpayer. *Partners, 2-percent shareholders of S corporations, sole proprietors, and independent contractors are not employees of the taxpayer for purposes of this section.*[961]
- **Parking facility** - The term parking facility includes indoor and outdoor garages and other structures, as well as parking lots and other areas, where a taxpayer provides qualified parking to one or more of its employees. The term parking facility may include one or more parking facilities but does not include parking spaces on or near property used by an employee for residential purposes.[962]
- **Total parking expenses** - The term total parking expenses means all expenses of the taxpayer related to total parking spaces in a parking facility including, but not limited to, repairs,

[959] Proposed Reg. §1.274-13(b)(1)

[960] Preamble to REG-119307-19, SUPPLEMENTARY INFORMATION, Proposed Applicability Date

[961] Proposed Reg. §1.274-13(b)(2)

[962] Proposed Reg. §1.274-13(b)(4)

maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a *portion of a rent or lease payment (if not broken out separately). A deduction for an allowance for depreciation on a parking facility owned by a taxpayer and used for parking by the taxpayer's employees is an allowance for the exhaustion, wear and tear, and obsolescence of property, and not included in total parking expenses for purposes of this section.* Expenses paid or incurred for nonparking facility property, including items related to property next to the parking facility, such as landscaping or lighting, also are not included in total parking expenses.[963]

Qualified Transportation Fringe (QTF) Parking Expenses General Special Rules

Either or both of the following special rules can be used when computing total parking expenses and total parking spaces under either the *Primary Use Methodology* or *Cost per Space Methodology* for computing disallowed QTF parking expenses under IRC §274(e). The aggregation of spaces by geographic location special rule can also be used under the *General Rule* for computing disallowed QTF parking expense.[964]

Calculation of Mixed Parking Expenses

One of the key questions that often came up when dealing with the safe harbor found in Notice 2018-99 was how a taxpayer was supposed to separate out costs that weren't separately stated when leasing a building with a parking lot, or the taxpayer simply owned the building and parking lot and paid various expenses related to the overall property.

The term *mixed parking expense* means a single expense amount paid or incurred by a taxpayer that includes both parking facility and nonparking facility expenses for a property that a taxpayer owns or leases.[965]

The proposed regulations provide two options for determining how much of the mixed costs represent the parking facility's portion of the mixed facility expenses:

- A taxpayer may use a reasonable methodology to allocate the applicable portion of mixed parking expenses to a parking facility.
- A taxpayer may choose to allocate 5 percent of the following mixed parking expenses to a parking facility:
  - Lease or rental agreement expenses,
  - Property taxes,

[963] Proposed Reg. §1.274-13(b)(12)

[964] Proposed Reg. §1.274-13(c)

[965] Proposed Reg. §1.274-13(b)(13)

– Interest expense, and

– Expenses for utilities and insurance.[966]

The second method is simple to use and likely will be what many taxpayers gravitate to, since the overall impact may not be material. However, a taxpayer can use another method so long as it is reasonable.

Aggregation of Spaces for Multiple Facilities in a Single Geographic Location

If two parking facilities meet the test described below for being located in a single *geographic location*, a taxpayer may aggregate the number of spaces in those facilities for purposes of calculating the disallowance of deductions for QTF parking expenses.[967]

The term geographic location means contiguous tracts or parcels of land owned or leased by the taxpayer. Two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.[968]

The proposed regulations provide:

> For example, parking spaces at an office park or an industrial complex in the geographic location may be aggregated. However, a taxpayer may not aggregate parking spaces in parking facilities that are in different geographic locations.[969]

Methods for Calculating Disallowed QTF Parking Expenses

The proposed regulations provide five different methods for computing the disallowed portion of QTF parking expenses:

- A method that must be used if the taxpayer pays a third party for the parking QTF

- Four methods from which a taxpayer may select if the taxpayer owns or leases a parking facility at which it provides the parking QTF:

  – General rule;

  – Qualified parking limit methodology;

  – Primary use methodology (very similar to the Notice 2018-99 safe harbor method);

[966] Proposed Reg. §1.274-13(c)(1)

[967] Proposed Reg. §1.274-13(c)(2)

[968] Proposed Reg. §1.274-13(b)(5)

[969] Proposed Reg. §1.274-13(c)(2)

– Cost per space methodology.[970]

If the taxpayer owns or leases parking facilities, the taxpayer can select the general rule or any of the other methodologies for each taxable year and for each parking facility.[971]

Third-Party Paid for Parking QTF

If the employer pays a third party for the parking QTF (such as paying for use of spaces by employees in a public parking garage), the disallowance "generally is calculated as the taxpayer's total annual cost of employee parking qualified transportation fringes paid to the third party."[972]

EXAMPLE 1, PROPOSED REG. §1.274-13(F)

Taxpayer A pays B, a third party who owns a parking garage adjacent to A's place of business, $100 per month per parking space for each of A's 10 employees to park in B's garage, or $12,000 for parking in 2020 (($100 x 10) x 12 = $12,000). The $100 per month paid for each of A's 10 employees for parking is excludible under section 132(a)(5), and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable. Thus, the entire $12,000 is subject to the section 274(a)(4) disallowance under paragraphs (a) and (d)(1) of this section.

EXAMPLE 2, PROPOSED REG. §1.274-13(F)

Assume the same facts as in paragraph (f)(1) of this section (Example 1), except A pays B $300 per month for each parking space, or $36,000 for parking for 2020 (($300 x 10) x 12 = $36,000). Of the $300 per month paid for parking for each of 10 employees, $270 is excludible under section 132(a)(5) for 2020 and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount. A properly treats the excess amount of $30 ($300 - $270) per employee per month as compensation and wages. Thus, $32,400 (($270 x 10) x 12 = $32,400) is subject to the section 274(a)(4) disallowance under paragraphs (a) and (d)(1) of this section.

The excess amount of $30 per employee per month is not excludible under section 132(a)(5). As a result, the exceptions in section 274(e)(2) and paragraph (e)(2)(i) of this section are applicable to this amount. Thus, $3,600 ($36,000 - $32,400 = $3,600) is not subject to the section 274(a)(4) disallowance and remains deductible.

General Rule for Owned or Leased Parking Facilities

The general rule provides that the taxpayer must compute the disallowed QTF parking expense under IRC §274(a)(4) for each employee using a reasonable method. The taxpayer can use the aggregation of spaces special rule described earlier as part of its general rule computation, but is not allowed to use the special mixed cost rule. [973]

[970] Proposed Reg. §1.274-13(d)

[971] Proposed Reg. §1.247-13(d)(2)

[972] Proposed Reg. §1.274-13(d)(1)

[973] Proposed Reg. §1.274-13(d)(2)(i)

While this appears to give the taxpayer a lot of freedom to choose a method, the IRS does provide certain restrictions in developing an acceptable reasonable method:

- A taxpayer must not use value to determine expense. A taxpayer may not use the value of employee parking to determine expenses allocable to employee parking that is either owned or leased by the taxpayer because section 274(a)(4) disallows a deduction for the expense of providing a qualified transportation fringe, regardless of its value.[974]

- A taxpayer must not deduct expenses related to reserved employee spaces. A taxpayer must determine the allocable portion of total parking expenses that relate to any reserved employee spaces. No deduction is allowed for the parking expenses that relate to reserved employee spaces.[975]

- A taxpayer must not improperly apply the exception for qualified parking made available to the public. A taxpayer must not improperly apply the exception in section 274(e)(7) or paragraph (e)(2)(ii) of this section to parking facilities, for example, by treating a parking facility regularly used by employees as available to the general public merely because the general public has access to the parking facility.[976]

A taxpayer who owns or leases a parking facility may, in lieu of using the general method, use one of the three following simplified methodologies.

For all three methodologies, the *peak demand period* is a key concept that must be applied. The regulations define the term as follows:

> The term *peak demand period* refers to the period of time on a typical business day when the greatest number of the taxpayer's employees are utilizing parking spaces in the taxpayer's parking facility. If a taxpayer's employees work in shifts, the peak demand period would take into account the shift during which the largest number of employees park in the taxpayer's parking facility. However, a brief transition period during which two shifts overlap in their use of parking spaces, as one shift of employees is getting ready to leave and the next shift is reporting to work, may be disregarded. *Taxpayers may use any reasonable methodology to determine the total number of spaces used by employees during the peak demand period on a typical business day. A reasonable methodology may include periodic inspections or employee surveys*.[977]

Qualified Parking Limit Methodology

If a taxpayer elects to use the *qualified parking limit methodology*, the taxpayer must multiply:

[974] Proposed Reg. §1.274-13(d)(2)(i)(A)

[975] Proposed Reg. §1.274-13(d)(2)(i)(B)

[976] Proposed Reg. §1.274-13(d)(2)(i)(C)

[977] Proposed Reg. §1.274-13(b)(14)

- The total number of spaces used by employees during the peak demand period, or the total number of the taxpayer's employees,
- By the IRC §132(f)(2) monthly per employee limit on exclusion ($270[978] for 2020) for each month in the tax year

to determine the amount disallowed under IRC §274(a)(4).[979]

But there's a catch—the employer must determine the *value* of the parking QTF provided to each employee, and include the excess of that value over the monthly limit (if any) as wages for the employee and as compensation expense on the taxpayer's income tax return.[980]

The regulation also provides:

> In addition, the exception to the disallowance for amounts treated as employee compensation provided for in section 274(e)(2) and in paragraph (e)(2)(i) of this section cannot be applied to reduce a section 274(a)(4) disallowance calculated using this method.[981]

Essentially, if you use this method you can't simply add $270 to the employee's compensation each month subject to tax each month and then obtain a full deduction for the parking expense.

EXAMPLE 3, PROPOSED REG. §1.274-13(F)

Taxpayer C leases 200 parking spaces from a third party at a rate of $500 per space, per month in 2020. C's annual lease payment for the parking spaces is $1,200,000 ((200 x $500) x 12 = $1,200,000). The number of available parking spaces used by C's employees during the peak demand period is 200.

C uses the qualified parking limit methodology described in paragraph (d)(2)(ii)(A) of this section to determine the disallowance under section 274(a)(4). Under this methodology, the section 274(a)(4) disallowance is calculated by multiplying the number of available parking spaces used by employees during the peak demand period, 200, the section 132(f)(2) monthly per employee limitation on exclusion, $270, and 12, the number of months in the applicable taxable year. The amount subject to the section 274(a)(4) disallowance is $648,000 (200 x $270 x 12 = $648,000). This amount is excludible from C's employees' gross incomes under section 132(a)(5) and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount. The excess $552,000 ($1,200,000 - $648,000) for which C is not disallowed a deduction under 274(a)(4) is included in C's employees' gross incomes because it exceeds the section 132(f)(2) monthly per employee limitation on exclusion.

Primary Use Methodology

The primary use methodology is very similar to the method first provided as a safe harbor in Notice 2018-99. A taxpayer uses a four-step calculation to compute the amount of disallowed deduction under §274(a)(4) for parking QTF expenses. As was true under Notice 2018-99, while the costs

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978 Revenue Procedure 2019-44

979 Proposed Reg. §1.274-13(d)(2)(ii)(A)

980 Proposed Reg. §1.274-13(d)(2)(ii)(A)

981 Proposed Reg. §1.274-13(d)(2)(ii)(A)

assigned to any reserved employee spaces must be treated as disallowed, if over ½ of the spaces are generally available for use by the general public, no additional disallowance is required.

- Step 1 - Calculate the disallowance for reserved employee spaces. A taxpayer must identify the total parking spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for the taxpayer's employees. The taxpayer must then determine the percentage of reserved employee spaces in relation to total parking spaces and multiply that percentage by the taxpayer's total parking expenses for the parking facility. The product is the amount of the deduction for total parking expenses that is disallowed under section 274(a)(4) for reserved employee spaces. There is no disallowance for reserved employee spaces if the primary use (as defined in paragraphs (b)(11) and (d)(2)(ii)(B)(2) of this section) of the available parking spaces is to provide parking to the general public, and there are five or fewer reserved employee spaces in the parking facility and the reserved employee spaces are 5 percent or less of the total parking spaces.

- Step 2 - Determine the primary use of available parking spaces. A taxpayer must identify the available parking spaces in the parking facility and determine whether their primary use is to provide parking to the general public. If the primary use of the available parking spaces in the parking facility is to provide parking to the general public, then total parking expenses allocable to available parking spaces at the parking facility are excepted from the section 274(a)(4) disallowance by the general public exception under section 274(e)(7) and paragraph (e)(2)(ii) of this section. Primary use of available parking spaces is based on the number of available parking spaces used by employees during the peak demand period. Nonreserved parking spaces that are available to the general public but empty during normal business hours on a typical business day are treated as provided to the general public.

- Step 3 - Calculate the allowance for reserved nonemployee spaces. If the primary use of a taxpayer's available parking spaces is not to provide parking to the general public, the taxpayer must identify the number of available parking spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for nonemployees. A taxpayer that has no reserved nonemployee spaces may proceed to Step 4 in paragraph (d)(2)(ii)(B)(4) of this section. If the taxpayer has reserved nonemployee spaces, it may determine the percentage of reserved nonemployee spaces in relation to remaining total parking spaces and multiply that percentage by the taxpayer's remaining total parking expenses. The product is the amount of the deduction for remaining total parking expenses that is not disallowed because the spaces are not available for employee parking.

- Step 4 - Determine remaining use of available parking spaces and allocable expenses. If a taxpayer completes Steps 1 - 3 in paragraph (d)(2)(ii)(B) of this section and has any remaining total parking expenses not specifically categorized as deductible or nondeductible, the taxpayer must reasonably allocate such expenses by determining the total number of available parking spaces used by employees during the peak demand period.[982]

The proposed regulations provide the following key definitions for applying this methodology:

[982] Proposed Reg. §1.274-13(d)(1)(ii)(B)

- **General public** - The term general public includes, but is not limited to, customers, clients, visitors, individuals delivering goods or services to the taxpayer, students of an educational institution, and patients of a health care facility. *If a taxpayer owns or leases space in a multi-tenant building, the term general public includes employees, partners, 2-percent shareholders of S corporations, sole proprietors, independent contractors, clients, or customers of unrelated tenants in the building. The term general public does not include individuals that are employees, partners, 2-percent shareholders of S corporations, sole proprietors, or independent contractors of the taxpayer*. Also, an exclusive list of guests is not the general public.[983]

- **Total parking spaces** - The term total parking spaces means the total number of parking spaces, *or the taxpayer's portion thereof*, in the parking facility.[984]

- **Reserved employee spaces** - The term reserved employee spaces means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for the taxpayer's employees. Employee spaces in the parking facility, or portion thereof, may be exclusively reserved for employees by a variety of methods, including, but not limited to, specific signage (for example, "Employee Parking Only") or a separate facility or portion of a facility segregated by a barrier to entry or limited by terms of access. Inventory/unusable spaces are not included in reserved employee spaces.[985]

- **Reserved nonemployee spaces** - The term reserved nonemployee spaces means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for nonemployees. *For example, such parking spaces may include, but are not limited to, spaces reserved exclusively for visitors, customers, partners, sole proprietors, 2-percent shareholders of S corporations, vendor deliveries, and passenger loading/unloading.* Nonemployee spaces in the parking facility, or portion thereof, may be exclusively reserved for nonemployees by a variety of methods, including, but not limited to, specific signage (for example, "Customer Parking Only") or a separate facility, or portion of a facility, segregated by a barrier to entry or limited by terms of access. Inventory/unusable spaces are not included in reserved nonemployee spaces.[986]

- **Available parking spaces** - The term available parking spaces means the total parking spaces, less reserved employee spaces and less inventory/unusable spaces, that are available to employees and the general public.[987]

- **Inventory/unusable spaces** - The term inventory/unusable spaces means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively used or reserved for inventoried vehicles, qualified nonpersonal use vehicles described in §1.274-5(k), or other fleet vehicles used in the taxpayer's business, or that are otherwise not usable for parking by employees. Examples of such parking spaces include, but are not limited to, parking spaces for vehicles that are intended

[983] Proposed Reg. §1.274-13(b)(3)

[984] Proposed Reg. §1.274-13(b)(6)

[985] Proposed Reg. §1.274-13(b)(7)

[986] Proposed Reg. §1.274-13(b)(8)

[987] Proposed Reg. §1.274-13(b)(10)

to be sold or leased at a car dealership or car rental agency, parking spaces for vehicles owned by an electric utility used exclusively to maintain electric power lines, or parking spaces occupied by trash dumpsters (or similar property).[988]

- **Primary use** - The term primary use means greater than 50 percent of actual or estimated usage of the available parking spaces in the parking facility.[989]

EXAMPLE 4, PROPOSED REG. §1.274-13(F)

Facts. Taxpayer D, a big box retailer, owns a surface parking facility adjacent to its store. D incurs $10,000 of total parking expenses for its store in the 2020 taxable year. D's parking facility has 510 spaces that are used by its customers, employees, and its fleet vehicles. None of D's parking spaces are reserved. The number of available parking spaces used by D's employees during the peak demand period is 50. Approximately 30 nonreserved parking spaces are empty during normal business hours on a typical business day. D's fleet vehicles occupy 10 parking spaces.

Methodology. D uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

- Step 1. Because none of D's parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(1) of this section.
- Step 2. D's number of available parking spaces is the total parking spaces reduced by the number of reserved employee spaces and inventory/unusable spaces or 500 (510 – 0 – 10 = 500). The number of available parking spaces used by D's employees during the peak demand period is 50. Of the 500 available parking spaces, 450 are used to provide parking to the general public, including the 30 empty nonreserved parking spaces that are treated as provided to the general public. The primary use of D's available parking spaces is to provide parking to the general public because 90% (450 / 500 = 90%) of the available parking spaces are used by the general public under paragraph (d)(2)(ii)(B)(2) of this section. Because the primary use of the available parking spaces is to provide parking to the general public, the exception in section 274(e)(7) and paragraph (e)(2)(ii) of this section applies and none of the $10,000 of total parking expenses is subject to the section 274(a)(4) disallowance.

EXAMPLE 5, PROPOSED REG. §1.274-13(F)

Facts. Taxpayer E, a manufacturer, owns a surface parking facility adjacent to its plant. E incurs $10,000 of total parking expenses in 2020. E's parking facility has 500 spaces that are used by its visitors and employees. E reserves 25 of these spaces for nonemployee visitors. The number of available parking spaces used by E's employees during the peak demand period is 400.

Methodology. E uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

- Step 1. Because none of E's parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(1) of this section.
- Step 2. The primary use of E's parking facility is not to provide parking to the general public because 80% (400 / 500 = 80%) of the available parking spaces are used by its employees. Thus, expenses allocable to those spaces are not excepted from the section 274(a) disallowance by section 274(e)(7)

[988] Proposed Reg. §1.274-13(b)(9)

[989] Proposed Reg. §1.274-13(b)(11)

and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2) of this section.

- Step 3. Because 5% (25 / 500 = 5%) of E's available parking spaces are reserved nonemployee spaces, up to $9,500 ($10,000 x 95% = $9,500) of E's total parking expenses are subject to the section 274(a)(4) disallowance under this step as provided in paragraph (d)(2)(ii)(B)(3) of this section. The remaining $500 ($10,000 x 5% = $500) of expenses allocable to reserved nonemployee spaces is excepted from the section 274(a) disallowance and continues to be deductible.
- Step 4. E must reasonably determine the employee use of the remaining parking spaces by using the number of available parking spaces used by E's employees during the peak demand period and determine the expenses allocable to employee parking spaces under paragraph (d)(2)(ii)(B)(4) of this section.

EXAMPLE 6, PROPOSED REG. §1.274-13(F)

Facts. Taxpayer F, a manufacturer, owns a surface parking facility adjacent to its plant. F incurs $10,000 of total parking expenses in 2020. F's parking facility has 500 spaces that are used by its visitors and employees. F reserves 50 spaces for management. All other employees park in nonreserved spaces in F's parking facility; the number of available parking spaces used by F's employees during the peak demand period is 400. Additionally, F reserves 10 spaces for nonemployee visitors.

Methodology. F uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

- Step 1. Because F reserved 50 spaces for management, $1,000 ((50 / 500) x $10,000 = $1,000) is the amount of total parking expenses that is nondeductible for reserved employee spaces under section 274(a)(4) and paragraphs (a) and (d)(2)(ii)(B)(1) of this section. None of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount.
- Step 2. The primary use of the remainder of F's parking facility is not to provide parking to the general public because 89% (400 / 450 = 89%) of the available parking spaces in the facility are used by its employees. Thus, expenses allocable to these spaces are not excepted from the section 274(a)(4) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2) of this section.
- Step 3. Because 2% (10 / 450 = 2.22%) of F's available parking spaces are reserved nonemployee spaces, the $180 allocable to those spaces (($10,000 - $1,000) x. 2%) is not subject to the section 274(a)(4) disallowance and continues to be deductible under paragraph (d)(2)(ii)(B)(3) of this section.
- Step 4. F must reasonably determine the employee use of the remaining parking spaces by using the number of available parking spaces used by F's employees during the peak demand period and determine the expenses allocable to employee parking spaces under paragraph (d)(2)(ii)(B)(4) of this section.

EXAMPLE 7, PROPOSED REG. §1.274-13(F)

Facts. Taxpayer G, a financial services institution, owns a multi-level parking garage adjacent to its office building. G incurs $10,000 of total parking expenses in 2020. G's parking garage has 1,000 spaces that are used by its visitors and employees. However, one floor of the parking garage is segregated by an electronic barrier that can only be accessed with a card provided by G to its employees. The segregated parking floor contains 100 spaces. The other floors of the parking garage are not used by employees for parking during the peak demand period.

Methodology. G uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

- Step 1. Because G has 100 reserved spaces for employees, \$1,000 ((100 / 1,000) x \$10,000 = \$1,000) is the amount of total parking expenses that is nondeductible for reserved employee spaces under section 274(a)(4) and paragraph (d)(2)(ii)(B)(1) of this section. None of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount.
- Step 2. The primary use of the available parking spaces in G's parking facility is to provide parking to the general public because 100% (900 / 900 = 100%) of the available parking spaces are used by the public. Thus, expenses allocable to those spaces, \$9,000, are excepted from the section 274(a)(4) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2).

EXAMPLE 8, PROPOSED REG. §1.274-13(F)

Facts. Taxpayer H, an accounting firm, leases a parking facility adjacent to its office building. H incurs \$10,000 of total parking expenses related to the lease payments in 2020. H's leased parking facility has 100 spaces that are used by its clients and employees. None of the parking spaces are reserved. The number of available parking spaces used by H's employees during the peak demand period is 60.

Methodology. H uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

- Step 1. Because none of H's leased parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(1) of this section.
- Step 2. The primary use of H's leased parking facility under paragraph (d)(2)(ii)(B)(2) of this section is not to provide parking to the general public because 60% (60 / 100 = 60%) of the lot is used by its employees. Thus, H may not utilize the general public exception from the section 274(a)(4) disallowance provided by section 274(e)(7) and paragraph (e)(2)(ii) of this section.
- Step 3. Because none of H's parking spaces are exclusively reserved for nonemployees, there is no amount to be specifically allocated to reserved nonemployee spaces under paragraph (d)(2)(ii)(B)(3) of this section.
- Step 4. H must reasonably determine the use of the parking spaces and the related expenses allocable to employee parking. Because the number of available parking spaces used by H's employees during the peak demand period is 60, H reasonably determines that 60% (60 / 100 = 60%) of H's total parking expenses or \$6,000 (\$10,000 x 60% = \$6,000) is subject to the section 274(a)(4) disallowance under paragraph (d)(2)(ii)(B)(4) of this section.

EXAMPLE 9, PROPOSED REG. §1.274-13(F)

Facts. Taxpayer I, a large manufacturer, owns multiple parking facilities adjacent to its manufacturing plant, warehouse, and office building at its complex in the city of X. All of I's tracts or parcels of land at its complex in city X are located in a single geographic location. I owns parking facilities in other cities. I incurs \$50,000 of total parking expenses related to the parking facilities at its complex in city X in 2020. I's parking facilities at its complex in city X have 10,000 total parking spaces that are used by its visitors and employees of which 500 are reserved for management. All other spaces at parking facilities in I's complex in city X are nonreserved. The number of nonreserved spaces used by I's employees other than management during the peak demand period at I's parking facilities in city X is 8,000.

Methodology. I uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4). I chooses to apply the special rule in paragraph (c)(2) of this section to aggregate all parking facilities in the geographic location that comprises its complex in city X. However, I may not aggregate parking facilities in other cities with its parking facilities in city X because they are in different geographic locations.

- Step 1. Because 500 spaces are reserved for management, $2,500 ((500 / 10,000) x $50,000 = $2,500) is the amount of total parking expenses that is nondeductible for reserved employee spaces for I's parking facilities in city X under section 274(a)(4) and paragraphs (a) and (d)(2)(ii)(B)(1) of this section.
- Step 2. The primary use of the remainder of I's parking facility is not to provide parking to the general public because 84% (8,000 / 9,500 = 84%) of the available parking spaces in the facility are used by its employees. Thus, expenses allocable to these spaces are not excepted from the section 274(a)(4) disallowance by section 274(e)(7) or paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2) of this section.
- Step 3. Because none of I's parking spaces in its parking facilities in city X are exclusively reserved for nonemployees, there is no amount to be specifically allocated to reserved nonemployee spaces under paragraph (d)(2)(ii)(B)(3) of this section.
- Step 4. I must reasonably determine the use of the remaining parking spaces and the related expenses allocable to employee parking for its parking facilities in city X. Because the number of available parking spaces used by I's employees during the peak demand period in city X during an average workday is 8,000, I reasonably determines that 84.2% (8,000 / 9,500 = 84.2%) of I's remaining parking expense or $39,900 (($50,000 - $2,500) x 84% = $39,900) is subject to the section 274(a)(4) disallowance under paragraph (d)(2)(ii)(B)(4) of this section.

Cost per Space Methodology

The final simplified method is the cost per space methodology. The taxpayer determines the cost per space in the lot and then computes the disallowed amount by "multiplying the cost per space by the total number of available parking spaces used by employees during the peak demand period."[990]

The regulation provides "a taxpayer may calculate cost per space by dividing total parking expenses by total parking spaces."[991]

This method simply eliminates the intermediate tests in the primary use methodology that might serve to reduce the disallowance of deductions for parking expenses. The taxpayer gains simplicity, but at the potential cost of a higher disallowance than would exist under the other method.

EXAMPLE 10, PROPOSED REG. §1.274-13(F)

Taxpayer J, a manufacturer, owns a parking facility and incurs mixed parking expenses along with other parking expenses. J uses the special rule in paragraph (c)(1) of this section to allocate 5% of certain mixed parking expenses to its parking facility. Applying the special rule, J determines that it incurred $100,000 of total parking expenses in 2020. J's parking facility has 500 spaces that are used by its visitors and employees. The number of available parking spaces used by J's employees during the peak demand period is 475.

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[990] Proposed Reg. §1.274-13(d)(1)(ii)(C)

[991] Proposed Reg. §1.274-13(d)(1)(ii)(C)

J uses the cost per space methodology described in paragraph (d)(2)(ii)(C) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4). Under this methodology, J multiples the cost per space by the number of available parking spaces used by J's employees during the peak demand period. J calculates the cost per space by dividing total parking expenses by the number of parking spaces ($100,000 / 500 = $200). J determines that $95,000 ($200 x 475 = $95,000) of J's total parking expenses is subject to the section 274(a)(4) disallowance and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable.

Expenses for Transportation in a Commuter Highway Vehicle or Transit Pass

The proposed regulation at Proposed Reg. §1.274-13(d)(3) provides that:

- If a taxpayer pays a third party an amount for its employees' commuter highway vehicle or a transit pass qualified transportation fringe, the section 274(a)(4) disallowance generally is equal to the taxpayer's total annual cost of employee commuter highway vehicle or a transit pass qualified transportation fringes paid to the third party.
- If a taxpayer provides transportation in a commuter highway vehicle or transit pass qualified transportation fringes in kind directly to its employees, the taxpayer must calculate the disallowance of deductions for expenses for such fringes based on a reasonable interpretation of section 274(a)(4).[992]

The regulation bars the taxpayer from using the value of the transit pass to the employee, rather than the cost incurred by the employer, to compute the disallowed deduction under IRC §274(a)(4).[993]

Exceptions to Disallowance Under §274(a)(4)

If the expenditures listed below are otherwise deductible under the IRC, they are not treated as barred from deduction under IRC §274(a)(4).[994]

Certain QTF Expenses Treated as Compensation

Expenses otherwise paid for QTFs are not treated as disallowed for deduction by IRC §274(a)(4) if the expense is treated by the taxpayer:

- On the taxpayer's Federal income tax return as originally filed, as compensation paid to the employee; and
- As wages to the employee for purposes of withholding under chapter 24 (relating to collection of Federal income tax at source on wages).[995]

[992] Proposed Reg. §1.274-13(d)(3)

[993] Proposed Reg. §1.274-13(d)(3)

[994] Proposed Reg. §1.274-13(e)(1)

[995] Proposed Reg. §1.274-13(e)(2)(i)(A)

However, this exception is subject to the following limitation:

> The exception in section 274(e)(2) and paragraph (e)(2)(i) of this section does not apply to expenses paid or incurred for qualified transportation fringes the value of which (including a purported value of zero) is less than the sum of the amount, if any, paid by the employee for the fringe benefits and any amount excluded from gross income under section 132(a)(5). Thus, if an employer provides an employee with qualified transportation fringes the value of which is less than the applicable statutory monthly per employee limit under section 132(a)(5), the exception in section 274(e)(2) and paragraph (e)(2)(i) of this section does not apply to expenses paid or incurred for the fringe benefits.[996]

The preamble provides the following explanation for this limitation:

> However, section 132(a)(5) excludes the value of QTFs from an employee's gross income subject to the limitations on exclusion provided by section 132(f)(2). Therefore, in determining whether the section 274(e)(2) exception for expenses treated as compensation applies, the proposed regulations provide that the exception in section 274(e)(2) does not apply to expenses paid or incurred for QTFs the value of which (including a purported value of zero) is excluded from an employee's gross income under section 132(a)(5).[997]

Similarly, the IRS provides the following special rule to shut down another potential loophole:

> The exception in section 274(e)(2) and paragraph (e)(2)(i) of this section does not apply to expenses paid or incurred for qualified transportation fringes for which the value that is included in gross income of the employee is less than the amount required to be included in gross income under §1.61-21. Similarly, if the amount required to be included in gross income under §1.61-21 is purportedly zero, the exception in section 274(e)(2) and paragraph (e)(2)(i) of this section does not apply.[998]

The employer must also follow the proper rules for inclusion of amounts in the employee's income to make use of the IRC § 274(e) exception to disallowance. Reg §1.274-13(e)(2)(i)(D) provides:

> The exception in section 274(e)(2) and paragraph (e)(2)(i) of this section applies to expenses paid or incurred for qualified transportation fringes the value of which exceeds the sum of the amount, if any, paid by the employee for the fringe benefits and any amount excluded from gross income under section 132(a)(5), if treated as compensation on the taxpayer's Federal income tax return as originally filed and as wages to the employee for purposes of withholding under chapter 24. Thus, assuming no other statutory exclusion applies, if an employer provides an employee with qualified transportation fringes the value of which exceeds the applicable

[996] Proposed Reg. §1.274-13(e)(2)(i)(B)

[997] Preamble to REG-119307-19, Explanation of Provisions 1.E.i

[998] Proposed Reg. §1.274-13(e)(2)(i)(C)

> statutory monthly limit and the employee does not make any payment, the value of the benefits provided in excess of the applicable statutory monthly limit must be included in the employee's wages for income and employment tax purposes in accordance with section 274(e)(2) and paragraph (e)(2)(i) of this section. See §1.61-21(b)(1) and §1.132-9(b), Q/A-8.[999]

As the preamble explains:

> As noted above, section 132(a)(5) excludes the value of QTFs from an employee's gross income subject to the monthly per employee limitations on exclusion provided by section 132(f)(2). Section 132(f)(2) provides that the amount of QTFs that can be excluded from gross income cannot exceed a maximum monthly dollar amount, adjusted for inflation. For taxable years beginning in 2020, the monthly per employee limitation under section 132(f)(2)(A) regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $270 per employee. The monthly limitation under section 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $270 per employee. Rev. Proc. 2019- 44, 2019-47 I.R.B. 1093. Therefore, if an employer provides an employee with QTFs, the value of which exceeds the sum of the amount, if any, paid by the employee for the fringe benefits and the applicable statutory monthly per employee limit, then the employer must include the value of the benefits provided in excess of the amount paid by the employee and the applicable statutory per employee monthly limit in the employee's wages for income and employment tax purposes. See §1.61–21(b)(1) and §1.132-9(b), Q/A-8. The proposed regulations provide that the employer must follow this treatment in order to rely on the exception in section 274(e)(2).[1000]

Expenses for Transportation in a Commuter Highway Vehicle, Transit Pass or Parking Made Available to the Public

Another exception is found under IRC §274(e)(7) for transportation in a commuter highway vehicle, transit pass or parking made available to the public. As the regulation provides:

> Under section 274(e)(7) and this paragraph (e)(2)(ii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe and that is also made available to the general public, is not subject to the disallowance of deductions provided for in paragraph (a) of this section to the extent that such transportation, transit pass, or parking is made available to the general public. With respect to parking, this exception applies to the entire amount of the taxpayer's parking expense, less any expenses specifically attributable to employees (for example, expenses allocable to reserved employee spaces), if the primary use of the parking is

[999] Proposed Reg. §1.274-13(e)(2)(i)(D)

[1000] Preamble to REG-119307-19, Explanation of Provisions 1.E.i

> by the general public. If the primary use of the parking is not by the general public, this exception applies only to the costs attributable to the parking used by the general public.[1001]

Expenses for Transportation in a Commuter Highway Vehicle, Transit Pass, or Parking Sold to Customers

Finally, no disallowance is required for expenses for transportation in a commuter highway vehicle, transit pass, or parking sold to customers. The regulation provides:

> Under section 274(e)(8) and this paragraph (e)(2)(iii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe to the extent such transportation, transit pass, or parking is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth, is not subject to the disallowance of deductions provided for in paragraph (a) of this section. For purposes of this paragraph (e)(2)(iii), the term customer includes an employee of the taxpayer who purchases the transportation in a bona fide transaction for an adequate and full consideration in money or money's worth.[1002]

Commuting Expense

Reg. §1.274-14 disallows most deductions for any commuting benefit expenditure to an employee. The general rule provides:

> Except as provided in this section, no deduction is allowed for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence, as defined in §1.121-1(b)(1), and place of employment. Travel between the employee's residence and place of employment includes travel that originates at a transportation hub near the employee's residence or place of employment. For example, an employee who commutes to work by airplane from an airport near the employee's residence to an airport near the employee's place of employment is traveling between the residence and place of employment. These transportation and commuting expenses do not include any expenditure of any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer. All qualified transportation fringe expenses are required to be analyzed under section 274(a)(4) and §1.274-13.[1003]

[1001] Proposed Reg. §1.274-13(e)(2)(ii)

[1002] Proposed Reg. §1.274-13(e)(2)(iii)

[1003] Proposed Reg. §1.274-14(a)

However, the TCJA does allow an exception if such expenses are paid for the safety of the employee. The regulation provides:

> The disallowance for the deduction for expenses incurred for providing any transportation or commuting in paragraph (a) of this section does not apply if the transportation or commuting expense is necessary for ensuring the safety of the employee. The transportation or commuting expense is necessary for ensuring the safety of the employee if a bona fide business-oriented security concern, as described in §1.132-5(m), exists for the employee.[1004]

SECTION: 401
QUESTIONS AND ANSWERS ISSUED IN IRS NOTICE REGARDING SECURE ACT AND MINER'S ACT CHANGES TO RETIREMENT PROGRAMS

Citation: Notice 2020-68, 9/2/20

The SECURE Act, enacted in late 2019 by the Congress, provided for a number of changes to retirement plans and IRAs. In Notice 2020-68[1005] the IRS has provided initial guidance on some of these changes in question and answer format. The Notice also covered plan related provisions found in the Bipartisan American Miner's Act of 2019 (Miners Act) that was enacted at the same time as the SECURE Act.

Business Credit for Automatic Contribution Arrangement (IRC §45T)

The law provides an income tax credit for an employer establishing an *eligible automatic contribution arrangement* (EACA). The Notice describes this credit as follows:

> Section 105 of the SECURE Act amends the Internal Revenue Code (Code) to add new § 45T, which provides a business credit under § 38 of the Code for an eligible employer that establishes an eligible automatic contribution arrangement under a qualified employer plan. The credit is equal to $500 for any taxable year of an eligible employer that occurs during a credit period. Under § 45T(b)(2), a taxable year is not treated as occurring during a credit period unless the arrangement is included in the plan for the taxable year. Under § 105(d) of the SECURE Act, the new credit applies to taxable years beginning after December 31, 2019.[1006]

[1004] Proposed Reg. §1.274-14(b)

[1005] Notice 2020-68, September 2, 2020, https://www.irs.gov/pub/irs-drop/n-20-68.pdf (retrieved September 3, 2020)

[1006] Notice 2020-68, Section A

The Notice clarifies that an employer can only receive a credit for single three-year period.

> Q. A-1: May an eligible employer receive a credit with respect to taxable years in more than one 3-year credit period?
>
> A. A-1: No. An eligible employer may receive a credit for taxable years only during a single 3-year credit period that begins when the employer first includes an EACA in any qualified employer plan. [1007]

The Q&A provides two examples of applying this provision:

EXAMPLE 1, NOTICE 2020-68, SECTION A, Q&A-1

For example, if an eligible employer, Employer W, first includes an EACA in one of its qualified employer plans, Plan A, during Employer W's 2021 taxable year (so that the 2021, 2022, and 2023 taxable years included in Employer W's 3-year credit period are all taxable years after § 45T is applicable), and also includes an EACA in a second qualified employer plan, Plan B, during the 2022, 2023, and 2024 taxable years, Employer W may receive no more than a $500 credit for each taxable year during the 3-year credit period that begins with the 2021 taxable year and is not permitted to receive the credit for the 2024 taxable year. [1008]

EXAMPLE 2, NOTICE 2020-68, SECTION A, Q&A-1

As another example, if a different eligible employer, Employer X, first included an EACA in one of its qualified employer plans, Plan C, during Employer X's 2018 taxable year (so that the only taxable year included in Employer X's 3-year credit period after § 45T is applicable is 2020) and also includes an EACA in a second qualified employer plan, Plan D, during the 2020, 2021, and 2022 taxable years, Employer X may receive only a $500 credit for the 2020 taxable year and no credit for subsequent taxable years.[1009]

The employer must continue to use the same EACA for the following two years to get any available credits for those years.

> Q. A-2: To be eligible for the § 45T credit for the second or third taxable years of an eligible employer's 3-year credit period that begins when the eligible employer first includes an EACA in a qualified employer plan, must the eligible employer include the same EACA in the same plan in that second or third taxable year?
>
> A. A-2: Yes. [1010]

[1007] Notice 2020-68, Section A

[1008] Notice 2020-68, Section A

[1009] Notice 2020-68, Section A

[1010] Notice 2020-68, Section A

The IRS provides the following example as part of the Notice, which explains a method for having a second plan spun out to carry on an EACA rather than creating a new plan and terminating the EACA in the first plan which would bar claiming the credit from that point forward.

EXAMPLE 1, NOTICE 2020-68, SECTION A, Q&A-2

For example, if an eligible employer, Employer Y, first includes an EACA in one of its qualified employer plans, Plan E, for its 2021 taxable year, amends Plan E to remove the EACA from Plan E during its 2022 taxable year, and includes an EACA in another qualified employer plan, Plan F, during its 2023 taxable year, Employer Y will not be eligible for the § 45T credit for its 2023 taxable year.

If, however, rather than amending Plan E to remove the EACA during the 2022 taxable year, Employer Y spun-off a portion of Plan E and continued to include the EACA in the spun-off portion of Plan E during its 2022 and 2023 taxable years, Employer Y would be treated as continuing to maintain the same EACA in the same plan for those taxable years and would be eligible for the credit for those taxable years.[1011]

This tax credit applies separately to each employer involved in a multiple employer plan.

> Q. A-3: Does the § 45T credit apply separately to each eligible employer that participates in a multiple employer plan (MEP) under § 413(c)?
>
> A. A-3: Yes. The § 45T credit applies to an eligible employer that participates in a MEP in the same way that the credit would apply if each employer participating in the MEP were the sponsor of a single-employer plan maintained by the eligible employer. Thus, each employer that is an eligible employer (after application of the rules in Notice 98-4 under which certain related employers are treated as a single employer) generally would be eligible for the credit for the 3-year credit period beginning with the first taxable year in which the eligible employer's participating employees are first covered by an EACA under the MEP.[1012]

The Notice provides the following example of the application of the credit in an MEP setting.

[1011] Notice 2020-68, Section A

[1012] Notice 2020-68, Section A

EXAMPLE 1, NOTICE 2020-68, SECTION A, Q&A-3

For example, if an eligible employer, Employer Z, had not previously maintained a plan that included an EACA, and a MEP, Plan G, first includes an EACA that covers Employer Z's participating employees during the 2020 taxable year, the 3-year credit period consisting of the 2020, 2021, and 2022 taxable years would apply to Employer Z.

In addition, Employer Z would continue to be eligible for the credit for the 2021 and 2022 taxable years if Plan G spun off the assets attributable to Employer Z to Plan H, a single-employer plan maintained by Employer Z, and Employer Z continued to include an EACA in Plan H for the 2021 and 2022 taxable years.[1013]

Contributions to a Traditional Individual Retirement Account After Age 70 ½ (Repeal of Prior IRC §219(d)(1))

The SECURE Act eliminated the bar on contributions to traditional IRAs beginning with the tax year the taxpayer attained age 70 ½. The law also added a special provision that applied to any taxpayer who made such a contribution and then later makes a qualified charitable distribution (QCD) from a traditional IRA that barred the treatment of the contribution as a QCD until the distributions exceeded the prior post 70 ½ contributions.

The Q&As provide first that a financial institution is not required to accept post 70 ½ contributions to an IRA the agency is custodian for:

> Q. B-1: Is a financial institution that serves as trustee, issuer, or custodian for an IRA (financial institution) required to accept post-age 70½ contributions in 2020 or subsequent taxable years?
>
> A. B-1: No. A financial institution is not required to accept post-age 70½ contributions. However, a financial institution may choose to accept post-age 70½ contributions beginning on a date after December 31, 2019, as selected by the financial institution.[1014]

However, if a financial institution does accept such contributions, the IRA contracts of the institution will need to be amended to allow for such contributions.

> Q. B-2: If a financial institution chooses to accept post-age 70½ contributions, must the financial institution amend its IRA contracts to provide for those contributions, and if so, what is the deadline for the amendment?
>
> A. B-2: Yes. A financial institution that chooses to accept post-age 70½ contributions must amend its IRA contracts to provide for those contributions. See Q&A G-1 of this notice for the deadline for a financial institution to amend its IRA contracts. The IRS expects to issue revised model IRAs and prototype language

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[1013] Notice 2020-68, Section A

[1014] Notice 2020-68, Section B

> addressing changes made to the relevant Code provisions under the SECURE Act.[1015]

The revised contract will have to be distributed to each benefitted individual.

> Q. B-3: If a financial institution chooses to amend an IRA contract to accept post-age 70½ contributions, must the financial institution distribute a copy of the amendment and a new disclosure statement to each benefited individual?
>
> A. B-3: Yes. If a financial institution chooses to amend an IRA contract to accept post-age 70½ contributions, the financial institution must update the disclosure statement that is required under § 408(i) to reflect the contents of the amended IRA and must distribute copies of the amendment and the amended disclosure statement to each benefited individual. Section 1.408-6(d)(4)(ii)(c) provides that the financial institution must deliver or mail the copies to the last known address of the benefited individual not later than the 30th day after the later of the date on which the amendment is adopted or the date it becomes effective.[1016]

The IRA beneficiary is not allowed to offset the distribution with the IRA contribution when reporting on their tax return for the year in question.

> Q. B-4: May an individual offset the amount of required minimum distributions for a taxable year from the individual's IRA by the amount of post-age 70½ contributions for the same taxable year?
>
> A. B-4: No. An individual may not offset the amount of required minimum distributions from the individual's IRA by the amount of post-age 70½ contributions for the same taxable year. Contributions and distributions are each separate transactions and are independently reported by the financial institution to the IRS.[1017]

Section B concludes with Q&A B-5 that provides the following example of the reduction of the excludable amount of qualified charitable distributions caused by a deduction of post-age 70½ contributions

EXAMPLE, NOTICE 2020-68, SECTION B, Q&A-5

An individual who turned age 70½ before 2020 deducts $5,000 for contributions for each of 2020 and 2021 but makes no contribution for 2022. The individual makes no qualified charitable distributions for 2020 and makes qualified charitable distributions of $6,000 for 2021 and $6,500 for 2022.

The excludable amount of qualified charitable distributions for 2021 is the $6,000 of qualified charitable distributions reduced by the $10,000 aggregate amount of post-age 70½ contributions for 2021 and earlier taxable years. For this individual, these amounts are $5,000 for each of 2020 and 2021, resulting in no excludable amount of qualified charitable distributions for 2021 (that is, $6,000 - $10,000 = ($4,000)).

[1015] Notice 2020-68, Section B

[1016] Notice 2020-68, Section B

[1017] Notice 2020-68, Section B

The excludable amount of the qualified charitable distributions for 2022 is the $6,500 of qualified charitable distributions reduced by the portion of the $10,000 aggregate amount of post-age 70½ contributions deducted that did not reduce the excludable portion of the qualified charitable distributions for earlier taxable years. Thus, $6,000 of the aggregate amount of post-age 70½ contributions deducted does not apply for 2022 because that amount has reduced the excludable amount of qualified charitable distributions for 2021. The remaining $4,000 of the aggregate amount of post-age 70½ contributions deducted reduces the excludable amount of any qualified charitable distributions for subsequent taxable years. Accordingly, the excludable amount of the qualified charitable distributions for 2022 is $2,500 ($6,500 - $4,000 = $2,500).

As described above, because the $4,000 amount reduced the excludable amount of qualified charitable distributions for 2022, that $4,000 amount does not apply again in later years, and no amount of post-age 70½ contributions remains to reduce the excludable amount of qualified charitable distributions for subsequent taxable years.[1018]

§401(k) Plan Mandatory Coverage of Long-Term Part Time Employees (IRC §401(k)(2)(D))

The SECURE Act requires §401(k) plans to offer limited participation to employees who have more than 500 hours of service in three preceding years. The rule takes effect for years beginning after December 31, 2020, but for purposes of handling the 500-hour test to require participation, 12-month periods beginning before January 1, 2021 are not taken into account.[1019]

As a practical matter, this means the provision will first serve to require certain part time employees to be offered limited participation in plan years beginning after January 1, 2024.

The special rules excluding periods beginning before January 1, 2021 for allowing these employees into the plan do not apply to also exclude those periods from the revised vesting calculations of this provision. The IRS provides in the single Q&A for this provision:

> Q. C-1: Does the exception in § 112(b) of the SECURE Act that excludes 12-month periods beginning before January 1, 2021, from being taken into account for purposes of the special eligibility rule in § 401(k)(2)(D)(ii) of the Code also apply for purposes of the special vesting rules in § 401(k)(15)(B)(iii) of the Code?
>
> A. C-1: No. Generally, all years of service with the employer or employers maintaining the plan must be taken into account for purposes of determining a long-term, part-time employee's nonforfeitable right to employer contributions under the special vesting rules in § 401(k)(15)(B)(iii).
>
> Section 401(k)(15)(B)(iii) provides that, for purposes of determining whether a long-term, part-time employee has a nonforfeitable right to employer contributions (other than elective deferrals) under the arrangement, each 12-month period for which the employee has at least 500 hours of service is treated as a year of service.

[1018] Notice 2020-68, Section B

[1019] Notice 2020-68, Section C

> Section 411(a)(4) generally requires that all years of service with the employer or employers maintaining the plan be taken into account for purposes of determining an employee's nonforfeitable right to employer contributions, subject to certain exceptions. Those exceptions include, for example, years of service before the employee attains age 18 (see § 411(a)(4)(A)).
>
> Section 112(b) of the SECURE Act excludes 12-month periods beginning before January 1, 2021, for purposes of determining a long-term, part-time employee's eligibility to participate under § 401(k)(2)(D)(ii) of the Code. However, § 112(b) of the SECURE Act does not exclude 12-month periods beginning before January 1, 2021, for purposes of determining a long-term, part-time employee's nonforfeitable right to employer contributions under § 401(k)(15)(B)(iii) of the Code. Therefore, unless a long-term, part-time employee's years of service may be disregarded under § 411(a)(4), all years of service with the employer or employers maintaining the plan must be taken into account for purposes of determining the long-term, part-time employee's nonforfeitable right to employer contributions under § 401(k)(15)(B)(iii), including 12-month periods beginning before January 1, 2021.

Qualified Birth or Adoption Expense Distributions from IRAs and Qualified Retirement Plans (IRC §72(t))

The SECURE Act added a new provision to §72 dealing with distributions made within one year of the birth of the taxpayers' child or the taxpayers' adoption of a child. The Notice describes this provision as follows:

> Section 113 of the SECURE Act amended § 72(t)(2) of the Code to add a new exception to the 10% additional tax for any qualified birth or adoption distribution. Section 72(t)(2)(H) permits an individual to receive a distribution from an applicable eligible retirement plan of up to $5,000 without application of the 10% additional tax if the distribution meets the requirements to be a qualified birth or adoption distribution. An applicable retirement plan is defined in § 72(t)(2)(H)(vi)(I) as an eligible retirement plan described in § 402(c)(8)(B) other than a defined benefit plan. A qualified birth or adoption distribution is includible in gross income, but is not subject to the 10% additional tax under § 72(t)(1). A qualified birth or adoption distribution is defined as any distribution from an applicable eligible retirement plan to an individual if made during the 1-year period beginning on the date on which the child of the individual is born or the legal adoption by the individual of an eligible adoptee is finalized.
>
> An individual generally may recontribute a qualified birth or adoption distribution (not to exceed the aggregate amount of all qualified birth and adoption distributions made to the individual from the plan) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made. However, a qualified birth or adoption distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules of § 401(a)(31), the notice requirement under §402(f), or the mandatory withholding rules under § 3405. The

Treasury Department and the IRS intend to issue regulations under § 72(t) that will address the recontribution rules, including rules related to the timing of recontributions.[1020]

The IRS divides up this section into two portions, one aimed at individuals receiving a distribution and the other dealing with qualified plans looking to add such a provision.

Individuals Receiving a Qualified Birth or Adoption Distribution

The IRS begins by defining what qualifies for this type of distribution.

> Q. D-1: What is a qualified birth or adoption distribution?
>
> A. D-1: A qualified birth or adoption distribution, as defined in § 72(t)(2)(H)(iii)(I), is any distribution of up to $5,000 from an applicable eligible retirement plan to an individual if made during the 1-year period beginning on the date on which the child of the individual is born or the legal adoption by the individual of an eligible adoptee is finalized.
>
> Q. D-2: Are there any additional requirements for a distribution to be a qualified birth or adoption distribution?
>
> A. D-2: Yes. Section 72(t)(2)(H)(vi)(III) provides that a distribution to an individual will not be treated as a qualified birth or adoption distribution with respect to any child or eligible adoptee unless the individual includes the name, age, and the Taxpayer Identification Number (TIN) of the child or eligible adoptee on the individual's tax return for the taxable year in which the distribution is made.[1021]

The types of retirement plans eligible to provide such a distribution are listed in Q&A D-3:

> Q. D-3: Which types of plans are eligible to permit a qualified birth or adoption distribution?
>
> A. D-3: A qualified birth or adoption distribution may be made from an applicable eligible retirement plan, which is defined in § 72(t)(2)(H)(vi)(I) as an eligible retirement plan described in § 402(c)(8)(B), other than a defined benefit plan. Therefore, a § 401(a) qualified defined contribution plan, a § 403(a) annuity plan, a § 403(b) annuity contract, a governmental § 457(b) plan, or an IRA is eligible to permit a qualified birth or adoption distribution.[1022]

[1020] Notice 2020-68, Section D

[1021] Notice 2020-68, Section D

[1022] Notice 2020-68, Section D

The qualified birth or adoption distribution is exempted from the 10% early distribution tax under IRC §72(t):

> Q. D-4: Is a qualified birth or adoption distribution subject to the 10% additional tax under § 72(t)?
>
> A. D-4: No. While a qualified birth or adoption distribution is includible in gross income, it is not subject to the 10% additional tax under § 72(t)(1).[1023]

Note that the distribution is subject to tax unless the balance is recontributed. While the law provides no limit on the time during which a recontribution may be made, unless the amounts are recontributed before the statute of limitations for claiming a refund for the year of distribution expires, the taxpayer would be unable to get a refund of the taxes paid.

The IRS provides information on who is an eligible adoptee in questions 5 and 6:

> Q. D-5: Who is an eligible adoptee?
>
> A. D-5: Section 72(t)(2)(H)(iii)(II) defines the term "eligible adoptee" as any individual who has not attained age 18 or is physically or mentally incapable of self-support. However, an eligible adoptee does not include an individual who is the child of the taxpayer's spouse.
>
> Q. D-6: For purposes of determining who is an eligible adoptee, when is an individual considered "physically or mentally incapable of self-support?"
>
> A. D-6: For purposes of § 72(t)(2)(H)(iii)(II), the determination of whether an individual is physically or mentally incapable of self-support is made in the same manner as the determination of whether an individual is disabled under § 72(m)(7), which defines when an individual is disabled for purposes of the exception to the 10% additional tax under § 72(t)(2)(A)(iii). Section 72(m)(7) provides that an individual is considered to be disabled if that individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.[1024]

The limitation on the amount of the distribution applies on both a per parent and per child basis.

> Q. D-7: May each parent receive a qualified birth or adoption distribution up to $5,000 with respect to the same child or eligible adoptee?
>
> A. D-7: Yes. Each parent may receive a qualified birth or adoption distribution of up to $5,000 with respect to the same child or eligible adoptee.

[1023] Notice 2020-68, Section D

[1024] Notice 2020-68, Section D

> Q. D-8: May an individual receive qualified birth or adoption distributions with respect to multiple births of children or adoptions of eligible adoptees (for example, twins or triplets)?
>
> A. D-8: Yes. An individual is permitted to receive qualified birth or adoption distributions with respect to the birth of more than one child or the adoption of more than one eligible adoptee if the distributions are made during the 1-year period following the date on which the children are born or the legal adoption for the eligible adoptees is finalized.

EXAMPLE BASED ON NOTICE 2020-68, SECTION D, Q&AS 7 AND 8

Employee A gives birth to twins in October 2020. Employee A takes a $10,000 distribution from her § 401(k) plan in January 2021. The entire $10,000 distribution is a qualified birth or adoption distribution, assuming that Employee A includes the TINs of her twins and other required information on her 2021 tax return.

Employee A's spouse is also allowed to take a $10,000 distribution from a qualified retirement plan, subject to the same requirements as apply to Employee A. So the couple will be able to take total distributions of up to $20,000 for the birth of twins.[1025]

Finally, the IRS addresses the recontribution issue in Q&A 9:

> Q. D-9: May an individual recontribute a qualified birth or adoption distribution to an applicable eligible retirement plan?
>
> A. D-9: Yes. An individual may recontribute any portion of a qualified birth or adoption distribution (up to the entire amount of the qualified birth or adoption distribution) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made under § 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16), as applicable.[1026]

Eligible Retirement Plans and Qualified Birth or Adoption Distributions

The IRS provides additional guidance to those maintaining plans that are eligible to make such distributions.

First, the IRS notes that a plan is *not required* to offer these qualified birth or adoption distributions:

> Q. D-10: Is an applicable eligible retirement plan required to permit in-service distributions for qualified birth or adoption distributions under § 72(t)(2)(H)?
>
> A. D-10: No. It is optional for an applicable eligible retirement plan to permit in-service distributions for qualified birth or adoption distributions pursuant to § 72(t)(2)(H). Plan amendments adopted to permit qualified birth or adoption

[1025] Notice 2020-68, Section D

[1026] Notice 2020-68, Section D

distributions are discretionary amendments for purposes of the plan amendment rules discussed in Q&A G-1 of this notice.[1027]

As well, a plan wishing to offer such an option will be required to amend the plan to allow for these distributions:

> Q. D-11: If an employer chooses to amend its applicable eligible retirement plan to permit in-service distributions for qualified birth or adoption distributions, what is the deadline for adopting that amendment?
>
> A. D-11: For information relating to the deadline for adopting plan amendments, see Q&A G-1 of this notice.[1028]

The IRS provides that a plan is generally allowed to accept the participant's representation that the participant is eligible for such a distribution.

> Q. D-12: May a plan sponsor or plan administrator rely on a reasonable representation from an individual that the individual is eligible for a qualified birth or adoption distribution?
>
> A. D-12: Yes. In making a determination whether an individual is eligible for a qualified birth or adoption distribution, a plan sponsor or plan administrator of an applicable eligible retirement plan is permitted to rely on reasonable representations from the individual, unless the plan sponsor or plan administrator has actual knowledge to the contrary.[1029]

Plans that allow for such distributions are also required to accept recontributions:

> Q. D-13: If an applicable eligible retirement plan permits qualified birth or adoption distributions, is the plan required to accept a recontribution of that distribution to the plan?
>
> A. D-13: Yes. An applicable eligible retirement plan must accept the recontribution of a qualified birth or adoption distribution from an individual if the following apply:
>
> > (a) the plan permits qualified birth or adoption distributions;
> >
> > (b) the individual received a qualified birth or adoption distribution from that plan; and

[1027] Notice 2020-68, Section D

[1028] Notice 2020-68, Section D

[1029] Notice 2020-68, Section D

(c) the individual is eligible to make a rollover contribution to that plan at the time the individual wishes to recontribute the qualified birth or adoption distribution to the plan.

As will be noted later, a participant may still be allowed to treat a distribution allowed under another provision of the plan as a qualified birth or adoption distribution. But if the plan does not provide separately for qualified birth or adoption distributions, it would not need to accept the recontribution of the distribution that was treated by the employee as a qualified birth or adoption distribution, though the employee could deposit the funds in an IRA to complete the repayment.

The guidance also provides that such distributions are treated as allowed distributions for purposes of various plan qualification provisions:

> Q. D-14: Do qualified birth or adoption distributions from an applicable eligible retirement plan meet the distribution restriction requirements in §§ 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11), and 457(d)(1)(A)?
>
> A. D-14: Qualified birth or adoption distributions are treated as meeting the distribution restrictions for qualified cash or deferred arrangements under §401(k)(2)(B)(i), custodial accounts under § 403(b)(7)(A)(i), annuity contracts under §403(b)(11), and governmental deferred compensation plans under § 457(d)(1)(A). Thus, for example, an employer may expand the distribution options under its plan to allow an amount attributable to an elective, qualified nonelective, qualified matching, or safe harbor contribution under a § 401(k) plan to be distributed as a qualified birth or adoption distribution even though it is distributed before an otherwise permitted distributable event, such as severance from employment, disability, or attainment of age 59½.[1030]

The IRS indicates that the distribution is not going to trigger a number of rules that apply to qualified plans when an otherwise qualified rollover distribution is made, including having no requirement for the withholding of tax from the distribution by the plan:

> Q. D-15: Is a qualified birth or adoption distribution treated by an applicable eligible retirement plan as an eligible rollover distribution for purposes of the direct rollover rules, § 402(f) notice requirements, and the mandatory withholding rules?
>
> A. D-15: No. A qualified birth or adoption distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules of § 401(a)(31), the notice requirement under § 402(f), and the mandatory withholding rules under § 3405. Thus, the plan is not required to offer an individual a direct rollover with respect to a qualified birth or adoption distribution. In addition, the plan administrator is not required to provide a § 402(f) notice. Finally, the plan administrator or payor of the qualified birth or adoption distribution is not required to withhold an amount equal to 20% of the distribution, as generally is required in

[1030] Notice 2020-68, Section D

§ 3405(c)(1). However, a qualified birth or adoption distribution is subject to the voluntary withholding requirements of § 3405(b) and § 35.3405-1T.[1031]

When a participant recontributes the distribution to the plan or IRA, the plan or IRA will treat that as a direct transfer within 60 days of the distribution (even though the recontribution will almost certainly be far past the 60 day time period):

> Q. D-16: Is a recontribution made with respect to a qualified birth or adoption distribution from an applicable eligible retirement plan other than an IRA treated as the direct transfer of an eligible rollover distribution as defined in § 402(c)(4)?
>
> A. D-16: Yes. Section 72(t)(2)(H)(v)(III) provides that, in the case of a recontribution made with respect to a qualified birth or adoption distribution from an applicable eligible retirement plan other than an IRA, an individual is treated as having received the distribution as an eligible rollover distribution (as defined in § 402(c)(4)) and as having transferred the amount to an applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution.
>
> Q. D-17: Is a recontribution made with respect to a qualified birth or adoption distribution from an IRA treated as the direct transfer of an eligible rollover distribution as defined in § 408(d)(3)?
>
> A. D-17: Yes. Section 72(t)(2)(H)(v)(IV) provides that, in the case of a recontribution made with respect to a qualified birth or adoption distribution from an IRA, an individual is treated as having received the distribution as an eligible rollover distribution (as defined in § 408(d)(3)) and as having transferred the amount to an applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution.[1032]

The Q&A also provides a potential workaround for participants in plans that do not provide for qualified birth and adoption distributions. If the participant has the right to an in-service distribution from the plan and takes that distribution, the participant is allowed to treat that distribution as a qualified birth or adoption distribution. The participant also can later recontribute that balance back to an IRA even if the plan it came from won't accept such recontributions.

> Q. D-18: If an applicable eligible retirement plan does not permit qualified birth or adoption distributions, may an individual treat an otherwise permissible in-service distribution as a qualified birth or adoption distribution?
>
> A. D-18: Yes. If an applicable eligible retirement plan does not permit qualified birth or adoption distributions and an individual receives an otherwise permissible in-service distribution that meets the requirements of a qualified birth or adoption distribution, the individual may treat the distribution as a qualified birth or

[1031] Notice 2020-68, Section D

[1032] Notice 2020-68, Section D

> adoption distribution on the individual's federal income tax return. The distribution, while includible in gross income, is not subject to the 10% additional tax under § 72(t)(1). If the individual decides to recontribute the amount to an eligible retirement plan, the individual may recontribute the amount to an IRA.[1033]

Difficulty of Care Payments as the Basis for a Retirement Plan Contribution (IRC §§408(o)(5) and 415(c)(8))

The SECURE Act dealt with the use of difficulty of care payments to fund a retirement plan. As the Notice describes the issue:

> A difficulty of care payment is a type of qualified foster care payment that is excludable from gross income under § 131. Because a difficulty of care payment is excludable from gross income, it was not, prior to the SECURE Act, included in a participant's compensation for purposes of calculating the annual additions limit of § 415(c)(1). Accordingly, an employee who received difficulty of care payments from an employer was not permitted to make contributions to, or receive allocations under, the employer's plan based on the difficulty of care payments.[1034]

The applicable SECURE Act changes are detailed in the Notice as follows:

> Section 116(a) of the SECURE Act adds § 408(o)(5) to the Code to allow a taxpayer to elect to increase the nondeductible contribution limit by the amount of excludable difficulty of care payments in a situation in which the taxpayer does not have sufficient compensation that is includible in the taxpayer's gross income to equal the deductible amount under § 219(b)(5) of the Code. The addition of § 408(o)(5) applies to contributions made after December 20, 2019.
>
> Section 116(b) of the SECURE Act adds § 415(c)(8) to the Code to increase the annual additions limit for retirement plans to include difficulty of care payments. Section 415(c)(8)(A), as amended, provides that a participant's compensation for purposes of § 415(c)(1) is increased by the amount of excludable difficulty of care payments. Accordingly, a participant may make contributions to, or receive allocations under, the plan that are based on the participant receiving difficulty of care payments, even if the participant has no other compensation. Section 415(c)(8)(B), as amended, provides that if a contribution is made based on difficulty of care payments, the contribution is treated as investment in the contract and will not cause a plan to be treated as failing any requirements of §§ 1 through 1400Z-2 solely by reason of allowing the contribution. The addition of § 415(c)(8) applies to plan years beginning after December 31, 2015.[1035]

[1033] Notice 2020-68, Section D

[1034] Notice 2020-68, Section E

[1035] Notice 2020-68, Section E

While the amount may be added to the §415(c)(1) compensation amount of an employer plan to increase the annual additions limit, the amount will not be considered compensation unless the amount is paid by the employer:

> Q. E-1: Are difficulty of care payments received by an employee from a person other than his or her employer includible in the definition of compensation under that employer's plan?
>
> A. E-1: No. Compensation under § 415(c)(3) only includes compensation from an individual's employer. Thus, difficulty of care payments received by an employee from a person other than his or her employer are not includible in the definition of compensation under that employer's plan.[1036]

Generally, a plan will not be amended to include such payments in §415(c)(1) compensation unless the employer is paying or begins paying such payments to employees.

> Q. E-2: If an employer does not make difficulty of care payments to its employees that are eligible to participate in the employer's plan, must the plan be amended to include difficulty of care payments in the plan's definition of § 415(c)(1) compensation?
>
> A. E-2: No. If an employer does not make difficulty of care payments to its employees that are eligible to participate in the employer's plan, then the plan does not need to be amended to include difficulty of care payments in the plan's definition of §415(c)(1) compensation. However, if the employer changes its practice and begins to make difficulty of care payments to its employees, the plan must be amended timely to include difficulty of care payments in that definition.[1037]

Interestingly, the IRS declines to provide an answer at this time to the question of whether the excise tax on excess contributions under §4973 is applicable to nondeductible IRA contributions based on difficulty of care payments:

> Q. E-3: Does the excise tax on excess IRA contributions under § 4973 apply to nondeductible IRA contributions that are based on difficulty of care payments?
>
> A. E-3: The applicability of the excise tax on excess IRA contributions under §4973 to nondeductible IRA contributions that are based on difficulty of care payments will be addressed in future guidance.[1038]

[1036] Notice 2020-68, Section E

[1037] Notice 2020-68, Section E

[1038] Notice 2020-68, Section E

Reduction of Minimum Age for In-Service Distributions to 59 ½ (IRC §401(a)(36)

The Miner's Act was also part of the package of bills passed as the Further Consolidated Appropriations Act, 2020 along with the SECURE Act. While the SECURE Act was the location for the vast majority of retirement plan provisions, one new provision applicable to qualified retirement plans was found at Section 104 of the Miner's Act.

The Notice describes the change, which reduces the minimum age at which a plan may permit in-service distributions from age 62 (or 70 ½ for §457 plans) to age 59 ½, as follows:

> Under § 401(a)(36), a pension plan does not fail to be qualified solely because the plan provides that a distribution may be made from the plan to an employee who has attained a minimum age and who is not separated from employment at the time of the distribution (generally referred to as an in-service distribution). Prior to the effective date of the Miners Act, the minimum age for allowable in-service distributions under §401(a)(36) was age 62. Section 104(a) of the Miners Act lowers the minimum age from age 62 to age 59½.
>
> In order to be an eligible deferred compensation plan under § 457(b), a plan must satisfy the distribution requirements of § 457(d). Section 457(d)(1)(A) provides that amounts under the plan may not be made available earlier than the occurrence of certain events. Prior to the enactment of the Miners Act, § 457(d)(1)(A)(i) provided, in general, that amounts may not be made available to participants earlier than the calendar year in which a participant attains age 70½ or when a participant has a severance from employment with the employer. Section 104(b) of the Miners Act amended § 457(d)(1)(A)(i) of the Code to provide that, in the case of a governmental plan under § 457(b) of the Code (that is, a plan maintained by an employer that is a State, a political subdivision of a State, or any agency or instrumentality of a State or political subdivision of a State, as provided in § 457(e)(1)(A) of the Code), amounts may be made available as early as the calendar year in which a participant attains age 59½.[1039]

These changes apply to plan years beginning after December 31, 2019.[1040]

These changes are not ones that a plan is required to implement. Q&A 1 of Section F provides:

> Q. F-1: Is a plan qualified under § 401(a) of the Code (qualified plan) or a governmental plan under § 457(b) of the Code required to implement the changes made by § 104 of the Miners Act?
>
> A. F-1: No. In general, neither a qualified plan nor a § 457(b) governmental plan is required to provide for in-service distributions. Thus, if a plan does not provide for in-service distributions, or provides for in-service distributions at an age that is later

[1039] Notice 2020-68, Section F

[1040] Notice 2020-68, Section F

than age 59½ (the minimum age permitted by § 104(a) or (b) of the Miners Act), the plan is not required to be amended to permit in-service distributions to commence at age 59½.

EXAMPLE, NOTICE 2020-68, SECTION F, Q&A 1

A qualified plan that provides for in-service distributions commencing at age 62 is not required to be amended to provide for in-service distributions commencing at age 59½.[1041]

The IRS provides the following guidance in response to the question of whether a pension plan that lowers its minimum age for an in-service distribution to age 59 ½ may also change its definition of normal retirement age to the same age or higher, but lower than age 62. Essentially, the answer is that an employer cannot simply assume that an age lower than 62 will not cause an issue with plan qualification.

> Q. F-2: If a pension plan is amended to lower its minimum age for an in-service distribution from age 62 to age 59½ pursuant to § 401(a)(36), may the plan also change its definition of normal retirement age to age 59½ or later without violating other qualification requirements, such as the definitely determinable benefit requirement in § 1.401(a)-1(b)(1)(i)?
>
> A. F-2: The in-service distribution rule in § 401(a)(36) is separate from the definitely determinable benefit requirement in § 1.401(a)-1(b)(1)(i). A plan does not fail to satisfy the requirements in § 1.401(a)-1(b)(1)(i) merely because the plan provides for in-service distributions in accordance with § 401(a)(36). In addition to satisfying other applicable qualification requirements (such as § 411(d)(6)), any change to a pension plan's definition of normal retirement age must satisfy the requirements in § 1.401(a)-1(b)(2), including the requirement that a normal retirement age must be an age that is not earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. A normal retirement age of age 62 or later is deemed to satisfy the reasonably representative requirement (see § 1.401(a)-1(b)(2)(ii)). For purposes of the reasonably representative requirement, governmental pension plans may continue to rely on proposed regulations that were published in the Federal Register on January 27, 2016 (81 FR 4599).[1042]

[1041] Notice 2020-68, Section F

[1042] Notice 2020-68, Section F

Plan Amendments With Regard to These Provisions

The guidance ends with a Q&A regarding the dates that a plan must be amended to comply with the SECURE Act and §104 of the Miner's Act:

> Q. G-1: When must a retirement plan be amended to reflect the provisions of the SECURE Act, the regulations thereunder, or § 104 of the Miners Act?
>
> A. G-1: The deadlines to amend a retirement plan for provisions of the SECURE Act, the regulations thereunder, or § 104 of the Miners Act are set forth in this Q&A G-1. These amendment deadlines apply to both required and discretionary plan amendments.
>
> **(a) Qualified plans**
>
> In general, for a qualified plan that is not a governmental plan within the meaning of § 414(d) of the Code, or an applicable collectively bargained plan, the deadline to amend a plan for provisions of the SECURE Act, the regulations thereunder, or § 104 of the Miners Act is the last day of the first plan year beginning on or after January 1, 2022. The plan amendment deadline for a qualified governmental plan, as defined in § 414(d), or for an applicable collectively bargained plan, is the last day of the first plan year beginning on or after January 1, 2024.
>
> A sponsor of a qualified plan may amend its plan to reflect the SECURE Act, the regulations thereunder, or § 104 of the Miners Act after the dates set forth in the preceding paragraph, in accordance with Rev. Proc. 2016-37, as modified by Rev. Proc. 2017-41 and Rev. Proc. 2020-40. However, under Rev. Proc. 2016-37, amendments made after the dates set forth in the preceding paragraph, are not entitled to the anti-cutback relief provided by § 411(d)(6) of the Code or § 204(g) of ERISA.
>
> **(b) Section 403(b) plans**
>
> In general, the deadline for a § 403(b) plan that is not maintained by a public school, as described in § 403(b)(1)(A)(ii), to amend a plan for provisions of the SECURE Act or the regulations thereunder is the last day of the first plan year beginning on or after January 1, 2022. The plan amendment deadline for a § 403(b) plan that is maintained by a public school, as described in § 403(b)(1)(A)(ii), is the last day of the first plan year beginning on or after January 1, 2024.
>
> A sponsor of a § 403(b) plan may be entitled to amend its plan to reflect the SECURE Act or the regulations thereunder after the dates set forth in the preceding paragraph, in accordance with Rev. Proc. 2019-39, as modified by Notice 2020-35 and Rev. Proc. 2020-40. However, under Rev. Proc. 2019-39, amendments to a § 403(b) plan that is subject to ERISA that are made after the dates set forth in the preceding paragraph are not entitled to the anti-cutback relief provided by § 204(g) of ERISA.

(c) Section 457(b) governmental plans

The deadline to amend a governmental plan under § 457(b) of the Code for provisions of the SECURE Act, the regulations thereunder, or § 104 of the Miners Act is the later of (i) the last day of the first plan year beginning on or after January 1, 2024, or (ii) if applicable, the first day of the first plan year beginning more than 180 days after the date of notification by the Secretary that the plan was administered in a manner that is inconsistent with the requirements of § 457(b) of the Code.

(d) Individual retirement plans

The deadline to amend the trust governing an IRA that is an individual retirement account or the contract issued by an insurance company with respect to an IRA that is an individual retirement annuity for provisions of the SECURE Act or the regulations thereunder is December 31, 2022, or such later date as the Secretary prescribes in guidance.

In the case of a deemed IRA described in § 408(q), the deadline to amend the deemed IRA provisions is the deadline applicable to the plan under which the deemed IRA is established.[1043]

SECTION: 401 ESOP WITH NUMEROUS DOCUMENTATION AND OPERATIONAL ISSUES LOSES QUALIFIED PLAN STATUS

Citation: Ed Thielking Inc. v. Commissioner, TC Memo 2020-5, 1/9/20

A series of problems led to the Tax Court agreeing with the IRS that an employee stock ownership plan (ESOP) and trust (ESOT) were not qualified in the case of *Ed Thielking Inc. v. Commissioner*, TC Memo 2020-5.[1044]

The case involved an S corporation that was wholly owned by Ed Thielking. His father, a CPA, developed a plan for the S corporation to adopt an ESOP.[1045] The plan was adopted on March 31,

[1043] Notice 2020-68, Section F

[1044] *Ed Thielking Inc. v. Commissioner*, TC Memo 2020-5, January 9, 2020, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12130 (retrieved January 10, 2020)

[1045] His father had been involved in three prior cases before the Tax Court, including one from 2018 that was the subject of an article on the Current Federal Tax Developments site when it was issued. See Ed Zollars, “Use of CPA Who Did Significant Other Work for ESOP and Sponsor as Appraiser Did Not Run Afoul of Independent Appraiser Requirements,” *Current Federal Tax Developments* website, June 28, 2018, https://www.currentfederaltaxdevelopments.com/blog/2018/6/28/use-of-cpa-who-did-significant-other-work-for-esop-and-sponsor-as-appraiser-did-not-run-afoul-of-independent-appraiser-requirements

2006 with an effective date of March 10, 2006.[1046] The Court describes the following details of the plan's terms and implementation:

> Article 2 of the ESOP agreement states in pertinent part that participation in the ESOP begins immediately after one year of service, provided the participant is at least 21 years old on that date. In addition to the year of service, article 4 of the ESOP agreement states that employer contributions to the plan require at least 1,000 hours of service during a plan year. The ESOP agreement defines an hour of service as an hour for which an employee is paid or entitled to payment by the employer.
>
> Further, article 4 of the ESOP agreement incorporates the limitations under section 415(e). With regards to distributions, article 14 of the ESOP agreement states in pertinent part:
>
> > If distribution has begun on or before the Required Beginning Date and if the Participant dies before his entire Accrued Benefit has been distributed to him the remaining portion of his Accrued Benefit which is not payable to a beneficiary designated by the Participant's will shall be distributed within five years after the Participant's death or over the life of the beneficiary or over a period certain not extending beyond the life expectancy of the beneficiary, commencing not later than the end of the calendar year following the calendar year in which the Participant would have attained the age 70 ½.
>
> The record contains no restatements or amendments to either the ESOP or the ESOT agreements, despite respondent's repeated requests for those documents on January 28, 2010, October 26, 2011, and January 31, 2012.[1047]

Mr. Thielking contributed his ½ interest in Gray Thielking Electric (GTE) to the S corporation, and the flow through income from that partnership made up the primary source of the S corporation's income.[1048] Contributions were made to the plan as described by the Court:

> Petitioner's primary source of income in FYE 2007 was an income allocation from GTE. Petitioner did not report any compensation of officers or salaries and wages as deductible expenses. Nothing in the record indicates that petitioner filed employment and unemployment tax returns, or that it issued and filed Forms W-2, Wage and Tax Statement, or Forms 1099-MISC, Miscellaneous Income, for FYE 2007.
>
> In FYE 2007 petitioner's board of directors resolved to issue a dividend payable in capital stock to the participants of the ESOP or at their election to their ESOT accounts. The only plan participant, Mr. Thielking, elected for petitioner to

[1046] *Ed Thielking Inc. v. Commissioner*, p. 3

[1047] *Ed Thielking Inc. v. Commissioner*, p. 4

[1048] *Ed Thielking Inc. v. Commissioner*, pp. 3-4

> contribute the dividend to his ESOT account. Petitioner claimed a deduction with respect to the ESOT contribution, which largely offset the income allocation to it from GTE. With no material variance, petitioner followed this course of action for all the years at issue. Petitioner issued share certificates representing the following class B capital stock dividends to Mrs. Thielking, as trustee for the ESOT…[1049]
>
> The only other contribution occurred on or about November 6, 2007, when the ESOT received a purported rollover contribution of $15,634 from a section 401(k) account of Mrs. Thielking. Petitioner's board of directors authorized the purchase by the ESOT of an additional 15,635 class B shares with the funds contributed in the section 401(k) rollover.[1050]

The Court also described key factors related to the plan's reporting as follows:

> Petitioner reported on Form 5500, Annual Return/Report of Employee Benefit Plan, for PYE February 28, 2007, only one participant, Mr. Thielking. Mr. Thielking's account consisted of 23,000 shares of petitioner's stock. Stephen Thielking prepared a written appraisal that valued each share of petitioner's stock at $1, resulting in a valuation of $23,000 for Mr. Thielking's ESOT account. The appraisal, however, did not include Stephen Thielking's signature or his qualifications as an appraiser.
>
> Petitioner also reported Mr. Thielking as the only participant in the ESOP5 on Form 5500 for PYE February 28, 2008. The plan received a rollover contribution on behalf of Mrs. Thielking during PYE February 28, 2008, even though she was not reported as a plan participant for that period. The plan reported total assets of 59,434 shares of petitioner's stock. Again, Stephen Thielking valued each share at $1, resulting in a net plan asset value of $59,434, but he again failed to sign the appraisal or include his qualifications.
>
> Petitioner finally reported a second participant for the first time, Mrs. Thielking, on its Form 5500 for PYE February 28, 2009. Once again petitioner relied on an unsigned appraisal prepared by Stephen Thielking, valuing the 66,234 shares of petitioner held by the ESOT at $1 each, or $66,234.[1051]

Readers who work with qualified retirement plans may have noticed a number of issues, and those with a background in ESOPs may have found some others. These issues did not fail to attract the attention of the IRS or the court.

For a retirement plan to be treated as a qualified plan (and thus eligible for the various tax benefits available for such plans), it must comply with the numerous requirements found in IRC §401(a)—which has subsections that number from (1) to (37). Many of those subsections have additional long and detailed provisions. Suffice it to say there are a lot of ways to create plan qualification issues—

[1049] *Ed Thielking Inc. v. Commissioner*, p. 5

[1050] *Ed Thielking Inc. v. Commissioner*, p. 6

[1051] *Ed Thielking Inc. v. Commissioner*, pp. 6-7

and if the plan fails badly enough to be treated as no longer qualified, the results are rather nasty, not of the least of which is the loss of tax deferral on contributions and earnings in the plan.

The Tax Court describes the matters as follows:

> Section 401(a) lists requirements that must be met for a plan and its underlying trust to qualify for preferential tax treatment under section 501(a). A plan must meet the section 401(a) requirements in both form and operation. *Ludden v. Commissioner*, 620 F.2d 700, 702 (9th Cir. 1980), aff'g 68 T.C. 826 (1977); sec. 1.401-1(b)(3), Income Tax Regs. In addition, the terms of the plan must be in writing. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, sec. 402(a)(1), 88 Stat. at 875; see also sec. 1.401-1(a)(2), Income Tax Regs. Congress established the writing requirement so that every employee, on examining the plan document, may determine exactly what his or her rights and obligations are under the plan and who is responsible for operating the plan. See *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 83 (1995); H.R. Conf. Rept. No. 93-1280, at 297 (1974), 1974-3 C.B. 415, 458.
>
> A qualification failure pursuant to section 401(a) is a continuing failure because allowing a plan to requalify in subsequent years would allow a plan "to rise phoenix-like from the ashes of such disqualification and become qualified for that year." *Pulver Roofing Co. v. Commissioner*, 70 T.C. 1001, 1015 (1978).[1052]

As the Court notes, there are two key issues:

- Form Issues: The plan document must contain all terms required under the law. A failure of the plan document to contain the necessary terms will potentially trigger disqualification. As well, since Congress changes the rules from time to time, plans must be regularly amended to take into account new rules; and

- Operational issues: Even if the plan document is pristine and totally up to date, if the plan is not operated in accordance with the plan terms and the law, the plan also faces potential disqualification.

Statute of Limitations

The taxpayer believed that the IRS had made a fundamental error—many of the items being questioned about the plan's documentation and operation had occurred more than three years prior to the IRS raising the issues. However, the Court notes, the statute only applies to assessment of tax against years, and the basic issue of qualification of a plan does not fall directly into that category:

> Before we reach the merits of respondent's determination to disqualify the plan, we must address petitioner's contention that respondent "erred in issuing its revocation letter because the statute of limitations has run with respect to one or more of the plan years at issue." Petitioner's limitations contention is misplaced. Section 6501(a)

[1052] *Ed Thielking Inc. v. Commissioner*, pp. 9-10

> limits only the assessment and collection of tax; it does not limit respondent's broad authority to audit retirement plans and, if appropriate, to issue a final nonqualification letter. The period of limitations prescribed by section 6501(a), therefore, does not apply to proceedings under section 7476 or to respondent's determinations regarding the qualification of retirement plans under section 401(a), as they do not involve the imposition of any tax. *Christy & Swan Profit Sharing Plan v. Commissioner*, T.C. Memo. 2011-62, 2011 WL 913190, at *3. Accordingly, respondent's determination to disqualify the ESOP is not barred by any period of limitations set forth in section 6501.[1053]

This is crucial because, as was noted earlier, once a plan is disqualified due to form and/or operational issues, it remains permanently disqualified.

In this case it means the IRS has the right to consider events that took place all the way back to the origination of the plan in determining if the plan remains (or ever was) a qualified plan.

Form Issues

As was noted earlier, a plan must have all terms required by §401(a) in order to be considered a qualified plan. When the law changes, the IRS or Congress will generally set a date by which plan documents must be updated and provide that, in the interim, the plan is to be operated as if it has the required terms. But once that deadline hits, the fact that a plan might have never in operation violated the revised rules under the law won't help if the plan document still contains contrary provisions.

The taxpayer may feel that all is well because they have a determination letter received when the plan was adopted that indicates the terms comply with the law. But such a letter only deals with the law that existed as of the determination letter date. And, as the Court notes in this case, the taxpayer never actually produced the determination letter the taxpayer claimed to rely on.

> Under section 6110(k)(3), determination letters may not be used or cited as precedent, and this Court has refused to consider determination letters proffered by taxpayers. See Derby v. Commissioner, T.C. Memo. 2008-45, 2008 WL 540271, at *20 (concluding that a taxpayer could not rely on a determination letter issued to another taxpayer); see also Reserve Mech. Corp. v. Commissioner, T.C. Memo. 2018-86, at *49 (refusing to consider 39 determination letters because they cannot be used as precedent under section 6110(k)(3)). Consistent with section 6110(k)(3) and our precedent, petitioner cannot rely on a determination letter issued to a different taxpayer. Moreover, petitioner has failed to actually identify the determination letter on which it attempts to rely; even if it had identified it, petitioner failed to provide any evidence that both plans were identical.[1054]

[1053] *Ed Thielking Inc. v. Commissioner*, p. 9

[1054] *Ed Thielking Inc. v. Commissioner*, pp. 22-23

More importantly, the plan never showed that it had adopted any of the amendments that were necessary following the plan's initial adoption in 2006:

> Petitioner contends that it amended the ESOP agreement as required. Petitioner stated that it failed to provide respondent with the amendments because respondent did not request them and later because the Government seized its accountant's records. These contentions are unsupported by the record. First, the plan documents and all amendments were repeatedly requested on at least three occasions — January 28, 2010, October 26, 2011, and January 31, 2012. Second, O&T's records were not seized until September 12, 2012, months after the third request for the amendments. Finally, a taxpayer has a responsibility under section 6001 to maintain adequate records. Petitioner's reliance on its accountant to maintain records does not relieve it of its responsibility to maintain its own records.[1055]

While the Court did not rely solely on this failure to update the plan to find the IRS was justified in revoking the plan's qualified status, clearly being unable to show the plan had been updated since 2006 was not a factor working in the plan's favor.

Operational Issues

While the plan documentation issues were troubling, there were a number of significant operational issues.

A key issue that's seen too often is the owner ignoring the participation rules in the plan when it comes to his/her own coverage. In this case the Court had trouble finding that either Mr. or Mrs. Thielking had actually performed the 1,000 hours of service for one year prior to entering the plan.

The Court pointed out that, based on the terms of the plan, it would have been impossible for anyone to qualify to enter it in the first year, which Mr. Thielking did:

> Eligibility to participate in the ESOP began "immediately after one year of service". Eligibility for contributions also required the purported participant to complete at least 1,000 hours of service within the plan year. Petitioner was [*12] incorporated on March 10, 2006, and reported Mr. Thielking as a plan participant on its Form 5500 for PYE February, 28, 2007.
>
> Petitioner had not been incorporated for one full year when it reported Mr. Thielking as a plan participant; therefore, it is impossible for Mr. Thielking to have attained a year of service as of February 28, 2007. Moreover, the record contains no credible evidence establishing that Mr. Thielking performed services for petitioner that met the 1,000 hours of service requirement. The ESOP agreement defines an hour of service as each hour for which an employee is paid for the performance of duties. Petitioner did not report as deductions either officer compensation or salaries and wages for FYE February 28, 2007, and failed to otherwise provide any evidence

[1055] *Ed Thielking Inc. v. Commissioner*, pp. 23-24

> that it compensated Mr. Thielking for any duties performed for petitioner. Because Mr. Thielking failed both prongs of the test for eligibility, his admission as a plan participant in PYE February 28, 2007, created an operational failure.[1056]

And, although Mrs. Thielking did not enter the plan until the following year via a rollover, the Court had similar issues with her:

> …[T]he ESOT accepted a rollover contribution from Mrs. Thielking during PYE February 28, 2008, but petitioner did not report Mrs. Thielking as a participant until PYE February 28, 2009. Because Mrs. Thielking was not a participant when the ESOT accepted the rollover contribution, an operational failure occurred.[1057]

The Court also did not accept the taxpayer's explanation for the lack of salaries paid not being evidence that, in fact, there was not 1,000 hours of service performed and these individuals were not employees. The Court notes:

> We are not persuaded by petitioner's perfunctory contention that both Mr. and Mrs. Thielking performed substantial services for petitioner and were compensated in the form of year-end bonuses only if circumstances permitted. In the absence of any credible evidence in the record of the services performed or any material yearend bonuses paid in PYE February 28, 2007, we conclude that neither individual performed the requisite 1,000 hours of service.[1058]

The IRS also contended that the contributions made to the ESOP were in excess of the amounts allowed under IRC §401(a)(16) and allocations to participants' accounts were in excess of the amounts allowed under IRC §415(c). The Tax Court agreed, noting:

> Employee stock option plan contributions and other additions with respect to a participant are limited to the lesser of $40,000 (adjusted for inflation, see sec. 415(d)) or 100% of the participant's compensation. Secs. 401(a)(16), 415(c)(1). As mentioned above, petitioner did not claim as deductions either officer compensation or salaries and wages for FYE February 28, 2007. See sec. 415(c)(3). Additionally, it failed to provide any evidence that Mr. Thielking performed any duties for petitioner. Consequently, Mr. Thielking's contribution limit for PYE February 28, 2007, was zero.
>
> Because petitioner contributed property with an alleged value of $23,000 to the ESOT for the account of Mr. Thielking, it exceeded the contribution limit under sections 401(a)(16) and 415(c). This excess contribution constitutes an operational failure for PYE February 28, 2007.[1059]

[1056] *Ed Thielking Inc. v. Commissioner,* pp. 11-12

[1057] *Ed Thielking Inc. v. Commissioner*, p. 12

[1058] *Ed Thielking Inc. v. Commissioner*, p. 13

[1059] *Ed Thielking Inc. v. Commissioner*, pp. 13-14

As well, the IRS argued that the appraisal performed by Mr. Thielking's father failed to satisfy the independent appraiser requirements imposed by IRC §401(a)(28)(C). IRC §401(a)(28)(C) reads:

> (C) Use of independent appraiser.—
>
> A plan meets the requirements of this subparagraph if all valuations of employer securities which are not readily tradable on an established securities market with respect to activities carried on by the plan are by an independent appraiser. For purposes of the preceding sentence, the term "independent appraiser" means any appraiser meeting requirements similar to the requirements of the regulations prescribed under section 170(a)(1).

The first problem was that the appraiser was Mr. Thielking's father, and the use of a related party as the appraiser is barred by the regulations:

> An "independent appraiser" means any appraiser meeting the requirements of a "qualified appraiser" under the section 170(a)(1) regulations. Sec. 401(a)(28)(C). The regulations provide a list of persons who cannot serve as a "qualified appraiser". Sec. 1.170A-13(c)(5)(i)(C), Income Tax Regs. Specifically, the regulations exclude the donor of the property, any party to the transaction in which the donor acquired the property, and the donee of the property from the list of persons eligible to serve as "qualified appraisers". Sec. 1.170A-13(c)(5)(iv)(A), (B), and (C), Income Tax Regs. Any person related to any of the above within the meaning of section 267(b) is also excluded as a qualified appraiser (the constructive ownership rules of section 267(c) apply to this determination). See sec. 267(c); sec. 1.170A-13(c)(5)(iv)(E), Income Tax Regs.
>
> Under section 267(c), stock owned by a trust is considered owned proportionately by its beneficiaries. Sec. 267(c)(1). Stock owned by an individual is constructively owned by his family members, including ancestors and lineal descendants. Sec. 267(c)(2), (4). Finally, stock owned by a corporation is considered owned by any individual owning more than 50% of the stock of the corporation. Sec. 267(b)(2).
>
> As a starting point, petitioner, the donor of the property, is an excluded person. Mr. Thielking, as the sole beneficiary of the ESOT (in PYE February 28, 2007), constructively owned all of petitioner's stock. See sec. 267(c)(1). Stephen Thielking, as Mr. Thielking's father, constructively owns all the stock of petitioner that his son owns. See sec. 267(c)(2), (4). Because Stephen Thielking constructively owns more than 50% of petitioner, he is a related person and is not an independent appraiser.[1060]

[1060] *Ed Thielking Inc. v. Commissioner*, pp. 15-16

In addition to being a related party, Mr. Thielking's father also failed to sign the appraisal, another requirement imposed for a proper independent appraisal.

> In addition to the independence requirement the regulations impose certain collateral requirements: (1) the appraisal must include a declaration that the individual holds himself out to the public as an appraiser and (2) the qualified appraiser who signs the appraisal must list his or her background, experience, education, and membership, if any, in professional appraisal associations. Sec. 1.170A-13(c)(5)(i)(A) and (B), Income Tax Regs. The appraisal letters covering PYE February 28, 2007, through PYE February 28, 2009, state that "[t]he undersigned holds himself out to be an appraiser." However, because there is no signature below that statement or elsewhere on the letters, the appraisals fail the first collateral requirement. See *Hollen v. Commissioner*, 2011 WL 13637, at *4; see also *K.H. Co., LLC Emp. Stock Ownership Plan v. Commissioner*, T.C. Memo. 2014-31, at *27-*32. The appraisals fail the second collateral requirement because Stephen Thielking did not list his qualifications. See *Churchill, Ltd. Emp. Stock Ownership Plan & Tr. v. Commissioner*, T.C. Memo. 2012-300, at *20-*23.[1061]

The taxpayer argued that the plan should be excused what it viewed as violations of these technicalities, arguing that the plan had achieved substantial compliance with the law. The Court did not agree, noting:

> Petitioner relies on *Bond v. Commissioner*, 100 T.C. 32 (1993), where the Court found the regulations under section 170(a) are directory and not mandatory with respect to the section 170 statutory purpose. In *Bond* the Court did not, however, address the independence requirement of section 401(a)(28)(C). We conclude that the independence requirement of section 1.170A-13(c)(5)(iv), Income Tax Regs., which bars certain related people from serving as qualified appraisers, relates to the essence of section 401(a)(28)(C) — therefore the doctrine of substantial compliance cannot excuse the independence requirement.[1062]

The taxpayer also argued that the Court had previously ruled that his father's appraisals in another case met the substantial compliance requirement—but the Tax Court found that the facts of that case were different in important ways, noting:

> …[P]etitioner contends that, in *Val Lanes Recreation Ctr. Corp. v. Commissioner*, at *23-*24, this Court previously found that Stephen Thielking was an independent appraiser. But see *Churchill, Ltd. Emp. Stock Ownership Plan & Tr. v. Commissioner*, at *24-*25 (finding that Stephen Thielking was not an independent appraiser because, inter alia, he failed to sign the appraisals and include his qualifications). *Val Lanes*, however, is distinguishable on multiple grounds. First, Stephen Thielking had no familial relationship with the primary beneficiary of the employee stock option plan in *Val Lanes*. Second, while the appraisals in the record did not include a

[1061] *Ed Thielking Inc. v. Commissioner*, pp. 16-17

[1062] *Ed Thielking Inc. v. Commissioner*, p. 17

> signature, the Court there found on the basis of credible testimony — absent here — that signed appraisals were in fact provided to the Department of Labor. In contrast, here, Stephen Thielking valued stock beneficially owned by his son, and nothing in the record indicates that the appraisals were ever signed.[1063]

Given the multiple problems found, it's not surprising the opinion concludes:

> Because of the operational and form failures set forth above, we find no abuse of discretion in respondent's determination that the plan does not qualify under section 401(a) for PYE February 28, 2007, and because it is a continuing failure, all subsequent plan years. See, e.g., Martin Fireproofing Profit Sharing Plan & Tr. v. Commissioner, 92 T.C. 1173, 1184 (1989). We sustain respondent's determination that the ESOP and the ESOT were disqualified for the 2007 plan year and for all plan years thereafter.[1064]

SECTION: 402
QUALIFIED PLAN OFFSET LOAN AMOUNT PROPOSED REGULATIONS ISSUED BY IRS

Citation: REG-116475-19, 8/17/20

The IRS has issued proposed regulations[1065] that provide information on the extended time period for those plan participants receiving a noncash distribution from a retirement plan that is a *qualified plan loan offset* (QPLO) to rollover the amount to another retirement plan. This provision was added to the law by the Tax Cuts and Jobs Act (TCJA).

The proposed regulations provide that taxpayers may rely on these regulations beginning with respect to plan loan offset amounts, including qualified plan loan offset amounts, treated as distributed on or after the date the proposed regulations are published in the *Federal Register*[1066] and before the date the regulations are published in the *Federal Register* in final form.[1067]

TCJA Law Change

The Tax Cuts and Jobs Act revised IRC §402(c)(3) in the following manner, as described in the preamble to the proposed regulations:

1063 *Ed Thielking Inc. v. Commissioner*, p. 18

1064 *Ed Thielking Inc. v. Commissioner*, p. 24

1065 REG-116475-19, August 17, 2020 (to be published on August 20, 2020), https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-16564.pdf (retrieved August 17, 2020)

1066 Scheduled per the original draft release to be published on August 20, 2020

1067 REG-116475-19, August 17, 2020, Proposed Applicability Date and page one header on the original draft released in PDF form on August 17

> Section 13613 of TCJA amended section 402(c)(3) of the Code to provide an extended rollover deadline for qualified plan loan offset (QPLO) amounts (as defined in section 402(c)(3)(C)(ii)). Any portion of a QPLO amount (up to the entire QPLO amount) may be rolled over into an eligible retirement plan by the individual's tax filing due date (including extensions) for the taxable year in which the offset occurs.[1068]

Qualified Plan Loan Offset Amount

The preamble notes that a QPLO amount is defined under the statute as a plan loan offset amount treated as distributed from a qualified employer plan to an employee or beneficiary *solely* by reason of:

- The termination of the qualified employer plan, *or*
- The failure to meet the repayment terms of the loan from such plan because of the severance from employment of the employee.[1069]

The loan must be one that met the requirements to be treated as a plan loan under §72(p)(2) not treated as a distribution right up until such time as the QPLO amount is treated as distributed.[1070]

Note that not all plan loan offsets are qualified plan loan offsets—the proposed regulations defined the broad term plan loan offsets as follows:

> For purposes of section 402(c), a plan loan offset amount is the amount by which, under the plan terms governing a plan loan, an employee's accrued benefit is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in an employee's accrued benefit). A distribution of a plan loan offset amount can occur in a variety of circumstances, for example, when the terms governing a plan loan require that, in the event of the employee's termination of employment or request for a distribution, the loan be repaid immediately or treated as in default. A distribution of a plan loan offset amount also occurs when, under the terms governing the plan loan, the loan is cancelled, accelerated, or treated as if it were in default (for example, when the plan treats a loan as in default upon an employee's termination of employment or within a specified period thereafter). A distribution of a plan loan offset amount is an actual distribution, not a deemed distribution under section 72(p).[1071]

[1068] REG-116475-19, August 17, 2020, Background, Section 2

[1069] REG-116475-19, August 17, 2020, Background, Section 2, Proposed Reg. §1.402(c)-3(a)(2)(iii)(B)(1)

[1070] REG-116475-19, August 17, 2020, Background, Section 2, Proposed Reg. §1.402(c)-3(a)(2)(iii)(B)(2)

[1071] Proposed Reg. §1.402(c)-3(a)(2)(iii)(A)

A severance from employment is determined by reference to Reg. §1.401(k)-1(d)(2).[1072] That regulation provides the following is treated as a severance from employment.[1073]

> An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee. For example, a new employer maintains a plan with respect to an employee by continuing or assuming sponsorship of the plan or by accepting a transfer of plan assets and liabilities (within the meaning of section 414(l)) with respect to the employee.[1074]

The distribution is deemed to be offset due to the termination of employment when the following conditions are met:

> A plan loan offset amount is treated as distributed from a qualified employer plan to an employee or beneficiary solely by reason of the failure to meet the repayment terms of a plan loan because of severance from employment of the employee if the plan loan offset:
>
> > (1) Relates to a failure to meet the repayment terms of the plan loan, and
> >
> > (2) Occurs within the period beginning on the date of the employee's severance from employment and ending on the first anniversary of that date.[1075]

Note that this provides a 12 month period during which the QPLO must be recognized by the plan to be covered under these rules.

Time Period to Rollover the QPLO Amount

QPLO amounts receive an extended time period during which they can be rolled over by the former participant to another retirement plan. That period runs from the date of the QPLO amount distribution up through the individual's tax filing due date (including extensions) for the taxable year in which the QPLO amount is treated as distributed from the plan.[1076]

The preamble provides that this rollover will be covered by the automatic extended time period to complete certain actions provided by Reg. §301.9100-2(b), so that a taxpayer that files his/her return

[1072] Proposed Reg. §1.402(c)-3(a)(2)(iv)(A)

[1073] Proposed Reg. §1.402(c)-3(a)(2)(ii)(A)

[1074] Reg. §1.401(k)-1(d)(2)

[1075] Proposed Reg. §1.402(c)-3(a)(2)(iv)(B)

[1076] Proposed Reg. §1.402(c)-3(a)(2)(ii)(B) timely will have until the extended due date of that return to complete the rollover even if no extension of time to file the return is requested. The preamble notes:

> If a taxpayer to whom a QPLO amount is distributed satisfies the conditions in §301.9100-2(b), the taxpayer will have an extended period past his or her tax filing due date in which to complete a rollover of the QPLO amount, even if the taxpayer does not request an extension to file his or her income tax return but instead files the return by the unextended tax filing due date.[1077]

The provisions of Reg. §301.9100-2(b) apply to taxpayers that meet the following two conditions:

- The taxpayer's return was timely filed for the year the QPLO amount is treated as distributed; *and*
- The taxpayer takes appropriate corrective action within the six-month period following the original unextended due date (in this case that means completes the rollover).[1078]

The extended period to rollover the QPLO amount does *not* extend the time to rollover any part of the rollover distribution that is not a QPLO amount (that is, normally the portion received in cash or employer securities by the employee or amounts withheld and transmitted to the IRS by the plan as federal withholding taxes for the participant).

Examples

The regulations provide the following examples of applying its provisions:

EXAMPLE 1, PROPOSED REG. §1.402(C)-3(A)(2)(V)

Direct rollover of balance after QPLO

(1) In 2020, Employee A has an account balance of $10,000 in Plan Y, of which $3,000 is invested in a plan loan to Employee A that is secured by Employee A's account balance in Plan Y. Employee A has made no after-tax employee contributions to Plan Y. The plan loan meets the requirements of section 72(p)(2). Plan Y does not provide any direct rollover option with respect to plan loans. Employee A severs from employment on June 15, 2020. After severance from employment, Plan Y accelerates the plan loan and provides Employee A 90 days to repay the remaining balance of the plan loan. Employee A, who is under the age set forth in section 401(a)(9)(C)(i)(II), does not repay the loan within the 90 days and instead elects a direct rollover of Employee A's entire account balance in Plan Y. On September 18, 2020 (within the 12-month period beginning on the date that Employee A severed from employment), Employee A's outstanding loan is offset against the account balance.

(2) In order to satisfy section 401(a)(31), Plan Y must make a direct rollover by paying $7,000 directly to the eligible retirement plan chosen by Employee A. When Employee A's account balance was offset by the amount of the $3,000 unpaid loan balance, Employee A received a plan loan offset amount (equivalent to $3,000) that is an eligible rollover distribution. However, under §1.401(a)(31)-1, Q&A-16, Plan Y satisfies section 401(a)(31), even though a direct rollover option was not provided with respect to the $3,000 plan loan offset amount.

[1077] REG-116475-19, August 17, 2020, Explanation of Provisions, Section 2

[1078] REG-116475-19, August 17, 2020, Background, Section 2

(3) No withholding is required under section 3405(c) on account of the distribution of the $3,000 plan loan offset amount because no cash or other property (other than the plan loan offset amount) is received by Employee A from which to satisfy the withholding.

(4) The $3,000 plan loan offset amount is a qualified plan loan offset amount within the meaning of paragraph (a)(2)(iii)(B) of this section. Accordingly, Employee A may roll over up to the $3,000 qualified plan loan offset amount to an eligible retirement plan within the period that ends on the employee's tax filing due date (including extensions) for the taxable year in which the offset occurs.

EXAMPLE 2, PROPOSED REG. §1.402(C)-3(A)(2)(V)

No QPLO at time of severance of employment, later loan default

(1) The facts are the same as in Example 1, except that, rather than accelerating the plan loan, Plan Y permits Employee A to continue making loan installment payments after severance from employment. Employee A continues making loan installment payments until January 1, 2021, at which time Employee A does not make the loan installment payment due on January 1, 2021. In accordance with §1.72(p)-1, Q&A-10, Plan Y allows a cure period that continues until the last day of the calendar quarter following the quarter in which the required installment payment was due. Employee A does not make a plan loan installment payment during the cure period. Plan Y offsets the unpaid $3,000 loan balance against Employee A's account balance on July 1, 2021 (which is after the 12-month period beginning on the date that Employee A severed from employment).

(2) The conclusion is the same as in Example 1, except that the $3,000 plan loan offset amount is not a qualified plan loan offset amount (because the offset did not occur within the 12-month period beginning on the date that Employee A severed from employment). Accordingly, Employee A may roll over up to the $3,000 plan loan offset amount to an eligible retirement plan within the 60-day period provided in section 402(c)(3)(A) (rather than within the period that ends on Employee A's tax filing due date (including extensions) for the taxable year in which the offset occurs).

EXAMPLE 3, PROPOSED REG. §1.402(C)-3(A)(2)(V)

Offset due to terms of plan, employee does not request an offset

(1) The facts are the same as in Example 1, except that the terms governing the plan loan to Employee A provide that, upon severance from employment, Employee A's account balance is automatically offset by the amount of any unpaid loan balance to repay the loan. Employee A severs from employment but does not request a distribution from Plan Y. Nevertheless, pursuant to the terms governing the plan loan, Employee A's account balance is automatically offset on June 15, 2020, by the amount of the $3,000 unpaid loan balance.

(2) The $3,000 plan loan offset amount is a qualified plan loan offset amount within the meaning of paragraph (a)(2)(iii)(B) of this section. Accordingly, Employee A may roll over up to the $3,000 qualified plan loan offset amount to an eligible retirement plan within the period that ends on Employee A's tax filing due date (including extensions) for the taxable year in which the offset occurs.

EXAMPLE 4, PROPOSED REG. §1.402(C)-3(A)(2)(V)

Employee takes a cash distribution after QPLO rather than a direct rollover

(1) The facts are the same as in Example 1, except that Employee A elects to receive a cash distribution of the account balance that remains after the $3,000 plan loan offset amount, instead of electing a direct rollover of the remaining account balance.

(2) The amount of the distribution received by Employee A is $10,000 (not $3,000). Because the amount of the $3,000 plan loan offset amount attributable to the loan is included in determining the amount of the eligible rollover distribution to which withholding applies, withholding in the amount of $2,000 (20 percent of $10,000) is required under section 3405(c). The $2,000 is required to be withheld from the $7,000 to be distributed to Employee A in cash, so that Employee A actually receives a cash amount of $5,000.

(3) The $3,000 plan loan offset amount is a qualified plan loan offset amount within the meaning of paragraph (a)(2)(iii)(B) of this section. Accordingly, Employee A may roll over up to the $3,000 qualified plan loan offset to an eligible retirement plan within the period that ends on the Employee A's tax filing due date (including extensions) for the taxable year in which the offset occurs. In addition, Employee A may roll over up to $7,000 (the portion of the distribution that is not related to the offset) within the 60-day period provided in section 402(c)(3).

Note that in this example, the employee will need to come up with the $2,000 of taxes withheld within 60 days to complete a rollover. Only the $3,000 QPLO amount receives the extended period during which a rollover may be completed.

EXAMPLE 5, PROPOSED REG. §1.402(C)-3(A)(2)(V)

Employer securities rather than cash distributed

(1) The facts are the same as in Example 4, except that the $7,000 distribution to Employee A after the offset consists solely of employer securities within the meaning of section 402(e)(4)(E).

(2) No withholding is required under section 3405(c) because the distribution consists solely of the $3,000 plan loan offset amount and the $7,000 distribution of employer securities. This is the result because the total amount required to be withheld does not exceed the sum of the cash and the fair market value of other property distributed, excluding plan loan offset amounts and employer securities.

(3) Employee A may roll over up to the $7,000 of employer securities to an eligible retirement plan within the 60-day period provided in section 402(c)(3). The $3,000 plan loan offset amount is a qualified plan loan offset amount within the meaning of paragraph (a)(2)(iii)(B) of this section. Accordingly, Employee A may roll over up to the $3,000 qualified plan loan offset amount to an eligible retirement plan within the period that ends on Employee A's tax filing due date (including extensions) for the taxable year in which the offset occurs.

EXAMPLE 6, PROPOSED REG. §1.402(C)-3(A)(2)(V)

Employee fails to make payments on plan loan

(1) Employee B, who is age 40, has an account balance in Plan Z. Plan Z provides for no after-tax employee contributions. In 2022, Employee B receives a loan from Plan Z, the terms of which satisfy section 72(p)(2), and which is secured by elective contributions subject to the distribution restrictions in section 401(k)(2)(B).

(2) Employee B fails to make an installment payment due on April 1, 2023, or any other monthly payments thereafter. In accordance with §1.72(p)-1, Q&A-10, Plan Z allows a cure period that continues until the last day of the calendar quarter following the quarter in which the required installment payment was due (September 30, 2023). Employee B does not make a plan loan installment payment during the cure period. On September 30, 2023, pursuant to section 72(p)(1), Employee B is taxed on a deemed distribution equal to the amount of the unpaid loan balance. Pursuant to §1.402(c)-2, Q&A4(d), the deemed distribution is not an eligible rollover distribution.

(3) Because Employee B has not severed from employment or experienced any other event that permits the distribution under section 401(k)(2)(B) of the elective contributions that secure the loan, Plan Z is

prohibited from executing on the loan. Accordingly, Employee B's account balance is not offset by the amount of the unpaid loan balance at the time of the deemed distribution. Thus, there is no distribution of an offset amount that is an eligible rollover distribution on September 30, 2023.

EXAMPLE 7, PROPOSED REG. §1.402(C)-3(A)(2)(V)

Employee defaults on plan loan, separates from service afterward

(1) The facts are the same as in Example 6, except that Employee B has a severance from employment on November 1, 2023. On that date, Employee B's unpaid loan balance is offset against the account balance on distribution.

(2) The plan loan offset amount is not a qualified plan loan offset amount. Although the offset occurred within 12 months after Employee B severed from employment, the plan loan does not meet the requirement in paragraph (a)(2)(iii)(B) of this section (that the plan loan meet the requirements of section 72(p)(2) immediately prior to Employee B's severance from employment). Instead, the loan was taxable on September 30, 2023 (prior to Employee B's severance from employment on November 1, 2023), because of the failure to meet the level amortization requirement in section 72(p)(2)(C). Accordingly, Employee B may roll over the plan loan offset amount to an eligible retirement plan within the 60-day period provided in section 402(c)(3)(A) (rather than within the period that ends on Employee B's tax filing due date (including extensions) for the taxable year in which the offset occurs).

SECTION: 402
NOTICE PROVIDES DETAILS ON CARES ACT RETIREMENT PLAN PROVISIONS

Citation: Notice 2020-50, 6/19/20

Guidance has been issued on various employee benefit plan relief provisions found in the CARES Act in Notice 2020-50.[1079]

Coronavirus-Related Distributions from Retirement Plans

CARES Act §2202(a) provides specific relief to beneficiaries of retirement plans for a coronavirus-related distribution. Specifically, the Notice describes this relief in Section 1 of the Notice for such distributions as follows:

> The section provides an exception to the 10% additional tax under § 72(t) of the Code (including the 25% additional tax under § 72(t)(6) for certain distributions from SIMPLE IRAs), allows the distribution to be included in income ratably over 3 years, and provides that the distribution will be treated as though it were paid in a direct rollover to an eligible retirement plan if the distribution is eligible for tax-free rollover treatment and is recontributed to an eligible retirement plan within the 3-year period beginning on the day after the date on which the distribution was received.[1080]

[1079] Notice 2020-50, June 19 2020, https://www.irs.gov/pub/irs-drop/n-20-50.pdf (retrieved June 19, 2020)

[1080] Notice 2020-50, Section 1.A.

To be eligible for such relief, a person must be a *qualified individual.* The law specifically describes the following categories of qualified individuals to include an individual:

- Who is diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (referred to collectively in this notice as COVID-19) by a test approved by the Centers for Disease Control and Prevention (including a test authorized under the Federal Food, Drug, and Cosmetic Act);
- Whose spouse or dependent (as defined in section 152 of the Code) is diagnosed with COVID-19 by a test approved by the Centers for Disease Control and Prevention (including a test authorized under the Federal Food, Drug, and Cosmetic Act); or
- Who experiences adverse financial consequences as a result of:
  - the individual being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19;
  - the individual being unable to work due to lack of childcare due to COVID-19; or
  - closing or reducing hours of a business owned or operated by the individual due to COVID-19.[1081]

As well, the CARES Act at §2202(a)(4)(A)(ii)(III) allows the IRS to provide for other factors that would make the participant a qualified individual eligible for coronavirus-related distributions. In Notice 2020-50 the IRS provides that a qualified individual also includes an individual who experiences adverse financial consequences as a result of:

- The individual having a reduction in pay (or self-employment income) due to COVID-19 or having a job offer rescinded or start date for a job delayed due to COVID-19;
- The individual's spouse or a member of the individual's household being quarantined, being furloughed or laid off, or having work hours reduced due to COVID-19, being unable to work due to lack of childcare due to COVID-19, having a reduction in pay (or self-employment income) due to COVID-19, or having a job offer rescinded or start date for a job delayed due to COVID-19; or
- Closing or reducing hours of a business owned or operated by the individual's spouse or a member of the individual's household due to COVID-19.[1082]

A member of the taxpayer's household is defined as "someone who shares the individual's principal residence."[1083]

[1081] Notice 2020-50, Section 1.B.

[1082] Notice 2020-50, Section 1.B.

[1083] Notice 2020-50, Section 1.B.

The relief relates to a *coronavirus-related distribution*. The Notice describes the law provision as follows:

> Section 2202(a)(4)(A) of the CARES Act defines a coronavirus-related distribution as any distribution from an eligible retirement plan made on or after January 1, 2020, and before December 31, 2020, to a qualified individual. Section 2202(a)(2) of the CARES Act limits the amount of aggregate distributions from all eligible retirement plans that can be treated as coronavirus-related distributions to no more than $100,000.[1084]

The Notice provides that it is the individual and not the plan that ultimately designates a distribution as a corona-virus related distribution, so long as it meets the necessary requirements. The Notice continues:

> This designation is permitted to be made with respect to any distribution to a qualified individual that would meet the requirements of a coronavirus-related distribution without regard to whether the plan treated the distribution as a coronavirus-related distribution. Thus, periodic payments and distributions that would have been required minimum distributions but for section 2203 of the CARES Act, received by a qualified individual from an eligible retirement plan on or after January 1, 2020, and before December 31, 2020, are permitted to be treated as coronavirus-related distributions and, therefore, permitted to be included in income ratably over 3 years. Similarly, any distribution received by a qualified individual as a beneficiary can be treated as a coronavirus-related distribution. In addition, a reduction or offset of a qualified individual's account balance in order to repay a plan loan, as described in Q&A-9(b) of § 1.402(c)-2, including a qualified plan loan offset, is permitted to be treated as a coronavirus-related distribution.[1085]

However, the employer retirement plan is allowed to (but not required to) treat a distribution as a coronavirus-related distribution. The Notice provides:

> As explained in section 2.C of this notice, an employer retirement plan also is permitted, but not required, to treat a plan distribution meeting the conditions described in this section 1.C as a coronavirus-related distribution. It is possible that a qualified individual's designation of a coronavirus-related distribution may be different from the employer retirement plan's treatment of the distribution. This different treatment could occur, for example, if a qualified individual has more than one plan distribution that meets the requirements of a coronavirus-related distribution, but one of those distributions occurs before the effective date of the plan amendment providing for coronavirus-related distributions. The different treatment could also occur, for example, if a qualified individual has distributions

[1084] Notice 2020-50, Section 1.C.

[1085] Notice 2020-50, Section 1.C.

> from more than one eligible retirement plan, and the aggregate amount of those distributions exceeds $100,000.[1086]

However, the Notice provides that certain distributions, described in Q&A 4 of Reg. §1.402(c)-2, are not permitted to be treated as coronavirus-related distributions. This would include:

- Corrective distributions of elective deferrals and employee contributions that are returned to the employee (together with the income allocable thereto) in order to comply with the § 415 limitations,
- Excess elective deferrals under § 402(g),
- Excess contributions under § 401(k),
- Excess aggregate contributions under § 401(m);
- Loans that are treated as deemed distributions pursuant to § 72(p);
- Dividends paid on applicable employer securities under § 404(k);
- The costs of current life insurance protection; prohibited allocations that are treated as deemed distributions pursuant to § 409(p);
- Distributions that are permissible withdrawals from an eligible automatic contribution arrangement within the meaning of § 414(w); and
- Distributions of premiums for accident or health insurance under § 1.402(a)-1(e)(1)(i).[1087]

Once an individual is found to be a qualified individual to receive a coronavirus-related distribution, there is no limit on what the distribution can be used for. The Notice provides:

> The definition of a coronavirus-related distribution under section 2202(a)(4) of the CARES Act does not limit these distributions to amounts withdrawn solely to meet a need arising from COVID-19. Thus, for example, for an individual who is a qualified individual as a result of experiencing adverse financial consequences as described above, coronavirus-related distributions are permitted without regard to the qualified individual's need for funds, and the amount of the distribution is not required to correspond to the extent of the adverse financial consequences experienced by the qualified individual.[1088]

[1086] Notice 2020-50, Section 1.C

[1087] Notice 2020-50, Section 1.C.

[1088] Notice 2020-50, Section 1.C.

The Notice also explains that some, but not all, coronavirus-related distributions are eligible for a special 3-year rollover treatment. It begins by explaining that, generally, a distribution must be of a type otherwise eligible for rollover treatment, providing:

> …[O]nly a coronavirus-related distribution that is eligible for tax-free rollover treatment under § 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16) is permitted to be recontributed to an eligible retirement plan, and that recontribution will be treated as having been made in a trustee-to-trustee transfer to that eligible retirement plan.[1089]

Specifically, while a distribution made to the beneficiary of an inherited IRA or retirement account can qualify for the 3-year inclusion rule for coronavirus-related distributions, "[a]ny coronavirus-related distribution (whether from an employer retirement plan or an IRA) paid to a qualified individual as a beneficiary of an employee or IRA owner (other than the surviving spouse of the employee or IRA owner) cannot be recontributed."[1090]

Hardship distributions are not normally eligible for rollover treatment, but the Notice provides:

> In general, a distribution from an employer retirement plan made on account of hardship is not an eligible rollover distribution. However, if the distribution satisfies the requirements under section 1.C of this notice, then, except as otherwise provided in section 6 of this notice (relating to nonqualified deferred compensation plans), the distribution is not treated as made on account of hardship for purposes of this notice and, thus, any portion of the distribution is permitted to be recontributed to an eligible retirement plan.[1091]

Guidance for Individuals Receiving Coronavirus-Related Distributions

The Notice provides that individuals entitled to tax-favored treatment for coronavirus-related distributions will report the distribution on Form 8915-E, *Qualified 2020 Disaster Retirement Plan Distributions and Repayments*, a form expected to be available by the end of 2020. The same form will be used to report any recontribution made during a tax year and to determine the amount of the coronavirus-related distribution includible in income for the taxable year.

An individual makes an election to treat a distribution that meets the requirements to be a coronavirus-related distribution as such on his/her individual return, subject to the cap of $100,000 for the individual.[1092]

[1089] Notice 2020-50, Section 1.C.

[1090] Notice 2020-50, Section 1.C.

[1091] Notice 2020-50, Section 1.C.

[1092] Notice 2020-50, Section 4.A

EXAMPLE 1-NOTICE 2020-50, SECTION 4.A.

If a qualified individual receives a distribution of $50,000 in August of 2020 and a distribution of $75,000 in September of 2020 and both distributions satisfy the definition of a coronavirus-related distribution, only $100,000 of the $125,000 received by the qualified individual can be treated as a coronavirus-related distribution. Thus, the individual can only treat $100,000 of the August and September distributions as coronavirus-related distributions on the individual's 2020 federal income tax return. Assuming no § 72(t)(2) exception applies, the remaining $25,000 of the distribution is an early distribution that is subject to the 10% additional tax. This amount must be included on the individual's 2020 federal income tax return and will not be eligible for 3-year recontribution to an eligible retirement plan.

EXAMPLE 2 NOTICE 2020-50, SECTION 4.A.

A section 401(k) plan distributes $35,000 to a qualified individual on December 1, 2020. The qualified individual also receives a distribution from the individual's IRA on December 1, 2020, of $15,000. The individual is permitted to treat both the $35,000 from the plan and the $15,000 from the IRA as coronavirus-related distributions on the individual's 2020 federal income tax return.

The notice provides an individual with a choice of two tax treatments for a qualified coronavirus-related distribution:

- A qualified individual who receives a coronavirus-related distribution is permitted to include the taxable portion of the distribution in income ratably over a 3-year period that begins in the year of the distribution.

- Alternatively, a qualified individual is permitted to elect out of the 3-year ratable income inclusion and include the entire amount of the taxable portion of the distribution in income in the year of the distribution.[1093]

The election cannot be made or changed after the timely filing of the individual's federal income tax return (including extensions) for the year the distribution is received. All coronavirus-related distributions received during the year are required to be treated in the same fashion—that is, the election is an all or nothing election with regard to the distributions for the year.[1094]

EXAMPLE NOTICE 2020-50 SECTION 4.B.

Taxpayer A receives a $30,000 distribution from his or her IRA on October 1, 2020. Taxpayer A is a qualified individual and elects to treat the distribution as a coronavirus-related distribution. Taxpayer A uses the 3-year ratable income inclusion for the $30,000 distribution. Taxpayer A should include $10,000 in income with respect to the coronavirus-related distribution on each of the individual's 2020, 2021, and 2022 federal income tax returns.

Recontributions are more complicated, since the 3-year period to recontribute extends well beyond the due date for the tax return for the year of the distribution. As well, the taxpayer may have opted to either include the entire amount in income in the first year, or spread the taxable amount of the distribution over three years.

[1093] Notice 2020-50, Section 4.B.

[1094] Notice 2020-50, Section 4.B.

Regardless of which election is made for income inclusion, the taxpayer can make a recontribution of an otherwise-qualified rollover distribution:

> If a coronavirus-related distribution is eligible for tax-free rollover treatment (taking into account section 1.D of this notice), a qualified individual is permitted, at any time in the 3-year period beginning the day after the date of a coronavirus related distribution, to recontribute any portion of the distribution, but not an amount in excess of the amount of the distribution, to an eligible retirement plan. A recontribution of a coronavirus-related distribution will not be treated as a rollover contribution for purposes of the one-rollover-per-year limitation under § 408(d)(3)(B).[1095]

The Notice first discusses the tax treatment for an individual that had *not* chosen to include the original distribution in income over three years. Not unexpectedly, the individual will need to include the amount of the distribution in income for the year of distribution unless the recontribution is made prior to the timely filing of the individual's tax return for the year of the distribution.

The Notice then describes what will happen once the amount is recontributed:

> If a qualified individual includes a coronavirus-related distribution in gross income in the year of the distribution and recontributes the distribution to an eligible retirement plan after the timely filing of the individual's federal income tax return for the year of the distribution (that is, after the due date, including extensions), the individual will need to file an amended federal income tax return for the year of the distribution. The qualified individual will need to file a revised Form 8915-E (with his or her amended federal income tax return) to report the amount of the recontribution and should reduce his or her gross income by the amount of the recontribution, but not in an amount exceeding the amount of the coronavirus-related distribution.[1096]

EXAMPLE 1 NOTICE 2020-50 SECTION 4.D.

Taxpayer B receives a $45,000 distribution from a § 403(b) plan on November 1, 2020. Taxpayer B is a qualified individual and treats the distribution as a coronavirus-related distribution. Taxpayer B receives no other coronavirus-related distribution from any eligible retirement plan. Taxpayer B recontributes $45,000 to an IRA on March 31, 2021. Taxpayer B reports the recontribution on Form 8915-E and files the 2020 federal income tax return on April 10, 2021. For Taxpayer B, no portion of the coronavirus-related distribution is includible as income for the 2020 tax year.

EXAMPLE 2 NOTICE 2020-50 SECTION 4.D.

The facts are the same as in Example 1 of this section 4.D, except that Taxpayer B timely requests an extension of time to file the 2020 federal income tax return and makes a recontribution on August 2, 2021, before filing the 2020 federal income tax return. Taxpayer B files the 2020 federal income tax return on

[1095] Notice 2020-50, Section 4.C.

[1096] Notice 2020-50, Section 4.D.

August 10, 2021. As in Example 1, no portion of the coronavirus-related distribution is includible in income for the 2020 tax year because Taxpayer B made the recontribution before the timely filing of the 2020 federal income tax return.

EXAMPLE 3 NOTICE 2020-50 SECTION 4.D.

Taxpayer C receives a $15,000 distribution from a governmental § 457(b) plan on March 30, 2020. Taxpayer C is a qualified individual and treats the distribution as a coronavirus-related distribution. Taxpayer C elects out of the 3-year ratable income inclusion on Form 8915-E and includes the entire $15,000 in gross income for the 2020 taxable year. On December 31, 2022, Taxpayer C recontributes $15,000 to the § 457(b) plan. Taxpayer C will need to file an amended federal income tax return for the 2020 tax year to report the amount of the recontribution and reduce the gross income by $15,000 with respect to the coronavirus-related distribution included on the 2020 original federal income tax return.

For those electing a 3-year inclusion in income, only a portion of the distribution may have been subject to tax when the recontribution is made. Initially the recontribution reduces the amount included in the next return due to be filed as follows:

> As explained above, a qualified individual is permitted to include a coronavirus-related distribution in income ratably over a 3-year period. If a qualified individual includes a coronavirus-related distribution ratably over a 3- year period and the individual recontributes any portion of the coronavirus-related distribution to an eligible retirement plan at any date before the timely filing of the individual's federal income tax return (that is, by the due date, including extensions) for a tax year in the 3-year period, the amount of the recontribution will reduce the ratable portion of the coronavirus-related distribution that is includible in gross income for that tax year. See section 4.F of this notice for recontributions that affect income inclusion in other tax years.

EXAMPLE 1 NOTICE 2020-50 SECTION 4.E.

Taxpayer D receives $75,000 from a section 401(k) plan on December 1, 2020. Taxpayer D is a qualified individual and treats the $75,000 distribution as a coronavirus-related distribution. Taxpayer D uses the 3-year ratable income inclusion method for the distribution. Taxpayer D makes one recontribution of $25,000 to the section 401(k) plan on April 10, 2022. Taxpayer D files the 2021 federal income tax return on April 15, 2022. Without the recontribution, Taxpayer D should include $25,000 in income with respect to the coronavirus-related distribution on each of D's 2020, 2021, and 2022 federal income tax returns. However, as a result of the recontribution to the section 401(k) plan, Taxpayer D should include $25,000 in income with respect to the coronavirus-related distribution on the 2020 federal income tax return, $0 in income with respect to the coronavirus-related distribution on the 2021 federal income tax return, and $25,000 in income with respect to the coronavirus-related distribution on the 2022 federal income tax return.

EXAMPLE 2 NOTICE 2020-50 SECTION 4.E.

The facts are the same as in Example 1 of this section 4.E, except that Taxpayer D recontributes $25,000 to the section 401(k) plan on August 10, 2022. Taxpayer D files the 2021 federal income tax return on April 15, 2022, and does not request an extension of time to file that federal income tax return. As a result of the recontribution to the section 401(k) plan, Taxpayer D should include $25,000 in income with respect to the coronavirus-related distribution on the 2020 federal income tax return, $25,000 in income with respect to the coronavirus-related distribution on the 2021 federal income tax return, and $0 in income with respect to the coronavirus-related distribution on the 2022 federal income tax return.

If the amount of the recontribution exceeds the amount to be included in the next return to be filed, the Notice provides for a carryback or carryforward of the excess:

> If a qualified individual using the 3-year ratable income inclusion method recontributes an amount of a coronavirus-related distribution for a tax year in the 3-year period that exceeds the amount that is otherwise includible in gross income for that tax year, as described in section 4.E of this notice, the excess amount of the recontribution is permitted to be carried forward to reduce the amount of the coronavirus-related distribution that is includible in gross income in the next tax year in the 3-year period. Alternatively, the qualified individual is permitted to carry back the excess amount of the recontribution to a prior taxable year or years in which the individual included income attributable to a coronavirus-related distribution. The individual will need to file an amended federal income tax return for the prior taxable year or years to report the amount of the recontribution on Form 8915-E and reduce his or her gross income by the excess amount of the recontribution. [1097]

EXAMPLE NOTICE 2020-50 SECTION 4.F.

Taxpayer E receives a distribution of $90,000 from his or her IRA on November 15, 2020. Taxpayer E is a qualified individual and treats the distribution as a coronavirus-related distribution. Taxpayer E ratably includes the $90,000 distribution in income over a 3-year period. Without any recontribution, Taxpayer E will include $30,000 in income with respect to the coronavirus-related distribution on each of the 2020, 2021, and 2022 federal income tax returns. Taxpayer E includes $30,000 in income with respect to the coronavirus-related distribution on the 2020 federal income tax return. Taxpayer E then recontributes $40,000 to an IRA on November 10, 2021 (and makes no other recontribution in the 3-year period). Taxpayer E is permitted to do either of the following:

- Option 1. Taxpayer E includes $0 in income with respect to the coronavirus-related distribution on the 2021 federal income tax return. Taxpayer E carries forward the excess recontribution of $10,000 to 2022 and includes $20,000 in income with respect to the coronavirus-related distribution on E's 2022 federal income tax return.
- Option 2. Taxpayer E includes $0 in income with respect to the coronavirus-related distribution on the 2021 tax return and $30,000 in income on the 2022 federal income tax return. Taxpayer E also files an amended federal income tax return for 2020 to reduce the amount included in income as a result of the coronavirus-related distribution to $20,000 (that is, the $30,000 original amount includible in income for 2020 minus the remaining $10,000 recontribution that is not offset on either the 2021 or 2022 federal tax return).

[1097] Notice 2020-50, Section 4.F.

It is possible that the recipient who elected a 3-year inclusion in income may die prior to the end of the three-year period. In that case, the Notice provides:

> If a qualified individual dies before the full taxable amount of the coronavirus-related distribution has been included in gross income, then the remainder must be included in gross income for the taxable year that includes the individual's death.

The IRS also addresses the impact of taking a coronavirus-related distribution for a participant who is currently receiving substantially equal periodic payments to avoid the imposition of the 10% additional tax for distributions received prior to age 59 ½. The Notice provides the following to avoid disruption of the exception:

> In the case of an individual receiving substantially equal periodic payments from an eligible retirement plan, the receipt of a coronavirus-related distribution from that plan will not be treated as a change in substantially equal payments as described in § 72(t)(4) merely because of the coronavirus-related distribution.[1098]

Employer Retirement Plans Making Coronavirus-Related Distributions

The Notice points out that under CARES Act §2202(a)(6) "a distribution designated as a coronavirus-related distribution by an employer retirement plan is treated as meeting the distribution restrictions for qualified cash or deferred arrangements under § 401(k)(2)(B)(i), custodial accounts under § 403(b)(7)(A)(i), annuity contracts under § 403(b)(11), governmental deferred compensation plans under § 457(d)(1)(A), and the Thrift Savings Plan under 5 U.S.C. 8433(h)(1)."[1099]

The Notice goes on to explain this special exception to the distribution requirements for such plans as follows:

> [F]or example, an employer may expand the distribution options under its plan to allow an amount attributable to an elective, qualified nonelective, qualified matching, or safe harbor contribution under a qualified cash or deferred arrangement to be distributed as a coronavirus-related distribution even though it is distributed before an otherwise permitted distributable event, such as severance from employment, disability, or attainment of age 59½.[1100]

However, the CARES Act does not otherwise change such distribution rules for these plans:

> Except as described above, section 2202 of the CARES Act does not change the rules for when plan distributions are permitted to be made from employer retirement plans. Thus, for example, a qualified plan that is a pension plan (such as a money purchase pension plan) is not permitted to make a distribution before an otherwise permitted distributable event merely because the distribution, if made,

[1098] Notice 2020-50, Section 4.H.

[1099] Notice 2020-50, Section 2.A.

[1100] Notice 2020-50, Section 2.A.

> would qualify as a coronavirus-related distribution. Further, a pension plan is not permitted to make a distribution under a distribution form that is not a qualified joint and survivor annuity without spousal consent merely because the distribution, if made, could be treated as a coronavirus-related distribution.[1101]

The requirements to issue a §402(f) notice, offer a direct rollover or the mandatory withholding of 20% of the distribution do not apply to a qualified plan's coronavirus-related distributions:

> …[T]he plan is not required to offer the qualified individual a direct rollover with respect to the distribution. In addition, the plan administrator is not required to provide a § 402(f) notice. Finally, the plan administrator or payor of the coronavirus-related distribution is not required to withhold an amount equal to 20% of the distribution, as is usually required under § 3405(c)(1). However, a coronavirus-related distribution is subject to the voluntary withholding requirements of § 3405(b) and § 35.3405-1T.[1102]

The employer is permitted significant latitude with the plan-level designation of coronavirus-related distributions. The Notice provides:

> An employer is permitted to choose whether, and to what extent, to treat distributions under its plans as coronavirus-related distributions (as well as whether, and to what extent, to apply coronavirus-related plan loan rules described in section 5 of this notice). Thus, for example, an employer may choose to provide for coronavirus-related distributions but choose not to change its plan loan provisions or loan repayment schedules. Further, the employer (or plan administrator) is permitted to develop any reasonable procedures for identifying which distributions are treated as coronavirus-related distributions under its retirement plans.[1103]

Nevertheless, the plan must be consistent in its treatments. The Notice provides:

> However, if, under an employer retirement plan, any distribution of an amount subject to § 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11) or 457(d)(1)(A) is treated as a coronavirus-related distribution, the plan must be consistent in its treatment of similar distributions. Accordingly, the amount of the distribution must be taken into account in determining the $100,000 limit on coronavirus-related distributions made under all the retirement plans maintained by the employer. [1104]

[1101] Notice 2020-50, Section 2.A.

[1102] Notice 2020-50, Section 2.B.

[1103] Notice 2020-50, Section 2.C.

[1104] Notice 2020-50, Section 2.C

As well, as noted in the section on individuals' treatments of coronavirus-related distributions, the plan's designation does not bind the individual if the distribution otherwise meets the requirement of being a coronavirus-related distribution:

> Even if, under a plan, a distribution is not treated as coronavirus-related, a qualified individual may treat a distribution that meets the requirements of section 1.C of this notice as a coronavirus-related distribution on the individual's federal income tax return.[1105]

While the employer cannot determine how much, if any, an employee has taken as coronavirus-related distributions from other plans, the employer is required to cap coronavirus-related distributions from the plans it does sponsor on a per employee basis:

> The total amount of distributions treated by an employer as coronavirus related distributions under all its retirement plans with respect to a qualified individual is not permitted to exceed $100,000. For purposes of this rule, the term "employer" means the employer maintaining the plan and those employers required to be aggregated with the employer under § 414(b), (c), (m), or (o). However, a plan will not fail to satisfy any requirement under the Code merely because a qualified individual's total coronavirus-related distributions exceed $100,000 taking into account distributions from IRAs or other eligible retirement plans maintained by unrelated employers.[1106]

A plan is allowed to accept an employee's certification that the individual meets the conditions to be a qualified individual unless the administrator has actual knowledge to the contrary. An administrator does not have to make an inquiry into whether the individual satisfies the conditions, but rather is limited to cases where the administrator is already aware the individual does not qualify.[1107]

The Notice provides the following sample certification an administrator can have an employee complete stating he/she is a qualified individual:

> Name: ________________________ (and other identifying information requested by the employer for administrative purposes).
>
> I certify that I meet at least one of the following conditions: (1) I was diagnosed with the virus SARS-CoV-2 or with coronavirus disease 2019 (referred to collectively as COVID-19) by a test approved by the Centers for Disease Control and Prevention (including a test authorized under the Federal Food, Drug, and Cosmetic Act); (2) my spouse or my dependent was diagnosed with COVID-19 by a test approved by the Centers for Disease Control and Prevention (including a test authorized under the Federal Food, Drug, and Cosmetic Act); or (3) I have experienced adverse financial consequences because: (i) I, my spouse, or a member of

[1105] Notice 2020-50, Section 2.C.

[1106] Notice 2020-50, Section 2.D.

[1107] Notice 2020-50, Section 2.E.

my household was quarantined, furloughed or laid off, or had work hours reduced due to COVID-19; (ii) I, my spouse, or a member of my household was unable to work due to lack of childcare due to COVID-19; (iii) a business owned or operated by me, my spouse, or a member of my household closed or reduced hours due to COVID-19; or (iv) I, my spouse, or a member of my household had a reduction in pay (or self-employment income) due to COVID-19 or had a job offer rescinded or start date for a job delayed due to COVID-19.

> Signature: ______________________

The fact that a plan may have treated a distribution as a coronavirus-related distribution does *not* mean the individual may treat the distribution in that manner. Rather, the individual is responsible for determining if he/she meets the requirements for a coronavirus-related distribution.[1108]

Finally, the Notice provides information on the ability to operate the plan as if it had been amended to implement CARES Act provisions, so long as an actual amendment is made by specified dates:

> An employer retirement plan will not be treated as failing to operate in accordance with its terms merely because the plan implements the provisions of section 2202 of the CARES Act if the employer amends its plan by the dates described in this paragraph. For employer retirement plans other than governmental plans under § 414(d) of the Code, the date by which any plan amendment to reflect the CARES Act is required to be made is the last day of the first plan year beginning on or after January 1, 2022. For governmental plans under § 414(d) of the Code, the date by which any plan amendment to reflect the CARES Act is required to be made is the last day of the first plan year beginning on or after January 1, 2024. Pursuant to the authority of the Secretary under section 2202(c)(2) of the CARES Act, these dates may be extended in future guidance.[1109]

Plans Making or Accepting Recontributions of Coronavirus-Related Distributions

Tax reporting for plans (including IRAs) is covered in Section 3 of the notice.

The plans will report distributions on Forms 1099-R as follows:

> An eligible retirement plan must report the payment of a coronavirus related distribution to a qualified individual on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. This reporting is required even if the qualified individual recontributes the coronavirus-related distribution to the same eligible retirement plan in the same year. If a payor is treating the payment as a coronavirus-related distribution and no other appropriate code applies, the payor is permitted to use distribution code 2 (early

[1108] Notice 2020-50, Section 2.E.

[1109] Notice 2020-50, Section 2.F.

> distribution, exception applies) in box 7 of Form 1099-R. However, a payor also is permitted to use distribution code 1 (early distribution, no known exception) in box 7 of Form 1099-R.[1110]

For plans that decide to accept recontributions, the Notice provides the following guidance:

> In general, a qualified individual who receives a coronavirus-related distribution that is eligible for tax-free rollover treatment is permitted to recontribute, at any time in a 3-year period, any portion of the distribution to an eligible retirement plan that is permitted to accept eligible rollover contributions. The relief in Q&A-14 of § 1.401(a)(31)-1 applies to an employer retirement plan accepting recontributions of coronavirus-related distributions. In order to obtain the relief described in Q&A-14 of § 1.401(a)(31)-1, a plan administrator accepting the recontribution of a coronavirus-related distribution must reasonably conclude that the recontribution is eligible for direct rollover treatment under section 2202(a)(3) of the CARES Act and that the recontribution is made in accordance with the rules under section 4.C of this notice. In making this determination, the rule in section 2.E of this notice applies. Thus, the administrator of an eligible retirement plan may rely on an individual's certification that the individual satisfies the conditions to be a qualified individual in determining whether a distribution is a coronavirus-related distribution, unless the administrator has actual knowledge to the contrary.[1111]

Note that a plan does *not* have to accept recontributions of coronavirus-related distributions. As the Notice provides:

> In general, it is anticipated that eligible retirement plans will accept recontributions of coronavirus-related distributions, which are to be treated as rollover contributions. However, eligible retirement plans generally are not required to accept rollover contributions. For example, if a plan does not accept any rollover contributions, the plan is not required to change its terms or procedures to accept recontributions of coronavirus-related distributions.[1112]

Qualified Plan Loans

While CARES Act §2202(b) provides special short-term revisions to liberalize rules related to loans from qualified retirement plans to participants, the Notice makes clear an employer is not required to allow use of these revisions by plan participants:

> As described in section 2.C of this notice, an employer is permitted to choose whether, and to what extent, to apply coronavirus-related plan loan rules described in this section (regardless of how coronavirus-related distributions are treated).[1113]

[1110] Notice 2020-50, Section 3.A.

[1111] Notice 2020-50, Section 3.B.

[1112] Notice 2020-50, Section 3.B.

[1113] Notice 2020-50, Section 5

If a plan sponsor decides to implement the provision, the CARES Act allows for an increase in the maximum amount a participant may borrow from the plan:

> Special rules apply to a loan made from a qualified employer plan (as defined in § 1.72(p)-1, Q&A-2) to a qualified individual on or after March 27, 2020 (the date of enactment of the CARES Act) and before September 23, 2020. For these loans, section 2202(b)(1) of the CARES Act changes the limits under § 72(p)(2)(A) of the Code. In applying § 72(p) to a plan loan, the $50,000 aggregate limit in § 72(p)(2)(A)(i) is increased to $100,000 and the rule in § 72(p)(2)(A)(ii) limiting the aggregate amount of loans to 50 percent of the employee's vested accrued benefit is increased to 100 percent of the employee's vested accrued benefit.[1114]

Since qualified retirement plans are regulated by both the IRS and the Department of Labor, in a footnote the Notice provides assurance that the Department of Labor will not take action against an employer implementing these provisions:

> The Department of Labor has advised the Department of the Treasury and the IRS that it will not treat any person as having violated the provisions of Title I of the Employee Retirement Income Security Act (ERISA), including the adequate security and reasonably equivalent basis requirements in ERISA section 408(b)(1) and 29 CFR 2550.408b-1, solely because the person made a plan loan to a qualified individual during the period beginning on March 27, 2020, and ending on September 22, 2020, in compliance with CARES Act section 2202(b)(1) and the provisions of this notice. See EBSA Disaster Relief Notice 2020-01.[1115]

The CARES Act also permits, but does not require, a plan to provide for suspension of payment on plan loans and a related extension of loan terms. The Notice describes these permitted modifications as follows:

> A special rule applies if a qualified individual has an outstanding loan from a qualified employer plan on or after March 27, 2020. Section 2202(b)(2) of the CARES Act provides that, for purposes of § 72(p), in the case of a qualified individual with a loan from a qualified employer plan outstanding on or after March 27, 2020, if the due date pursuant to § 72(p)(2)(B) or (C) for any repayment with respect to the loan occurs during the period beginning on March 27, 2020, and ending on December 31, 2020, the due date shall be delayed for 1 year. In addition, any subsequent repayments of the loan shall be adjusted appropriately to reflect the delay and any interest accruing during the delay, and the period of delay must be disregarded in determining the 5-year period and the term of the loan under § 72(p)(2)(B) and (C). The effect of section 2202(b)(2) of the CARES Act is to permit a delay in certain plan loan repayments without causing the loans to violate § 72(p)(2)(B) and (C). It does not, however, require a delay in plan loan repayments in order to satisfy § 72(p)(2)(B) and (C). Thus, an employer is permitted to choose to allow this delay in loan repayments under its plan with respect to qualified

[1114] Notice 2020-50, Section 5.A.

[1115] Notice 2020-50, Section 5.A., Footnote 2 individuals, and, if it does, there will not be a deemed distribution to those individuals under § 72(p) due to the delay. For example, each repayment that becomes due during the period from March 27, 2020, through December 31, 2020, may be delayed for up to 1 year and then reamortized (taking into account interest) over a period that is up to 1 year longer than the original term of the loan. Each reamortized repayment may then be added to other reamortized repayments and to non-reamortized repayments to construct an overall loan reamortization schedule.[1116]

The Notice provides for a safe harbor where the plan will be treated as satisfying the requirements necessary to avoid having the loan treated as a distribution under IRC §72(p) if the following steps are followed:

- A qualified individual's obligation to repay a plan loan is suspended under the plan for any period beginning not earlier than March 27, 2020, and ending not later than December 31, 2020 (suspension period).
- The loan repayments must resume after the end of the suspension period, and the term of the loan may be extended by up to 1 year from the date the loan was originally due to be repaid.
- If a qualified employer plan suspends loan repayments during the suspension period, the suspension will not cause the loan to be deemed distributed even if, due solely to the suspension, the term of the loan is extended beyond 5 years.
- Interest accruing during the suspension period must be added to the remaining principal of the loan.
- A plan satisfies these rules if the loan is reamortized and repaid in substantially level installments over the remaining period of the loan (that is, 5 years from the date of the loan, assuming that the loan is not a principal residence loan, plus up to 1 year from the date the loan was originally due to be repaid).
- If an employer, under its plan, chooses to permit a suspension period that is less than the maximum suspension period described above, the employer is permitted to extend the suspension period subsequently, but not beyond December 31, 2020. [1117]

EXAMPLE APPLYING THE SAFE HARBOR NOTICE 2020-50 SECTION 5.B.

On April 1, 2020, a participant with a nonforfeitable account balance of $40,000 borrowed $20,000 to be repaid in level monthly installments of $368.33 each over 5 years, with the repayments to be made by payroll withholding. The participant makes payments for 3 months through June 30, 2020. The participant is a qualified individual (as described in section 1.B of this notice). The participant's employer takes action to suspend payroll withholding repayments, for the period from July 1, 2020, through December 31, 2020, for loans to qualified individuals that are outstanding on or after March 27, 2020. Because the participant is a qualified individual, no further repayments are made on the participant's loan until January 1, 2021 (when

[1116] Notice 2020-50, Section 5.B.

[1117] Notice 2020-50, Section 5.B.

the balance is $19,477). At that time, repayments on the loan resume, with the amount of each monthly installment reamortized to be $343.27 in order for the loan to be repaid by March 31, 2026 (which is the date the loan originally would have been fully repaid, plus 1 year).

The Notice recognizes that the above is meant to be treated as a safe harbor, not as the sole way to satisfy the law. The Notice provides:

> The Department of the Treasury and the IRS recognize that there may be additional reasonable, if more complex, ways to administer section 2202(b) of the CARES Act. For example, in a plan with a suspension period beginning April 1, 2020, each repayment that becomes due during the suspension period may be delayed to April 1, 2021 (the 1-year anniversary of the beginning of the suspension period). After originally scheduled repayments for January through March of 2021 are made, the outstanding balance of the loan on April 1, 2021, including the delayed repayments with interest, may be reamortized over a period that is up to 1 year longer than the original term of the loan.[1118]

An employer can rely on an employee's certification that he/she is a qualified individual under the same terms as provided for coronavirus-related distributions. The same certification form may be used to satisfy documenting the employee's qualification as was provided in the Notice for the certification for coronavirus-related distributions.[1119]

Deferral Elections Under Nonqualified Deferred Compensation Plans

The IRS provided relief in this notice for certain cases involving nonqualified deferred compensation plans for situations where a service provider receives a coronavirus-related distribution from an eligible retirement plan. The Notice provides:

> Under § 1.409A-3(j)(4)(viii), a nonqualified deferred compensation plan subject to § 409A may provide for a cancellation of a service provider's deferral election, or such a cancellation may be made, due to an unforeseeable emergency or a hardship distribution pursuant to § 1.401(k)-1(d)(3). If a service provider receives a distribution from an eligible retirement plan that constitutes a coronavirus-related distribution, that distribution will be considered a hardship distribution pursuant to § 1.401(k)-1(d)(3) for purposes of § 1.409A-3(j)(4)(viii). As a result, a nonqualified deferred compensation plan may provide for a cancellation of the service provider's deferral election, or such a cancellation may be made, due to a coronavirus-related distribution described in section 1.C of this notice. The deferral election must be cancelled, not merely postponed or otherwise delayed.[1120]

[1118] Notice 2020-50, Section 5.B.

[1119] Notice 2020-50, Section 5.C.

[1120] Notice 2020-50, Section 6

SECTION: 446
SMALL BUSINESS ACCOUNTING METHOD PROPOSED REGULATIONS RELEASED

Citation: REG-132766-18, 7/29/20

The IRS has issued proposed regulations to implement the various small business optional accounting rules added to IRC §§263A, 448, 460 and 471 by the Tax Cuts and Jobs Act (TCJA).[1121] These rules are generally available to small businesses that are not tax shelters and have average annual gross receipts in the preceding three years not in excess of an amount annually adjusted for inflation. For 2020 the revenue limit is $26 million.[1122]

Qualifying entities are:

- Allowed to use the cash basis of accounting (any change of method is treated as a change initiated by the taxpayer and made with the consent of the IRS). [IRC §448(b)(3), (d)(7)]
- Allowed to be exempt from the application of the uniform capitalization rules of IRC §263A [IRC §263A(i)]
- Allowed to be exempt from the requirement to keep inventories under the rules of §471(a) (though such items must either be tracked as if they were non-incidental supplies or treated in conformity with the entity's applicable financial statement/books and records if no AFS exists). [IRC §471(c)]
- Treated as meeting the gross receipts requirement to be treated as a small contractor exempt from the percentage of completion method (this does not impact the second requirement that the expected length of contracts must also be less than 2 years to be exempt from percentage of completion). [IRC §460(e)(1)(B)]

Any change of method required for the above is treated as a change initiated by the taxpayer and made with the consent of the IRS for purposes of IRC §481.

Taxpayers May Rely on Proposed Regulations

Although the regulations are issued in proposed form, Treasury provides that taxpayers may rely on these regulations in the interim. The preamble to the proposed regulations provides:

> However, for taxable years beginning after December 31, 2017, and before the date the Treasury Decision adopting these regulations as final regulations is published in the Federal Register, a taxpayer may rely on these proposed regulations, provided

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[1121] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf (retrieved July 30, 2020)

[1122] Revenue Procedure 2019-44, November 6, 2019, Section 3.21, https://www.irs.gov/pub/irs-drop/rp-19-44.pdf (retrieved July 30, 2020) that the taxpayer follows all the applicable rules contained in the proposed regulations for each Code provision that the taxpayer chooses to apply.[1123]

The IRS had previously issued preliminary guidance for taxpayers qualifying for and adopting these optional methods, as well as a request for comments, in Revenue Procedure 2018-40. This procedure will continue to contain the automatic accounting method change procedures under these regulations.

Some of the key items in these proposed regulations are discussed in this article.

Entities Qualifying for Special Small Business Accounting Methods (IRC §448(c))

To qualify to use these special small business methods, a taxpayer must meet requirements outlined in IRC §448(c) and not be a tax shelter as defined in IRC §448(d)(2).

IRC §448(c) provides the following gross receipts test:

> (c) Gross receipts test
>
> For purposes of this section—
>
> (1) In general
>
> A corporation or partnership meets the gross receipts test of this subsection for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25,000,000.[1124]
>
> (2) Aggregation rules
>
> All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1).
>
> (3) Special rules
>
> For purposes of this subsection—
>
>> (A) Not in existence for entire 3-year period
>>
>> If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.

[1123] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf, p. 42

[1124] For 2020 this is set at $26,000,000 under the inflation adjustment provided for at IRC §448(c)(4) and published in Revenue Procedure 2019-44 noted earlier.

(B) Short taxable years

Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

(C) Gross receipts

Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.

(D) Treatment of predecessors

Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.

(4) Adjustment for inflation

In the case of any taxable year beginning after December 31, 2018, the dollar amount in paragraph (1) shall be increased by an amount equal to—

(A) such dollar amount, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 2017" for "calendar year 2016" in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of $1,000,000, such amount shall be rounded to the nearest multiple of $1,000,000.

The IRS has proposed the creation of a new regulation (Proposed Reg. §1.448-2) to apply to years beginning after December 31, 2017, with Reg. §1.448-1 retained to deal with years beginning prior to that date.

The IRS summarized the key differences in the preamble to the proposed regulations as follows:

> These rules are generally similar to the existing regulations under §1.448-1 and §1.448-1T of the Temporary Income Tax Regulations, including the short taxable year rule and the aggregation rule. However, for taxable years beginning after December 31, 2017, the proposed regulations update the rules to reflect the post-TCJA Section 448(c) gross receipts test. These proposed regulations also clarify that the gross receipts of a C corporation partner are included in the gross receipts of a partnership if the aggregation rules apply to the C corporation partner and the partnership.[1125]

[1125] REG-132766-18, July 29, 2020, https://www.irs.gov/pub/irs-drop/reg_132766_18.pdf, p. 13

Gross Receipts Test

Proposed Reg. §1.448-2(c)(2) contains the details of the gross receipts test. The proposed regulation provides generally:

> A corporation meets the gross receipts test of this paragraph (c)(2) if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence, annualized as required) ending with such prior taxable year does not exceed the gross receipts test amount provided in paragraph (c)(2)(v) of this section (section 448(c) gross receipts test). In the case of a C corporation exempt from Federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (b)(1) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. A partnership with a C corporation as a partner meets the gross receipts test of paragraph (c)(2) of this section if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence annualized as required) ending with such prior year does not exceed the gross receipts test amount of paragraph (c)(2)(v) of this section. Except as provided in paragraph (c)(2)(ii) of this section, the gross receipts of the corporate partner are not taken into account in determining whether a partnership meets the gross receipts test of paragraph (c)(2) of this section.[1126]

Related entities are aggregated for purposes of this test. Proposed Reg. §1.448-1(c)(2)(ii) provides that the aggregation rules remain the same as they were, referencing Reg. §1.448-1T(f)(2)(ii). That rule provides:

> (ii) Aggregation of gross receipts.
>
> For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52(a) or (b), or section 414 (m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisfied.[1127]

For purposes of applying the gross receipts test, aggregation rules under IRC §§52(a), (b), 404(m) and (o) are used to combine related entities. Thus, the entities that must be combined are:

- Under IRC §52(a) and (b):

[1126] Proposed Reg. §1.448-2(c)(2)(i)

[1127] Reg. §1.448-1T(f)(2)(ii)

- A set of corporations that would be a controlled group of corporations under IRC §1563(a) if "more than 50 percent" were substituted for "at least 80 percent" each place it appears in §1563(a)(1) (the parent-subsidiary test);
- The determination was made without regard to §§1563(a)(4) and (e)(3); and
- A similar rule is applied to unincorporated entities

■ An affiliated service group under IRC §414(m); and

■ Groups named in the regulations under IRC §414(o) that combine the following when organized to avoid employee benefit requirements:

- Separate organizations;
- Employee leasing, or
- Other arrangements.

The §52 related groups are likely to be the most significant problem advisers will encounter in this area. Those groups are:

■ A parent-subsidiary relationship where one or more chains of corporations connected through stock ownership with a common parent corporation if

- stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations; and
- the common parent corporation owns stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations;

■ A brother-sister controlled group which consists of two or more corporations if 5 or fewer persons who are individuals, estates, or trusts own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50 percent of the total value of shares of all classes of stock of each corporation, taking into account the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation; and

■ A combined group which consists of three or more corporations each of which is a member of a group of corporations that fit into one of the prior two groups, and one of which

- Is a common parent corporation included in a parent-subsidiary group, and also

– Is included in a brother-sister controlled group.[1128]

The proposed regulations also keep the prior rules for treatment of short taxable years[1129] found in Temporary Regulation §1.448-1T:

> (iii) Treatment of short taxable year.
>
> In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.[1130]

Finally, the same rules for the determination of gross receipts are retained,[1131] also coming from Temporary Regulation §1.448-1T:

> The term "gross receipts" means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (e.g., a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.[1132]

[1128] IRC §1563(a) as modified by the language in §52(a)

[1129] Proposed Reg. §1.448-2(c)(iii)

[1130] Temp. Reg. §1.448-1T(f)(2)(iii)

[1131] Proposed Reg. §1.448-1(c)(iv)

[1132] Temp. Reg. §1.448-1T(f)(2)(iv)

The proposed regulations provide the following example of the application of their provisions:

EXAMPLE, PROPOSED REG. §1.448-2(C)(2)(V)(B)

Taxpayer A, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. A's gross receipts for the 2017- 2019 taxable years are $20 million, $16 million, and $30 million, respectively. A's average annual gross receipts for the three taxable-year period preceding the 2020 taxable year is $22 million (($20 million + $16 million + $30 million) / 3 = $22 million. A may use the cash method for its trade or business for the 2020 taxable year because its average annual gross receipts for the preceding three taxable years is not more than the gross receipts test amount of paragraph (c)(2)(vi) of this section, which is $26 million for 2020.

Some of the special rules on the gross receipts test are found outside of the regulations under IRC §448, especially as they apply to individuals. Proposed Reg. §1.263A-1(j)(2) provides the following for testing the gross receipts of individuals to qualify under the gross receipts test:

> Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.[1133]

The regulation continues to provide that individuals also take into account their proportionate share of gross receipts of partnerships and S corporations for purposes of the gross receipts test:

> Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's pro rata share of S corporation gross receipts taken into account by the S corporation under section 1363(b).[1134]

The proposed regulation gives two examples of applying these rules to individuals:

EXAMPLE 1, PROPOSED REG. §1.263A-1(J)(2)(IV)

Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, Profit or Loss from Business, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of $5 million, and the other trade or business has average annual gross receipts of $35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section ($5 million + $35 million = $40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

[1133] Proposed Reg. §1.263A-1(j)(2)(ii)

[1134] Proposed Reg. §1.263A-1(j)(2)(iii)

EXAMPLE 2, PROPOSED REG. §1.263A-1(J)(2)(IV)

Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of $15 million, Business Y is a dance studio with average annual gross receipts of $6 million, and Business Z is a car repair shop with average annual gross receipts of $12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section ($15 million + $6 million + $12 million = $33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26 million).

The above provisions are also found in Proposed Reg. §1.460-3(b)(3) and Proposed Reg. §1.471-1(b)(2).

Tax Shelters

But it's not just the gross receipts test that must be taken into account—even if the prior three years' average gross receipts are below the level for the tax year in question, the taxpayer may still be denied access to these accounting methods if the entity is a tax shelter as defined at IRC §448(d)(3).

That definition reads:

> The term "tax shelter" has the meaning given such term by section 461(i)(3) (determined after application of paragraph (4) thereof). An S corporation shall not be treated as a tax shelter for purposes of this section merely by reason of being required to file a notice of exemption from registration with a State agency described in section 461(i)(3)(A), but only if there is a requirement applicable to all corporations offering securities for sale in the State that to be exempt from such registration the corporation must file such a notice.[1135]

The proposed regulations provide the following list of tax shelters for this purpose:

- An enterprise, other than a C corporation, if at any time (including taxable years beginning before January 1, 1987) 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;
- A tax shelter (which seems a circular definition, but this "tax shelter" is a subset of the larger §448(d)(3) tax shelter, this one defined at §6662(d)(2)(C), so we'll refer to this as a *§6662 tax shelter*); or
- A syndicate.[1136]

[1135] IRC §448(d)(3)

[1136] Proposed Reg. §1.448-2(b)(2)(i)

An enterprise other than a C corporation is considered to be one that had a requirement of registration if it meets the following requirements:

> …[A]n offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to register the offering would result in a violation of the applicable Federal or state law; this rule applies regardless of whether the offering is in fact registered. In addition, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or state law, regardless of whether the notice is in fact filed. However, an S corporation is not treated as a tax shelter for purposes of section 448(d)(3) or this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if all corporations offering securities for sale in the state must file such a notice in order to be exempt from such registration.[1137]

A *§6662 tax shelter* is defined to include:

- A partnership or other entity,
- Any investment plan or arrangement, or
- Any other plan or arrangement,

if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.[1138]

The proposed regulations provide for a special presumption of a principal purpose of tax avoidance for certain farming activities:

> …[M]arketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (for example, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).[1139]

The presumption means the burden will be on the taxpayer to clearly demonstrate that there was not a principal purpose of tax reduction in this arrangement. Note that a *principal purpose* is generally regarded as being a more important purpose than a *significant purpose*. It's not clear why the proposed regulation used that term rather than a presumption of a *significant* purpose.

[1137] Proposed Reg. §1.448-2(b)(2)(ii)

[1138] IRC §6662(d)(2)(C)(ii)

[1139] Proposed Reg. §1.448-2(b)(2)(iv)

The category that has traditionally been the most challenging has been the *syndicate* category. IRC §448 refers to the definition found at IRC §461(i)(3) which then references IRC §1256(e)(3)(B). However, the proposed regulation provides a generally self-contained definition that draws from those sections.

The basic definition of a *syndicate* is provided as follows by the proposed regulation:

> …[T]he term syndicate means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs.[1140]

In these proposed regulations the IRS has opted to continue to use the *allocated* test found in the prior §448 regulations even though §1256(e)(3)(B) itself uses the term *allocable*. Thus, if there is no loss generated for a tax year, the entity will not be a syndicate for that year. But if the entity has both profitable and unprofitable years, it may move in and out of syndicate status depending on the percentage of amounts allocated in loss years to equity holders qualifying as limited entrepreneurs or who are limited partners.

The proposed regulation goes on to define the term *limited entrepreneur*, providing:

> …[T]he term limited entrepreneur has the same meaning given such term in section 461(k)(4).

IRC §461(k)(4) has the actual definition, which provides that a *limited entrepreneur* is a person who:

- Has an interest in an enterprise other than as a limited partner, and
- Does not actively participate in the management of such enterprise.[1141]

The 35% loss rule is tested without regard to the limitation on the deduction of business interest found in §163(j).[1142] In a separate set of proposed regulations issued a day earlier with regard to the business interest rule, the IRS provided for a similar proposed change in Proposed Reg. §1.1256(3)-2[1143] and gave the following example of how to compute whether an undertaking has a loss as follows:

EXAMPLE, PROPOSED REG. §1.1256(3)-2(E)(2)(C)

Entity is an S corporation that is equally owned by individuals A and B. A provides all of the goods and services provided by Entity. B provided all of the capital for Entity but does not participate in Entity's business. For the current taxable year, Entity has gross receipts of $5,000,000, non-interest expenses of $4,500,000, and interest expense of $600,000.

1140 Proposed Reg. §1.448-2(b)(2)(iii)(A)

1141 IRC §461(k)(4)

1142 Proposed Reg. §1.448-2(b)(2)(v)

1143 REG-107911-18, July 28, 2020, https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf (retrieved July 30, 2020)

Under the tax syndicate loss testing rules, Entity has a net loss of $100,000 ($5,000,000 minus $5,100,000) for the current taxable year. One half (50 percent) of this loss is allocated to B, a limited owner. Therefore, for the current taxable year, Entity is a syndicate within the meaning of section 1256(e)(3)(B).

In the preamble to the proposed regulations under §163(j) the IRS noted the reason why this special rule is necessary that was cited in comments received by the IRS:

> One commenter asked for clarification on how to compute the amount of losses to be allocated for purposes of determining syndicate status under section 1256(e)(3)(A). The commenter provided a particular fact pattern in which a small business would be caught in an iterative loop of (a) having net losses due to an interest deduction, (b) which would trigger disallowance of the exemption in section 163(j)(3), (c) which would trigger the application of section 163(j)(1) to reduce the amount of the interest deduction, (d) which would then lead to the taxpayer having no net losses and therefore being eligible for the application of section 163(j)(3). To address this fact pattern, the Treasury Department and the IRS have added rules providing that, for purposes of section 1256(e)(3)(B), losses are determined without regard to section 163(j). See proposed §§1.163(j)-2(d)(3) and 1.1256(e)-2(b).[1144]

Even with this change, it clearly is possible an undertaking that has been profitable could suddenly become a tax shelter for §448 purposes if it generates a loss for the year. The proposed regulations provide that an entity must change its accounting method for the year it becomes a tax shelter.[1145]

Note that this will be true even if the loss is a one-time special event (such as due to an accounting method change adjustment under IRC §481(a)). Taxpayers may need to consider making elections that may be available opting out of claiming certain tax benefits once the total consequences of becoming a syndicate are considered.[1146]

While by default a taxpayer tests for tax shelter status by using the current year's return to see if 35% of losses have been allocated to limited partners or limited entrepreneurs, for purposes of the small business accounting method rules a taxpayer can elect to perform the test based on the prior year's activity:

> …[T]o determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs, instead of using the current taxable year's allocation of losses, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation.[1147]

1144 REG-107911-18, July 28, 2020, https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf, p. 111

1145 Proposed Reg. §1.448-2(b)(2)(v)

1146 The same syndicate test is applied for purposes of determining if otherwise exempt small taxpayer will nevertheless have to apply the §163(j) limitation rules in the final and proposed §163(j) regulations issued the day before these proposed regulations.

1147 Proposed Reg. §1.448-2(b)(2)(iii)(B)

Such an election is binding on the taxpayer unless the permission of the IRS is received to change the election—and even then the proposed regulations provide for limits on the IRS's ability to grant the permission in some cases:

> An election under this paragraph (b)(2)(iii)(B) applies to the first taxable year for which the election is made and to all subsequent taxable years, unless the Commissioner of Internal Revenue or his delegate (Commissioner) permits a revocation of the election in accordance with this paragraph. An election under this paragraph (b)(2)(iii)(B) may never be revoked earlier than the fifth taxable year following the first taxable year for which the election was made unless extraordinary circumstances are demonstrated to the satisfaction of the Commissioner. Once an election has been revoked, a new election under this paragraph (b)(2)(iii)(B) cannot be made until the fifth taxable year following the taxable year for which the previous election was revoked unless extraordinary circumstances are demonstrated to the satisfaction of the Commissioner.[1148]

Obtaining that permission will require applying and paying for a private letter ruling:

> An election made under this paragraph (b)(2)(iii)(B) may only be revoked with the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures for requesting a letter ruling (for example, see Revenue Procedure 2020-1, 2020-01 IRB 1 (or its successor)).[1149]

The proposed regulations provide the requirements and limitations for a taxpayer making this election:

> A taxpayer making this election must attach a statement to its timely filed Federal income tax return (including extension) that this election is made beginning with that taxable year. If such a statement is not attached, the election is not valid and has no effect for any purpose. No late elections will be permitted. Further, an election cannot be made by filing an amended Federal income tax return. [1150]

The election to determine tax shelter status based on the prior year applies for *all* purposes under the IRC where it is relevant, not just these small business accounting methods. That would include taxpayers to whom the §163(j) business limitation rules would apply should they be treated as a tax shelter.

> In addition to section 448, this election also applies for purposes of all provisions of the Code that refer to section 448(a)(3) to define tax shelter.[1151]

[1148] Proposed Reg. §1.448-2(b)(2)(iii)(B)

[1149] Proposed Reg. §1.448-2(b)(2)(iii)(B)

[1150] Proposed Reg. §1.448-2(b)(2)(iii)(B)

[1151] Proposed Reg. §1.448-2(b)(2)(iii)(B)

The proposed regulations provide the following example of applying these rules:

EXAMPLE, PROPOSED REG. §1.448-2(B)(2)(III)(B)

Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. In 2019, B is profitable and allocates 80 percent of its profits to its general partner and 20 percent of its profits to its limited partner. In 2020, B has a loss and allocates 60 percent of losses to its general partner and 40 percent of its losses to its limited partner. In 2020 B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. For 2020, B is not a syndicate because B is treated as having allocated 20 percent of its profits to its limited partner in 2020 for purposes of paragraph (b)(2)(iii) of this section. For 2021, B is a syndicate because B is treated as having allocated 40 percent of its losses to its limited partner for purposes of paragraph (b)(2)(iii) of this section.

Cash Basis of Accounting Under IRC §446

While the major change to the optional use of the cash method of accounting was the simple increase in the dollar limit from $5 million to a much higher inflation adjusted number (now $26,000,000) and granting protection to all entity types, the proposed regulations contain items that taxpayers should be aware of if the entity has revenues that float above and below the limit.

Previously, a covered taxpayer who had ever had average revenue above the limit was permanently barred from using the cash method of accounting. As the preamble notes, that requirement was removed from the IRC and has been removed from the proposed regulations.

> The TCJA removed the requirement under section 448(c) that all prior taxable years of a taxpayer must satisfy the Section 448(c) gross receipts test for the taxpayer to qualify for the cash method for taxable years beginning after December 31, 2017. Thus, section 448 no longer permanently prevents a C corporation or a partnership with a C corporation partner from using the cash method for a year subsequent to a taxable year in which its gross receipts first exceed the dollar threshold for the Section 448(c) gross receipts test. Accordingly, the proposed regulations do not require taxpayers to meet the gross receipts test for all prior taxable years in order to satisfy the Section 448(c) gross receipts test.[1152]

Taxpayers who find their average revenue for the prior three years has now grown above the limit for the year in question and had previously been using the overall cash method of accounting will be forced to change their accounting method at that time:

> Any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g). In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. A taxpayer must change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section or a subsequent taxable year in which the taxpayer is newly subject to this section after previously making a change in method of accounting that complies with section 448 (mandatory section 448 year). A taxpayer may have

[1152] REG-132766-18, July 29, 2020, pp. 16-17

> more than one mandatory section 448 year. For example, a taxpayer may exceed the gross receipts test of section 448(c) in non-consecutive taxable years. If the taxpayer complies with the provisions of paragraph (g)(3) of this section for its mandatory section 448 year, the change shall be treated as made with the consent of the Commissioner. The change shall be implemented pursuant to the applicable administrative procedures to obtain the automatic consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (See Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor) (see §601.601(d)(2) of this chapter)). This paragraph (g) applies only to a taxpayer who changes from the cash method as required by this section. This paragraph (g) does not apply to a change in method of accounting required by any Code section (or applicable regulation) other than this section.[1153]

If a taxpayer later falls below the limit, special rules apply if it has been less than five year since the change to the overall accrual method of accounting was mandated due to the average revenue rule:

> A taxpayer that otherwise meets the requirements of paragraph (c) of this section, and that had during any of the five taxable years ending with the taxable year changed its overall method of accounting from the cash method because it no longer met the gross receipts test of section 448(c) provided under paragraph (c) of this section or because it was a tax shelter as provided under paragraph (b)(2) of this section, may not change its overall method of accounting back to the cash method without the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures to obtain the written consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (see also §601.601(d)(2) of this chapter). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.[1154]

The preamble suggests that the IRS may not be likely to grant this relief if a taxpayer requests it, as the preamble notes:

> A taxpayer that makes multiple changes in its overall method of accounting within a short period of time may not be treating items of income and expense consistently from year to year, and a change back to the cash method within the five year period may not clearly reflect income, as required by §1.446-1(a)(2), even if section 448 otherwise does not prohibit the use of the cash method.[1155]

[1153] Proposed Reg. §1.448-2(g)(1)

[1154] Proposed Reg. §1.448-2(g)(3)

[1155] REG-132766-18, July 29, 2020, p. 17

Inventories Under IRC §471

The proposed regulations provide some additional explanations of how a taxpayer who opts to use the provisions of §471(c) to avoid the standard inventory rules of §471 will handle the accounting for items that are normally in inventory.

Proposed Reg. §1.471-1(b)(3) describes the small business inventory options as follows:

> A taxpayer eligible to use, and that chooses to use, the exemption described in paragraph (b) of this section may account for its inventory by either:
>
> > (i) Accounting for its inventory items as non-incidental materials and supplies, as described in paragraph (b)(4) of this section; or
> >
> > (ii) Using the method for each item that is reflected in the taxpayer's applicable financial statement (AFS) (AFS section 471(c) inventory method); or, if the taxpayer does not have an AFS for the taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures, as defined in paragraph (b)(6)(ii) of this section (non-AFS section 471(c) inventory method).

Inventory Treated as Non-Incidental Materials and Supplies

If the taxpayer opts to treat inventory as non-incidental materials and supplies, the taxpayer initially capitalizes the items that would have made up inventory and then recovers the costs in the *later* of the taxable year when:

- Such inventory is actually used or consumed in the taxpayer's business, which is the taxable year in which the taxpayer provides the items to its customer; or
- The taxable year in which the taxpayer pays for (for a taxpayer using the overall cash method of accounting) or incurs (for a taxpayer using the overall accrual method of accounting) the costs of the items.[1156]

The *Blue Book* for the Tax Cuts and Jobs Act had suggested a taxpayer electing the option to treat inventory items as materials and supplies could use the *de minimis* election provisions found at Reg. §1.263(a)-1(f) to immediately write off formerly inventory items that cost less than $2,500 (or $5,000 if the taxpayer had an applicable financial statement).[1157] However, the proposed regulations provide for just the opposite, barring the use of the Reg. §1.263(a)-1(f) *de minimis* election to achieve zero inventories.

As the IRS explains in the preamble to the proposed regulations:

[1156] Proposed Reg. §1.471-1(b)(4)(i)

[1157] Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS 1-18, December 2018, p. 113

> Two commenters asked for clarification on whether a taxpayer using the nonincidental materials and supplies method under section 471(c)(1)(B)(i) may use the de minimis safe harbor election of §1.263(a)-1(f). As discussed in part 4.B of this Explanation of Provisions, the Treasury Department and the IRS continue to interpret inventory treated as non-incidental materials and supplies as remaining characterized as inventory property. Consequently, proposed §1.471-1(b)(4)(i) provides that inventory treated as section 471(c) non-incidental materials and supplies is not eligible for the de minimis safe harbor election under §1.263(a)-1(f). Extending the regulatory election under §1.263(a)-1(f) to encompass section 471(c) materials and supplies is outside the intended scope of the election and runs counter to section 471(c), which indicates section 471(c) materials and supplies are inventory property.[1158]

As promised in the preamble, Proposed Reg. §1.471-1(b)(4)(i) provides, in part, "[i]nventory treated as nonincidental materials and supplies under this paragraph (b)(4) is not eligible for the de minimis safe harbor election under §1.263(a)-1(f)(2)."

The proposed regulations provide that taxpayers identify the costs of the deemed non-incidental materials and supplies under this method as follows:

> A taxpayer may determine the amount of the section 471(c) materials and supplies that are recoverable through costs of goods sold by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that method is used consistently. See §1.471-2(d). A taxpayer that uses the section 471 materials and supplies method may not use any other method described in the regulations under section 471, or the last-in, first-out (LIFO) method described in section 472 and the accompanying regulations, to either identify section 471(c) materials and supplies, or to value those section 471(c) materials and supplies. The inventory costs includible in the section 471(c) materials and supplies method are the direct costs of the property produced or property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b)(4) of this section, in whole or in part, under a provision of the Internal Revenue Code.[1159]

The regulation goes on to provide the following options for a taxpayer to allocate the various costs to items of material and supplies:

> The section 471 materials and supplies method may allocate the costs of such inventory items by using specific identification or using any reasonable method.[1160]

[1158] REG-132766-18, July 29, 2020, p. 30

[1159] Proposed Reg. §1.471-1(b)(4)(ii)

[1160] Proposed Reg. §1.471-1(b)(4)(iii)

The proposed regulations provide the following example of applying the non-incidental materials and supplies option for taxpayers opting to use the small business option under IRC §471(c):

EXAMPLE, PROPOSED REG. §1.471-1(B)(4)(IV)

Taxpayer D is a baker that reports its baking trade or business on Schedule C, Profit or Loss From Business, of the Form 1040, Individual Tax Return, and D's baking business has average annual gross receipts for the 3-taxable years prior to 2019 of less than $100,000. D meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) in 2019. Therefore, D qualifies as a small business taxpayer under paragraph (b)(2) of this section. D uses the overall cash method, and the section 471(c) non-incidental materials and supplies method. D purchases $50 of peanut butter in November 2019. In December 2019, D uses all of the peanut butter to bake cookies available for immediate sale. D sells the peanut butter cookies to customers in January 2020. The peanut butter cookies are used or consumed under paragraph (b)(4)(i) of this section in January 2020 when the cookies are sold to customers, and D may recover the cost of the peanut butter in 2020.

Taxpayers may have hoped that the IRS would have allowed the taxpayers to treat the item as "used" when incorporated into the product, but the agency has decided that it only counts when the product incorporating the item is in the hands of a customer.

Taxpayers Using the AFS Method

If a taxpayer does not wish to use the materials and supplies option and has an applicable financial statement, the taxpayer's only other option under IRC §471(c) is to use what is referred to in the regulations as the *AFS Section 471(c) Method*.

An *applicable financial statement* (AFS) has the same meaning for these purposes as it does under IRC §451(b)(3). Proposed Reg. §1.451-3(c)(1) defines an applicable financial statement as follows:

> [An] *applicable financial statement* (AFS) means the taxpayer's financial statement listed in paragraphs (c)(1)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (c)(1)(i)(B) and (c)(1)(ii)(B) of this section. The financial statements are, in order of descending priority:
>
> (i) *GAAP Statements*. A financial statement that is certified as being prepared in accordance with generally accepted accounting principles (GAAP) and is:
>
> > (A) A Form 10–K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC);
> >
> > (B) An audited financial statement of the taxpayer that is used for:
> >
> > > (1) Credit purposes;
> > >
> > > (2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or
> > >
> > > (3) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service;

(ii) *IFRS Statements*. A financial statement that is certified as being prepared in accordance with international financial reporting standards (IFRS) and is:

(A) Filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC, and has reporting standards not less stringent than the standards required by the SEC;

(B) An audited financial statement of the taxpayer that is used for:

(1) Credit purposes;

(2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(3) Any other substantial non-tax purpose;

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service, or a foreign government or agency of a foreign government, other than an agency that is equivalent to the SEC or the Internal Revenue Service; or

(iii) *Other Statements*. A financial statement, other than a tax return, filed with the Federal government or any Federal agency, a state government or state agency, or a self-regulatory organization (for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority). Additional financial statements included in this paragraph (c)(1)(iii) may be provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(iv) *Additional rules for determining priority*. If a taxpayer restates revenue in an AFS prior to the date that the taxpayer files its Federal income tax return for such taxable year, for purposes of determining priority, the restated AFS must be used instead of the original AFS. A taxpayer with different financial accounting and taxable years that is required to file both annual financial statements and periodic financial statements covering less than a year with a government agency must use the annual statement filed with the agency to determine priority.

The *AFS Section 471(c) Method* is described in general terms as follows:

A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section and that has an AFS for such taxable year may use the AFS section 471(c) method described in this paragraph to account for its inventory costs for the taxable

> year. For purposes of the AFS section 471(c) method, an inventory cost is a cost that a taxpayer capitalizes to property produced or property acquired for resale in its AFS. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) method recovers its inventory costs in accordance with the inventory method used in its AFS.[1161]

However, the proposed regulations do impose an additional timing limitation, so that the timing of inclusion of an item in cost of sales in an AFS may not control when it appears on the tax return:

> Notwithstanding the timing rules used in the taxpayer's AFS, the amount of any inventoriable cost may not be capitalized or otherwise taken into account for Federal income tax purposes any earlier than the taxable year during which the amount is paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer, inventoriable costs must satisfy the all events test, including economic performance, of section 461. See §1.446-1(c)(1)(ii) and section 461 and the accompanying regulations.[1162]

The proposed regulations provide the following example of the application of the AFS Section 471(c) Method:

EXAMPLE, PROPOSED REG. §1.471-1(5)(IV)

H is a calendar year C corporation that is engaged in the trade or business of selling office supplies and providing copier repair services. H meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) for 2019 or 2020. For Federal income tax purposes, H chooses to account for purchases and sales of inventory using an accrual method of accounting and for all other items using the cash method. For AFS purposes, H uses an overall accrual method of accounting. H uses the AFS section 471(c) method of accounting. In H's 2019 AFS, H incurred $2 million in purchases of office supplies held for resale and recovered the $2 million as cost of goods sold. On January 5, 2020, H makes payment on $1.5 million of these office supplies. For purposes of the AFS section 471(c) method of accounting, H can recover the $2 million of office supplies in 2019 because the amount has been included in cost of goods sold in its AFS inventory method and section 461 has been satisfied.

Taxpayers Using the Non-AFS Section 471(c) Method

If a taxpayer does not have an AFS for the taxable year in question, the taxpayer's option other than using the non-incidental materials and supplies method is to use the *Non-AFS Section 471(c) Method* defined at Proposed Reg. §1.471-1(b)(6).

The regulation provides the following general discussion of the method:

[1161] Proposed Reg. §1.471-1(b)(5)(i)

[1162] Proposed Reg. §1.471-1(b)(5)(iii)

> A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section for a taxable year and that does not have an AFS, as defined in paragraph (b)(5)(ii) of this section, for such taxable year may use the non-AFS section 471(c) method to account for its inventories for the taxable year in accordance with this paragraph (b)(6). The non-AFS section 471(c) method is the method of accounting used for inventory in the taxpayer's books and records that properly reflect its business activities for non-tax purposes and are prepared in accordance with the taxpayer's accounting procedures. For purposes of the non-AFS section 471(c) method, an inventory cost is a cost that the taxpayer capitalizes to property produced or property acquired for resale in its books and records, except as provided in paragraph (b)(6)(ii) of this section. In lieu of the inventory method described in section 471(a), a taxpayer using the non-AFS section 471(c) method recovers its costs through its book inventory method of accounting. A taxpayer that has an AFS for such taxable year may not use the non-AFS section 471(c) method.[1163]

One point that a reader may miss in initially reading the provision is the requirement that the method must *properly reflect* the entity's business activities for *non-tax purposes*. Thus, the IRS has left open the option to challenge the taxpayer's book method by arguing the arrangement is purely for tax purposes and the reporting is not appropriate for non-tax purposes.

Taxpayers should be ready to demonstrate actual use of the statements generated unadjusted from the books and records using this method for non-tax purposes. Conversely, if the taxpayer provides lenders with financial statements that use another method to report inventory costs (such as one that is GAAP compliant), the IRS would likely argue the method does not meet the requirements noted in the regulation. In fact, the first example the IRS offers in the regulations for the Non-AFS Section 471(c) Method (reproduced later) specifically deals with this sort of situation.

As with the AFS Section 471(c) Method, the regulations also contain a similar timing rule:

> Notwithstanding the timing of costs reflected in the taxpayer's books and records, a taxpayer may not deduct or recover any costs that have not been paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1), or that are neither deductible nor otherwise recoverable but for the application of this paragraph (b)(6), in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g) or 274). For example, in the case of an accrual method taxpayer or a taxpayer using an accrual method for purchases and sales, inventory costs must satisfy the all events test, including economic performance, under section 461(h). See §1.446-1(c)(1)(ii), and section 461 and the accompanying regulations.[1164]

[1163] Proposed Reg. §1.471-1(b)(6)(i)

[1164] Proposed Reg. §1.471-1(b)(6)(ii)

The proposed regulations provide two examples of the application of these provisions:

EXAMPLE 1, PROPOSED REG. §1.471-1(B)(6)

Taxpayer E is a C corporation that is engaged in the retail trade or business of selling beer, wine, and liquor. In 2019, E has average annual gross receipts for the prior 3-taxable-years of less than $15 million, and is not otherwise prohibited from using the cash method under section 448(a)(3). E does not have an AFS for the 2019 taxable year. E is eligible to use the non-AFS section 471(c) method of accounting. E uses the overall cash method, and the non-AFS section 471(c) method of accounting for Federal income tax purposes. In E's electronic bookkeeping software, E treats all costs paid during the taxable year as presently deductible. As part of its regular business practice, E's employees take a physical count of inventory on E's selling floor and its warehouse on December 31, 2019, and E also makes representations to its creditor of the amount of inventory on hand for specific categories of product it sells. E may not expense all of its costs paid during the 2019 taxable year because its books and records do not accurately reflect the inventory records used for non-tax purposes in its regular business activity. E must use the physical inventory count taken at the end of 2019 to determine its ending inventory. E may include in cost of goods sold for 2019 those inventory costs that are not properly allocated to ending inventory.

EXAMPLE 2, PROPOSED REG. §1.471-1(B)(6)

F is a C corporation that is engaged in the manufacture of baseball bats. In 2019, F has average annual gross receipts for the prior 3-taxableyears of less than $25 million, and is not otherwise prohibited from using the cash method under section 448(a)(3). F does not have an AFS for the 2019 taxable year. For Federal income tax purposes, F uses the overall cash method of accounting, and the non-AFS section 471(c) method of accounting. For its books and records, F uses an overall accrual method and maintains inventories. In December 2019, F's financial statements show $500,000 of direct and indirect material costs. F pays its supplier in January 2020. Under paragraph (b)(6)(ii) of this section, F recovers its direct and indirect material costs in 2020.

Section 471(c) Does Not Impact Other IRC Provisions

The proposed regulations also provide that these §471(c) rules do not override any IRC provisions other than the rules at §471(a). The proposed regulations provide:

> Nothing in section 471(c) shall have any effect on the application of any other provision of law that would otherwise apply, and no inference shall be drawn from section 471(c) with respect to the application of any such provision. For example, a taxpayer that includes inventory costs in its AFS is required to satisfy section 461 before such cost can be included in cost of goods sold for the taxable year. Similarly, nothing in section 471(c) affects the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. If an item of income or expense is not treated consistently from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section.[1165]

[1165] Proposed Reg. §1.471-1(b)(7)

Accounting Method Issues

The proposed regulations provide that a taxpayer opting to move away from using §471(a) to the provisions found at §471(c) is undergoing a change of accounting methods and must seek the IRS's permission to make the change.[1166]

Taxpayers may find they have an AFS in some years and don't have an AFS in other years. If a taxpayer merely changes from the AFS Section 471(c) Method to the Non-AFS Section 471(c) Method or vice versa related to years with/without an AFS, that is not considered to be an accounting method change and IRS permission does not have to be sought.[1167]

Uniform Capitalization Rules Under IRC §263A

The IRS has made various changes to the regulations to take into account the small taxpayer's ability to "opt-out" from the application of the uniform capitalization rules of §263A (often referred to as UNICAP).

Small Reseller Exception

The IRS did decide to remove the small reseller gross receipts test from the regulations as being no longer relevant. As the preamble to the proposed regulations note:

> Prior to the TCJA, the Section 263A small reseller exception in section 263A(b)(2)(B) exempted from section 263A resellers with gross receipts of $10 million or less (small reseller gross receipts test). The TCJA removed the Section 263A small reseller exception provided in section 263A(b)(2)(B).
>
> Consistent with the TCJA, these proposed regulations remove existing §1.263A-3(a)(2)(ii) and modify existing §1.263A-3(b) by removing the small reseller gross receipts test. The Treasury Department and the IRS expect that most taxpayers who previously satisfied the small reseller gross receipts test will meet the Section 448(c) gross receipts test due to the increased dollar threshold in section 448(c), and therefore would be eligible to apply the small business taxpayer exemption under section 263A(i).[1168]

However, the IRS notes that this definition was cross-referenced, triggering changes in other regulations due to the above change:

> The definition of gross receipts used for the small reseller gross receipts test under existing §1.263A-3(b) is applied for purposes of other simplifying conventions under the existing section 263A regulations. Since the TCJA removed the small reseller gross receipts test and added the Section 263A small business taxpayer exemption that refers to section 448(c), these proposed regulations update those

[1166] Proposed Reg. §1.471-1(b)(8)

[1167] Proposed Reg. §1.471-1(b)(8)

[1168] REG-132766-18, July 29, 2020, p. 8

simplifying conventions by cross referencing to the definition of gross receipts set forth in the proposed regulations under section 448 where applicable.

> Specifically, proposed §1.263A-3(a)(5) modifies the definition of gross receipts that is used to determine whether a reseller has de minimis production activities and proposed §1.263A-1(d)(3)(ii)(B)(1) modifies the definition of gross receipts used to permit certain taxpayers to use the simplified production method under §1.263A-2(b) by cross referencing to the definition of "gross receipts" for purposes of the Section 448(c) gross receipts test.[1169]

Capitalization of Interest Impact

The proposed regulations also provide that the small business exception under IRC §263A will also apply to cases where interest is required to be capitalized under the provision (such as for self-constructed property) and the preamble to the proposed regulations notes regulatory changes proposed to deal with this issue:

> Prior to the TCJA, section 263A(f)(1) required the capitalization of interest if the taxpayer produced certain types of property (designated property). The Section 263A small business taxpayer exception applies for all purposes of section 263A, including the requirement to capitalize interest under section 263A(f). Accordingly, these proposed regulations modify §1.263A-7 and §1.263A-8 to add new paragraphs to implement the Section 263A(i) small business taxpayer exemption for purposes of the requirement to capitalize interest.
>
> Additionally, existing §1.263A-9 contains an election that permits taxpayers whose average annual gross receipts do not exceed $10 million to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt. Again, the Section 263A small business taxpayer exception applies for all purposes of section 263A, including the election for small business taxpayers who choose to capitalize interest under section 263A(f). Therefore, these proposed regulations modify §1.263A-9 to remove the $10 million gross receipts test in the definition of eligible taxpayer and replace it with the Section 448(c) gross receipts test. The Treasury Department and the IRS have determined that the use of a single gross receipts test under the section 263A (other than the pre-existing higher $50 million threshold for testing eligibility to apply the simplified production method) simplifies application of the UNICAP rules for taxpayers.[1170]

In response to a comment asking for additional guidance on what would now be required to be capitalized for self-constructed assets when a qualified taxpayer takes advantage of the ability to opt-

[1169] REG-132766-18, July 29, 2020, pp. 8-9

[1170] REG-132766-18, July 29, 2020, pp. 9-10 out of §263A, the IRS has decided to ask for comments on what type of guidance is needed in this area:

> One commenter stated that the costing rules for self-constructed property used in a taxpayer's trade or business prior to the enactment of section 263A, which would apply to small business taxpayers choosing to apply the Section 263A small business taxpayer exemption, are not clear. The commenter asked for clarification of what costs a small business taxpayer is required to capitalize to its depreciable property if the taxpayer has chosen to apply the Section 263A small business taxpayer exemption. The Treasury Department and the IRS request further comments on specific clarifications needed regarding the costing rules that existed prior to the enactment of the UNICAP rules under section 263A.[1171]

Farming Trade or Business Issues

The IRS discusses special issues impacting farming trades or businesses under these new provisions. First the agency discusses the pre-existing election under IRC §263A(d)(3), noting the pre-existing election and the conditions for using it:

> Prior to the TCJA, section 263A(d)(3) permitted certain taxpayers to elect not to have the rules of section 263A apply to certain plants produced in a farming business conducted by the taxpayer. An electing taxpayer and any related person, as defined in §1.263A-4(d)(4)(iii), are required to apply the alternative depreciation system, as defined in section 168(g)(2), to property used in the taxpayer's and any related persons' farming business and placed in service in the taxable years in which the election was in effect.[1172]

Now small farmers may find that, rather than having to live with those restrictions, they would prefer to make use of the small taxpayer accounting method option instead to bypass §263A. The IRS notes:

> The Treasury Department and the IRS are aware that taxpayers that made an election under section 263A(d)(3) may also qualify for the Section 263A small business taxpayer exemption, and may prefer to apply that exemption rather than the election under section 263A(d)(3). Proposed §1.263A-4(d)(5) permits a taxpayer to revoke its section 263A(d)(3) election for any taxable year in which the taxpayer is eligible for and wants to apply the Section 263A small business taxpayer exemption by following applicable administrative guidance, such as Revenue Procedure 2020-13 (2020-11 IRB 515). In addition, some taxpayers may be eligible to apply the election under section 263A(d)(3) in a taxable year in which they cease to qualify for the Section 263A small business taxpayer exemption. Therefore, proposed §1.263A-4(d)(6) permits such a taxpayer to change its method of accounting from the exemption under section 263A(i) by making a section 263A(d)(3) election in the

[1171] REG-132766-18, July 29, 2020, p. 11

[1172] REG-132766-18, July 29, 2020, p. 10

> same taxable year by following applicable administrative guidance, such as Revenue Procedure 2020-13.[1173]

The IRS also notes that they are taking this opportunity to clean up what they now refer to as a drafting error in prior regulations:

> Proposed §1.263A-4(d)(3)(i) is modified to remove the requirement that the election under section 263A(d)(3) by a partnership or S corporation be made by the partner, shareholder or member. The Treasury Department and the IRS believe that the inclusion of this requirement was a drafting error, as sections 703(b) and 1363(c) require the election to be made at the entity level.[1174]

As well, the IRS is taking this opportunity to publish regulations on a provision related to citrus plants added by TCJA:

> The TCJA added new section 263A(d)(2)(C), which provides a special temporary rule for citrus plants lost by reason of casualty. The provision, which expires in 2027, provides that section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner if certain conditions are met. Proposed §1.263A-4(e)(5) is added to incorporate this special temporary rule.[1175]

SECTION: 471
CANNABIS BUSINESS WAS A RESELLER, NOT A PRODUCER, THUS LIMITING COSTS THAT COULD BE TREATED AS COSTS OF GOODS SOLD

Citation: Richmond Patients Group v. Commissioner, TC Memo 2020-52, 5/4/20

For a cannabis business, it is important to understand if the business is considered a producer, reseller or perhaps a bit of both, since that impacts the calculation of the one thing that such a business can deduct under the restrictions of IRC §280E—cost of goods sold. In the case of *Richmond Patients Group v. Commissioner*, TC Memo 2020-52[1176] the taxpayer attempted to argue it was a producer based on the actions it took. The taxpayer's position was rejected by the Tax Court.

The issue presents an "Alice in Wonderland" world for many tax professionals—generally a business wants to avoid having costs classified as items that have to be treated as part of cost of goods sold, since such costs are held in inventory until the product is sold. But since §280E bars a deduction for

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[1173] REG-132766-18, July 29, 2020, p. 10

[1174] REG-132766-18, July 29, 2020, p. 11

[1175] REG-132766-18, July 29, 2020, p. 11

[1176] *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, May 4, 2020, https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12223 (retrieved May 5, 2020) any items except costs of goods sold, a cannabis business generally wants to capitalize into inventory as much as the business can.

Cost of goods sold are generally governed by the provisions of IRC §471 and the regulations under that provision. The key regulation governing the calculation of cost of goods sold is found at Reg. §1.471-3. For businesses other than producers Reg. §1.471-3(b) provides that the items in cost of sales are:

- Merchandise purchased;
- Transportation costs and
- Other necessary charges incurred in acquiring the product.[1177]

Basically, the costs that end up in cost of goods sold are limited to direct costs of acquiring the merchandise.

However, the regulations cast a much broader net for inventoriable expenses for producers. Reg. §1.471-3(c) provides that the inventoriable costs for a producer include:

- Raw materials and supplies;
- Direct labor; and
- Indirect production costs, including an appropriate portion of management costs.[1178]

The topic is complex enough that an entirely separate regulation is devoted to the topic of the calculation of such costs for manufacturers/producers (Reg. §1.471-11).

As should be clear, producers get to include a much larger portion of their expenses incurred in their cost of sales calculation which, in this Alice in Wonderland world of cannabis taxation, is a good thing.

Note that neither a reseller nor a producer gets access to §263A which normally requires capitalizing additional expenses into inventory. IRC §263A(a)(2) provides in part that "[a]ny cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph."

So what did the taxpayer in this case actually do in its cannabis business? The Tax Court provides the following description of the entity's activities:

> Richmond's marijuana dispensary was around 3,000 square feet, and approximately 50% of the total space was designated for purchasing and processing marijuana products. The reception and retail floor occupied 25% of the total space, and administration and storage occupied the remaining 25%. Richmond employed a

1177 Reg. §1.471-3(b)

1178 Reg. §1.471-3(c)

staff of approximately 22 members, including 2 buying managers and an accounting manager.

The buying managers were responsible for purchasing bulk marijuana products. Richmond purchased marijuana-containing products consisting of flowers, concentrates, and edibles. Marijuana flowers accounted for at least 60% of its products, concentrates accounted for 20%, and edibles accounted for 10%. The remaining purchases were nonmarijuana products. For the years in issue Richmond acquired all of its bulk marijuana products from individuals who were members of the dispensary, referred to as member providers. These transactions took place in a designated area of the dispensary. Richmond did not provide any of its member providers with clones or seeds. All nonmarijuana products were purchased from third-party vendors.

Richmond purchased marijuana flowers in one-pound increments and concentrates in one-ounce increments. The buying managers inspected product quality, graded marijuana products, and determined how much to offer member providers for the products. Member providers who had an existing relationship with Richmond or who offered a product that was in high demand were paid in full at the time of purchase. Richmond often paid member providers a 25% to 50% down payment when the product was brought in and paid the remainder once the product passed testing. All marijuana that failed testing was returned to the member providers.

Consistent with a city of Richmond ordinance, all marijuana products had to be tested offsite by an independent laboratory before Richmond could sell the products to its members. Richmond contracted with a third-party independent laboratory to test the products it purchased. After initial inspection the buying managers were responsible for contacting the laboratory to collect product samples for testing. Richmond paid the laboratory for the cost of testing.

After testing, marijuana products were transferred into separate storage safes. Marijuana flowers from member providers came already trimmed and dried (or cured) to a certain degree. Richmond further trimmed marijuana flowers of nonsellable stems and dried them in its storage safes. During this process the flowers could lose 3-10 grams of their weight. Richmond used a portion of the trimmings to create secondary products such as pre-rolled joints and smaller buds.

Richmond's employees processed and broke down marijuana flowers and concentrates into salable units — marijuana flowers into increments of 1 gram, 1.75 gram, and 3.25 grams, and concentrates into half- and one-gram increments. Edibles were purchased in bulk but came in individually prepackaged units ready for immediate resale. Other than testing, edibles did not require further processing.

Richmond stored marijuana flowers in plastic bags or glass containers while they continued drying until they reached an optimal moisture content. Richmond used humidity control systems designed to ensure that marijuana flowers would not dry out too quickly or increase moisture content before being sold to members. Other

> than the humidity-controlled storage area, drying the marijuana flowers did not require any special type of machinery. Richmond packaged marijuana flowers in safety-sealed Mylar bags with warning labels required by the State of California. Richmond packaged concentrates in small glass or plastic containers. Richmond labeled the products to conform with California labeling laws.
>
> Richmond used MJ Freeway Business Solutions (MJ Freeway), a point of sale system, to track its inventory from purchase through processing to final sale. All marijuana products stayed in MJ Freeway as bulk inventory until Richmond received the test results. Richmond used MJ Freeway to track byproducts, stem and weight loss of marijuana flowers, packaging loss, and any weight variances.[1179]

Richmond claimed it was a producer based on these facts, eligible to use a much broader category of expenses in calculating cost of goods sold, while the IRS claimed Richmond was simply a reseller, and thus stuck with the very narrow category of direct costs. The Tax Court sided with the IRS on this issue.

The Tax Court noted they had decided an earlier case on a similar issue, writing:

> In *Patients Mut*., 151 T.C. at 213, also involving a California medical marijuana dispensary, we held that the taxpayer was a reseller, not a producer, for purposes of section 471. The taxpayer did not own the marijuana plants during cultivation, did not own or control the grower-provider, and was under no obligation to purchase what the grower produced. Id. at 212-213. However, the taxpayer did provide marijuana clones to its members to grow. Id. at 212.[1180]

The Court found that Richmond's activities did not even rise to the level of *Patients Mutual*:

> In contrast Richmond did not provide live plants, clones, or seeds to its members. Richmond was under no obligation to purchase what its member providers offered for sale. Rather, it purchased bulk marijuana grown by its members for resale. Member providers trimmed the marijuana flowers before Richmond purchased them. No improvements were made to the marijuana from the time it was purchased to the time it was sold. Richmond inspected, sent out for testing, trimmed, dried and maintained the stock, and packaged and labeled marijuana. These activities are those of a reseller and not a producer. See *Alt. Health Care Advocates v. Commissioner*, 151 T.C. 225, 243 (2018) (holding that the taxpayer was not a producer because it did not grow, create, or improve its marijuana products to the extent required by section 263A or 471 as the only evidence before the Court was "that the dispensary, inspected, packaged, trimmed, dried, and maintained the stock"); *Patients Mut.*, 151 T.C. at 213 n.26 (noting that the taxpayer's processing, which included reinspection, packaging, and labeling, were activities that "resellers do without losing their character as resellers").

[1179] *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, pp. 3-7

[1180] *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, p. 16

> We conclude that Richmond was a reseller for purposes of section 471. Therefore, Richmond is not allowed to deduct additional indirect costs included in COGS for the tax years in issue.[1181]

SECTION: 501
FORM 1023 MUST BE FILED ELECTRONICALLY BY ORGANIZATIONS APPLYING FOR §501(C)(3) EXEMPT STATUS

Citation: Revenue Procedure 2020-8, 1/31/20

Entities looking to apply for tax-exempt status under IRC §501(c)(3) on Form 1023 (*Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*) now must submit that form electronically. In Revenue Procedure 2020-8[1182] the IRS updated the procedures under Revenue Procedure 2020-5 to mandate that applications for exempt organization determination letters must be handled electronically for applications after January 31, 2020. However, the procedure does provide for a temporary 90-day transition relief period.

IRS News Release IR-2020-25[1183] provides the following summary of the changes:

> Beginning January 31, 2020, applications for recognition of exemption on Form 1023 must be submitted electronically online at Pay.gov. The IRS will provide a 90-day grace period during which it will continue to accept paper versions of Form 1023 (Rev. 12-2017).
>
> The required user fee for Form 1023 will remain $600 for 2020. Applicants must pay the fee through Pay.gov when submitting the form. Payment can be made directly from a bank account or by credit or debit card.

The Form 1023-EZ previously had been accepted only electronically, so this simply makes all applicants use the electronic system once the grace period ends.

Section 4 of Revenue Procedure 2020-5 provides the following 90-day transition relief, which will run through April 30:

> The Internal Revenue Service will accept for processing a completed paper Form 1023 accompanied by the correct user fee, as described in Rev. Proc. 2020-5, without applying the modifications of this revenue procedure, if the submission of the Form1023 is postmarked on or before the date that is 90 days after the effective date of this revenue procedure.[1184]

[1181] *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, pp. 16-17

[1182] Revenue Procedure 2020-8, January 31, 2020, https://www.irs.gov/pub/irs-drop/rp-20-08.pdf (retrieved February 2, 2020)

[1183] "IRS revises Form 1023 for applying for tax-exempt status," News Release IR-2020-25, January 31, 2020, https://www.irs.gov/newsroom/irs-revises-form-1023-for-applying-for-tax-exempt-status (retrieved February 2, 2020)

[1184] Revenue Procedure 2020-8, Section 4.02

Once that period expires, it appears the IRS does not plan to offer any sort of paper filing option to applicants:

> Except as provided in section 4.02, an organization seeking recognition of tax exempt status under § 501(c)(3) using Form 1023 must electronically submit the form and user fee online at www.pay.gov.[1185]

The IRS's intent to move to mandatory electronic filing of these forms was announced in October 2019. Questions had been raised regarding issues that could arise with these changes.

In December 2019, the IRS issued a letter responding to a query by two attorneys with Jones Day.[1186] First the letter addressed the question of whether an applicant would be able to download a copy of their completed electronically filed Form 1023.

> You asked if an applicant will be able download an exact copy of their electronically submitted Form 1023 in a format that is easy to read and understand. Yes, applicants will be able to download an exact copy of the form and the attachment submitted in an easily readable PDF file format. Applicants will access the Form 1023 PDF file and attachment through their Pay.gov accounts.[1187]

The letter also addressed a concern that arose based on the size limits on attachments in the electronic filing system:

> You also asked what mechanism will be offered to an applicant that wishes to submit more pages of attachments than the electronic system allows. Form 1023 on Pay.gov will accept a single PDF file, up to 15MB. If the PDF file exceeds the 15MB limit, the applicant should remove any items over the limit and contact IRS Customer Accounts Services (CAS) at 877-829-5500 for assistance on how to submit the removed items. CAS will provide the applicant a fax number, allowing the material to be faxed to the IRS to complete the application. This information will be available on the Form 1023 Pay.gov landing page as well as in the Instructions for Form 1023. [1188]

That is, the paperless submission will be followed up with paper-based fax submissions to contain the additional material when the application is larger than the electronic system is capable of handling.

In a *Tax Notes Today Federal* article regarding the IRS announcement, Gerald Griffith of Jones Day, one of the authors of the inquiry that led to the December letter, is cited as cautioning charities that

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[1185] Revenue Procedure 2020-8, Section 4.01

[1186] "IRS Answers Practitioners' Questions on E-Filing of EO Applications," Author: Margaret Von Lienen,

Director, Exempt Organizations and Government Entities (Internal Revenue Service),*Tax Notes Today Federal*, 2020 TNTF 2-16, December 19, 2019, https://www.taxnotes.com/tax-notes-today-federal/exempt-organizations/irs-answers-practitioners-questions-e-filing-eo-applications/2020/01/03/2bqxt (Subscription required, retrieved February 2, 2020)

[1187] "IRS Answers Practitioners' Questions on E-Filing of EO Applications"

[1188] "IRS Answers Practitioners' Questions on E-Filing of EO Applications" this process may lead to the availability of a completed Form 1023 online via the IRS's own site, or posted on sites such as Guidestar, the National Center for Charitable Statistics, or *ProPublica*.[1189]

The article continues:

> "So in the future, any stakeholder may be able to easily access the [Form] 1023 without the organization's knowledge instead of having to ask the organization or the IRS for a copy," Griffith said. [1190]

SECTION: 1031
PROPOSED REGULATIONS ISSUED DEFINING REAL PROPERTY FOR POST-TCJA LIKE-KIND EXCHANGES

Citation: Proposed Reg. §1.1031-3, REG-117589-18, 6/11/20

The Tax Cuts and Jobs Act limited like-kind exchanges under §1031 to exchanges of real property effective January 1, 2018. The IRS has issued proposed regulations, [1191] upon which taxpayers may rely,[1192] to implement these revisions in §1031.

Real Property Definition Needed Specifically for §1031

The most significant item covered in these regulations is the definition of what is considered real property for like-kind exchanges under §1031. The preamble notes:

> The determination of whether property is real property has taken on additional significance as a result of the TCJA amendments limiting like-kind exchange treatment under section 1031 to exchanges of real property. Prior to enactment of the TCJA, neither the Code nor the Income Tax Regulations provided a definition of the term "real property" for purposes of section 1031. The Treasury Department and the IRS have determined that regulations providing guidance on whether property is real property under section 1031 are needed because taxpayers need certainty regarding whether any part of the replacement property received in an exchange is non-like-kind property subject to the gain recognition rules of section 1031(b).[1193]

[1189] Fred Stokeld, "Mandatory E-Filing of EO Form Arrives," *Tax Notes Today Federal*, February 3, 2020, https://www.taxnotes.com/tax-notes-today-federal/exempt-organizations/mandatory-e-filing-eo-form-arrives/2020/02/03/2c4cm (retrieved February 2, 2020, subscription required).

[1190] Fred Stokeld, "Mandatory E-Filing of EO Form Arrives," *Tax Notes Today Federal*, February 3, 2020, https://www.taxnotes.com/tax-notes-today-federal/exempt-organizations/mandatory-e-filing-eo-form-arrives/2020/02/03/2c4cm (retrieved February 2, 2020, subscription required).

[1191] REG-117589-18, June 11, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-11530.pdf (retrieved June 12, 2020)

[1192] REG-117589-18, SUPPLEMENTARY INFORMATION, Proposed Applicability Date

[1193] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section I.A.

The preamble notes that there are many different definitions of real property in the IRC, but these existing individual definitions have various differences due to the specific issues each section deals with. Thus, the IRS concludes that a §1031 specific definition of real property is necessary to determine whether an asset is real property for a like-kind exchange:

> …[I]nstead of a wholesale adoption of an existing real property definition used in another Code or regulations section, these proposed regulations incorporate certain aspects from existing regulatory definitions of real property that are consistent with the legislative history underlying the TCJA amendment to section 1031 indicating that real property eligible for like-kind exchange treatment under pre-TCJA law should continue to be eligible for like-kind exchange treatment after the enactment of the TCJA. See, for example, §§1.263(a)-3(b)(3) and 1.856-10 defining the term "real property" to mean land and improvements to land such as buildings and other inherently permanent structures, and their structural components, and providing that local law is not controlling for purposes of determining whether property is real property under that section; §1.263A-8(c) providing that real property includes unsevered natural products of land such as growing crops and plants, mines wells and other natural deposits; and §1.856-10(c) providing, in relevant part, that the term "land" includes "water and air space superjacent to land.[1194]

Definition of Real Property for §1031

The proposed regulations add new Proposed Reg. §1.1031-3, Definition of Real Property.

The regulation begins by defining *real property* as:

- Land;
- Improvements to land;
- Unsevered natural products of land; and
- Water and airspace adjacent to land.[1195]

This includes interests in real property such as:

- Fee ownership;
- Co-ownership;
- A leasehold;
- An option to acquire real property;

[1194] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section I.A.

[1195] Proposed Reg. §1.1031(a)-3(a)(1)

- An easement; or
- A similar interest.[1196]

However, the regulation points out that local law definitions are <u>not</u> controlling for purposes of §1031—this is a federal tax law definition specific to §1031.[1197]

The regulation also makes clear that these definitions are *solely* for the purposes of §1031 and do not apply to other provisions in the IRC:

> The rules provided in this section concerning the definition of real property apply only for purposes of section 1031. No inference is intended with respect to the classification or characterization of property for other purposes of the Code, such as depreciation and sections 1245 and 1250. For example, a structure or a portion of a structure may be section 1245 property for depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or the portion of the structure is real property under this section. Also, a taxpayer transferring relinquished property that is section 1245 property in a section 1031 exchange is subject to the gain recognition rules under section 1245 and the regulations under section 1245, notwithstanding that the relinquished property or replacement property is real property under this section. In addition, the taxpayer must follow the rules of section 1245 and the regulations under section 1245, and section 1250 and the regulations under section 1250, based on the determination of the relinquished property and replacement property being, in whole or in part, section 1245 property or section 1250 property under those Code sections and not under this section.[1198]

Proposed Reg. §1.1031-3(a) continues by providing detailed definitions of various classes of assets.

Distinct Asset

Several of the definitions reference a *distinct asset*, a term defined in the regulations. The regulations provide:

> A distinct asset is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.[1199]

1196 Proposed Reg. §1.1031(a)-3(a)(1)

1197 Proposed Reg. §1.1031(a)-3(a)(1)

1198 Proposed Reg. §1.1031(a)-3(a)(6)

1199 Proposed Reg. §1.1031(a)-3(a)(4)(i)

The regulation provides the following test to determine if an item is a distinct asset for the purposes of these regulations:

> The determination of whether a particular separately identifiable item of property is a distinct asset is based on all the facts and circumstances. In particular, the following factors must be taken into account—
>
> > (A) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
> >
> > (B) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
> >
> > (C) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
> >
> > (D) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.[1200]

Improvements to Land

Improvements to land include:

- Inherently permanent structures and
- Structural components of inherently permanent structures.[1201]

Inherently Permanent Structures

The regulation defines *inherently permanent structures* as "any building or other structure that is a distinct asset" that is permanently affixed to real property and "will ordinarily remain affixed for an indefinite period of time."[1202]

A *building* is defined as:

> … any structure or edifice enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.[1203]

The regulations provide that buildings include the following distinct assets if permanently affixed:

- Houses

[1200] Proposed Reg. §1.1031(a)-3(a)(4)(ii)

[1201] Proposed Reg. §1.1031(a)-3(a)(2)(i)

[1202] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(A)

[1203] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(B)

- Apartments
- Hotels and motels:
- Enclosed stadiums and arenas
- Enclosed shopping malls
- Factories and office buildings
- Warehouses
- Barns
- Enclosed garages
- Enclosed transportation stations and terminals and
- Stores.[1204]

Other inherently permanent structures include the following items if permanently affixed:

> …in-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under section 1033(g)(3) is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore drilling platforms, derricks, oil and gas storage tanks; grain storage bins and silos; and enclosed transportation stations and terminals.[1205]

The regulation provides the following guidance to determine if an asset is permanently affixed:

> Affixation to real property may be accomplished by weight alone. If property is not listed as an inherently permanent structure in this paragraph (a)(2)(ii)(C), the determination of whether the property is an inherently permanent structure under this paragraph (a)(2)(ii) is based on the following factors—
>
> > (1) The manner in which the distinct asset is affixed to real property;
> >
> > (2) Whether the distinct asset is designed to be removed or to remain in place;

[1204] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(B)

[1205] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(C)

(3) The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;

(4) Any circumstances that suggest the expected period of affixation is not indefinite; and

(5) The time and expense required to move the distinct asset.[1206]

Machinery is generally not considered part of real property, as it is not normally an inherently permanent structure.[1207] However, the regulation does provide an exception:

> In the case, however, of a building or inherently permanent structure that includes property in the nature of machinery as a structural component, the machinery is real property provided it serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space.[1208]

Structural Components

A *structural component* is a distinct asset "that is a constituent part of, and integrated into, an inherently permanent structure."[1209] The regulation notes that "[i]f interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component."[1210]

The regulation provides the following additional detailed rules for structural components:

- If a distinct asset is customized, the customization does not affect whether the distinct asset is a structural component.
- Tenant improvements to a building that are inherently permanent or otherwise classified as real property are real property.
- Property produced for sale, such as bricks, nails, paint, and windowpanes, that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer.[1211]

[1206] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(C)

[1207] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(D)

[1208] Proposed Reg. §1.1031(a)-3(a)(2)(ii)(D)

[1209] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(A)

[1210] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(A)

[1211] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(A)

So long as the following items are a constituent part of and are integrated into an inherently permanent item, they are treated as structural components for purposes of §1031:

- Walls;
- Partitions;
- Doors;
- Wiring;
- Plumbing systems;
- Central air conditioning and heating systems;
- Pipes and ducts;
- Elevators and escalators;
- Floors;
- Ceilings;
- Permanent coverings of walls, floors, and ceilings;
- Insulation;
- Chimneys;
- Fire suppression systems, including sprinkler systems and fire alarms;
- Fire escapes;
- Security systems;
- Humidity control systems; and
- Other similar property.[1212]

For other items not included in the list, the regulation provides the following test to be used to determine if the item is a structural component:

> If a component of a building or inherently permanent structure is a distinct asset and is not listed as a structural component in this paragraph (a)(2)(iii)(B), the

[1212] Proposed Reg. §1.1031(a)-3(a)(2)(iii)(B)

> determination of whether the component is a structural component under this paragraph (a)(2)(iii) is based on the following factors—
>
> > (1) The manner, time, and expense of installing and removing the component;
> >
> > (2) Whether the component is designed to be moved;
> >
> > (3) The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and
> >
> > (4) Whether the component is installed during construction of the inherently permanent structure.

Unsevered Natural Products of Land

Real property for §1031 purposes includes *unsevered products of land* which is defined to include:

- Growing crops plants, and timber;
- Mines;
- Wells; and
- Other natural deposits.[1213]

The regulation goes on to note that "[n]atural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land."[1214]

Intangible Assets

In certain cases, an intangible asset can be treated as real property for §1031 purposes. The regulation provides:

> To the extent an intangible asset derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space, the intangible asset is real property or an interest in real property. Real property includes shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) if, at the time of the exchange, the shares have been recognized by the highest court of the State in

[1213] Proposed Reg. §1.1031(a)-3(a)(3)

[1214] Proposed Reg. §1.1031(a)-3(a)(3)

> which the company was organized, or by a State statute, as constituting or representing real property or an interest in real property.[1215]

The regulation devotes a more detailed discussion to the issue of when licenses and permits will be deemed to be real property for §1031 purposes, with the following qualifying as real property:

> A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement generally is an interest in real property under this section.[1216]

But the guidance finds the following licenses and permits are not real property for §1031 purposes:

> However, a license or permit to engage in or operate a business on real property is not real property or an interest in real property if the license or permit produces or contributes to the production of income other than consideration for the use and occupancy of space.[1217]

Examples

The regulation provides a series of twelve examples of applying these rules, found at Proposed Reg. §1.031-3(b). Advisers should look at these examples to become comfortable with how the IRS sees these rules being applied in specific situations. As is always true, pay special attention to the facts in each example that the IRS references in making the determination of whether the item is or is not real property.

The topics covered by the examples are:

- Example 1: Natural products of land
- Example 2: Water space superjacent to land
- Example 3: Indoor sculpture (an interesting example as it shows how an item not attached to other real property can nevertheless become real property due to its weight and the impracticality of moving the object)
- Example 4: Bus shelters (an illustration of the opposite conclusion to Example 3, the shelters in this case are found not to be real property)
- Example 5: Industrial 3D Printer (in this case the example illustrates how the 3D printer in question, despite being impractical to move, does not qualify as real property but a generator supplying electricity to the entire building does)

[1215] Proposed Reg. §1.1031(a)-3(a)(5)(i)

[1216] Proposed Reg. §1.1031(a)-3(a)(5)(ii)

[1217] Proposed Reg. §1.1031(a)-3(a)(5)(ii)

- Example 6: Generator for Industrial 3D Printer (changes the facts in Example 5 so that the generator solely supports the 3D printer and thus ceases to be real property)
- Example 7: Raised flooring for Industrial 3D Printer (continuing with the 3D printer issue, this example finds the raised flooring for the 3D printer is not real property given the facts of the example)
- Example 8: Steam Turbine (again the item is found to be part of machinery and not real property, even though it has certain attributes, including being permanently affixed, that might lead an adviser to believe it would qualify as real property)
- Example 9: Partitions (while a conventional partition system is found to be real property, a modular partition system is found not to be real property)
- Example 10: Pipeline transmission system (the pipeline and isolation valves are found to be real property, but meters are not)
- Example 11: Land use permit. (a right to use land owned by the Federal government to put up a cell tower is found to be real property)
- Example 12: License to operate a business. (even though limited to a particular location, this license is not real property).

Incidental Personal Property Safe Harbor

In addition to the definition of real property, the IRS addressed concerns about the receipt of incidental amounts of personal property by a qualified intermediary destroying a like-kind exchange based on existing rules. As the IRS describes the issue in the preamble:

> The Treasury Department and the IRS are aware that taxpayers have questioned the effect of the receipt of personal property that is incidental to the taxpayer's replacement real property in an intended section 1031 exchange. For example, taxpayers have asked whether an exchange fails to meet the requirements of §1.1031(k)-1(g)(6)(i) if funds from the transfer of relinquished property held by the qualified intermediary are used to acquire an office building, including the personal property in the office building. Taxpayers and qualified intermediaries are concerned that a taxpayer would be considered to be in constructive receipt of all of the exchange funds held by the qualified intermediary if the taxpayer is able to direct the qualified intermediary to use those funds to acquire property that is not of a like kind to the taxpayer's relinquished property. Under §1.1031(k)-1(a), if a taxpayer actually or constructively receives the funds held by a qualified intermediary before receiving the replacement property, the transaction is a sale and not a section 1031 like-kind exchange.[1218]

[1218] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section II

The preamble goes on to describe the solution proposed for this issue, creating a special rule allowing the receipt of such property to be disregarded if the receipt of personal property is incidental to the overall exchange of real property:

> In response to these inquiries, the proposed regulations add to the items in §1.1031-1(g)(7) that are disregarded in determining whether the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. The proposed regulations provide that personal property that is incidental to replacement real property is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by a qualified intermediary are expressly limited as provided in §1.1031(k)-1(g)(6). Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property. This incidental property rule in the proposed regulations is based on the existing rule in §1.1031(k)-1(c)(5), which provides that certain incidental property is ignored in determining whether a taxpayer has properly identified replacement property under section 1031(a)(3)(A) and §1.1031(k)-1(c).[1219]

The proposed regulations would insert the following into existing Reg. §1.1031(k)-1(g)(7):

> (iii) Personal property that is incidental to real property acquired in an exchange.
>
> For purposes of this paragraph (g)(7), personal property is incidental to real property acquired in an exchange if--
>
>> (A) In standard commercial transactions, the personal property is typically transferred together with the real property; and
>>
>> (B) The aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property.[1220]

The IRS provided the following example of the application of this provision:

[1219] REG-117589-18, SUPPLEMENTARY INFORMATION, Explanation of Provisions, Section II

[1220] Proposed Reg. §1.1031(k)-1(g)(7)(iii)

EXAMPLE (PROPOSED REG. §1.1031(K)-1(G)(8)(VII))

Example 6. (A) In 2020, B transfers to C real property with a fair market value of $1,100,000 and an adjusted basis of $400,000. B's replacement property is an office building and, as a part of the exchange, B also will acquire certain office furniture in the building that is not real property, which is industry practice in a transaction of this type. The fair market value of the real property B will acquire is $1,000,000 and the fair market value of the personal property is $100,000.

(B) In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. The fair market value of the personal property B will acquire does not exceed 15 percent of the fair market value of the office building B will acquire. Accordingly, under paragraph (g)(7)(iii) of this section, the personal property is incidental to the real property in the exchange and is disregarded in determining whether the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property are expressly limited as provided in paragraph (g)(6) of this section. Upon the receipt of the personal property, B recognizes gain of $100,000 under section 1031(b), the lesser of the realized gain on the disposition of the relinquished property, $700,000, and the fair market value of the non-like-kind property B acquired in the exchange, $100,000.

SECTION: 280E
§280E IS NOT AN EXCESSIVE FINE UNDER THE EIGHTH AMENDMENT AND ALSO IS NOT LIMITED JUST TO BARRING DEDUCTIONS UNDER §162

Citation: Northern California Small Business Assistants Inc. v. Commissioner, 153 TC No. 4, 10/23/19

A majority of the Tax Court concluded in the case of *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4,[1221] that the denial of deductions for those operating businesses trafficking in cannabis is not a fine. Therefore, the provision could not be found to be an excessive fine.

The Eighth Amendment to the U.S. Constitution provides:

> Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted.

The taxpayer, a medical marijuana dispensary operating under California law that allows such operations, argued that IRC §280E served as an excessive fine under the Eighth Amendment and thus should be disregarded by the Court.

IRC §280E provides:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the

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[1221] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, October 23, 2019, https://www.ustaxcourt.gov/UstcInOp/OpinionViewer.aspx?ID=12102, retrieved October 23, 2019

> activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

Marijuana is defined by statute to be a controlled substance, and thus all deductions or credits related to the operations are denied by the statute aside from those properly deducted as a cost of sale.

The majority opinion finds that the denial of a deduction is not a fine under this provision of the Constitution. First, the Court notes that the 16th Amendment gives the Congress the absolute right to tax income and that deductions are also left to Congress' discretion.

> Congress has the power to lay and collect income taxes under Article I, Section 8 of the Constitution. The Sixteenth Amendment grants Congress the power to lay and collect taxes on "incomes, from whatever source derived" without requiring apportionment among the States as required by Article I. The Supreme Court has held that any deductions from gross income are a matter of legislative grace and can be reduced or expanded in accordance with Congress' policy objectives. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); see *Keeler v. Commissioner*, 70 T.C. 279, 284-285 (1978). Under the Sixteenth Amendment, "[t]he power of Congress to tax gross income is unquestionable." *Bagnall v. Commissioner*, 96 F.2d 956, 957 (9th Cir. 1938), *aff'g* 35 B.T.A. 1 (1936).
>
> … Deductions from gross income do not turn on equitable considerations; rather they are pure acts of legislative grace, the prudence of which is left to Congress. *Deputy v. du Pont*, 308 U.S. 488, 493 (1940); *White v. United States*, 305 U.S. 281, 292 (1938); *Hokanson v. Commissioner*, 730 F.2d 1245, 1250 (9th Cir. 1984), *aff'g* T.C. Memo. 1982-414; *United States v. Akin*, 248 F.2d 742, 743 (10th Cir. 1957); *Gen. Fin. Co. v. Commissioner*, 32 B.T.A. 949, 954 (1935), *aff'd*, 85 F.2d 846 (3d Cir. 1936). Congress is free to grant, restrict, and deny deductions as it sees fit. *J.E. Riley Inv. Co. v. Commissioner*, 110 F.2d 655, 658 (9th Cir. 1940), *aff'd*, 311 U.S. 55 (1940); *Barbour Coal Co. v. Commissioner*, 74 F.2d 163 (10th Cir. 1934).[1222]

The majority opinion therefore concludes:

> Petitioner does not cite, and we are not aware of, any case where the disallowance of a deduction was construed a penalty. This is especially telling given that Congress enacted section 280E over 37 years ago in 1982, and over that 37 years it has never been held to be a penalty by any Federal court. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, sec. 351(a), 96 Stat. at 640. The overwhelming precedent establishing that deductions from gross income are a matter purely left to congressional discretion by the Sixteenth Amendment explains why over the last 37 years an Eighth Amendment attack on any section of the Code that limits deductions from gross income has been a nonstarter. … The Sixteenth

[1222] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, pp. 7-8

> Amendment does not accommodate the assertion that the disallowance of a deduction is a penalty. There is simply no way to reconcile the argument that section 280E creates a penalty with the authority of Congress to tax gross income. Therefore, we hold that section 280E is not a penalty provision and, consequently, the Eighth Amendment's Excessive Fines Clause does not apply.[1223]

While all Tax Court judges agreed in the result of this case (the taxpayer should not prevail in its claim that §280E represented an excessive fine), five judges held that the taxpayer failed to show the amount was excessive. Two judges specifically declined to rule on whether §280E was a penalty or not (finding it wasn't relevant if there was no evidence of it being excessive),[1224] while three held that §280E did operate as a fine but since there was no evidence presented that it was excessive, the taxpayer could not prevail.[1225]

The taxpayer advanced other theories, one of which deserves some additional comment. The taxpayer argued that §280E's bar on deductions only applied to those allowed under IRC §162 (for ordinary and necessary business expenses). As the majority opinion notes:

> Petitioner would have us find that section 280E applies only to section 162 deductions. According to petitioner, the text of section 280E "tracks" that of section 162, which allows for all ordinary and necessary business expense deductions, suggesting that section 280E should apply only to limit section 162 deductions.[1226]

IRC §164 allows a deduction for taxes paid by the taxpayer, while §167 allows the deduction for depreciation. Applying the taxpayer's logic, the dispensary would also apparently be allowed deductions under §179 (for expensing equipment purchases) and §199A (the qualified business income deduction).

But the Tax Court determined that §280E broadly denies *any* deduction aside from cost of sales, ruling:

> However, petitioner's argument misses the first line of section 280E: "<u>No deduction</u> or credit shall be allowed". (Emphasis added.) Congress could not have been clearer in drafting this section of the Code.
>
> The broader statutory scheme also supports our conclusion that section 280E means what it says — no deductions under any section shall be allowed for businesses that traffic in a controlled substance. Section 261, in part IX of subchapter B of chapter 1 of the Code, provides that "no deduction shall in any case be allowed in respect of the items specified in this part." Section 280E is in part IX. Similarly, section 161 provides that deductions found in part VI of subchapter B of chapter 1 of the Code are allowed "subject to the exceptions provided in part IX". Part VI provides a comprehensive list of allowable deductions for taxpayers. This list includes section

[1223] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, pp. 11-13

[1224] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, p. 21

[1225] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, pp. 22, 44

[1226] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, pp. 11-13

> 162 and section 165 deductions, which we have previously disallowed pursuant to section 280E. See *CHAMP*, 128 T.C. at 180-181 (disallowing section 162 deductions under section 280E); *Beck v. Commissioner*, T.C. Memo. 2015-149, at *18 (disallowing a section 165 loss deduction under section 280E). As relevant here, part VI also includes sections 164 and 167, two additional sections petitioner believes would allow it a deduction. Clearly, sections 164 and 167 are limited by the exceptions in part IX, including section 280E. Thus, section 280E precluded petitioner from taking any deductions under sections 164 and 167 that are tied to its medical marijuana dispensary.[1227]

Note IRC §199A is also found in part VI of subchapter B of chapter 1 of the Code, so the reference in §161 limiting such deductions to those not barred by part IX would also appear to apply to that provision. As well, IRC §164 would be the provision under which state income taxes are deducted, so the decision also appears to bar the deduction for corporate income taxes paid by a dispensary organized as a C corporation.

SECTION: 3121
TAXPAYER HAS NO RECOURSE FOR EXCESS MEDICARE TAX WITHHELD WHEN DEFERRED COMPENSATION NOT PAID IN FULL

Citation: Koopman, et al. v. United States, US Court of Federal Claims, Case No. 1:09-cv-00333, 9/30/20

Life can be unfair, and the tax law even more so. In the case of *Koopman, et al v. United States*[1228] the taxpayers found the law left them no recourse when they never received amounts on which they had previously paid Medicare taxes due to the bankruptcy of United Airlines.

The case involves a United Airlines nonqualified deferred compensation arrangement Mr. Koopman was a participant in. As the Court describes the facts of the case:

> The underlying facts of this case are undisputed. In 2001, Mr. Koopmann retired from United Airlines, and was covered by United Airlines' non-qualified deferred compensation plan. Def. Mot. Ex. A at 3-4. Pursuant to the special timing rule, Mr. Koopmann paid the present value of his FICA taxes the year in which he retired. Def. Mot. Ex. A at 3-4. Mr. Koopmann received benefits under United Airlines' non-qualified deferred compensation plan from 2001 through 2006. Def. Mot. Ex. A at 3. The hospital insurance tax was 1.45% of an individual's "wages" received with respect to employment. Def. Mot. Ex. A at 4.
>
> On December 9, 2002, two years after Plaintiff's retirement, United Airlines filed a Chapter 11 bankruptcy petition. Def. Ans. ⁋ 13. In 2006, the Seventh Circuit

[1227] *Northern California Small Business Assistants Inc. v. Commissioner*, 153 TC No. 4, pp. 14-15

[1228] *Koopman, et al. v. United States*, US Court of Federal Claims, Case No. 1:09-cv-00333, September 30, 2020, https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2009cv0333-363-0 (retrieved October 6, 2020

> Court of Appeals approved United Airlines' reorganization plan. Def. Ans. ⁋ 13; see also *In re UAL Corp.,* 468 F.3d 444 (7th Cir. 2006). As a result of these proceedings, United Airlines' obligation to pay Plaintiff's deferred compensation was discharged, with a portion of Mr. Koopmann's benefits never having been paid. See Def. Ex. A at 3; Pl. Resp. at 4, 5-6. Specifically, Mr. Koopmann paid tax on $415,025.91 worth of non-qualified deferred compensation, of which he received only $248,293. Def. Ex. A at 3. He paid $6,017.88 of FICA tax on these benefits, which reflects the 1.45% HI tax rate applied to the $415,025.91 present value of the benefits. Def. Mot. Ex. A at 3.
>
> As partial compensation for the bankruptcy discharge of Mr. Koopman's retirement benefits, United issued common stock to Mr. Koopmann, with the last issuance taking place on April 24, 2007. Pl. Resp. at 4. Sometime thereafter, Mr. Koopmann filed an administrative claim for refund, on IRS Form 843, which he signed on August 5, 2007. See Def. Mot. Ex. A at 2; Pl. Resp. at 4. Mr. Koopmann's refund claim purported to relate to the tax period from "1/1/06 to 12/31/06." Def. Mot. Ex. A at 2. However, attachments to the refund claim indicate that Koopmann was seeking a refund of "withheld Medicare taxes on the entire amount in the [non-qualified deferred compensation] plan in 2001." Def. Mot. Ex. A at 3.[1229]

The IRS denied Mr. Koopman's claim for refund. One key problem was that he had filed the claim more than three years after the tax had been withheld, and thus any refund, whether or not otherwise allowable, would be barred by IRC §6511(a)—the standard three year statute of limitations on claims for refund.

Statute of Limitations for Filing a Claim for Refund

The Court of Federal Claims agreed with the IRS, finding that the time had long ago past for Mr. Koopman to have filed a claim for a refund of Medicare taxes withheld in 2001. The Court found:

- The three-year statute under IRC §6511(a) applies to any tax imposed by the IRC, which includes the Medicare tax Mr. Koopman was looking to recover;
- The statute of limitations is not subject to equitable tolling—so the mere fact this may appear unfair isn't relevant; and
- The statute has no "discovery" rule that delays the running of the statute until the taxpayer learns a tax has been paid in error.[1230]

The opinion notes that this is not the first time this issue has come before the courts:

> In fact, at least two other courts have rejected Mr. Koopmann's statute of limitations arguments. In *Jackson v. Internal Revenue Service*, No. 7:07-CV-168-H(2), 2008 WL 755916 (E.D.N.C. 2008), the district court held that a refund claim was untimely

[1229] *Koopman, et al. v. United States*, pp. 4-5

[1230] *Koopman, et al. v. United States*, pp.8-10

> in circumstances virtually identical to those here. There, a retired United pilot sought a refund of FICA taxes withheld on "the present value of his entire non-qualified pension plan" under the special timing rule in § 3121(v)(2). Id. at *1. When that pilot retired, United paid FICA taxes totaling $8,239.05, based on the present value of his entire non-qualified pension plan of $568,210.04. When United filed for bankruptcy, that plaintiff's pension plan was terminated, with plaintiff only receiving payments totaling $137,611.60. Id. at *1. The pilot in that case filed a refund claim with the IRS on August 3, 2006, seeking a refund for the 2002 tax year of FICA tax paid on August 9, 2002. Id. The court held that Mr. Jackson had not filed a timely administrative claim under § 6511 and dismissed his suit as a result. *Id*.
>
> Likewise, in *United States v. Bates*, No. 8:12-cv-833-T, 2015 WL 7444285 (M.D. Fla. 2015), the district court entered a judgment in the Government's favor in a suit under § 7405 to recover an erroneous refund of tax. Mr. Bates, who was also a plaintiff in both *Koopmann* and *Sofman*, had filed an administrative refund claim on January 8, 2008, seeking a refund of FICA taxes that United had paid in 2004. *Id*. at *1-2. An IRS Appeals Officer issued an erroneous refund which the United States sued to recover. *Id*. at *2. The district court held that "the Office of Appeals exceeded its authority when it authorized the refund . . . to the Bates because the request for refund was filed outside the statutory limitations period provided by 26 U.S.C. § 6511." *Id*. at *5. In reaching its holding, the district court rejected the argument that "there was no basis to request a refund until the bankruptcy court definitively ruled that Mr. Bates would no longer be receiving any payments from United under the Plan," because "the limitations period under section 6511 is not subject to equitable tolling." *Id*. at *4.[1231]

The Court notes that Mr. Koopman could have challenged the special timing rule that triggers the FICA taxation of deferred compensation by default when the right to the funds vest, rather than when the deferred compensation is paid, before the running of the statute:

> Mr. Koopmann could have filed a claim for refund protesting the application of the special timing rule. In this respect, § 6511(a) did not entirely deprive Mr. Koopmann of an opportunity to file a refund. Further, there may have been good reason for Mr. Koopmann and other similarly situated plaintiffs not to challenge the legality of the special timing rule. While it is true that taxation of the compensation at its present value can sometimes work to an employee's disadvantage such as in the case of an employer going bankrupt, the special timing rule can also work to an employee's advantage. Indeed, Mr. Koopmann may have potentially benefitted from the application of the special timing rule in this case. Mr. Koopmann paid only a 1.45% Medicare tax on the present value of his compensation in the 2001 tax year, for a total tax of $6,017.88. See Def. Mot. Ex. A at 3. Had Mr. Koopmann paid FICA tax on the deferred compensation as he received it in 2001 through 2006, and

[1231] *Koopman, et al. v. United States*, pp. 10-11 had his income fallen under the Social Security wage cap, he would have paid both a 1.45% Medicare tax and a 6.2% Social Security tax on the compensation he later received. See I.R.C. § 3101(a) (imposing "tax equal to 6.2 percent of the wages").[1232]

The Taxpayer's Claim Would Have Failed Even if Not Time Barred

The Court notes that while the taxpayer's claim had been filed too late to be heard by the Court, the taxpayer's underlying claim was doomed even if he had filed in time. The Court of Federal Claims had already rejected a challenge to the special timing rule:

> Finally, even if Mr. Koopmann's claims are not time-barred, his arguments would nevertheless fail, as the Federal Circuit has already rejected Mr. Koopmann's arguments related to the Treasury Department's application of the special timing rule in the identical situation. *Balestra*, 803 F.3d at 1369-1373 (ruling that Treasury regulation concerning special timing rule was not invalid or inapplicable where United Airlines was in bankruptcy proceedings when the present value of the deferred compensation was calculated). In *Balestra*, a retired United Airlines pilot brought a suit seeking a FICA tax refund. Like the present case, Mr. Balestra paid FICA taxes on retirement benefits he never received due to United Airlines' bankruptcy. Mr. Balestra challenged the Treasury Department's application of the special timing rule, which taxed plaintiff's deferred compensation at the "present value" as of the date of plaintiff's retirement but also "prohibited consideration of an employer's financial condition (e.g., bankruptcy) in calculating the amount deferred." *Balestra*, 803 F.3d at 1365 (citing 26 C.F.R. § 31.3121(v)(2)-1(c)(2)(ii)).
>
> The Federal Circuit rejected Mr. Balestra's arguments that these regulations were invalid stating, "[i]t may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion." *Balestra*, 803 F.3d at 1374 (holding that Treasury Department's regulation was due deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984)). Regardless of this Court's views on *Chevron* deference, it is axiomatic that this Court is bound by the Supreme Court's decision and the Federal Circuit's analysis and holding in *Balestra*, 803 F.3d at 1365, and Mr. Koopmann has not provided a persuasive reason why his case should be treated differently.[1233]

[1232] *Koopman, et al. v. United States*, p. 12

[1233] *Koopman, et al. v. United States*, p. 14

SECTION: 3121
MINISTER FINDS THAT CHURCH WAS NOT REQUIRED TO AND HAD NOT WITHHELD FICA AND HE THUS FAILS TO QUALIFY FOR FICA OR MEDICARE

Citation: Hermann Kuma v. Greater New York Conference of Seventh-Day Adventist Church et al, USDC SD NY, Case No. 1:19-cv-0848, 8/28/20

In the case of *Hermann Kuma v. Greater New York Conference of Seventh-Day Adventist Church et al.*[1234] a former pastor was suing a church for failing to classify him as an employee and withhold FICA and Medicare taxes on the wages he was paid over a 21 year period.

Mr. Kuma was told when he attempted to apply for Social Security benefits that he did not have enough quarters of coverage on his account to qualify for benefits or to be eligible for Medicare. Mr. Kuma claimed that the church had treated him improperly as an independent contractor, causing him to face the loss of benefits under Social Security and Medicare and was looking to be awarded damages in compensation.

But Mr. Kuma faced a problem. Even if he was correct that the church had improperly treated him as an independent contractor, something the court did not specifically rule on, that would not have created his problem.

While generally employers are required to withhold and pay FICA taxes on wages paid to employees (see IRC §3111(a)), IRC §3121(b)(8)(A) specifically excludes from FICA withholding or the payment of employer FICA the "service performed by a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry or by a member of a religious order in the exercise of duties required by such order,…"

Rather, such ministers are subject to self-employment tax under IRC §1402(a)(8), unless they have been granted an exemption from the tax (for instance, pursuant to IRC §1402(e)(1)). Note that an exemption under §1402(e)(1) would have also resulted in Mr. Kuma being ineligible for the benefits as he would also lack sufficient quarters of coverage.

Thus, Mr. Kuma as either an employee minister or an independent contractor should have reported his income as self-employment income under IRC §1402(a), paying the self-employment tax that would have qualified him for the benefits he now finds he is unable to obtain. The church had acted properly in not withholding and paying FICA taxes on Mr. Kuma's earnings for those 21 years.

[1234] *Hermann Kuma v. Greater New York Conference of Seventh-Day Adventist Church et al.*, USDC SD NY, Case No. 1:19-cv-0848

SECTION: FFCRA
2020 FORMS W-2 WILL CONTAIN INFORMATION ON FFCRA LEAVE PAID

Citation: Notice 2020-54, 7/8/20

Under the sick pay provisions enacted as part of the Families First Coronavirus Relief Act (FFCRA), a self-employed individual can qualify for a refundable tax credit if the self-employed individual meets the tests to qualify for such relief. However, such relief is reduced to the extent the self-employed person receives qualified sick pay as an employee.

Obviously, the IRS will need information on such sick pay on a per employee basis in order to apply this rule. As well, employees likely will also not have a record of such pay. So in Notice 2020-54[1235] the IRS has provided that employers will provide such information on Form W-2 for 2020.

The Notice provides:

> In order to provide self-employed individuals who also receive wages or compensation as employees with the information they need to properly claim any qualified sick leave equivalent or qualified family leave equivalent credits for which they are eligible, this notice requires employers to report to employees the amount of qualified sick leave wages and qualified family leave wages paid to the employees under sections 7001 or 7003 of the Families First Act, respectively.[1236]

General Guidance

The employer must separately provide information to the employee regarding:

- Sick pay under Division E of the FFCRA (EPSLA) pursuant to Act §5102(a)(1), (2) or (3) of that division which are generally paid when COVID-19 directly impacts the employee in a manner described in the Act;
- Sick pay under EPLSA pursuant to Act §5102(a)(4), (5) or (6) of that division which are paid when COVID-19 impacts a member of the employee's family in a manner described in the Act; and
- Qualified family leave wages under Division C of the FFCRA, named the Family and Medical Leave Expansion Act (EFMLEA) pursuant to Act §3102(b).[1237]

The information will be provided either in Box 14 of the Form W-2 or in a separate statement.[1238]

[1235] Notice 2020-54, July 8, 2020, https://www.irs.gov/pub/irs-drop/n-20-54.pdf (retrieved July 8, 2020)

[1236] Notice 2020-54, Section III

[1237] Notice 2020-54, Section III

[1238] Notice 2020-54, Section III

The self-employed individual will use this information as follows:

> Self-employed individuals claiming qualified sick leave equivalent or qualified family leave equivalent credits must then report these qualified sick leave and qualified family leave wage amounts on Form 7202, *Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals*, included with their income tax returns, and reduce (but not below zero) any qualified sick leave or qualified family leave equivalent credits by the amount of these qualified leave wages.[1239]

Reporting Qualified Sick Leave Wages

The Notice provides the following detailed information regarding what the employer is to report and how it is to be reported when qualified sick leave wages are paid:

> In addition to including qualified sick leave wages in the amount of wages paid to the employee reported in Boxes 1, 3 (up to the social security wage base), and 5 of Form W-2 (or, in the case of compensation subject to the RRTA, in the amount of RRTA compensation paid to the employee reported in Boxes 1 and 14 of Form W-25), employers must report to the employee the following type and amount of the wages that were paid, with each amount separately reported either in Box 14 of Form W-2 or on a separate statement:
>
> - the total amount of qualified sick leave wages paid for reasons described in paragraphs (1), (2), or (3) of section 5102(a) of the EPSLA; in labeling this amount, the employer must use the following, or similar, language: "sick leave wages subject to the $511 per day limit;" and
>
> - the total amount of qualified sick leave wages paid for reasons described in paragraphs (4), (5), or (6) of section 5102(a) of the EPSLA; in labeling this amount, the employer must use the following or similar language: "sick leave wages subject to the $200 per day limit."
>
> If a separate statement is provided and the employee receives a paper Form W-2, then the statement must be included with the Form W-2 provided to the employee, and if the employee receives an electronic Form W-2, then the statement shall be provided in the same manner and at the same time as the Form W-2.[1240]

Reporting Qualified Family Leave Wages

Similar rules apply to reporting qualified family leave wages. The Notice provides:

> In addition to including qualified family leave wages in the amount of wages paid to the employee reported in Boxes 1, 3 (up to the social security wage base), and 5 of Form W-2 (or, in the case of compensation subject to RRTA, in the amount of

[1239] Notice 2020-54, Section III

[1240] Notice 2020-54, Section III

> RRTA compensation paid to the employee reported in Boxes 1 and 14 of Form W-2), employers must separately report to the employee the total amount of qualified family leave wages paid to the employee under the EFMLEA either in Box 14 of Form W-2 or on a separate statement. In labeling this amount, the employer must use the following, or similar, language: "emergency family leave wages." If a separate statement is provided and the employee receives a paper Form W-2, then the statement must be included with the Form W-2 sent to the employee, and if the employee receives an electronic Form W-2, then the statement shall be provided in the same manner and at the same time as the Form W-2.[1241]

Model Language for Employee Instructions

Employees may very well have questions about this information, so employers may wish to provide instructions to the employees regarding this item to hopefully reduce calls to whomever handles payroll issues on the matter. The IRS provides the following model language in the Notice that can be used to provide such instructions:

> Included in Box 14, if applicable, are amounts paid to you as qualified sick leave wages or qualified family leave wages under the Families First Coronavirus Response Act. Specifically, up to three types of paid qualified sick leave wages or qualified family leave wages are reported in Box 14:
>
> - Sick leave wages subject to the $511 per day limit because of care you required;
> - Sick leave wages subject to the $200 per day limit because of care you provided to another; and
> - Emergency family leave wages.
>
> If you have self-employment income in addition to wages paid by your employer, and you intend to claim any qualified sick leave or qualified family leave equivalent credits, you must report the qualified sick leave or qualified family leave wages on Form 7202, *Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals*, included with your income tax return and reduce (but not below zero) any qualified sick leave or qualified family leave equivalent credits by the amount of these qualified leave wages. If you have self-employment income, you should refer to the instructions for your individual income tax return for more information.[1242]

[1241] Notice 2020-54, Section III

[1242] Notice 2020-54, Section III

SECTION: PPP LOAN
SBA PROVIDES RELIEF FROM FORGIVENESS REDUCTION FOR PPP LOANS OF $50,000 OR LESS, AND LIMITS NEED FOR LENDER TO REVIEW EXPENSES IN EXCESS OF THOSE NECESSARY FOR FORGIVENESS

Citation: RIN 3245-AH59, Business Loan Program Temporary Changes; Paycheck Protection Program – Additional

Revisions to Loan Forgiveness and Loan Review Procedures Interim Final Rules, Small Business Administration, 10/8/20

The SBA published an additional interim final rule on PPP loan forgiveness on October 8, 2020.[1243] The October 8, 2020 IFR which provides:

- Additional guidance concerning the forgiveness and loan review processes for PPP loans of $50,000 or less and
- For PPP loans of all sizes, lender responsibilities with respect to the review of borrower documentation of eligible costs for forgiveness in excess of a borrower's PPP loan amount.[1244]

Loans of $50,000 or Less – Administrative Relief

After much speculation about a potential for a close to automatic PPP loan forgiveness provision for certain loans to be added legislatively that has failed to yet materialize, the SBA has acted to give some administrative relief for loans of $50,000 or less.

The SBA is at the same time releasing a new simplified form (Form 3508S[1245]) to be used by borrowers with loans of $50,000 or less, except for borrowers that together with affiliates received loans totaling $2 million or greater.[1246]

[1243] RIN 3245-AH59, Business Loan Program Temporary Changes; Paycheck Protection Program – Additional Revisions to Loan Forgiveness and Loan Review Procedures Interim Final Rules, Small Business Administration, October 8, 2020, https://home.treasury.gov/system/files/136/PPP--IFR--Additional-Revisions-Loan-Forgiveness-Loan-Review-Procedures-Interim-Final-Rules.pdf (retrieved October 8, 2020)

[1244] RIN 3245-AH59, pp. 1-2

[1245] Form 3508S, https://home.treasury.gov/system/files/136/PPP-Loan-Forgiveness-Application-Form-3508S.pdf and Instructions to Form 3508S https://home.treasury.gov/system/files/136/PPP-Loan-Forgiveness-Application-Form-3508S-Instructions.pdf (retrieved October 8, 2020)

[1246] RIN 3245-AH59, p. 5

The IFR provides:

> A borrower of a PPP loan of $50,000 or less, other than any borrower that together with its affiliates received loans totaling $2 million or greater, may use SBA Form 3508S (or lender's equivalent form) to apply for loan forgiveness.[1247]

A borrower who chooses to use the Form 3508S is exempt from any:

- Reductions in the borrower's loan forgiveness amount based on reductions in full-time equivalent (FTE) employees (section 1106(d)(2) of the CARES Act) or
- Reductions in employee salary or wages (section 1106(d)(3) of the CARES Act).[1248]

The IFR explains that the SBA is treating this as a *de minimis* exception, justifying the provision as follows:

> There are approximately 3.57 million outstanding PPP loans of $50,000 or less, totaling approximately $62 billion of the $525 billion in PPP loans. Approximately 1.71 million PPP loans of $50,000 or less were made to businesses that reported having zero employees (presumably not counting the owner as an employee) or one employee. To the extent that these businesses have no employees other than the owner (i.e., all businesses that reported having zero employees and, in SBA's judgment, the majority of businesses that reported having one employee), they are not affected by these exemptions. As a result, based on available data, we estimate that the outstanding PPP loans of the relevant set of potentially affected borrowers (businesses with at least one employee other than the owner) total approximately $49 billion, or 9 percent of the overall PPP loan amount. Within this population of potentially affected loans, SBA believes that most borrowers would not be affected by the loan forgiveness reduction requirements because (1) the borrowers did not reduce FTE employees or reduce employee salaries or wages, or (2) the borrowers would qualify for one of the existing exemptions from loan forgiveness amount reductions. Excluding such borrowers, the aggregate dollar amount of PPP funds affected by these exemptions relative to the aggregate dollar amount of all PPP funds is *de minimis*.[1249]

To account for the Form 3508S, the SBA added the following provision applicable to a lender's review of such an application for forgiveness:

> When a borrower submits SBA Form 3508S or lender's equivalent form, the lender shall:
>
> > i. Confirm receipt of the borrower certifications contained in the SBA Form 3508S or lender's equivalent form.

[1247] RIN 3245-AH59, Section III.1.b, p. 6

[1248] RIN 3245-AH59, Section III.1.b, p. 6

[1249] RIN 3245-AH59, Section III.1.b, pp. 7-8

ii. Confirm receipt of the documentation the borrower must submit to aid in verifying payroll and nonpayroll costs, as specified in the instructions to the SBA Form 3508S or lender's equivalent form.

Providing an accurate calculation of the loan forgiveness amount is the responsibility of the borrower, and the borrower attests to the accuracy of its reported information and calculations on the Loan Forgiveness Application. The borrower shall not receive forgiveness without submitting all required documentation to the lender.

As the First Interim Final Rule indicates, lenders may rely on borrower representations. As stated in paragraph III.3.c of the First Interim Final Rule, the lender does not need to independently verify the borrower's reported information if the borrower submits documentation supporting its request for loan forgiveness and attests that it accurately verified the payments for eligible costs.[1250]

Lenders Actions When a Borrower Submits Expenses in Excess of Those Necessary for Loan Forgiveness

The SBA has also provided relief from the need for lenders to review every submitted expense when a borrower submits expenses in excess of those necessary to qualify for full forgiveness.

The IFR provides:

d. What should a lender do if a borrower submits documentation of eligible costs that exceed a borrower's PPP Loan Amount?

The amount of loan forgiveness that a borrower may receive cannot exceed the principal amount of the PPP loan. Whether a borrower submits SBA Form 3508, 3508EZ, 3508S, or lender's equivalent form, a lender should confirm receipt of the documentation the borrower is required to submit to aid in verifying payroll and nonpayroll costs, and, if applicable (for SBA Form 3508, 3508EZ, or lender's equivalent form), confirm the borrower's calculations on the borrower's Loan Forgiveness Application, up to the amount required to reach the requested Forgiveness Amount.[1251]

[1250] RIN 3245-AH59, Section III.2.b, p. 9

[1251] RIN 3245-AH59, Section III.2.c, p. 10

SECTION: PPP LOAN
A LOOK AT THE SBA'S FORM 3508S FORGIVENESS APPLICATION FOR LOANS UP TO $50,000

Citation: Paycheck Protection Program PPP Loan Forgiveness Application Form 3508S, 10/8/20

The SBA has released the Form 3508S[1252] to go along with its new simplified PPP loan forgiveness application process for loans of $50,000 or less, as well as the related instructions.[1253]

Application Form

The form consists of two pages. The top portion of the first page contains basic identification and loan related information:

Paycheck Protection Program
PPP Loan Forgiveness Application Form 3508S

OMB Control No. 3245-0407
Expiration date: 10/31/2020

A BORROWER MAY USE THIS FORM ONLY IF THE BORROWER RECEIVED A PPP LOAN OF $50,000 OR LESS.
A Borrower that, together with its affiliates, received PPP loans totaling $2 million or greater cannot use this form.

Business Legal Name ("Borrower")	DBA or Tradename, if applicable	
Business Address	Business TIN (EIN, SSN)	Business Phone
		( ) -
	Primary Contact	E-mail Address

SBA PPP Loan Number: ____________________ **Lender PPP Loan Number:** ____________________

PPP Loan Amount: ____________________ **PPP Loan Disbursement Date:** ____________________

Employees at Time of Loan Application: ________ **Employees at Time of Forgiveness Application:** ________

EIDL Advance Amount: ____________________ **EIDL Application Number:** ____________________

Forgiveness Amount: ____________________

[1252] Paycheck Protection Program PPP Loan Forgiveness Application Form 3508S, October 8, 2020, https://home.treasury.gov/system/files/136/PPP-Loan-Forgiveness-Application-Form-3508S.pdf (retrieved October 9, 2020)

[1253] PPP Loan Forgiveness Application Form 3508S Instructions for Borrowers, October 8, 2020, https://home.treasury.gov/system/files/136/PPP-Loan-Forgiveness-Application-Form-3508S-Instructions.pdf (retrieved October 9, 2020)

The rest of the page contains the signature of the authorized representative of the borrower along with the representations:

By Signing Below, You Make the Following Representations and Certifications on Behalf of the Borrower:

The Authorized Representative of the Borrower certifies to all of the below by **initialing** next to each one.

_____ The dollar amount for which forgiveness is requested does not exceed the principal amount of the PPP loan and:

- was used to pay costs that are eligible for forgiveness (payroll costs to retain employees; business mortgage interest payments; business rent or lease payments; or business utility payments);
- includes payroll costs equal to at least 60% of the forgiveness amount;
- if a 24-week Covered Period applies, does not exceed 2.5 months' worth of 2019 compensation for any owner-employee or self-employed individual/general partner, capped at $20,833 per individual; and
- if the Borrower has elected an 8-week Covered Period, does not exceed 8 weeks' worth of 2019 compensation for any owner-employee or self-employed individual/general partner, capped at $15,385 per individual.

_____ I understand that if the funds were knowingly used for unauthorized purposes, the federal government may pursue recovery of loan amounts and/or civil or criminal fraud charges.

_____ The Borrower has accurately verified the payments for the eligible payroll and nonpayroll costs for which the Borrower is requesting forgiveness, and has accurately calculated the forgiveness amount requested.

_____ I have submitted to the Lender the required documentation verifying payroll costs, the existence of obligations and service (as applicable) prior to February 15, 2020, and eligible business mortgage interest payments, business rent or lease payments, and business utility payments.

_____ The information provided in this application and the information provided in all supporting documents and forms is true and correct in all material respects. I understand that knowingly making a false statement to obtain forgiveness of an SBA-guaranteed loan is punishable under the law, including 18 USC 1001 and 3571 by imprisonment of not more than five years and/or a fine of up to $250,000; under 15 USC 645 by imprisonment of not more than two years and/or a fine of not more than $5,000; and, if submitted to a Federally insured institution, under 18 USC 1014 by imprisonment of not more than thirty years and/or a fine of not more than $1,000,000.

_____ The tax documents I have submitted to the Lender are consistent with those the Borrower has submitted/will submit to the IRS and/or state tax or workforce agency. I also understand, acknowledge, and agree that the Lender can share the tax information with SBA's authorized representatives, including authorized representatives of the SBA Office of Inspector General, for the purpose of ensuring compliance with PPP requirements and all SBA reviews.

_____ I understand, acknowledge, and agree that SBA may request additional information for the purposes of evaluating the Borrower's eligibility for the PPP loan and for loan forgiveness, and that the Borrower's failure to provide information requested by SBA may result in a determination that the Borrower was ineligible for the PPP loan or a denial of the Borrower's loan forgiveness application.

The Borrower's eligibility for loan forgiveness will be evaluated in accordance with the PPP regulations and guidance issued by SBA through the date of this application. SBA may direct a lender to disapprove the Borrower's loan forgiveness application if SBA determines that the Borrower was ineligible for the PPP loan.

______________________________ Signature of Authorized Representative of Borrower	______________________ Date
______________________________ Print Name	______________________ Title

SBA Form 3508S (10/20)

The second page consists of the optional borrower demographic information that has been found with each application package.

What is missing from this form when compared even with the Form 3508-EZ is any computation of the forgiveness amount—the borrower just states the amount of forgiveness that is being requested. Only this form and the required documents, which are outlined in the instructions, are to be submitted.

Form 3508S Instructions

The instructions to Form 3508S contain a section outlining the computation of the forgiveness amount. The instructions note:

> Enter the total amount of your payroll and nonpayroll costs eligible for forgiveness. The amount entered cannot exceed the principal amount of the PPP loan. Use the following instructions to determine your forgiveness amount.[1254]

While a detailed computation is not being sent with the application for forgiveness, the borrower will need to be able to provide the detailed support if requested, as the instructions note in the section titled "Documents that Each Borrower Must Maintain but is Not Required to Submit":

> All records relating to the Borrower's PPP loan, including documentation submitted with its PPP loan application, documentation supporting the Borrower's certifications as to its eligibility for a PPP loan, documentation necessary to support the Borrower's loan forgiveness application, and documentation demonstrating the Borrower's material compliance with PPP requirements. The Borrower must retain all such documentation in its files for six years after the date the loan is forgiven or repaid in full, and permit authorized representatives of SBA, including representatives of its Office of Inspector General, to access such files upon request.[1255]

The instructions provide the standard information that has been provided on prior forms for the types of expenses eligible to be used in the forgiveness calculation, as well as the caveat that non-payroll costs can amount to no more than 40% of the forgiveness amount.[1256]

Even with the simplified application there are documents that must be submitted with the forgiveness application. The instructions provide that a borrower using Form 3508S must submit the following items with the application:

> **Payroll**: Documentation verifying the eligible cash compensation and non-cash benefit payments from the Covered Period or the Alternative Payroll Covered Period consisting of each of the following:
>
> > a. Bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees.

[1254] PPP Loan Forgiveness Application Form 3508S Instructions for Borrowers, p. 1

[1255] PPP Loan Forgiveness Application Form 3508S Instructions for Borrowers, p. 3

[1256] PPP Loan Forgiveness Application Form 3508S Instructions for Borrowers, pp. 1-2

b. Tax forms (or equivalent third-party payroll service provider reports) for the periods that overlap with the Covered Period or the Alternative Payroll Covered Period:

i. Payroll tax filings reported, or that will be reported, to the IRS (typically, Form 941); and

ii. State quarterly business and individual employee wage reporting and unemployment insurance tax filings reported, or that will be reported, to the relevant state.

c. Payment receipts, cancelled checks, or account statements documenting the amount of any employer contributions to employee health insurance and retirement plans that the Borrower included in the forgiveness amount.

Nonpayroll: Documentation verifying existence of the obligations/services prior to February 15, 2020 and eligible payments from the Covered Period.

a. Business mortgage interest payments: Copy of lender amortization schedule and receipts or cancelled checks verifying eligible payments from the Covered Period; or lender account statements from February 2020 and the months of the Covered Period through one month after the end of the Covered Period verifying interest amounts and eligible payments.

b. Business rent or lease payments: Copy of current lease agreement and receipts or cancelled checks verifying eligible payments from the Covered Period; or lessor account statements from February 2020 and from the Covered Period through one month after the end of the Covered Period verifying eligible payments.

c. Business utility payments: Copy of invoices from February 2020 and those paid during the Covered Period and receipts, cancelled checks, or account statements verifying those eligible payments.[1257]

While these documents are being submitted, apparently the lender merely will need to confirm that the documents have been submitted and will not be asked to actually verify the forgiveness calculation itself per the interim final rules released at the same time as the new application.[1258]

[1257] PPP Loan Forgiveness Application Form 3508S Instructions for Borrowers, p. 3

[1258] RIN 3245-AH59, October 8, 2020, Section III.2.b, p. 9, https://home.treasury.gov/system/files/136/PPP--IFR--Additional-Revisions-Loan-Forgiveness-Loan-Review-Procedures-Interim-Final-Rules.pdf (retrieved October 9, 2020)

SECTION: PPP LOAN
PRE-PPPFA LOANS DO NOT HAVE TO BE MODIFIED FOR EXTENDED DEFERRAL PERIOD

Citation: Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness, Small Business Administration, August 11, 2020 Revision, 8/11/20

The SBA has added a question and answer[1259] to the Paycheck Protection Program Loans Frequently Asked Questions to clarify how the extension of the deferral period in the Paycheck Protection Program Flexibility Act affected loans that were already in place when the PPPFA was enacted.

The original loans were written for the original six-month period for deferral of payments of all principal, interest and fees on PPP loans. When the PPPFA extended that period through the date that forgiveness is granted on the PPP loan as long as an application for forgiveness is made during the 10 months following end of the covered period, the key question was whether those PPP notes already signed before passage of the PPPFA had to be modified?

The SBA's answer is these loans do not need to be modified.

The SBA guidance provides:

> **52. Question:** The Paycheck Protection Program Flexibility Act of 2020 (Flexibility Act) extended the deferral period for borrower payments of principal, interest, and fees on all PPP loans to the date that SBA remits the borrower's loan forgiveness amount to the lender (or, if the borrower does not apply for loan forgiveness, 10 months after the end of the borrower's loan forgiveness covered period). Previously, the deferral period could end after 6 months. Are lenders and borrowers required to modify promissory notes used for PPP loans to reflect the extended deferral period?
>
> **Answer:** The extension of the deferral period under the Flexibility Act automatically applies to all PPP loans. Lenders are required to give immediate effect to the statutory extension and should notify borrowers of the change to the deferral period. SBA does not require a formal modification to the promissory note. A modification of a promissory note to reflect the required statutory deferral period under the Flexibility Act will have no effect on the SBA's guarantee of a PPP loan.

[1259] Question 52, Paycheck Protection Program Loans Frequently Asked Questions (FAQs), October 7, 2020, https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf (retrieved October 7, 2020)

SECTION: PPP LOAN
SBA ISSUES NOTICE REGARDING IMPACT OF CHANGE OF OWNERSHIP FOR PPP BORROWER

Citation: SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, 10/2/20

The Small Business Administration has issued guidance related to PPP loans when there is a change in ownership of the borrowing business.[1260] The notice provides for the required procedures when there is a change in ownership.

The notice defines a *change in ownership* as when any of the following take place:

- At least 20 percent of the common stock or other ownership interest of a PPP borrower (including a publicly traded entity) is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity,
- The PPP borrower sells or otherwise transfers at least 50 percent of its assets (measured by fair market value), whether in one or more transactions, or
- A PPP borrower is merged with or into another entity.[1261]

The SBA clarifies the need to look at all transfers to determine if there has been a change of ownership:

> For purposes of determining a change of ownership, all sales and other transfers occurring since the date of approval of the PPP loan must be aggregated to determine whether the relevant threshold has been met. For publicly traded borrowers, only sales or other transfers that result in one person or entity holding or owning at least 20% of the common stock or other ownership interest of the borrower must be aggregated.[1262]

Even with a change in ownership, the borrower still remains responsible for:

- The performance of all obligations under the PPP loan,
- The certifications made in connection with the PPP loan application, including the certification of economic necessity, and
- Compliance with all other applicable PPP requirements.[1263]

[1260] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, https://www.sba.gov/sites/default/files/2020-10/5000-20057.pdf (retrieved October 2, 2020)

[1261] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

[1262] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

[1263] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

As well, the SBA notes:

> Additionally, the PPP borrower remains responsible for obtaining, preparing, and retaining all required PPP forms and supporting documentation and providing those forms and supporting documentation to the PPP lender or lender servicing the PPP loan (referred to as the "PPP Lender" in this Notice) or to SBA upon request.[1264]

Notification Requirement

Borrowers should take note of the need to inform a lender of a change of ownership. The notice states:

> Prior to the closing of any change of ownership transaction, the PPP borrower must notify the PPP Lender in writing of the contemplated transaction and provide the PPP Lender with a copy of the proposed agreements or other documents that would effectuate the proposed transaction.[1265]

Procedures Upon Change of Ownership

The SBA notes that, depending on the circumstances, different procedures will be required for a change of ownership transaction.

PPP Loan is Fully Satisfied

The SBA provides the following information related to an ownership change if the PPP loan is fully satisfied:

> There are no restrictions on a change of ownership if, prior to closing the sale or transfer, the PPP borrower has:
>
> a. Repaid the PPP Note in full; or
>
> b. Completed the loan forgiveness process in accordance with the PPP requirements and:
>
> i. SBA has remitted funds to the PPP Lender in full satisfaction of the PPP Note; or
>
> ii. The PPP borrower has repaid any remaining balance on the PPP loan.[1266]

[1264] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

[1265] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 2

[1266] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 2

PPP Note is Not Fully Satisfied – Cases Where SBA Approval is Not Required

If the note is not fully satisfied, the SBA outlines that in some cases SBA approval will be required before the ownership change takes place, while in other cases no approval is required.

The SBA provides for the following case where no approval is required:

> i. **Change of ownership is structured as a sale or other transfer of common stock or other ownership interest or as a merger.** An individual or entity may sell or otherwise transfer common stock or other ownership interest in a PPP borrower without the prior approval of SBA only if:
>
> > a) The sale or other transfer is of 50% or less of the common stock or other ownership interest of the PPP borrower; or
> >
> > b) The PPP borrower completes a forgiveness application reflecting its use of all of the PPP loan proceeds and submits it, together with any required supporting documentation, to the PPP Lender, and an interest-bearing escrow account controlled by the PPP Lender is established with funds equal to the outstanding balance of the PPP loan. After the forgiveness process (including any appeal of SBA's decision) is completed, the escrow funds must be disbursed first to repay any remaining PPP loan balance plus interest.
>
> In any of the circumstances described in a) or b) above, the procedures described in paragraph #2.c. below must also be followed.[1267]

The "paragraph 2.c" items, which apply to all loans not already paid off, will be described after the next section.

The "no prior approval needed" rules continue as follows:

> ii. **Change of ownership is structured as an asset sale**. A PPP borrower may sell 50 percent or more of its assets (measured by fair market value) without the prior approval of SBA only if the PPP borrower completes a forgiveness application reflecting its use of all of the PPP loan proceeds and submits it, together with any required supporting documentation, to the PPP Lender, and an interest-bearing escrow account controlled by the PPP Lender is established with funds equal to the outstanding balance of the PPP loan. After the forgiveness process (including any appeal of SBA's decision) is completed, the escrow funds must be disbursed first to repay any remaining PPP loan balance plus interest. The PPP Lender must notify the appropriate SBA Loan Servicing Center of the location of, and the amount of funds in, the escrow account within 5 business days of completion of the transaction.[1268]

[1267] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, pp. 2-3

[1268] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 3

PPP Note is Not Fully Satisfied – Cases Where SBA Approval is Required

In other cases, the approval of the SBA will be required. The note continues:

> If a change of ownership of a PPP borrower does not meet the conditions in paragraph #2.a. above, prior SBA approval of the change of ownership is required and the PPP Lender may not unilaterally approve the change of ownership.
>
> To obtain SBA's prior approval of requests for changes of ownership, the PPP Lender must submit the request to the appropriate SBA Loan Servicing Center. The request must include:
>
> > i. the reason that the PPP borrower cannot fully satisfy the PPP Note as described in paragraph #1 above or escrow funds as described in paragraph #2.a above;
> >
> > ii. the details of the requested transaction;
> >
> > iii. a copy of the executed PPP Note;
> >
> > iv. any letter of intent and the purchase or sale agreement setting forth the responsibilities of the PPP borrower, seller (if different from the PPP borrower), and buyer;
> >
> > v. disclosure of whether the buyer has an existing PPP loan and, if so, the SBA loan number; and
> >
> > vi. a list of all owners of 20 percent or more of the purchasing entity.
>
> If deemed appropriate, SBA may require additional risk mitigation measures as a condition of its approval of the transaction.
>
> SBA approval of any change of ownership involving the sale of 50 percent or more of the assets (measured by fair market value) of a PPP borrower will be conditioned on the purchasing entity assuming all of the PPP borrower's obligations under the PPP loan, including responsibility for compliance with the PPP loan terms. In such cases, the purchase or sale agreement must include appropriate language regarding the assumption of the PPP borrower's obligations under the PPP loan by the purchasing person or entity, or a separate assumption agreement must be submitted to SBA.
>
> SBA will review and provide a determination within 60 calendar days of receipt of a complete request.[1269]

[1269] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, pp. 3-4

Rules Applicable for all Ownership Changes, Regardless of Whether Approval is Needed

The notice provides the following steps that will apply to all ownership transfers:

> In the event of a sale or other transfer of common stock or other ownership interest in the PPP borrower, or a merger of the PPP borrower with or into another entity, the PPP borrower (and, in the event of a merger of the PPP borrower into another entity, the successor to the PPP borrower) will remain subject to all obligations under the PPP loan. In addition, if the new owner(s) use PPP funds for unauthorized purposes, SBA will have recourse against the owner(s) for the unauthorized use.
>
> If any of the new owners or the successor arising from such a transaction has a separate PPP loan, then, following consummation of the transaction: (1) in the case of a purchase or other transfer of common stock or other ownership interest, the PPP borrower and the new owner(s) are responsible for segregating and delineating PPP funds and expenses and providing documentation to demonstrate compliance with PPP requirements by each PPP borrower, and (2) in the case of a merger, the successor is responsible for segregating and delineating PPP funds and expenses and providing documentation to demonstrate compliance with PPP requirements with respect to both PPP loans.
>
> The PPP Lender must notify the appropriate SBA Loan Servicing Center, within 5 business days of completion of the transaction, of the:
>
> > i. identity of the new owner(s) of the common stock or other ownership interest;
> >
> > ii. new owner(s)' ownership percentage(s);
> >
> > iii. tax identification number(s) for any owner(s) holding 20 percent or more of the equity in the business; and
> >
> > iv. location of, and the amount of funds in, the escrow account under the control of the PPP Lender, if an escrow account is required.[1270]

[1270] SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, pp. 4-5

Unit

16

Passthrough Entity Tax Developments

SECTION: 951A
S CORPORATIONS WITH TRANSITION AE&P ALLOWED TO ELECT ENTITY TREATMENT FOR GILTI

Citation: Notice 2020-69, 9/1/20

In Notice 2020-69[1271] the IRS outlined items that will be contained in to be issued proposed regulations related to S corporations with accumulated earnings and profits impacted by IRC §§951 and 951A. The revisions are meant to address the proposed and then modified final regulations on GILTI and FDII issued by the IRS previously. The IRS's change of direction from handling the S corporation as an entity for GILTI to treating it under an aggregate approach can lead to problems in getting shareholders the cash to pay the tax if the S corporation has accumulated earnings and profits. The Notice and eventual regulations seeks to address that issue.

GILTI in General

The Notice begins by discussing the provisions in general that will be impacted by the Notice:

> Section 951(a) of the Code generally requires a United States shareholder (as defined in § 951(b)) (U.S. shareholder), to include in its gross income its pro rata share of subpart F income (as defined in § 952) of a controlled foreign corporation (as defined in § 957) (CFC) and the amount determined under § 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under § 959(a)(2)) (subpart F inclusion).

[1271] Notice 2020-69, September 1, 2020, https://www.irs.gov/pub/irs-drop/n-20-69.pdf (retrieved September 30, 2020)

> Section 951A(a) requires a U.S. shareholder of any CFC for any taxable year to include in gross income the shareholder's GILTI for such taxable year (GILTI inclusion amount). The U.S. shareholder's GILTI inclusion amount is calculated based on certain items — such as tested income, tested loss, and QBAI — of each CFC owned by the U.S. shareholder (tested items). See § 1.951A-1(c) of the Income Tax Regulations. In general, a U.S. shareholder's GILTI inclusion amount is determined by reference to the U.S. shareholder's pro rata share of the tested items based on the stock of all the CFCs that the U.S. shareholder owns within the meaning of § 958(a). See § 951A(e)(1) (cross referencing § 951(a)(2)). The GILTI provisions in § 951A, enacted in § 14201(a) of the TCJA, apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See § 14201(d) of the TCJA.
>
> Section 951(b) defines a U.S. shareholder, with respect to any foreign corporation, as a United States person (U.S. person) that owns (within the meaning of § 958(a)), or is considered as owning by applying the ownership rules of § 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation or 10 percent or more of the value of all shares of all classes of stock of the foreign corporation. See also § 1.951-1(g). Section 957(c) generally defines a U.S. person for purposes of subpart F by reference to § 7701(a)(30), which defines a U.S. person as a citizen or resident of the United States, a domestic partnership, a domestic corporation, and certain estates and trusts.[1272]

Partnerships and S corporations pose a problem for this regime, since they aren't themselves taxable entities generally. The tax law sometimes views the partnership or S corporation as an entity (say for selecting the overall method of accounting) while other times looking through the structure to apply rules at the individual level (such as if a §1231 gain will be ultimately taxed at capital gain rates) applying an aggregate test. That is, the passthrough was viewed as simply an aggregation of the various owners.

> As the Notice indicates, IRC §1373(a) provides that an S corporation will be treated like a partnership for purposes of Subpart A and F of Part III and Part V of Subchapter N of the IRC. The Notice points out that, prior to TCJA, domestic partnerships and S corporations were treated as entities for the then applicable Subpart F inclusion for CFC. Thus, the test for the existence of a U.S. shareholder took place at the partnership/S corporation level, with the equity holder having to take into account his/her share of the Subpart F inclusion amount even if the equity holder was not him/herself a holder of enough of an interest in the CFC (even counting their proportionate share held by the partnership or S corporation) to be a U.S. shareholder of the CFC.

Foreign partnerships were treated differently, however. For those, the partners were each deemed to own proportionately the stock of the CFC held by the foreign partnership.

[1272] Notice 2020-69, Section 2.01

The original 2018 proposed regulations implementing the new GILTI provisions took a hybrid approach, borrowing from both the entity and aggregate view. As the Notice provides:

> On October 10, 2018, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-104390-18) in the Federal Register (83 FR 51072) under § 951A (2018 proposed regulations). Section 1.951A-5 of the 2018 proposed regulations (proposed § 1.951A-5) provided a "hybrid approach" to a domestic partnership that is a U.S. shareholder (U.S. shareholder partnership) of a CFC (partnership-owned CFC). Under the hybrid approach, a U.S. shareholder partnership would determine its GILTI inclusion amount, and the partners of the partnership that were not also U.S. shareholders of the partnership-owned CFC would take into account their distributive share of the partnership's GILTI inclusion amount. See proposed § 1.951A-5(b). Partners that also were U.S. shareholders of a partnership-owned CFC would not take into account their distributive share of the partnership's GILTI inclusion amount. Instead, such partners would be treated as proportionately owning the stock of the partnership-owned CFC within the meaning of § 958(a) as if the domestic partnership were a foreign partnership. See proposed § 1.951A-5(c).
>
> Because § 1373(a) treats S corporations as partnerships for purposes of subpart F, the hybrid approach in the 2018 proposed regulations also applied to S corporations that held stock of a CFC. For example, proposed § 1.951A-5(g)(5) (Example 5) applied entity treatment (outlined in section 2.02(1) of this notice) to an S corporation shareholder that was not a U.S. shareholder of a CFC owned by the S corporation (S corporation-owned CFC), and aggregate treatment (outlined in section 2.02(2) of this notice) to an S corporation shareholder that was a U.S. shareholder of the S corporation-owned CFC.[1273]

However, this approach was not taken in the 2019 final regulations. Those regulations shifted entirely to the aggregate view that previously applied to foreign partnerships for Subpart F income. The partnership itself is not tested to see if it is a U.S. shareholder—rather, each partner looks at his/her overall ownership interest in the CFC, including the equity holder's proportionate share of the entity's holdings, to determine if he/she will be treated as a U.S shareholder:

> On June 21, 2019, the Treasury Department and the IRS published final regulations (T.D. 9866) in the Federal Register (84 FR 29288) under § 951A (final regulations). The final regulations did not adopt the hybrid approach included in the 2018 proposed regulations and instead adopted aggregate treatment for domestic partnerships. Accordingly, under the final regulations, a domestic partnership does not have a GILTI inclusion amount, and therefore no partner of the partnership has a distributive share of a GILTI inclusion amount. See § 1.951A-1(e)(1). Rather, for purposes of determining the GILTI inclusion amount of any partner of a domestic partnership, each partner is treated as proportionately owning the stock of a CFC owned by the partnership within the meaning of § 958(a) in the same manner as if

[1273] Notice 2020-69, Section 2.02(3)

> the domestic partnership were a foreign partnership. Because only a U.S. person that is a U.S. shareholder can have a GILTI inclusion amount, a partner that is not a U.S. shareholder of a partnership-owned CFC does not have a GILTI inclusion amount determined by reference to the partnership-owned CFC. Section 1.951A-1(e)(1) applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See § 1.951A-7.[1274]

The Notice describes the resulting Subpart F and GILTI tax treatment for a partner under proposed regulations issued with the final regulations:

> On June 21, 2019, concurrent with the final regulations, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-101828-19) in the Federal Register (84 FR 29114) under § 958 (2019 proposed regulations). Section 1.958-1 of the 2019 proposed regulations (proposed § 1.958-1) mirrored the aggregate treatment of domestic partnerships for purposes of GILTI inclusions as set forth in the final regulations, and also extended it to apply for purposes of subpart F inclusions. See proposed § 1.958-1(d)(1). Accordingly, subject to certain exceptions in proposed §1.958-1(d)(2), for purposes of §§ 951 and 951A and any other provision that applies by reference to § 951 or 951A, the 2019 proposed regulations provided that a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of §958(a); instead, a domestic partnership is treated in the same manner as a foreign partnership for purposes of determining the persons that own stock of the foreign corporation within the meaning of § 958(a). See proposed § 1.958-1(d)(1). Under proposed § 1.958-1(d)(2), a domestic partnership is treated as an entity for purposes of determining whether any U.S. person (including the domestic partnership) is a U.S. shareholder, whether any U.S. shareholder is a controlling domestic shareholder (as defined in § 1.964-1(c)(5)), or whether any foreign corporation is a CFC.
>
> Consistent with the final regulations with respect to GILTI, under the 2019 proposed regulations a partner that is not a U.S. shareholder with respect to a partnership-owned CFC does not take into account a subpart F inclusion or GILTI inclusion amount by reference to the partnership-owned CFC.
>
> The 2019 proposed regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register. See proposed § 1.958-1(d)(4). Subject to a consistency requirement, however, the 2019 proposed regulations provide that a domestic partnership may apply the regulations, once finalized, to taxable years of a foreign corporation beginning after December 31, 2017, and to taxable years of the domestic partnership in which or with which such taxable years of the foreign corporation end. See id.[1275]

[1274] Notice 2020-69, Section 2.02(4)

[1275] Notice 2020-69, Section 2.02(5)

Impact of the Rules on S Corporation Distributions

The new aggregate approach creates issues with distributions from an S corporation. Under current regulations, an S corporation shareholder who now has an income inclusion under the aggregate approach on his/her personal return would not see a corresponding increase in AAA at the S corporation level, as that is a corporate account.

The Notice explains:

> The aggregate treatment provided in the final regulations, as applied to S corporations with AE&P, does not result in a positive adjustment of AAA because the GILTI inclusion amount arises at the shareholder level, rather than at the S corporation level. See § 1.951A-1(e). If an S corporation with AE&P distributes property to its shareholders, for example, to provide its shareholders with funds to pay the resulting federal income tax arising from their GILTI inclusion amount with respect to stock of CFCs owned by the S corporation, the S corporation would need an amount of AAA equal to the amount of that distribution to prevent the distribution from being included in such shareholders' gross income to the extent of AE&P. See generally § 1368(c). Although the S corporation could generate additional AAA as needed through a distribution from a CFC, comments have asserted that such an approach could result in foreign withholding taxes or undesired reductions in working capital that otherwise would be devoted to the CFC's businesses.
>
> As stated in section 2.02(7) of this notice, § 1368(c)(1) provides that tax-free distribution treatment to shareholders of an S corporation with AE&P results only to the extent the S corporation has sufficient AAA to support the distribution. In the absence of enough AAA, § 1368(c)(2) requires the distribution to be taxed as a dividend (as defined in § 316) to the S corporation's shareholders to the extent of the S corporation's AE&P. In other words, if an S corporation has no AAA, the amount of the adjusted basis in a shareholder's S corporation stock — including any positive basis adjustment under § 961(a) resulting from a shareholder's GILTI inclusion — does not affect dividend treatment. Once the S corporation exhausts its AE&P, distributions are once again applied to shareholder stock basis. Comments regarding the application of the final regulations to S corporations and their shareholders focused on these interactions between the aggregate treatment and the distribution rules for AE&P under subchapter S.[1276]

Thus, S corporations with shareholders who are seeing a GILTI inclusion amount may find they are paying tax on a distribution made to allow them to pay the tax if there is not a corresponding distribution from the CFC—a distribution that may not make sense for various reasons. The issue will only arise if the S corporation has accumulated earnings and profits (AE&P) since in that case the distributions will become tax dividends to shareholders once the corporate level AAA is exhausted.

[1276] Notice 2020-69, Section 2.02(8)

Election for S Corporation with AE&P to be Treated Under the Entity Method

The Notice announces that the IRS plans to address this problem in new regulations to be released under IRC §958. The Notice states:

> The Treasury Department and the IRS intend to issue the forthcoming S corporation regulations under § 958 of the Code to ease the transition of S corporations with AE&P on September 1, 2020 from the historic entity treatment and the hybrid treatment under proposed §1.951A-5 (and illustrated in § 1.951A-5(g)(5) (Example 5)) to the aggregate treatment required under the final regulations (transition rules). The forthcoming S corporation regulations will ensure that distributions of income already taxed to S corporation shareholders will be tax-free, and AE&P generated by a former C corporation will be taxed as dividends when distributed.
>
> The Treasury Department and the IRS intend the transition rules to assist S corporations with AE&P and their shareholders by allowing them to recognize the GILTI inclusion amount at the entity level so it is treated as an item of income, thereby increasing its AAA before allocation to the shareholders. This increase in AAA will allow S corporations to distribute property to shareholders and avoid dividend treatment. To achieve this result, the Treasury Department and the IRS expect to provide rules and examples consistent with those set forth in sections 3.02 and 3.03, respectively, of this notice. These transition rules are expected to apply solely to S corporations with "transition AE&P," as defined in section 3.02(3) of this notice.[1277]

To address this issue, the Notice provides the S corporation and its shareholders with an option to use the entity treatment for the GILTI inclusion amount:

> With respect to a taxable year, an S corporation is subject to entity treatment if (a) it (and its shareholders, if applicable) makes an election described in section 3.02(2) of this notice, (b) it has elected S corporation status before June 22, 2019, (c) it would be treated as owning stock of a CFC on June 22, 2019, within the meaning of § 958(a) if entity treatment applied, (d) it has transition AE&P (as defined in section 3.02(3) of this notice) on September 1, 2020, or on the first day of any subsequent taxable year, and (e) it maintains records to support the determination of the transition AE&P amount. Entity treatment means that an S corporation that owns stock of a CFC is treated as owning within the meaning of § 958(a) the CFC stock for purposes of applying § 951A. Thus, the S corporation determines its GILTI inclusion amount, and its shareholders take into account their distributive share of that GILTI inclusion amount. See section 2.02(1) of this notice.[1278]

[1277] Notice 2020-69, Section 3.01

[1278] Notice 2020-69, Section 3.02(1)

The Notice outlines the following rules for making this election:

> With respect to the first taxable year ending on or after September 1, 2020, an S corporation may irrevocably elect to apply entity treatment on a timely filed (including extensions) original Form 1120-S, U.S. Income Tax Return for an S Corporation. For taxable years of an S corporation ending before September 1, 2020 and after June 21, 2019, the S corporation and all of its shareholders may irrevocably elect the entity treatment provided in section 3.02(1) of this notice on timely filed (including extensions) original returns or on amended returns filed by March 15, 2021, by attaching a statement thereto.
>
> The election is made by attaching a statement to the Federal tax return. The election statement must identify the election being made, include the amount of transition AE&P as described in section 3.02(3) of this notice, and, where applicable, be signed by a person authorized to sign the return required to filed under § 6037. Form 1120-S, Schedules K-1 (Form 1120-S), and Form 8892, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, must be prepared consistent with the S corporation's election for shareholders to comply with § 6037(c).[1279]

Transition AE&P – A Requirement for the Election and Treatment

As was explained earlier, an S corporation that has no accumulated earnings and profits does not face a problem with making distributions to help pay the tax generated by GILTI inclusion by shareholders in the aggregate method found in the regulations. So the Notice limits the election only to those S corporations with AE&P existing at the transition date ("Transition AE&P") and only for the period the corporation continues to have such AE&P.

Transition AE&P is defined in the Notice as:

> For purposes of this notice, the term "transition AE&P" means, with respect to an S corporation and its shareholders, the amount of AE&P of the S corporation calculated as of September 1, 2020, reduced as described in section 3.02(5) of this notice. Transition AE&P is not increased as a result of transactions occurring (or entity classification elections described in § 301.7701-3 filed) after September 1, 2020.[1280]

The Notice provides that Transition AE&P is not transferrable—what would be transferred is "standard" AE&P.

> For purposes of this notice, transition AE&P of an S corporation is not transferrable to another person under any provision of the Code (for example, under §§ 312(h)

[1279] Notice 2020-69, Section 3.02(2)

[1280] Notice 2020-69, Section 3.02(3)

or 381 by reason of § 1371(a)). In other words, the transferee of the transition AE&P would receive AE&P not transition AE&P.[1281]

The Notice also points out that AE&P is only to be reduced by distributions (presumably either actual distributions or elective deemed distributions of S corporation earnings and profits):

> An S corporation with transition AE&P is treated as having no transition AE&P if, beginning after September 1, 2020, the S corporation distributes in one or more distributions a cumulative amount of AE&P equal to or greater than the amount of the S corporation's transition AE&P as of September 1, 2020.[1282]

The Notice provides that the entity status continues until transition AE&P is exhausted:

> Except as provided in Notice 2019-46, aggregate treatment applies to an S corporation if the S corporation has not made an election described in section 3.02(1) of this notice to apply the transition rules. In the case of an S corporation that has made an election to apply entity treatment as described in section 3.02(1) of this notice, aggregate treatment applies beginning with the S corporation's first taxable year for which the S corporation has no transition AE&P on the first day of that year, and to each subsequent taxable year of the S corporation. For purposes of this section 3.02(6), aggregate treatment means the treatment of an S corporation provided under § 1.951A-1(e).[1283]

Examples

The Notice has two examples of applying this election.

EXAMPLE 1, NOTICE 2020-69

S corporation with transition AE&P

(a) Facts. Individual A and Individual B, each U.S. citizens, respectively own 5% and 95% of the single class of stock of SCX, an S corporation. SCX's sole asset is 100% of the single class of stock of FC, a CFC, which SCX has held since June 1, 2019. Neither Individual A or Individual B own shares, directly or indirectly, in any other CFC. Individual A, Individual B, SCX, and FC all use the calendar year as their taxable year. On January 1, 2021, SCX has transition AE&P of $100x and AAA of $0. SCX elects to apply the transition rules under section 3.02(1) of this notice. During the 2021 taxable year, FC has $200x of tested income (within the meaning of § 1.951A-2(b)(1)) and $0 of QBAI (within the meaning of §1.951A-3(b)).

(b) Analysis — (i) S corporation-level. As an S corporation with transition AE&P on the first day of the taxable year (here, January 1, 2021), SCX is treated as owning (within the meaning of § 958(a)) all the stock of FC for purposes applying § 951A. Accordingly, SCX, a U.S. shareholder of FC, determines its GILTI inclusion amount under § 1.951A-1(c)(1) for its 2021 taxable year. SCX's pro rata share of FC's tested income is $200x, and its pro rata share of FC's QBAI is $0. SCX's net CFC tested income (within the meaning of § 1.951A-1(c)(2)) is $200x, and its net deemed tangible income return (within the meaning of § 1.951A-1(c)(3)) is $0. As a result, SCX's GILTI inclusion amount for 2021 is $200x. At the end of 2021, SCX increases its AAA by $200x to reflect

[1281] Notice 2020-69, Section 3.02(4)

[1282] Notice 2020-69, Section 3.02(5)

[1283] Notice 2020-69, Section 3.02(6)

the GILTI inclusion amount. Because SCX computes its income as an individual under § 1363(b), it cannot take a § 250 deduction for any GILTI inclusion amount. See § 1.250(a)-1(c)(1).

(ii) S corporation shareholder-level. Neither Individual A nor Individual B is treated as owning the stock in FC within the meaning of § 958(a). Accordingly, Individual A and Individual B include in gross income their pro rata shares of SCX's GILTI inclusion amount as described in § 1366(a), which is $10x ($200x x 5%) for Individual A and $190x ($200x x 95%) for Individual B.

EXAMPLE 2, NOTICE 2020-69

Effect of distribution on transition AE&P

(a) Facts. The facts are the same as in Example 1 of this section 3.03, except that, on December 31, 2021, SCX distributes $300x to its shareholders. In addition, FC has an additional $200x of tested income (within the meaning of § 1.951A-2(b)(1)) and $0 of QBAI (within the meaning of §1.951A-3(b)) during the 2022 taxable year.

(b) Analysis — (i) Determination of transition AE&P. Before taking into account the distribution on December 31, 2021, the results for taxable year 2021 are the same as set forth in paragraphs (b)(i) and (b)(ii) of Example 1 of this section 3.03. $200x, the portion of SCX's $300x distribution that does not exceed AAA, is subject to §1368(c)(1). The remaining distribution of $100x is treated as a dividend under § 316 to the extent of SCX's AE&P. As of January 1, 2022, SCX has $0 of transition AE&P under section 3.02(5) of this notice because the cumulative amount of SCX's distributions out of AE&P after September 1, 2020 equals or exceeds the amount of SCX's transition AE&P as of September 1, 2020.

(ii) S corporation-level. Because SCX has no transition AE&P as of January 1, 2022, aggregate treatment applies to SCX for its taxable year 2022 and for each subsequent taxable year. As a result, for purposes of determining a GILTI inclusion amount in its taxable year 2022, SCX is not treated as owning (within the meaning of §958(a)) the FC stock; instead, SCX is treated in the same manner as a foreign partnership for purposes of determining the FC stock owned by Individual A and Individual B under § 958(a)(2). See § 1.951A-1(e)(1). Accordingly, SCX does not have a GILTI inclusion amount for its 2022 taxable year (or for any subsequent taxable year) and therefore will not increase its AAA as a result of its ownership of FC stock for its taxable year 2022 (or for any subsequent taxable year).

(iii) S corporation shareholder-level — (A) Individual A. For purposes of determining the GILTI inclusion amount of Individual A for taxable year 2022, Individual A is treated as owning 5% of the FC stock under § 958(a). Individual A is not, however, a U.S. shareholder of FC because Individual A owns (within the meaning of § 958(a) and (b)) less than 10% (that is, only 5%) of the FC stock. Accordingly, Individual A does not have a GILTI inclusion amount for taxable year 2022.

(B) Individual B. For purposes of determining the GILTI inclusion amount of Individual B for taxable year 2022, Individual B is treated as owning 95% of the FC stock under § 958(a). In addition, Individual B is a U.S. shareholder of FC because Individual B owns (within the meaning of § 958(a) and (b)) at least 10% (that is, 95%) of the FC stock. Accordingly, Individual B's pro rata share of FC's tested income is $190x ($200x x 0.95), and Individual B's pro rata share of FC's QBAI is $0. Individual B's net CFC tested income is $190x, and Individual B's net deemed tangible income return is $0. As a result, Individual B's GILTI inclusion amount for taxable year 2022 is $190x.

SECTION: 1361
NONPROFIT CORPORATION COULD NOT ISSUE STOCK, THUS NO S ELECTION WAS POSSIBLE

Citation: Deckard v. Commissioner, 155 TC No. 8, 9/17/20

The Tax Court determined that Clinton Deckard did not own shares in Waterfront Fashion Week, Inc., and, as such, the corporation could not make a late S election. Mr. Decker was barred from claiming losses from that corporation on his personal return.[1284]

The taxpayer had formed Waterfront Fashion Week, Inc. as a nonprofit corporation under Kentucky law in May of 2012. The purpose of the corporation was explained in the opinion as follows:

> Waterfront produced an event called Waterfront Fashion Week that was held at the Louisville Waterfront Park from October 17 to 19, 2012. This event was marketed as benefiting Waterfront Development Corp., a nonprofit organization that maintains the Louisville Waterfront Park. The event failed, however, to break even. Consequently, Waterfront made no cash charitable contribution to Waterfront Development Corp. The record does not reflect that Waterfront engaged in any other activity at any relevant time.[1285]

Not only did Waterfront not generate earnings to be donated to Waterfront Development Corp., Mr. Deckard made significant transfers to the entity while trying to make a go of the event. As it became clear that Waterfront was never going to be able to have a successful event and recoup those losses, Mr. Deckard took the following actions:

> On October 28, 2014, Waterfront mailed to the IRS Form 2553, Election by a Small Business Corporation. The Form 2553 indicated that Waterfront was electing to be an S corporation retroactively as of the date of its incorporation, May 8, 2012.4 Petitioner signed the Form 2553 in his capacity as Waterfront's president. Petitioner also signed the Form 2553 shareholder's consent statement, indicating that he held a 100% ownership interest acquired on May 8, 2012.
>
> On January 13, 2015, Waterfront filed untimely Forms 1120S, U.S. Income Tax Return for an S Corporation, for its taxable years 2012 and 2013, reporting operating losses of $277,967 and $3,239 for 2012 and 2013, respectively. Attached to the Forms 1120S were Schedules K-1, Shareholder's Share of Income, Deductions, Credits, etc., reporting that petitioner had 100% stock ownership of Waterfront during 2012 and 2013.

[1284] *Deckard v. Commissioner*, 155 TC No. 8, September 17, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12322 (retrieved September 18, 2020)

[1285] *Deckard v. Commissioner*, 155 TC No. 8, p. 6

> On May 12, 2015, petitioner filed untimely Forms 1040, U.S. Individual Income Tax Return, for his taxable years 2012 and 2013. On the Schedules E, Supplemental Income and Loss, attached to these returns, petitioner reported passthrough, nonpassive losses from Waterfront of $277,967 and $3,239 for taxable years 2012 and 2013, respectively.[1286]

While the IRS argued both that the corporation hadn't made a valid S election and that Mr. Deckard was not a shareholder, the Tax Court disposed of the case by looking solely at the issue of whether Mr. Deckard was a shareholder, finding he was not a shareholder.

A Kentucky Nonprofit Corporation Cannot Have a Shareholder for S Corporation Purposes

The taxpayer claimed that the facts of the case indicate that even though Kentucky law may not allow for shareholders in a nonprofit corporation, he would be a shareholder for federal tax purposes due to the beneficial interest he had in the corporation:

> Petitioner's declaration in support of his cross-motion for partial summary judgment asserts, among other things: that on or about July 22, 2011, he hired Extraordinary Events, an unrelated event-planning business, to coordinate Waterfront Fashion Week; that on May 3, 2012, he hired Attorney D. Kevin Ryan to advise him on the creation of a legal entity to conduct Waterfront Fashion Week because Extraordinary Events had advised petitioner that a tax-exempt entity would encourage sponsors to make tax-deductible contributions to the legal entity; that Attorney Ryan never advised petitioner that sponsors might be able to deduct sponsorships as trade or business expenses even if the legal entity lacked tax-exempt status; that on May 8, 2012, Attorney Ryan formed Waterfront under the Act; that during 2012 and 2013 petitioner was president of Waterfront and its "sole decision maker"; that on or about August 10, 2012, he terminated the agreement with Extraordinary Events because it had failed to recruit enough sponsors or raise enough contributions to fund Waterfront Fashion Week; that he then assumed "complete control" over planning Waterfront Fashion Week, "abandoned plans" for Waterfront to obtain Federal tax-exempt status, and began treating Waterfront as a "for-profit business that I owned entirely"; and that in August 2012 he made over $275,000 of contributions to Waterfront representing over 85% of the total cost of Waterfront Fashion Week.[1287]

As the IRS did not specifically dispute these facts, the Tax Court assumed they were true—but, even so, it found Mr. Deckard was not a beneficial shareholder.

[1286] *Deckard v. Commissioner*, 155 TC No. 8, pp. 7-8

[1287] *Deckard v. Commissioner*, 155 TC No. 8, pp. 10-11

The Court found that, in determining if the shareholder had a beneficial interest that made him a shareholder for Subchapter S purposes, the Court would need to look at the following:

> The subchapter S regulations provide: "Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation." Sec. 1.1361-1(e)(1), Income Tax Regs. Citing this regulation, one court has observed that "the question whether a person was a shareholder on the date of the election to be taxed under Subchapter S is equivalent to the question whether, had there been a valid election, he would have been required to report as personal income profits earned by the corporation on that date." *Cabintaxi Corp. v. Commissioner*, 63 F.3d 614, 616 (7th Cir. 1995), *aff'g in part, rev'g in part on other grounds* T.C. Memo. 1994-316. The resolution of this question depends on whether the person "would have been deemed a beneficial owner of shares in the corporation, entitled therefore to demand from the nominal owner the dividends or any other distributions of earnings on those shares." *Id.*[1288]

The opinion notes that nonprofit corporations are generally prohibited from distributing profits to insiders who exercise control—such as Mr. Deckard. And, specifically, the Kentucky law under which the corporation was formed contains just such a prohibition:

> The prohibition on the distribution of profits is clearly embodied in the Act, which governs the formation, operation, and dissolution of nonstock, nonprofit corporations in Kentucky. A corporation subject to the provisions of the Act must possess two important characteristics. First, the corporation must be "nonprofit". Ky. Rev. Stat. Ann. sec. 273.161(1). A "[n]onprofit corporation" is defined as a corporation no part of the income or profit of which is distributable to its members, directors, and officers. *Id.* sec. 273.161(3). Consistent with this definition, the Act expressly prohibits a nonprofit corporation from paying a dividend or distributing any part of its income or profits to its members, directors, or officers. *Id.* sec. 273.237. Second, the corporation "shall not have or issue shares of stock." *Id.*[1289]

The Court found that:

- Under Kentucky law, the corporation had no stock and could issue no stock;
- Mr. Deckard, being unable under the law to have any of the profit of the corporation distributed to him or inure to his benefit, did not possess a beneficial interest equivalent to the holding of stock; and
- Due to similar restrictions, Mr. Deckard could not receive any assets on liquidation of the corporation.[1290]

[1288] *Deckard v. Commissioner*, 155 TC No. 8, pp. 11-12

[1289] *Deckard v. Commissioner*, 155 TC No. 8, pp. 16-17

[1290] *Deckard v. Commissioner*, 155 TC No. 8, pp. 18-19

The Court found that his assertion that he took full control of the entity did not change the issue—it was still organized as a Kentucky nonprofit corporation and had articles of incorporation in accordance with that law that continued to bar Mr. Deckman from receiving distributions:

> Petitioner asserts that in August 2012 he "assumed complete control over the planning of the fashion week event" and began "treating * * * [it] as a for-profit business". Even assuming that this is true, any such actions would not give rise to ownership rights in Waterfront greater than those afforded by the Act and Waterfront's articles of incorporation. Control over Waterfront was vested in its three directors, as fiduciaries entrusted with the duties and powers imposed upon them by the Act and the articles of incorporation. See Ky. Rev. Stat. Ann. sec. 273.215(1); *Ballard v. 1400 Willow Council of Co-Owners, Inc.*, 430 S.W.3d 229, 241 (Ky. 2013).[1291]

Substance Over Form

As we have noted previously in prior articles, the party that establishes the form of a transaction will generally be barred from arguing that the chosen form doesn't comport with reality. Nevertheless, Mr. Deckard attempted to argue substance over form—that even if the form would bar him from being a beneficial shareholder, the substance of the transactions meant he was a shareholder for federal tax purposes.

> Invoking the doctrine of substance over form, petitioner urges that we should disregard Waterfront's form as a nonprofit corporation and instead should regard it, in substance, as a for-profit entity. He asserts that he intended Waterfront to be a for-profit entity and "objectively operated" it "consistently with it being a for-profit entity that he owned entirely." He urges that "the only fact inconsistent with Waterfront * * * being a for-profit entity is that an attorney formed * * * [it] as a nonprofit corporation prior to when the economic realities of the project came to light." He states that although he "should have sought to change Waterfront['s] * * * corporate documents to reflect" these changed plans, he was "mistakenly unaware of these formalities of corporate law" and so treated Waterfront "like he was the sole owner in every practical sense."[1292]

The Court notes that taxpayers are almost always bound by the form for the transaction they selected, but that even if that wasn't the case the substance of this transaction was in line with its form:

> Nothing in the record suggests that Waterfront's form did not respect its substance. To the contrary, the record shows that in May 2012 Waterfront was purposefully organized as a nonprofit corporation, upon an attorney's advice, with the expectation that it would seek tax-exempt status so as to facilitate tax-deductible gifts. Its corporate existence as a nonprofit corporation began when its articles of incorporation were filed on May 8, 2012. See Ky. Rev. Stat. Ann. sec. 273.2531. It

[1291] *Deckard v. Commissioner*, 155 TC No. 8, p. 20

[1292] *Deckard v. Commissioner*, 155 TC No. 8, pp. 20-21

> was not until several months later that petitioner changed course, abandoned plans to obtain Federal tax-exempt status for Waterfront, and "assumed control". Any such actions after Waterfront's organization had no effect upon its status as a nonprofit corporation under the Act. Indeed, the parties have stipulated that at all relevant times Waterfront existed under the provisions of the Act.[1293]

Lack of Federal Tax-Exempt Status

Finally, Mr. Deckard argued that since the corporation never sought tax-exempt status under the IRC, it should be treated as a for-profit corporation. But the Court finds that Mr. Deckard is confusing federal and state law—whether a corporation is nonprofit under state law, and thus bound by the state's rules for such an entity, does not depend on the corporation obtaining federal tax-exempt status:

> Petitioner's argument confuses Federal tax-exempt status with status as a nonprofit corporation under State law. As noted, at all relevant times Waterfront was subject to the provisions of the Act. The decision not to seek Federal tax-exempt status for Waterfront has no bearing on its status as a nonprofit corporation under the Act or on the ownership constraints imposed thereunder.[1294]

SECTION: 1366
TAXPAYER NOT ALLOWED TO ASSERT SUBSTANCE OVER FORM, NO DEBT BASIS FOR LOANS FROM RELATED CORPORATION

Citation: Messina et ux. et al. v. Commissioner, Case No. 18-70186, CA9, 12/27/19

The Ninth Circuit Court of Appeals affirmed the Tax Court's 2017 decision in the case of *Messina et ux. et al. v. Commissioner.*[1295] The appellate decision explains why the IRS is allowed to argue substance over form for a transaction, but that argument will not generally be helpful for the taxpayer—as it failed to be in this case.

In 2017 we had previously written about this case when the Tax Court decision came down.[1296] In that article we summarized the facts of the case as follows:

> In this situation, the controlling shareholders of an S corporation formed another S corporation that loaned funds to a qualified S corporation subsidiary (QSUB) of the

[1293] *Deckard v. Commissioner*, 155 TC No. 8, p. 22

[1294] *Deckard v. Commissioner*, 155 TC No. 8, p. 23

[1295] *Messina et ux. et al. v. Commissioner*, Case No. 18-70186, CA9, 12/27/2019, http://cdn.ca9.uscourts.gov/datastore/memoranda/2019/12/27/18-70186.pdf

[1296] Ed Zollars, "Loans from Related Corporations Did Not Give Shareholders Basis for Losses," *Current Federal Tax Developments,* October 31, 2017, https://www.currentfederaltaxdevelopments.com/blog/2017/10/31/loans-from-related-corporations-did-not-shareholders-basis-for-losses

> first S corporation. The shareholders then attempted to claim losses from the first S corporation by using those loans as additional basis in the corporation—a position the IRS and, ultimately, the Tax Court disagreed with.
>
> The second S corporation was formed on the advice of the taxpayers' counsel in order to work around a problem. The loan was to be used to refinance third party debt to the QSUB. However, by terms of the agreement with other creditors (who had sold the business to the S corporation originally), any amounts borrowed from the shareholders of the S corporation had to be subordinated to the original owner's debts. The attorney advised the taxpayers by using a new S corporation, no subordination of the new debt would be required.[1297]

As we noted at the time, the Tax Court found that such debt from a related party did not give the shareholders basis—they couldn't ignore the existence of the lending corporation and treat the debt as coming directly from the shareholders.

The taxpayers appealed this decision, and the Ninth Circuit has rendered its decision, agreeing with the Tax Court that the taxpayers could not ignore the corporation that they had voluntarily formed to hold the loans.

The taxpayers argued that the substance of the transaction was a loan from them to the S corporation from which they wished to claim a loss, and that the court should respect this substance. But the Ninth Circuit rejects the idea that a *taxpayer* can argue substance over form when the form of the transaction is created by the taxpayer:

> We have not held that the "substance over form" doctrine is available to a taxpayer as well as the government. Indeed, we have previously rejected the notion that the taxpayer can "escape the tax consequences of a business arrangement which he made upon the asserted ground that the arrangement was fictional." *Maletis v. United States*, 200 F.2d 97, 98 (9th Cir. 1952) (quoting *Love v. United States*, 96 F. Supp. 919, 921 (Ct. Cl. 1951)).[1298]

The government is allowed to argue substance over form for the simple reason that the government was not involved in deciding the form of the transaction. The taxpayer, on the other hand, was free to choose whatever form he/she wished and, in this case, the taxpayers did not choose to structure this as a loan directly from the taxpayers to the S corporation.

[1297] Ed Zollars, "Loans from Related Corporations Did Not Give Shareholders Basis for Losses," *Current Federal Tax Developments,* October 31, 2017, https://www.currentfederaltaxdevelopments.com/blog/2017/10/31/loans-from-related-corporations-did-not-shareholders-basis-for-losses

[1298] *Messina et ux. et al. v. Commissioner*, p. 3

But even when the form over substance doctrine is available to a party, the party still needs to show that the form does not correspond to the substance of the arrangement—and the panel notes that that was not the case here. The panel continues:

> As the Tax Court properly held, the form of the loan acquisition in this case "corresponds to its substance" and should therefore "be respected for Federal tax purposes as it was implemented." *Messina v. Comm'r*, T.C. Memo. 2017-213, 2017 WL 4973291, at *16 (2017).
>
> KMGI's purchase of the third-party loan directly, rather than through Kirkland and Messina, was motivated by a number of non-tax business and regulatory considerations. In all circumstances except their tax returns, Taxpayers treated KMGI as an independent entity that was to acquire the third-party loan and serve as Club One's creditor. They reaped several benefits from doing so, including avoidance of a foreclosure on the casino that they co-own through Club One and a call on the personal guaranties that they signed in connection with the third-party loan. In addition, KMGI served business functions, including: being able to apply for the Gambling Commission's permission to acquire the loan; purchasing the loan from the third party potentially to maintain the loan's seniority to Club One's other obligations; receiving loan payments from Club One; and returning capital contributions to Kirkland and Messina. Thus, even if the "substance over form" doctrine were available to Taxpayers, it does not alter the outcome here[1299]

Since debts have to come directly from the shareholders to the corporation to be basis for loss deductions to the shareholders, these debts fail to qualify to create basis. Thus, the Tax Court correctly denied the taxpayers the losses they claimed that depended on this debt basis.

SECTION: 6031
IRS PROPOSES TO ADD DETAILED SCHEDULES K-2 AND K-3 FOR INTERNATIONAL PARTNERSHIP ITEMS

Citation: "Proposed International Changes to Form 1065, U.S. Return of Partnership Income for Tax Year 2021," IRS Website, 7/14/20

The IRS has released drafts of two new partnership tax forms for 2020 partnership returns, adding new Schedules K-2[1300] (20 pages) and K-3[1301] (22 pages) along with draft instructions for Schedules

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[1299] *Messina et ux. et al. v. Commissioner*, pp. 3-4

[1300] Schedule K-2, *Partners' Distributive Share Items—International* (Draft), July 8, 2020, https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-2-Form-1065.pdf (retrieved July 17, 2020)

[1301] Schedule K-3, *Partner's Share of Income, Deductions, Credits, etc.—International* (Draft), July 8, 2020, https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-3-Form-1065.pdf (retrieved July 17, 2020)

K-2[1302] (25 pages) and K-3[1303] (11 pages). The IRS announced these new forms on their website on July 14, 2020.[1304]

The IRS in the announcement provides the following reason for issuing these new forms:

> The Treasury Department and the IRS are proposing updates to the partnership form for tax year 2021 (filing season 2022). The updates will provide greater clarity for partners on how to compute their U.S. income tax liability with respect to international tax matters, including how to compute deductions and credits. The redesigned form and instructions also give useful guidance to partnerships on how to provide international tax information to their partners. This proposed form would apply to a partnership required to file Form 1065, but only if the partnership has items of international tax relevance (generally foreign activities or foreign partners). The proposed changes would not affect domestic partnerships with no items of international tax relevance.

The partnership instructions provide the following information regarding who will be required to file these forms:

> The partnership need not complete this schedule if the partnership does not have items of international tax relevance (typically, international activities or foreign partners).
>
> Any partnership required to file Form 1065 and that has items relevant to the determination of the U.S. tax or certain withholding tax or reporting obligations of its partners under the international provisions of the Internal Revenue Code must complete the relevant parts of Schedule K-2 and Schedule K-3. See each part and section for a more detailed description of who must file each part and section. Penalties may apply for filing Form 1065 without all required information or for furnishing Schedule K-3 to partners without all required information.[1305]

Schedule K-2, *Partners' Distributive Share Items—International* (Draft), contains the following sections, each providing detail on items previously found on pre-2020 Schedule K:

- Part I - Partnership's Share of Current Year International Transaction Information
- Part II - Foreign Tax Credit Limitation
  - Section 1—Gross Income

[1302] Partnership Instructions for Schedule K-2 (Form 1065) and Schedule K-3 (Form 1065) (Draft), July 9, 2020, https://www.irs.gov/pub/irs-utl/DRAFT-Sch-K-2-Instructions-Form-1065.pdf (retrieved July 17, 2020)

[1303] Partner's Instructions for Schedule K-3 (Form 1065) (Draft)

[1304] "Proposed International Changes to Form 1065, U.S. Return of Partnership Income for Tax Year 2021," IRS website, July 14, 2020, https://www.irs.gov/businesses/1065-form-changes (retrieved July 17, 2020)

[1305] Partnership Instructions for Schedule K-2 (Form 1065) and Schedule K-3 (Form 1065) (Draft), p. 1

- Section 2—Deductions

- Part III Other Information for Preparation of Form 1116 or 1118
  - Section 1—R&E Expenses Apportionment Factors
  - Section 2—Interest Expense Apportionment Factors
  - Section 3—Foreign Taxes
- Part IV Other Foreign Transaction Information for U.S. Partners
  - Section 1—Information on Partners' Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)
  - Section 2—Other Tax Information
  - Section 3—Distributions From Foreign Corporations to Partnership
- Part V Information on Partners' Section 951(a)(1) and Section 951A Inclusions
- Part VI Information To Complete Form 8621
  - Section 1—General Information on Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF)
  - Section 2—Additional Information on PFIC or QEF
- Part VII Partnership's Interest in Foreign Corporation Income (Section 960)
- Part VIII Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)
  - Section 1—Applicable Taxpayer
  - Section 2—Base Erosion Payments and Base Erosion Tax Benefits
- Part IX Foreign Partners' Character and Source of Income and Deductions
  - Section 1—Gross Income
  - Section 2—Deductions, Losses, and Net Income
  - Section 3—Allocation and Apportionment Methods for Deductions
  - Section 4—Section 871(m) Covered Partnerships

The Schedule K-3 to be provided to each partner contains the following sections:

- Part I Partner's Share of Current Year International Transaction Information
- Part II Foreign Tax Credit Limitation
  - Section 1—Gross Income
  - Section 2—Deductions
- Part III Other Information for Preparation of Form 1116 or 1118
  - Section 1—R&E Expenses Apportionment Factors
  - Section 2—Interest Expense Apportionment Factors
  - Section 3—Foreign Taxes
- Part IV Other Foreign Transaction Information for U.S. Partners
  - Section 1—Information on Partner's Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)
  - Section 2—Other Tax Information
  - Section 3—Distributions From Foreign Corporations to Partnership
- Part V Information on Partner's Section 951(a)(1) and Section 951A Inclusions
- Part VI Information To Complete Form 8621
  - Section 1—General Information on Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF)
  - Section 2—Additional Information on PFIC or QEF
- Part VII Partner's Share of Partnership's Interest in Foreign Corporation Income (Section 960)
- Part VIII Partner's Information for Base Erosion and Anti-Abuse Tax (Section 59A)
  - Section 1—Applicable Taxpayer (see instructions)
  - Section 2—Base Erosion Payments and Base Erosion Tax Benefits
- Part IX Foreign Partner's Character and Source of Income and Deductions
  - Section 1—Gross Income

- Section 2—Deductions, Losses, and Net Income
- Section 3—Allocation and Apportionment Methods for Deductions
- Section 4—Section 871(m) Covered Partnerships

- Part X Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

The IRS is looking for comments on these new forms. As the posting on the website states:

> The IRS is seeking comments from stakeholders during a 60-day period which will begin on the date of the press release. Those interested are invited to send comments to lbi.passthrough.international.form.changes@irs.gov with the subject line: "International Form Changes."
>
> Given the sweeping nature of the changes, the Treasury Department and the IRS are also planning a series of listening events to take comments and answer questions about the form. More details about participating in these events will be posted as soon as they are finalized. Please check back for further updates

SECTION: 6031
DRAFT 2020 FORM 1065 INSTRUCTIONS CONTAIN DETAILS OF TAX BASIS PARTNERS' CAPITAL ACCOUNT REPORTING REQUIREMENTS

Citation: 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, 10/21/20

The IRS has released a draft of the Form 1065 instructions for 2020 returns that contains the IRS's proposed requirement for reporting partners' capital on the K-1 on the tax basis.[1306] The IRS issued a news release on the matter at the same time.[1307]

[1306] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, https://www.irs.gov/pub/irs-dft/i1065--dft.pdf (retrieved October 22, 2020)

[1307] IR-2020-240, October 22, 2020, https://www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting (retrieved October 22, 202)

News Release Summary

The news release indicates that the IRS has decided to require partnerships to use the transactional approach in computing partners' capital on the tax basis, and require tax basis capital reporting on the 2020 Schedules K-1, Form 1065. The release states:

> The revised instructions indicate that partnerships filing Form 1065 for tax year 2020 are to calculate partner capital accounts using the transactional approach for the tax basis method. Under the tax basis method outlined in the instructions, partnerships report partner contributions, the partner's share of partnership net income or loss, withdrawals and distributions, and other increases or decreases using tax basis principles as opposed to reporting using other methods such as GAAP.
>
> According to IRS data, most partnerships already use the tax basis method although partnerships previously could report capital accounts determined under multiple methods.[1308]

This means that partnerships that have always reported on the tax basis for partners' capital (which is what the IRS refers to as the transactional approach) will not need to use one of the methods proposed in Notice 2020-43 to determine partners' capital, either initially or on a continuing basis. That notice had proposed barring the use of the transactional approach[1309] due to inconsistent use, but many commenters complained about the requirement to force partnerships that had always been reporting on something they felt was tax basis to go through one of the two alternative methods proposed in the Notice.

In the end, it appears the IRS not only relented and will allow continued use of the transactional approach, but has decided that is the only method to be allowed to be used following the computation of beginning partners' tax basis capital for 2020 Schedules K-1.

The IRS defined the transactional approach as follows in Notice 2020-43:

> Commenters have indicated that many partnerships that currently possess partner tax capital information generally develop and maintain partner tax capital by applying the provisions and principles of subchapter K of chapter 1 of the Code (subchapter K), including those contained in §§ 705, 722, 733, and 742 of the Code, to relevant partnership and partner events. In such a situation, commenters have indicated that partnerships maintaining tax capital (i) increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and (ii) decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the

[1308] IR-2020-240, October 22, 2020

[1309] Notice 2020-43, Section III (retrieved October 22, 2020)

> partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner (Transactional Approach).[1310]

The IRS will reserve the two methods discussed in Notice 2020-43 solely for partnerships that have not been reporting partners' capital on the tax basis. They can use these methods, among others, to compute their partners' beginning tax basis capital…

> Partnerships that did not prepare Schedules K-1 under the tax capital method for 2019 or otherwise maintain tax basis capital accounts in their books and records (for example, for purposes of reporting negative capital accounts) may determine each partner's beginning tax basis capital account balance for 2020 using one of the following methods: the Modified Outside Basis Method, the Modified Previously Taxed Capital Method, or the Section 704(b) Method, as described in the instructions, including special rules for publicly traded partnerships.[1311]

The news release also indicates the IRS plans to publish a notice granting penalty relief for partnerships in this year of transition to tax basis capital account reporting:

> To promote compliance with using the tax basis method described in the revised instructions, the Treasury Department and the IRS intend to issue a notice providing additional penalty relief for the transition in tax year 2020. The notice will provide that solely for tax year 2020 (for partnership returns due in 2021), the IRS will not assess a partnership a penalty for any errors in reporting its partners' beginning capital account balances on Schedules K-1 if the partnership takes ordinary and prudent business care in following the form instructions to calculate and report the beginning capital account balances. This penalty relief will be in addition to the reasonable cause exception to penalties for any incorrect reporting of a beginning capital account balance.[1312]

Likely the IRS has decided that the objections to date have primarily been related to the conversion of a minority of existing partnerships to the tax basis capital account reporting rather than the use of it on a continuing basis. So the agency has decided to be lenient in what will be allowed to compute the converted beginning tax basis capital account for partners, but then be strict regarding changes to those accounts being made only on the tax basis.

[1310] Notice 2020-43, Section III (retrieved October 22, 2020)

[1311] IR-2020-240, October 22, 2020

[1312] IR-2020-240, October 22, 2020

Instructions for Tax Basis Capital Accounts

The draft instructions begin by reminding taxpayers that the use of the tax basis is mandatory for 2020 partnership tax returns:

> **Tax basis method**. Figure each partner's capital account for the partnership's tax year using the transactional approach, discussed below, for the tax basis method. If you reported the partner's capital account last year using any other method (for example, GAAP, section 704(b), or other), you must use the tax basis method this year.[1313]

Basic Transactional Method Approach

The IRS begins by describing a standard rule taxpayers should use to report partnership events or transactions:

> If you are uncertain how to report a partnership event or transaction, you should account for the event or transaction in a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of sections 705, 722, 733, and 742 and by reporting the amount on the line for other increase (decrease). *<u>The partner's ending capital account as reported using the tax basis method in item L might not equal the partner's adjusted tax basis in its partnership interest. (emphasis added)</u>* Generally, this is because a partner's adjusted tax basis in its partnership interest includes the partner's share of partnership liabilities, as well as partner specific adjustments. Each partner is responsible for maintaining a record of the adjusted tax basis in its partnership interest.[1314]

Beginning Capital Account for Partnerships Previously Reporting on the Tax Basis

The IRS gives some information first for the majority of partnerships already purporting to report partners' capital on the tax basis about the beginning capital account reporting for 2020. The IRS starts by noting that taxpayers should, in this case, report the beginning capital account as the same number reported as the ending capital account on the prior year's Form 1065:

> If you figured the partner's capital account for last year using the tax basis method, enter the partner's ending capital account as determined for last year on the line for beginning capital account.[1315]

Some taxpayers, now understanding that the IRS is looking to focus on negative capital accounts, may decide to recalculate their tax basis capital accounts. The IRS indicates that if they do so, some

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[1313] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 30

[1314] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 30

[1315] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 30

additional information will be necessary for partners whose capital account was negative on the prior return, but now shows a positive beginning balance:

> If you reported a negative ending capital account to a partner last year and a different amount is figured for the partner's beginning capital account using the tax basis method this year, provide an explanation for the difference.[1316]

As well, the IRS provides guidance for dealing with partners who did not hold a partnership interest in the prior year:

> If a partner joined the partnership through a contribution to the partnership this year, enter zero as the partner's beginning capital account. If a new partner acquired its interest in the partnership from another partner in a purchase, exchange, gift, inheritance, or as the result of death this year, enter an amount for beginning capital account that is equal to the transferor partner's ending capital account with respect to the interest transferred immediately before the transfer figured using the tax basis method.[1317]

Contributions of Capital

The IRS gives the following instructions for properly reporting contributions of capital for tax basis capital account reporting:

> On the line for capital contributed during the year, enter the amount of cash plus the adjusted tax basis of all property contributed by the partner to the partnership during the year. The amount you enter on this line should be reduced by any liabilities assumed by the partnership in connection with, or liabilities to which the property is subject immediately before, the contribution. This amount might be negative.[1318]

Note that final sentence—if a taxpayer's capital contribution included liabilities in excess of the basis of the property contributed, the capital contribution *should be a negative number*.

Current Year Net Income (Loss)

The income or loss line should be filled in as follows per the instructions:

> On the line for current year net income (loss), enter the partner's distributive share of partnership income and gain (including tax-exempt income) as figured for tax purposes for the year, minus the partner's distributive share of partnership loss and

[1316] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 30

[1317] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, pp. 30-31

[1318] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

deductions (including nondeductible, noncapital expenditures) as figured for tax purposes for the year.[1319]

Other Increases (Decreases)

The IRS goes on to describe the items that would be found in the other increases (decreases) box, with certain specific examples:

> On the line for other increase (decrease), enter the sum of all other increases or decreases that affected the partner's capital account for tax purposes during the year and attach a statement explaining each adjustment. For example, include increases for the following.
>
> - The partner's distributive share of the excess of the tax deductions for depletion (other than oil and gas depletion) over the adjusted tax basis of the property subject to depletion.
> - The partner's share of any increase to the adjusted tax basis of partnership property under section 734(b).
>
> Include decreases for the following.
>
> - The partner's distributive share of tax deductions for depletion of any partnership oil and gas property, but not exceeding the partner's share of the adjusted tax basis of that property.
> - The partner's share of any decreases to the adjusted tax basis of partnership property under section 734(b).

While §734 adjustments do affect partners tax basis capital accounts under the IRS system, the other adjustment triggered by an election under §754 does *not* affect partners tax basis capital accounts. §734 adjustments are internal to the partnership and affect all partners, while the §743 adjustment only affects the partner acquiring an interest. The IRS not only warns about this, but requires partnerships that have recorded a §743 adjustment in a manner that causes it to be included in a partner's purported tax basis capital account to remove that net adjustment on the 2020 return:

> **Note**: Section 743(b) basis adjustments are not taken into account in calculating a partner's capital account under the tax basis method. If section 743(b) adjustments are included in a partner's beginning capital account balance (because they were included in last year's ending capital account), those section 743(b) adjustments, whether positive or negative adjustments, should be removed from the partner's capital account in the 2020 tax year and reported as a 2020 tax year other increase(decrease) item.[1320]

[1319] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1320] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

Withdrawals and Distributions

The box that contains withdrawals and distributions should be computed for tax basis capital accounts as follows per the IRS instructions:

> On the line for withdrawals and distributions, enter the amount of cash plus the adjusted tax basis of all property distributed by the partnership to the partner during the year. The amount you enter on this line should be reduced by any liabilities assumed by the partner in connection with, or liabilities to which the property is subject immediately before, the distribution. This amount might be negative.[1321]

Note that, as was true for capital contributions, distributions with liabilities in excess of basis may cause this number to properly be negative.

Ending Capital Account

Finally, the instructions discuss the ending capital account on the tax basis—and, not surprisingly, the IRS insists the column must add down to come up with the ending capital line:

> The sum of the amounts shown on the lines in item L above the line for ending capital account must equal the amount reported on the line for ending capital account. A partner's ending capital account determined under the tax basis method may be negative if the sum of a partner's losses and distributions exceeds the sum of the partner's contributions and share of income.[1322]

Reconciliation with Schedule L (Balance Sheet) Partners' Capital Accounts

So must the capital accounts on the Schedule K-1s in total agree with the partners' capital accounts reported on Schedule L (Balance Sheet)? The answer is no, but only if Schedule L is not prepared on the tax basis.

The instructions to Schedule M-2 indicate that it the reconciliation of partners' capital accounts is always prepared on the tax basis.[1323]

> Show what caused the changes during the tax year in the partners' capital accounts as reflected on the *partnership's books and records used in figuring the partnership's net income or loss for tax purposes*, the amount of any contributions and distributions of money or property made by the partnership to its partners, and any other increases or decreases to the partners' capital accounts *determined in a manner generally consistent with calculating the partners' adjusted tax bases in their partnership interests* (without regard to partnership liabilities), taking into account the rules and principles of sections 705, 722, 733, and 742.[1324]

[1321] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1322] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1323] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 55

[1324] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 55

But the instructions note that while you must reconcile Schedule L capital to the totals on partner's K-1 capital account balances if the Schedule L balance sheet is presented on the tax basis, the reconciliation is not required if the Schedule L balance sheet is not reported on the tax basis:

> The balance at the beginning of the year should equal the total of the amounts reported as the partners' beginning tax basis capital accounts in item L of all the partners' Schedules K-1. If not, the partnership should attach an explanation of the difference. Generally, the balance at the beginning of the year should equal the adjusted tax basis of the partnership's assets at the beginning of the year reduced by the partnership's liabilities at the beginning of the year. If the partnership's balance sheet (Schedule L) is reported on the tax basis and if the aggregate of the partners' beginning and ending capital accounts differ from the amounts reported on Schedule L, attach a statement reconciling any differences. *No such reconciliation is required if Schedule L is not reported on the tax basis*.[1325]

But Schedule M-2 will remain on the tax basis, as is clear in the instructions related to the balance at the end of the year section for Schedule M-2.

> The balance at the end of the year should equal the total of the amounts reported as the partners' ending capital accounts in item L of all the partners' Schedules K-1.

Partnerships Previously Reporting on a Method Other than Tax Basis for Partners' Capital

Those partnerships that, in prior years, used a method other than tax basis to report partners' capital are given special instructions for this year. As was noted earlier, these partners will have to report partners' capital on Schedule K-1 on the tax basis this year per the draft Form 1065 instructions.

Last year, partnerships that reported on a basis other than tax basis for partner's capital accounts did have to report negative tax basis capital accounts for any partners with such accounts. Thus, such partnerships may already have complete schedules of partners tax basis capital accounts calculated in which case those numbers should be used:

> If you reported partners' capital accounts using a method other than the tax basis method last year, but also maintained capital accounts in your books and records using the tax basis method (for example, for purposes of meeting the requirement to report partner negative tax capital accounts), you must report each partner's beginning capital account using the tax basis method.[1326]

If the partnership did not maintain such tax basis records, the IRS provides that such partnerships may refigure each partner's *beginning* capital account using one of the following methods, with the same method being used for each partner:

- Tax basis method;

[1325] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 55

[1326] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

- Modified outside basis method;
- Modified previously taxed capital method; or
- §704(b) method.[1327]

The partnership must use the standard tax basis methods described previously to report all other items on Schedule L aside from the beginning partners' capital balances, so this represents a one-time only calculation to obtain a starting point for a partner's tax basis capital account.[1328]

The following disclosures must also be made to each partner in this case as a statement attached to Schedule K-1:

> You must also attach a statement to the partners' Schedules K-1 indicating the method used to determine each partner's beginning capital account.[1329]

The three methods, aside from reconstructing the transaction tax basis capital accounts, are described in the following sections.

Modified Outside Basis Method

The first method for computing the partners' beginning tax basis capital accounts for the transition is the modified outside basis method. This method looks at the outside basis of each partner's capital account as a starting point.

The instructions describe the method as follows:

> The amount to report as a partner's beginning capital account under the modified outside basis method is equal to the partner's adjusted tax basis in its partnership interest as determined under the principles and provisions of subchapter K including, for example, sections 705, 722, 733, and 742; and subtracting from that basis (1) the partner's share of partnership liabilities under section 752 and (2) the sum of partner's section 743(b) adjustments (that is, net section 743(b) adjustments). For purposes of establishing a partner's beginning capital account, you may rely on the adjusted tax basis information provided by your partners.[1330]

Assuming each partner can provide the partnership with this information, or the partnership has maintained such information for each partner, this provides a relatively simple method to make the conversion.

However, this method will in many cases not result in total partners' tax basis capital that will reconcile to net tax basis capital for a balance sheet prepared on the tax basis. Thus, the method may

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[1327] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1328] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1329] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1330] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

require, as a practical matter, that the Schedule L balance sheet continue to be reported on a basis other than tax basis.

Modified Previously Taxed Capital Method

The second method looks to make use of the method found in the regulations under §743 to compute "previously taxed capital" for use in computing a §743(b) adjustment for a partner. The method looks to start with the cash each partner would receive if all partnership assets were sold, and then adjust that number to take into account the gains and losses that would be reported by each partner related to that sale. Thus, the calculation is meant to determine each partners' share of the inside net tax basis of partnership property.

The instructions describe this method as follows:

> The amount to report as a partner's beginning capital account under the modified previously taxed capital method is equal to the following.
>
> - The amount of cash the partner would receive if you liquidated after selling all of your assets in a fully taxable transaction for cash equal to the fair market value of the assets; increased by
>
> - The amount of tax loss determined without taking into account any section 743(b) basis adjustments (including any remedial allocations under Regulations section 1.704-3(d)) that would be allocated to the partner following such a liquidation (treating all liabilities as nonrecourse); and decreased by
>
> - The amount of tax gain determined without taking into account any section 743(b) basis adjustments (including any remedial allocations under Regulations section 1.704-3(d)) that would be allocated to the partner following such a liquidation (treating all liabilities as nonrecourse).
>
> Instead of using the assets' fair market value, you may determine the partnership's net liquidity value, and gain or loss, by using such assets' bases as determined under section 704(b), as determined for financial accounting purposes, or on the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management.[1331]

If this method is used, the following additional information must be provided to the partner:

> If the modified previously taxed capital method is used, the statement must also include the method used to determine the partnership's net liquidity value (fair market value, section 704(b) book value, etc.). The method, used to determine the

[1331] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

> partnership's net liquidity value, must be adopted for all partners in the partnership.[1332]

§704(b) Method

While the prior two methods were described by the IRS in Notice 2020-43, the draft instructions add a brand new method based on §704(b) capital accounts, referred to in the §704 regulations as "book capital" accounts.

The IRS describes this method as follows:

> The amount to report as a partner's beginning capital account under the section 704(b) method is equal to the partner's section 704(b) capital account, minus the partner's share of section 704(c) built-in gain in the partnership's assets, plus the partner's share of section 704(c) built-in loss in the partnership's assets. Property contributed to a partnership is section 704(c) property if, at the time of the contribution, its fair market value differs from its adjusted tax basis. Section 704(c) property also includes property with differences resulting from revaluations (reverse section 704(c) allocations). For more information see sections 704(b) and 704(c) and Regulations sections 1.704-1 through 1.704-3.

Most partnership agreements drafted by legal counsel will require the maintenance of capital accounts under the §704(b) regulations or, in the case of target capital accounts, will provide what is essentially a yearly computation of that account that is used to determine income/loss allocations. The §704(b) capital accounts are important for a partnership to be able to defend any special allocations in the partnership agreement against an IRS challenge.

Again, this beginning "tax basis" capital account will often result in the total of the individual partner capital accounts not agreeing with the total of net tax basis capital on a balance sheet prepared on the income tax basis. So, again, this would be most appropriate in cases where the partnership plans to continue to report its Schedule L balance sheet on other than the tax basis.

Special Beginning Tax Basis Capital Account Method for Publicly Traded Partnerships

Finally, the instructions conclude with the following special method for computing the partners' beginning capital account for a publicly traded partnership:

> In the case of a sale or exchange of an interest in a publicly traded partnership, you may determine a transferee partner's beginning capital account by adjusting the partner's beginning capital account to reflect the transferee partner's purchase price of the interest rather than entering the transferor partner's ending capital account. In making the adjustments, you may use information required to be reported to you under Regulations section 1.6031(c)-1T, and publicly available trading price information. If you are a publicly traded partnership and adopt the modified

[1332] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

previously taxed capital method, you may apply Regulations section 1.743-1(j)(4)(i)(B)(2) in figuring a partner's beginning capital account.[1333]

SECTION: 6221
WEB PAGE PROVIDING IRS GUIDANCE FOR BBA CENTRALIZED PARTNERSHIP AUDIT REGIME PUBLISHED BY THE AGENCY

Citation: "BBA Centralized Partnership Audit Regime," IRS website, 9/1/20

The IRS has established a web page on the agency's site devoted to the BBA Centralized Partnership Audit Regime.[1334]

The page is meant to provide a centralized location for the agency's information and guidance on the new audit regime introduced by the Bipartisan Budget Act of 2015, which replaces the prior TEFRA partnership audit regime.

The sections of guidance found on the page are:

- Filing Requirements;
- BBA Partnership Audit notices;
- Regulations for the BBA audits; and
- Interim Guidance for the BBA audits.

The page concludes with a high level comparison table:

Partnership Procedures	TEFRA	BBA
Partnership point of contact for examination	Tax Matters Partner	Partnership Representative
Partner participation rights during examination	Partners have the ability to participate in the examination and challenge partnership adjustments	Partners have no participation right to challenge partnership adjustment
Partner consistency of reporting	Partners must report items consistently with the partnership	Partners must report items consistently with the partnership

[1333] 2020 Instructions for Form 1065 (Draft), U.S. Partnership Return of Income, Draft as of October 21, 2020, p. 31

[1334] "BBA Centralized Partnership Audit Regime," IRS website, September 1, 2020 https://www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime (retrieved September 2, 2020)

Partnership Procedures	TEFRA	BBA
Notice requirements	Notice requirements (NBAP, FPAA)	Notice requirements (NAP, NOPPA, FPA)
Items adjusted during examination	Partnership item/Affected item	Partnership related item (PRI)
Where adjustments/assessments occur	Adjustments at the partnership level/tax assessment at the partner level	Adjustment and assessment at the partnership level (imputed underpayment)
Distinct phases of examination	Field examination	Field examination phase
	Not applicable	Modification phase (optional)
	FPAA phase	FPA phase
	Not applicable	Push-out phase (optional)

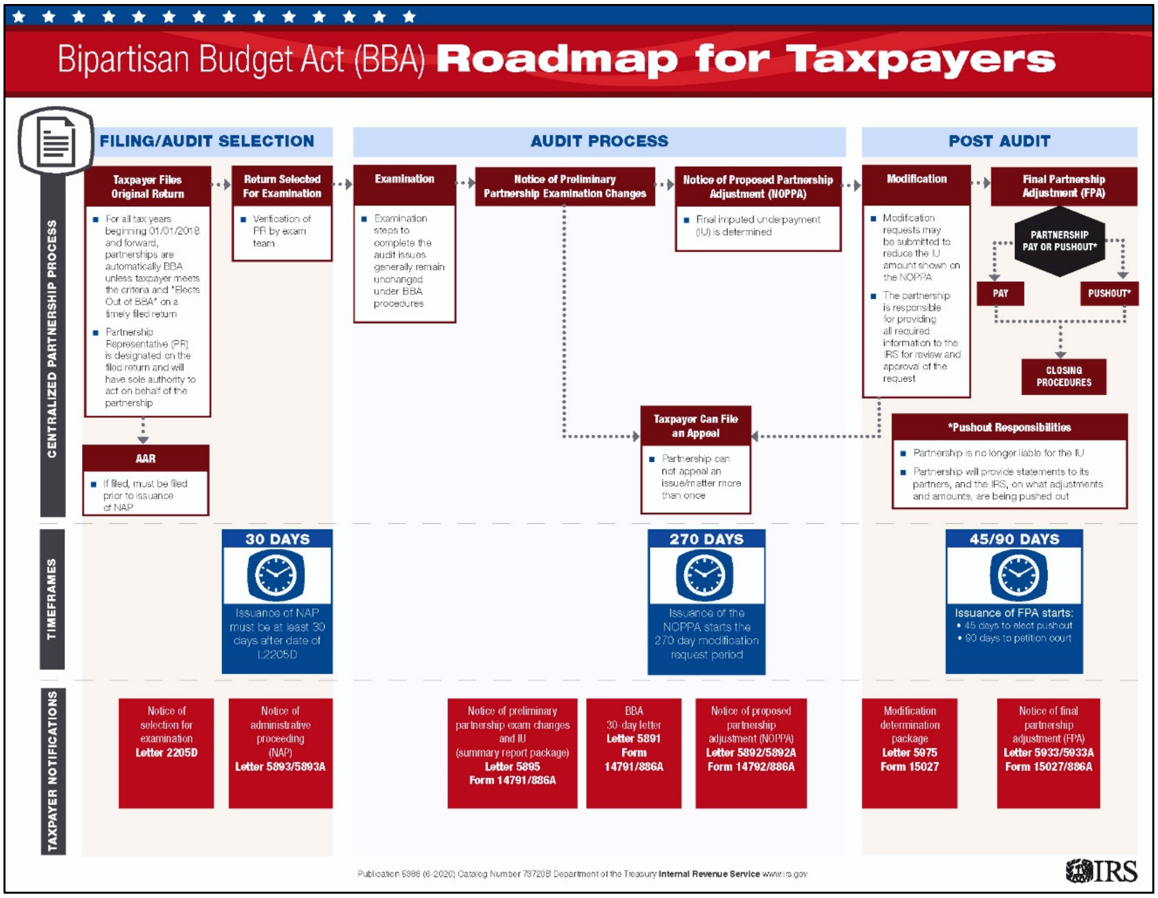
SECTION: 6221
FLOWCHART FOR BBA CPAR AUDIT REGIME PUBLISHED BY IRS

Citation: Publication 5388, Bipartisan Budget Act (BBA) Roadmap for Taxpayers, 6/30/20

The IRS has issued a flowchart outlining the processes in a Bipartisan Budget Act of 2015 partnership examination in Publication 5388, *Bipartisan Budget Act (BBA) Roadmap for Taxpayers.*[1335]

The Bipartisan Budget Act of 2015 repealed the prior TEFRA partnership audit regime and added a new fully centralized partnership regime. The flowchart outlines the process once an examination gets underway, including elections available to the taxpayer once the IRS has issued the Notice of Proposed Partnership Adjustment.

[1335] Publication 5388, *Bipartisan Budget Act (BBA) Roadmap for Taxpayers*, June 2020, https://www.irs.gov/pub/irs-pdf/p5388.pdf (retrieved July 11, 2020)



SECTION: 6698

SMALL PARTNERSHIP LATE FILING RELIEF IN REV. PROC. 84-35 CONTINUES TO APPLY DESPITE REPEAL OF §6231

Citation: Program Manager Technical Advice 2020-01, 1/15/20

Tax advisers who work with small partnerships have long been aware of the late filing relief provided by Revenue Procedure 84-35. But some have wondered that since the procedure refers to a provision removed from the Internal Revenue Code by the Bipartisan Budget Act of 2015 for tax years beginning on or after January 1, 2018, does it continue to apply?

In Program Manager Technical Advice 2020-01[1336] the Chief Counsel's office addressed that question, determining Revenue Procedure 84-35 still is available for taxpayers to use to obtain relief from partnership late filing penalties under IRC §6698.

[1336] Program Manager Technical Advice 2020-01, November 19, 2019, released on IRS website January 15, 2020 (retrieved January 17, 2020)

The Revenue Procedure provides:

> A domestic partnership composed of 10 or fewer partners and coming within the exceptions outlined in section 6231(a) (1)(B) of the Code will be considered to have met the reasonable cause test and will not be subject to the penalty imposed by section 6698 for the failure to file a complete or timely partnership return, provided that the partnership, or any of the partners, establishes, if so requested by the Internal Revenue Service, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.[1337]

But §6231(a)(1)(B) does not apply to partnership tax years beginning on or after January 1, 2018. Old §6231 was part of the TEFRA partnership audit rules, the entirety of which was removed from the law in the Bipartisan Budget Act of 2015 (BBA 2015) that ushered in a new comprehensive partnership audit regime.

The PTMA notes that the relief was mandated by Congress in legislation that predated the TEFRA audit regime:

> Congress enacted section 6698 in 1978 as part of Pub. L. No. 95-600, 92 Stat. 2763. In legislative history, Congress indicated that it intended for the reasonable cause exception to the section 6698 penalty to apply automatically to small partnerships that meet certain criteria. The Conference Committee Report stated:
>
> > The penalty will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return. Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions and credits of the partnership.
> >
> > H.R. Rep. No. 95-1800, at 221 (1978) (Conf. Rep.).
>
> Revenue Procedure 81-11 set forth procedures, consistent with the legislative history, under which partnerships with ten or fewer partners would not be subject to the section 6698 penalty for failure to file a partnership return.[1338]

Thus, the original revenue procedure providing for relief from the late filing penalties under IRC §6698 for small partnerships did not reference §6231(a)(1)(B), as it did not exist.

[1337] Revenue Procedure 84-35, Section 3.01

[1338] Program Manager Technical Advice 2020-01, p. 2

But noting a very similar definition of a small partnership added by Congress in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the IRS decided to use the same definition found in the then "new" TEFRA partnership rules by issuing a revised revenue procedure:

> Shortly after the issuance of Revenue Procedure 81-11, Congress enacted a definition of small partnership as part of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. 97-248. Section 6231(a)(1)(B), as enacted in TEFRA, provided that the term "partnership," for purposes of sections 6221 through 6232, did not include a partnership if the partnership had 10 or fewer partners, each of whom is a natural person (other than a nonresident alien) or an estate, and each partner's share of each partnership item is the same as such partner's share of every other item. A husband and wife, and their estates, were treated as one partner in determining whether the partnership had 10 or fewer partners for purposes of section 6231(a)(1)(B). TEFRA did not amend section 6698 or redefine the scope of the penalty for failure to file a partnership return.
>
> To conform the relief provided in Revenue Procedure 81-11 to the definition of small partnership newly provided by section 6231(a)(1)(B), the IRS issued Revenue Procedure 84-35 to modify and supersede Revenue Procedure 81-11. Revenue Procedure 84-35 cited the definition of small partnership provided by section 6231(a)(1)(B). In order to qualify for the relief provided in Revenue Procedure 84-35, the partnership must come "within the exceptions outlined in section 6231(a)(1)(B) of the Code." See Rev. Proc. 84-35, § 3.01. In citing section 6231(a)(1)(B), Revenue Procedure 84-35 was referencing law that existed at the time the revenue procedure was issued. The IRS did not express an intent that later amendments to TEFRA audit procedures would affect application of the exception to the partnership failure to file penalty.[1339]

The repeal of §6231 simply restored the law prior to TEFRA. But this relief had been mandated by Congress before the passage of TEFRA and Congress did not remove that relief as part of BBA 2015.

The PMTA concludes:

> A question was raised concerning how to interpret Revenue Procedure 84-35 now that section 6231(a)(1)(B) has been repealed and will be inapplicable to any partnership for which the relief provided in Revenue Procedure 84-35 is relevant. Significantly, the reference in Revenue Procedure 84-35 to IRC section 6231(a)(1)(B) is a reference to IRC section 6231(a)(1)(B) as it was in effect when Revenue Procedure 84-35 was originally issued. Thus, it is irrelevant that there does not exist any current section 6231(a)(1)(B) that is generally effective and applicable to partnerships seeking relief under Revenue Procedure 84-35. Moreover, the legislative history of section 6698, which is the basis for the relief provided in Revenue Procedure 84-35, is still relevant, and the scope of the section 6698 penalty for failure to file a partnership return has not been affected by the repeal of the

[1339] Program Manager Technical Advice 2020-01, pp. 3-4

> TEFRA provisions. Thus, Revenue Procedure 84-35 is not obsolete and continues to apply.
>
> Revenue Procedure 84-35 provides that in order to qualify for the relief provided in the revenue procedure, the partnership, or any of the partners, must establish, if so requested by the IRS, that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns. Rev. Proc. 84-35, § 3.01. Additionally, the revenue procedure states that all the relevant facts and circumstances will be taken into account in determining whether a partner has fully reported the partner's share of the income, deductions, and credits of the partnership. Rev. Proc. 84-35, § 3.04. Accordingly, the IRS may develop procedures in accordance with Revenue Procedure 84-35 to ensure that any partnership claiming relief is in fact entitled to such relief.[1340]

SECTION: 6699
ILLNESSES OF CORPORATE OFFICERS DID NOT PROVIDE REASONABLE CAUSE FOR LATE FILING OF S CORPORATION RETURNS

Citation: Hunter Maintenance and Leasing Corp. Inc. v. United States, US District Court ND Ill., Case No. 1:18-cv-06585, 2/27/20

An S corporation argued that it had reasonable cause for late filing its Forms 1120S for multiple years due to both its CEO and CFO having serious illnesses that in both cases led to their deaths. However, the corporation was not successful in the case of *Hunter Maintenance and Leasing Corp. Inc. v. United States*, US District Court ND Ill., Case No. 1:18-cv-06585 in obtaining an abatement of the penalties.

Victor Cacciatore had founded the company, along with a number of others, and was treated as CEO and Chairman of the Board of the Company, controlling and exercising final decision-making authority over all financial and tax matters.

The other party involved was described by the Court as follows:

> In 1996 George Tapling, a certified public accountant, was hired by Jos. Cacciatore & Co. According to plaintiff, Tapling "functioned as, possessed and exercised the responsibilities of Chief Financial Officer ("CFO")" for all the Cacciatore companies, including plaintiff, until his death in May 2016. Despite being called plaintiff's "de facto" CFO, Tapling was never an employee, officer, or director on the books and records of plaintiff, or any company other than Jos. Cacciatore & Co.
>
> Nonetheless, it is undisputed that Tapling was solely responsible for preparing and filing the federal and state income tax returns for all the Cacciatore companies, as

[1340] Program Manager Technical Advice 2020-01, p. 3

> well as preparing and issuing the Schedule K-1s to the shareholders. All IRS notices and correspondence issued to any of the companies were given directly to Tapling unopened.
>
> Tapling directly reported to and was supervised by Victor until Victor's death in 2013. After Victor's death, Tapling reported to and was supervised by Peter Cacciatore, President of Jos. Cacciatore & Co.

Both officers had issues with cancers that would prove fatal. The condition of Victor was described as follows:

> Sometime in 2008 or 2009 Victor was diagnosed with myelodysplastic syndrome ("MDS"), a cancer affecting the bone marrow. He became increasingly ill over the ensuing years, later being diagnosed with bladder cancer and an aggressive fast growing tumor that could not be treated through surgery because of the MDS. According to plaintiff, by 2010 through his death in 2013, Victor was incapacitated by his illness, which prevented him from exercising his responsibilities.

The CFO also had medical issues, as the Court noted:

> In 2010, Tapling himself became ill with melanoma skin cancer. He ultimately died from the disease in 2016 after it metastasized. Despite his illness, he remained in his position with Jos. Cacciatore & Co., and continued to act as the "de facto" CFO of the companies. He did not outwardly exhibit any behavior or symptoms that would lead anyone to question his abilities until shortly before his death. Unbeknownst to the companies, however, beginning in 2010 Tapling failed to file the income tax returns for plaintiff and some of the tax returns for some of the other companies. He did in fact prepare plaintiff's returns, and issued the Schedule K-1s, but failed to file the 1120S forms and other returns for 2010 through 2013.

The problems were uncovered following the CFO's passing. As the opinion continues:

> After Tapling's death, unopened IRS notices were found in his desk. The companies hired an outside firm to review the income tax filing compliance for all of the companies. It found that Tapling had prepared plaintiff's tax returns but failed to file them. In March 2017 that firm filed the delinquent returns for plaintiff.

The corporation clearly faced significant late filing penalties under IRC §6699. The corporation argued that the penalties should be abated for reasonable cause, as the corporation was disabled due to the incapacity of its CEO and CFO.

The opinion notes that reasonable cause is not defined in IRC §6699 and the IRS has not issued any regulations in that area. But the court found the regulations under §6651(a)(1) which deal with failure to file other returns to be appropriate to consult. The opinion notes:

> Under that standard a taxpayer demonstrates "reasonable cause" if it can show that it "exercised ordinary business care and prudence and was nevertheless unable to file

the return within the prescribed time period. 26 C.F.R. § 301.665-1(c)(1); *ATL & Sons Holdings, Inc. v. Commissioner* of Internal Rev,, 2019 WL 1220942 *6 (T.C. 2019)(holding the same standard applies to penalties imposed under § 6699).

The opinion begins its analysis by noting that a taxpayer bears a heavy burden when arguing for reasonable cause for late filing:

> In *Boyle*,[1341] the seminal case discussing reasonable cause, an executor of an estate hired an attorney to prepare and file the federal estate tax return. The attorney filed a return three months late, resulting in a penalty. The estate argued that the penalty should be waived for reasonable cause, arguing that the executor had in good faith relied on the attorney to timely file their returns. The Court rejected this argument, holding that the taxpayer could not demonstrate reasonable cause because Congress placed the burden of prompt filing on the taxpayer, not on an agent or employee of the taxpayer. The Court articulated a bright line rule that reliance could not "function as a substitute for compliance with an unambiguous statute." Id. at 252. "The failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for late filing under [§ 6699]." id.
>
> Defendant argues that *Boyle* is directly on point, and that plaintiff's failure to timely file was due solely to its reliance on its agent Tapling, who was supposed to file their returns but failed to do so. Tapling, according to defendant, was simply an agent of plaintiff, and under *Boyle*, reliance on an agent does not constitute reasonable cause excusing a late filer from penalties.

The corporation argued that the appropriate question was whether the corporation had the ability to perform the action in question, not just its reliance on Tapling. The opinion continues:

> There can be no dispute that an individual taxpayer's illness and severe health problems can constitute reasonable cause to file late. See e.g., *Meyer v. Comm.*, T.C. Memo 2003-12 (2003). Whether a corporation can be incapable of timely filing based on incapacity of a corporate officer is another matter. Plaintiff relies on *In Re American Biomaterials Corp.*, 954 F.2d 919 (3d Cir. 1992), in which the corporation's CEO and chairman of the board and its CFO and Treasurer were embezzling funds. The court affirmed a lower court's decision that these officers' actions "incapacitated the corporation" and rendered it unable to comply with the IRC. The court noted that these officers were the "only two corporate officers with responsibility for [the corporation's] tax filing. Id. at 922.

But the Court notes that while such cases exist where the conduct of an officer may make the corporation unable to complete its filing, such cases are rare—and this isn't one of them.

[1341] *U.S. v. Boyle*, 469 U.S. 241 (1985)

The opinion concludes:

> Despite the number of cases cited in plaintiff's briefs, only American Biomaterials concluded that the corporation was incapable of timely filing, and that was based on its officers' criminal activity. All the other cases equated the officers' activity to that of the attorney in Boyle. In the instant case, plaintiff relied on Tapling. And regardless of whether Tapling was its agent or its employee, plaintiff cannot simply rely on his illness to demonstrate the corporation's inability to file. The corporation had a president and board members independent from Tapling and Victor, all of whom had responsibility to ensure that the corporation carried out its statutory duties. Nor has plaintiff presented any evidence of any ordinary business controls to ensure that it met its responsibility. Indeed, it admits that it ceded all responsibility to Tapling without any oversight. This does not demonstrate ordinary and prudent business practice. Consequently, the court grants defendant's motion for summary judgment and denies plaintiff's motion for summary judgment.

The Court also refused to take into account the taxpayer's argument that the IRS had abated penalties for related companies also controlled by Victor noting in a footnote:

> Plaintiff points out that the government abated late filing penalties for some of the other Cacciatore companies "some of which" were based on the same reasonable cause arguments made by plaintiff in the instant case. Even if this is true, and the court has no evidence to demonstrate the reasoning of those decisions, they are irrelevant to the instant decision, which must be based solely on the facts presented to the court. Nor does the court have any evidence as to the corporate structures of the other companies or whether those companies can or did demonstrate ordinary and prudent business practices.

NOTES

Unit 17

Estate and Trusts Tax Developments

SECTION: 62
PROPOSED REGULATIONS UPON WHICH TAXPAYERS MAY RELY ISSUED FOR EXCESS DEDUCTIONS ON TERMINATION

Citation: REG-113295-18, 5/7/20

The long-awaited proposed regulations on the effect of IRC §67(g) on trusts and estates have now been issued by the IRS.[1342] The big item in the proposed regulations is an explanation of the treatment of excess deductions on termination under IRC §642(h)(2) after the Tax Cuts and Jobs Act provided, in IRC §67(g), that miscellaneous itemized deductions would no longer be deductible on individual income tax returns.

Existing Reg. §1.642(h)-1 provided that such deductions are "allowed only in computing taxable income and must be taken into account in computing the items of tax preference of beneficiaries; it is not allowed in computing adjusted gross income." This holding led to such deductions being treated as miscellaneous itemized deductions prior to the TCJA addition of §67(g).

The IRS had requested guidance in Notice 2018-61 regarding whether such a treatment was appropriate given the addition of IRC §67(g) in the Tax Cuts and Jobs Act. These proposed regulations contain the IRS's initial conclusions in this area.

[1342] REG-113295-18, May 7, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-09801.pdf?utm_medium=email&utm_campaign=pi+subscription+mailing+list&utm_source=federalregister.gov (retrieved May 8, 2020)

Effective Date and Ability to Rely on the Proposed Regulations

The IRS guidance contains the following information regarding the proposed effective date and the ability of taxpayers to rely on these proposed regulations in the interim.

> These proposed regulations apply to taxable years beginning after the date these regulations are published as final regulations in the Federal Register. However, estates, non-grantor trusts, and their beneficiaries may rely on these proposed regulations under section 67 for taxable years beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the Federal Register. Taxpayers may also rely on the proposed regulations under section 642(h) for taxable years of beneficiaries beginning after December 31, 2017, and on or before the date these regulations are published as final regulations in the Federal Register in which an estate or trust terminates.

Advisers should note that these regulations will affect returns already filed for 2018 and 2019, which may require the preparation of amended Forms 1041 and 1040 to obtain tax refunds for beneficiaries of trusts that distributed excess deductions on termination.

IRC §67(e) Deductions

The IRS has decided to revise the beginning of Reg. §1.67-4 to clarify costs in a trust described in IRC §67(e) as well as those that are miscellaneous itemized deductions. The clarified Proposed Reg. §1.67-4(a) reads:

> **§1.67-4. Costs paid or incurred by estates or non-grantor trusts.**
>
> (a) In general--(1) <u>Section 67(e) deductions.</u>
>
>> (i) An estate or trust (including the S portion of an electing small business trust) not described in §1.67-2T(g)(1)(i) (a non- grantor trust) shall compute its adjusted gross income in the same manner as an individual, except that the following deductions (Section 67(e) deductions) are allowed in arriving at adjusted gross income:
>>
>>> (A) Costs that are paid or incurred in connection with the administration of the estate or trust, which would not have been incurred if the property were not held in such estate or trust; and
>>>
>>> (B) Deductions allowable under section 642(b) (relating to the personal exemption) and sections 651 and 661 (relating to distributions).
>>
>> (ii) Section 67(e) deductions are not itemized deductions under section 63(d) and are not miscellaneous itemized deductions under section 67(b). Therefore, section 67(e) deductions are not disallowed under section 67(g).

> (2) Deductions subject to 2-percent floor. A cost is not a section 67(e) deduction and thus is subject to both the 2-percent floor in section 67(a) and section 67(g) to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust (including the S portion of an electing small business trust), and commonly or customarily would be incurred by a hypothetical individual holding the same property.

Excess Deductions on Termination

The more significant guidance is provided by the IRS on the issue of the treatment of excess deductions on termination. The proposed regulations no longer treat the total of excess deductions on termination as a miscellaneous itemized deduction in the hands of the beneficiary allocated the deduction.

Rather the proposed regulations provide:

> Each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust. An item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Code and must be separately stated if it could be so limited, as provided in the instructions to Form 1041, *U.S. Income Tax Return for Estates and Trusts* and the Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credit, etc.*, or successor forms.[1343]

The amount and allocation of excess deductions on termination are determined as follows:

- Each deduction directly attributable to a class of income is allocated in accordance with the provisions in Reg. §1.652(b)-3(a);
- To the extent of any remaining income after application of the prior rule deductions are allocated in accordance with the provisions in Reg. §1.652(b)-3(b) and (d) (the general rules for allocation of income and deductions in computing what makes up distributable net income of a trust or estate); and
- Deductions remaining after the application of the prior two rules comprise the excess deductions on termination of the estate or trust. These deductions are allocated to the beneficiaries succeeding to the property of the estate or trust in accordance with Reg. §1.642(h)-4.[1344]

The IRS provides the following example which makes clear those deductions retain their nature in the hands of the beneficiary or beneficiaries. As such, the trust will have to inform beneficiaries of the nature of the expenses after the allocation of expenses against income.

[1343] Proposed Reg. §1.642(h)-2(b)(1)

[1344] Proposed Reg. §1.642(h)-2(b)(2)

EXAMPLE (PROPOSED REG. §1.642(H)-2(C)(2))

Assume that a trust distributes all its assets to B and terminates on December 31, Year X. As of that date, it has excess deductions of $18,000, all characterized as allowable in arriving at adjusted gross income under section 67(e). _B, who reports on the calendar year basis, could claim the $18,000 as a deduction allowable in arriving at B's adjusted gross income for Year X. (emphasis added)_ However, if the deduction (when added to B's other deductions) exceeds B's gross income, the excess may not be carried over to any year subsequent to Year X.

The allocation of expenses will follow the rules used in computing the makeup of distributable net income (DNI) found at Reg. §1. 652(b)-3(b) and (d). Items of expense that are directly allocable to a class of income are first allocated to that class per Reg. §1.652(b)-3(a):

> All deductible items directly attributable to one class of income (except dividends excluded under section 116) are allocated thereto.[1345]

The regulation provides an example of such directly allocated items.

EXAMPLE

For example, repairs to, taxes on, and other expenses directly attributable to the maintenance of rental property or the collection of rental income are allocated to rental income. See § 1.642(e)-1 for treatment of depreciation of rental property. Similarly, all expenditures directly attributable to a business carried on by a trust are allocated to the income from such business.

If the deductions directly attributable to a particular class of income exceed that income, the excess is applied against other classes of income in the manner provided in paragraph (d) of this section.[1346]

The paragraph (d) noted in the example is Reg. §1.652(b)-3(d) which provides:

> To the extent that any items of deduction which are directly attributable to a class of income exceed that class of income, they may be allocated to any other class of income (including capital gains) included in distributable net income in the manner provided in paragraph (b) of this section, except that any excess deductions attributable to tax-exempt income (other than dividends excluded under section 116) may not be offset against any other class of income. See section 265 and the regulations thereunder. Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect. However, if the excess deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.[1347]

[1345] Reg. §1.652(b)-3(a)

[1346] Reg. §1.652(b)-3(a)

[1347] Reg. §1.652(b)-3(d)

Expenses not directly allocable to a class of income are allocated at the discretion of the trustee to any item of income used in computing DNI, in accordance with Reg. §1.652(b)-3(b) which provides:

> The deductions which are not directly attributable to a specific class of income may be allocated to any item of income (including capital gains) included in computing distributable net income, but a portion must be allocated to nontaxable income (except dividends excluded under section 116) pursuant to section 265 and the regulations thereunder.[1348]

The regulation explains the rule by using the following example:

EXAMPLE

For example, if the income of a trust is $30,000 (after direct expenses), consisting equally of $10,000 of dividends, tax-exempt interest, and rents, and income commissions amount to $3,000, one-third ($1,000) of such commissions should be allocated to tax-exempt interest, but the balance of $2,000 may be allocated to the rents or dividends in such proportions as the trustee may elect.

The fact that the governing instrument or applicable local law treats certain items of deduction as attributable to corpus or to income not included in distributable net income does not affect allocation under this paragraph. For instance, if in the example set forth in this paragraph the trust also had capital gains which are allocable to corpus under the terms of the trust instrument, no part of the deductions would be allocable thereto since the capital gains are excluded from the computation of distributable net income under section 643(a)(3).[1349]

The IRS provides a comprehensive example of such an allocation of excess deductions on termination in Proposed Reg. §1.642(h)-5(b)(2).

EXAMPLE

Example 2. Computations under section 642(h)(2) — (1) Facts. D dies in 2019 leaving an estate of which the residuary legatees are E (75%) and F (25%). The estate's income and deductions in its final year are as follows:

Income

- Dividends - $3,000
- Taxable interest - $500
- Rents - $2,000
- Capital Gain - $1,000

Thus, total income in the final year is $6,500

[1348] Reg. §1.652(b)-3(b)

[1349] Reg. §1.652(b)-3(b)

Deductions

IRC §67(e) Deductions

- Probate fees - $1,500
- Estate tax preparation fees - $8,000
- Legal fees - $4,500

Total §67(e) deductions (those used in computing the trust's adjusted gross income) are $14,000

Itemized Deductions

- Real estate taxes on rental property - $3,500

Total deductions are $17,500.

(2) Determination of character. Pursuant to §1.642(h)-2(b)(2), the character and amount of the excess deductions is determined by allocating the deductions among the estate's items of income as provided under §1.652(b)-3. Under §1.652(b)-3(a), $2,000 of real estate taxes is allocated to the $2,000 of rental income. In the exercise of the executor's discretion pursuant to §1.652(b)-3(b) and (d), D's executor allocates $4,500 of section 67(e) deductions to the remaining $4,500 of income. As a result, the excess deductions on termination of the estate are $11,000, consisting of $9,500 of section 67(e) deductions and $1,500 of itemized deductions.

(3) Allocations among beneficiaries. Pursuant to §1.642(h)-4, the excess deductions are allocated in accordance with E's (75 percent) and F's (25 percent) interests in the residuary estate. E's share of the excess deductions is $8,250, consisting of $7,125 of section 67(e) deductions and $1,125 of real estate taxes. F's share of the excess deductions is $2,750, consisting of $2,375 of section 67(e) deductions and $375 of real estate taxes. The real estate taxes on rental property must be separately stated as provided in §1.642(h)-2(b)(1).[1350]

However, this author believes this example has a couple of issues. First, it appears the example erroneously treats the real estate taxes on a rental property as an itemized deduction. IRC §67(e) provides that a trust generally computes its income in the same manner as an individual, with certain *additional* deductions allowed in the computation. IRC §62(a)(4) provides that deductions related to a rental property under IRC §212 are deductible in computing adjusted gross income and, by extension, are not itemized deductions.

In the author's view the example erroneously treats the excess of real estate taxes over the amount of rental income as an itemized deduction. Rather, this should be, along with the §67(e) expenses paid, treated as an expense allowed as a deduction in computing adjusted gross income per Proposed Reg. §1.642(h)-2(b)(1). The only item reported to the beneficiaries would be $11,000 of deductions allowed in computing adjusted gross income.

But even if those taxes were miscellaneous itemized deductions, not allocating them first against other income of the trust would normally be a poor tax move by the trustee. Reg. §1.652(b)-3(d) cited in the proposed regulations as the method to use to apply expenses to trust income specifically uses an example of applying excess rental deductions against such "above the line" income.[1351] So even in

[1350] Proposed Reg. §1.642(h)-5(b)(2)

[1351] "Thus, if the trust has rents, taxable interest, dividends, and tax-exempt interest, and the deductions directly attributable to the rents exceed the rental income, the excess may be allocated to the taxable interest or dividends in such proportions as the fiduciary may elect."

that case, there would be $11,000 of §67(e) deductions only remaining as excess deductions on termination, deductible by the beneficiaries in computing their own adjusted gross income.

SECTION: 642
FINAL REGULATIONS ISSUED ON TREATMENT OF EXCESS DEDUCTIONS ON TERMINATION FOLLOWING TCJA ADDITION OF IRC §67(G)

Citation: TD 9918, 9/21/20

The IRS has issued the final regulations dealing with the post-TCJA treatment of excess deductions on termination in TD 9918.[1352]

Previously Reg. §1.642(h)-2 had treated excess deductions on the termination of an estate or trust as miscellaneous itemized deductions for the beneficiary. The Tax Cuts and Jobs Act (TCJA) added IRC §67(g), effective for tax years beginning in 2018, that provided individuals would no longer receive a deduction for miscellaneous itemized deductions.

In Notice 2018-61 the IRS indicated that the agency was considering whether the treatment of such items as miscellaneous itemized deductions was appropriate following the effective date of IRC §67(g). In May of 2020 the IRS released proposed regulations (REG-113295-18) that would provide that the nature of such deductions would be determined by their treatment at the trust level. The final regulations adopt the proposed regulations with some modifications.

IRC §67(e) Treatment Overrides IRC §67(g) Disallowance

Some had worried when the TCJA was passed that expenses that are treated as incurred because an asset is in a trust and deductible in computing the trust's adjusted gross income would be treated as nondeductible due to IRC §67(g). The final regulations clarify that IRC §67(e) removes those expenses from the bar on deduction found at IRC §67(g).

> (ii) Not disallowed under section 67(g). Section 67(e) deductions are not itemized deductions under section 63(d) and are not miscellaneous itemized deductions under section 67(b). Therefore, section 67(e) deductions are not disallowed under section 67(g).[1353]

[1352] TD 9918, September 21, 2020 (release date by IRS – the date published in the *Federal Register* will be the official date the regulations are treated as issued), https://www.irs.gov/pub/irs-drop/td-9918.pdf (retrieved September 26, 2020)

[1353] Reg. §1.67-4(a)(1)(ii)

No Guidance on Impact of §67(e) on Computation of the Alternative Minimum Tax

The preamble provides that these regulations will not provide any guidance on whether such deductions under IRC §67(e) are or are not deductible in computing a trust or estate's alternative minimum tax. The preamble notes:

> Two commenters requested that the regulations address the treatment of deductions described in section 67(e)(1) and (2) in determining an estate or non-grantor trust's income for alternative minimum tax (AMT) purposes. The commenters suggested that such deductions are allowable as deductible in computing the AMT. The treatment of deductions described in section 67(e) for purposes of determining the AMT is outside the scope of these regulations concerning the effects of section 67(g); therefore, these regulations do not address the AMT. Further, no conclusions should be drawn from the absence of a discussion of the AMT in these regulations regarding the treatment of deductions described in section 67(e) for purposes of determining the AMT.[1354]

Treatment of Excess Deductions on Termination by the Beneficiary

The final regulations add in the body of the regulations, rather than a conclusion provided in an example, that the deductions retain their nature in the hands of the beneficiary. The added text is found at Reg. §1.642(h)-2(a)(2):

> (2) Treatment by beneficiary. A beneficiary may claim all or part of the amount of the deductions provided for in paragraph (a) of this section, as determined after application of paragraph (b) of this section, before, after, or together with the same character of deductions separately allowable to the beneficiary under the Internal Revenue Code for the beneficiary's taxable year during which the estate or trust terminated as provided in paragraph (c) of this section.[1355]

The character of the expense is detailed at Reg. §1.642(h)-2(b)(1):

> (b) Character and amount of excess deductions--(1) Character. The character and amount of the excess deductions on termination of an estate or trust will be determined as provided in this paragraph (b). Each deduction comprising the excess deductions under section 642(h)(2) retains, in the hands of the beneficiary, its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust. An item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Internal Revenue Code and must be separately stated if it could be so limited, as provided in the instructions to

[1354] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, A. Section 67

[1355] Reg. §1.642(h)-2(a)(2)

> Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and the Schedule K–1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credit, etc.*, or successor forms.[1356]

As was provided by the proposed regulations, the nature of the deductions passing out is determined by the trust or estate by using the mechanisms found in Reg. §1.652(b)-3 for determining the nature of income that makes up distributable net income of the trust or estate. The estate or trust determines the nature of the excess deductions using the following three steps:

- Deductions directly allocable to a class of income must be allocated to that class of income, using provisions found at Reg. §1.652(b)-3(a). For instance, real estate taxes paid on rental property would be used to offset that rental income.

- Any income remaining after the allocation of direct expenses is then subjected to the allocation of remaining deductions in accordance with provisions found at Reg. §1.652(b)-3(b) and (d). Generally, the trustee is allowed to exercise discretion in allocating remaining deductions, meaning that the trustee can attempt to offset less favored deductions for individuals at this level by using them against remaining income. So the trustee could take remaining real estate taxes subject to the $10,000 annual deduction limit that were allowed on the trust return against interest income and other investment income to remove the deduction from the calculation of excess deductions on termination. As well, if expenses directly related to a class of income exceeded that income, that excess deduction also becomes available to offset other income in this step.

- Finally, once all income has been eliminated, the remaining deductions comprise the excess deductions on termination, allocated to the beneficiaries in accordance with Reg. §1.642(h)-4.[1357]

The trustee would normally strive to have the excess deductions on termination be made up of items of deduction allowed in the computation of adjusted gross income for the trust or estate, which normally would produce the most favorable result for the beneficiary.

As was mentioned in our article discussing the proposed regulations, the IRS's detailed example of allocating expenses[1358] in the proposed regulations appeared to improperly treat the real estate taxes on the rental as being an itemized deduction when computing the make-up of excess deductions on termination. The IRS received a number of comments on this issue and others in the example, and revised that example:

> Multiple commenters noted that Example 2 raises several issues that could be potentially relevant to that example, such as whether the decedent was in a trade or

[1356] Reg. §1.642(h)-2(b)(1)

[1357] Reg. §1.642(h)-2(b)(2)

[1358] Ed Zollars, "Proposed Regulations Upon Which Taxpayers May Rely Issued For Excess Deductions on Termination," *Current Federal Tax Developments* website, May 8, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/5/8/proposed-regulations-upon-which-taxpayers-may-rely-issued-for-excess-deductions-on-termination (retrieved September 26, 2020) business and the application of section 469 to estates and trusts. To avoid these issues, which are extraneous to the point being illustrated, one commenter suggested that the example be revised so that the entire amount of real estate expenses on rental property equals the amount of rental income. The Treasury Department and the IRS did not intend to raise such issues in the example and consider both issues to be outside the scope of these regulations. Accordingly, the Treasury Department and the IRS adopt the suggestion by the commenter and modify Example 2 to avoid these issues by having rental real estate expenses entirely offset rental income with no unused deduction.

Commenters also noted that Example 2 does not properly allocate rental real estate expenses because the example characterizes the rental real estate taxes as itemized deductions. These commenters asserted that real estate taxes on property held for the production of rental income are not itemized deductions but instead are allowed in computing gross income and cited to section 62(a)(4) as providing that ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of property held for the production of income under section 212(2) that are attributable to property held for the production of rents are deductible as above-the-line deductions in arriving at adjusted gross income. One commenter suggested that, if the goal of Example 2 is to illustrate state and local taxes passing through to the beneficiary, then the example should include state income taxes rather than real estate taxes on rental real estate. The Treasury Department and the IRS have revised this example in the final regulations to include personal property tax paid by the trust rather than taxes attributable to rental real estate.

Lastly, commenters noted that Example 2 does not demonstrate the broad range of trustee discretion in §1.652(b)-3(b) and (d) for deductions that are not directly attributable to a class of income, or deductions that are, but which exceed such class of income, respectively. In response to these comments, the Treasury Department and the IRS have modified Example 2 to illustrate the application of trustee discretion as found in §1.652(b)-3(b) and (d).[1359]

The revised example reads as follows:

EXAMPLE 2, COMPUTATIONS UNDER SECTION 642(H)(2), REG. §1.642(H)-5(B)

(1) Facts. D dies in 2019 leaving an estate of which the residuary legatees are E (75%) and F (25%). The estate's income and deductions in its final year are as follows:

Income:

- Dividends - $3,000
- Taxable Interest - $500
- Rent - $2,000
- Capital Gain - $1,000

[1359] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, B. Section 642(h), 7. Example 2

Total Income: $6,500

Deductions:

Section 62(a)(4) deductions:

- Rental real estate expenses - $2,000

Section 67(e) deductions:

- Probate fees - $1,500
- Estate tax preparation fees - $8,000
- Legal fees - $2,500

Non-miscellaneous itemized deductions:

- Personal property taxes - $3,500

Total deductions: $17,500

(2) Determination of character. Pursuant to §1.642(h)–2(b)(2), the character and amount of the excess deductions is determined by allocating the deductions among the estate's items of income as provided under §1.652(b)–3. Under §1.652(b)–3(a), the $2,000 of rental real estate expenses is allocated to the $2,000 of rental income. In the exercise of the executor's discretion pursuant to §1.652(b)–3(b), D's executor allocates $3,500 of personal property taxes and $1,000 of section 67(e) deductions to the remaining income. As a result, the excess deductions on termination of the estate are $11,000, all consisting of section 67(e) deductions.

(3) Allocations among beneficiaries. Pursuant to §1.642(h)–4, the excess deductions are allocated in accordance with E's (75 percent) and F's (25 percent) interests in the residuary estate. E's share of the excess deductions is $8,250, all consisting of section 67(e) deductions. F's share of the excess deductions is $2,750, also all consisting of section 67(e) deductions.

4) Separate statement. If the executor instead allocated $4,500 of section 67(e) deductions to the remaining income of the estate, the excess deductions on termination of the estate would be $11,000, consisting of $7,500 of section 67(e) deductions and $3,500 of personal property taxes. The non-miscellaneous itemized deduction for personal property taxes may be subject to limitation on the returns of both B and C's trust under section 164(b)(6)(B) and would have to be separately stated as provided in §1.642(h)–2(b)(1).

Reporting Excess Deductions on Termination Information by an Estate or Trust

While not addressed in the regulation text, in the preamble the IRS discusses how this information is to be reported to beneficiaries. The preamble states:

> Section 1.642(h)-2(b)(1) of the proposed regulations provides that an item of deduction succeeded to by a beneficiary remains subject to any additional applicable limitation under the Code and must be separately stated if it could be so limited, as provided in the instructions to Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and the Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credit, etc*. Commenters requested that the Treasury Department and the IRS provide guidance on how the excess deductions are to be reported by both the terminated estate or trust and by its beneficiaries. The Treasury Department and the IRS released instructions for beneficiaries that chose to claim excess deductions on

> Form 1040 in the 2019 or 2018 taxable year based on the proposed regulations. In addition, the Treasury Department and the IRS plan to update the instructions for Form 1041, Schedule K-1 (Form 1041), and Form 1040, *U.S. Individual Income Tax Return*, for the 2020 and subsequent tax years to provide for the reporting of excess deductions that are section 67(e) expenses or non-miscellaneous itemized deductions.[1360]

The instructions for 2018 and 2019 referenced above are found on the IRS website.[1361]

The IRS notes that since some states do not conform to §67(g), some taxpayers may need access to miscellaneous itemized deduction excess deduction information for state tax purposes. However, the agency declined to provide information for such reporting in the regulations since the matter is not one that impacts federal returns.

> The Treasury Department and the IRS are aware that the income tax laws of some U.S. states do not conform to the Code with respect to section 67(g), such that beneficiaries may need information on miscellaneous itemized deductions of a terminated estate or trust. However, because miscellaneous itemized deductions are currently not allowed for Federal income tax purposes, that information is not needed for Federal income tax purposes. Therefore, it would not be appropriate to modify Federal income tax forms to require or accommodate the collection of such information while this deduction is suspended. Estates, trusts, and beneficiaries are advised to consult the relevant state taxing authority for information about deducting miscellaneous itemized expenses on their state tax returns[1362]

Trustees will likely find they will receive requests to prepare this information for beneficiaries even when no return is required to be file in the state where the beneficiary resides.

Net Operating Loss Clarification

Some commenters had requested the IRS change one example found in the regulations to illustrate how a beneficiary would carry back a net operating loss carryover passed out by the estate or trust. In the preamble the IRS responds by noting that, in fact, beneficiaries are not now, or were they under pre-TCJA law, able to carry such a loss back:

> Section 642(h)(1) provides a specific rule that allows the beneficiary to succeed to a net operating loss carryover of the estate or trust and deduct the amount of the net operating loss over the remaining carryover period that would have been allowable

[1360] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, B. Section 642(h), 3. Reporting of excess deductions

[1361] Reporting Excess Deductions on Termination of an Estate or Trust on Forms 1040, 1040-SR, and 1040-NR for Tax Year 2018 and Tax Year 2019, IRS website, September 19, 2020 revision, https://www.irs.gov/forms-pubs/reporting-excess-deductions-on-termination-of-an-estate-or-trust-on-forms-1040-1040-sr-and-1040-nr-for-tax-year-2018-and-tax-year-2019 (retrieved September 26, 2020)

[1362] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, B. Section 642(h), 3. Reporting of excess deductions

> to the estate or trust but for the termination of the estate or trust. The phrase in section 642(h)(1) "the estate or trust has a net operating loss carryover" means that the estate or trust incurred a net operating loss and either already carried it back to the earliest allowable year under section 172 or elected to waive the carryback period under section 172(b)(3), and now is limited to carrying over the remaining net operating loss. Accordingly, because the net operating loss is a carryover for the estate or trust, the beneficiary succeeding to that net operating loss may, under section 642(h)(1), only carry it forward.[1363]

The IRS added a specific reference to this rule in Example 1, found at Reg. §1.642(h)-5(a), and notes that the beneficiaries cannot carry back a net operating loss carryover passed out of a trust or estate in its final year.

Effective Date and Impact on Pre-2018 Years

The final regulations apply to years beginning after the regulations are published in the *Federal Register*, but the proposed regulations may be relied upon for years beginning after December 31, 2017 and before the final regulations are published.[1364]

The IRS explicitly deals with a question some had raised with regard to the proposed regulations—does the change in the nature of excess deductions on termination mean that this treatment should have been applied in prior years? And, therefore, would it be appropriate to file claims for refund where a taxpayer would have paid less tax in a pre-2018 tax year (the taxpayer was subject to the alternative minimum tax, did not itemize deductions or had some or all of the excess deductions offset by the 2% of adjusted gross income floor for miscellaneous itemized deductions)?

The IRS answer argues that the prior treatment was an appropriate interpretation of the provision that was within the discretion of the IRS, and thus will not allow taxpayers to use this new view of excess deductions on termination for years beginning before 2018:

> One commenter requested that §1.642(h)-2 of the proposed regulations be applied retroactively not only to taxable years beginning after December 31, 2017, but to all open years. The commenter asserted that the existing regulation treating excess deductions on termination of an estate as a miscellaneous itemized deduction was in error. As an example, the commenter argues that the current regulations mistakenly describe section 67(e) expenses as an exception to the rules applicable to miscellaneous itemized deductions, and therefore requested that the final regulations be applicable to all open years. The Treasury Department and the IRS have the authority to treat an excess deduction on termination of an estate or trust as a single miscellaneous itemized deduction. See section 642(h). The suspension under section 67(g) of miscellaneous itemized deductions caused the Treasury Department and the IRS to reconsider the treatment of excess deductions under section 642(h)(2) because the Treasury Department and the IRS do not interpret section 67(g) as

[1363] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, B. Section 642(h), 6. Example 1

[1364] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, C. Applicability Dates suspending such deductions allowable under section 642(h)(2). The Treasury Department and the IRS interpret section 67(g) as not disallowing excess deductions succeeded to beneficiaries from terminated estates and trusts under section 642(h)(2). Therefore, taxpayers may rely on these regulations as of the effective date of section 67(g), but not for earlier periods.[1365]

SECTION: 2001
ANTI-CLAWBACK REGULATIONS FINALIZED AND CLARIFIED

Citation: TD 9884, 11/26/19

The first item of the guidance promised by Assistant Treasury Secretary David Kautter to be released by the end of January 2020 has been published. In TD 9884[1366] the IRS finalized regulations on the anti-clawback rules that IRC §2001(g)(2) required the IRS to develop to prevent issues when the exclusions are scheduled to be reduced in 2026.

The problem is simple—generally a taxpayer's estate tax is computed by combining his/her taxable estate at death with his/her lifetime taxable gifts. A gross tax is computed using that figure. It is then reduced by a credit based on the appropriate exclusion amount plus any gift tax actually paid on taxable gifts. If the exclusion amount at death is lower than it was when gifts were made, it's possible that tax would be due at death with no assets available to pay the tax.

EXAMPLE

Harry gave his son Wayne a gift of $11,000,000 in 2019, the only taxable gift Harry made during his lifetime. No gift tax is due in 2019, since the gift is less than the basic exclusion amount (BEA) in place at that date. In 2026 the exclusion is reduced back to the lower amount in place before the Tax Cuts and Jobs Act, adjusted for inflation. We will assume that amount would be computed to be $6,000,000. Harry has a zero taxable estate on hand at his death.

The total estate tax would be based on the $11,000,000 gift Harry made in 2019. However, only $6,000,000 of exclusion would be available to compute a credit, which would result in a tax due being shown on the Form 706 unless an anti-clawback rule is in place to solve this problem.

The final regulations adopt, with some clarifications, the proposed regulations issued last year.[1367]

The final regulations provide at Reg. §20.2010-1(c) that the exclusion amount used in the computation will be the greater of the exclusion at the date in question or the total of gifts previously

[1365] TD 9918, Preamble, SUMMARY INFORMATION, Summary of Comments and Explanations, C. Applicability Dates

[1366] TD 9884, November 26, 2019 publication date in *Federal Register*, https://s3.amazonaws.com/public-inspection.federalregister.gov/2019-25601.pdf (retrieved November 23, 2019)

[1367] REG–106706–18, published November 23, 2019, https://www.govinfo.gov/content/pkg/FR-2018-11-23/pdf/2018-25538.pdf excluded from tax due to the use of the exclusion amount in place at the time of the transfer. Specifically, the regulation states:

> If the total of the amounts allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts, within the meaning of section 2001(b)(2), to the extent such credits are based solely on the basic exclusion amount as defined and adjusted in section 2010(c)(3), exceeds the credit allowable within the meaning of section 2010(a) in computing the estate tax, again only to the extent such credit is based solely on such basic exclusion amount, in each case by applying the tax rates in effect at the decedent's death, then the portion of the credit allowable in computing the estate tax on the decedent's taxable estate that is attributable to the basic exclusion amount is the sum of the amounts attributable to the basic exclusion amount allowable as a credit in computing the gift tax payable on the decedent's post-1976 gifts.[1368]

The regulation provides the following computational rules:

- In determining the amounts allowable as a credit:
  - The amount allowable as a credit in computing gift tax payable for any calendar period may not exceed the tentative tax on the gifts made during that period; and
  - The amount allowable as a credit in computing the estate tax may not exceed the net tentative tax on the taxable estate.
- In determining the extent to which an amount allowable as a credit in computing gift tax payable is based solely on the basic exclusion amount:
  - Any deceased spousal unused exclusion (DSUE) amount available to the decedent is deemed to be applied to gifts made by the decedent before the decedent's basic exclusion amount is applied to those gifts;
  - In a calendar period in which the applicable exclusion amount allowable with regard to gifts made during that period includes amounts other than the basic exclusion amount, the allowable basic exclusion amount may not exceed that necessary to reduce the tentative gift tax to zero; and
  - In a calendar period in which the applicable exclusion amount allowable with regard to gifts made during that period includes amounts other than the basic exclusion amount, the portion of the credit based solely on the basic exclusion amount is that which corresponds to the result of dividing the basic exclusion amount allocable to those gifts by the applicable exclusion amount allocable to those gifts.

[1368] Reg. §20.2010-1(c)

- In determining the extent to which an amount allowable as a credit in computing the estate tax is based solely on the basic exclusion amount, the credit is computed as if the applicable exclusion amount were limited to the basic exclusion amount.[1369]

The IRS provides the following two examples to illustrate the application of this provision to a taxpayer who has never been married.

EXAMPLE 1 - REG. §20.2010-1(C)(2)

Individual A (never married) made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the cumulative total of $11.4 million in basic exclusion amount allowable on the dates of the gifts. The basic exclusion amount on A's date of death is $6.8 million. A was not eligible for any restored exclusion amount pursuant to Notice 2017-15. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts (based on the $9 million of basic exclusion amount used to determine those credits) exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) applies, and the credit for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credits allowable in computing the gift tax payable on A's post-1976 gifts.

EXAMPLE 2 – REG. §20.2010-1(C)(2)

Assume that the facts are the same as in Example 1 of paragraph (c)(2)(i) of this section except that A made cumulative post-1976 taxable gifts of $4 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on A's post-1976 gifts is less than the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d).

Since 2011, a surviving spouse has been able to make use of a deceased spouse unused exclusion amount (DSUE) if the estate of the deceased spouse made the appropriate election. The application of the anti-clawback rules where a DSUE is involved is outlined in the following examples in the regulations.

EXAMPLE 3 – REG. §20.2010-1(C)(2)

Individual B's predeceased spouse, C, died before 2026, at a time when the basic exclusion amount was $11.4 million. C had made no taxable gifts and had no taxable estate. C's executor elected, pursuant to §20.2010-2, to allow B to take into account C's $11.4 million DSUE amount. B made no taxable gifts and did not remarry. The basic exclusion amount on B's date of death is $6.8 million. Because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gifts attributable to the basic exclusion amount (zero) is less than the credit based on the basic exclusion amount allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

EXAMPLE 4 – REG. §20.2010-1(C)(2)

Assume the facts are the same as in Example 3 of paragraph (c)(2)(iii) of this section except that, after C's death and before 2026, B makes taxable gifts of $14 million in a year when the basic exclusion amount is

[1369] Reg. §20.2010-1(c)(1)

$12 million. B is considered to apply the DSUE amount to the gifts before applying B's basic exclusion amount. The amount allowable as a credit in computing the gift tax payable on B's post-1976 gifts for that year ($5,545,800) is the tax on $14 million, consisting of $11.4 million in DSUE amount and $2.6 million in basic exclusion amount. This basic exclusion amount is 18.6 percent of the $14 million exclusion amount allocable to those gifts, with the result that $1,031,519 (0.186 x $5,545,800) of the amount allowable as a credit for that year in computing gift tax payable is based solely on the basic exclusion amount. The amount allowable as a credit based solely on the basic exclusion amount for purposes of computing B's estate tax ($2,665,800) is the tax on the $6.8 million basic exclusion amount on B's date of death. Because the portion of the credit allowable in computing the gift tax payable on B's post-1976 gifts based solely on the basic exclusion amount ($1,031,519) is less than the credit based solely on the basic exclusion amount ($2,665,800) allowable on B's date of death, this paragraph (c) does not apply. The credit to be applied for purposes of computing B's estate tax is based on B's $18.2 million applicable exclusion amount, consisting of the $6.8 million basic exclusion amount on B's date of death plus the $11.4 million DSUE amount, subject to the limitation of section 2010(d).

Thus, if a person dies before 2026 and a DSUE election is made to transfer the unused exclusion to the surviving spouse, that higher DSUE will survive the reduction in the basic exclusion amount (BEA) in 2026 if the surviving spouse dies after that date. The preamble to the final regulations state:

> The regulations in §§20.2010-1(d)(4) and 20.2010-2(c)(1) confirm that the reference to BEA is to the BEA in effect at the time of the deceased spouse's death, rather than the BEA in effect at the death of the surviving spouse. A DSUE election made on the deceased spouse's estate tax return allows the surviving spouse to take into account the deceased spouse's DSUE amount as part of the surviving spouse's AEA. Section 2010(c)(5); §20.2010-2(a). AEA is the sum of the DSUE amount and the BEA. Section 2010(c)(2). A decrease in the BEA after 2025 will reduce the surviving spouse's AEA only to the extent that it is based upon the BEA, but not to the extent that it is based on the DSUE amount. Therefore, the sunset of (or any other decrease in) the increased BEA has no impact on the existing DSUE rules and the existing regulations governing DSUE continue to apply.[1370]

Although the IRS declined to have these regulations directly address generation skipping transfer tax (GST) issues, the preamble contained the following guidance on the impact on GST issues:

> Several commenters asked for confirmation that, during the increased BEA period, donors may make late allocations of the increase in GST exemption to inter vivos trusts created prior to 2018. An increase in the BEA correspondingly increases the GST tax exemption, which is defined by reference to the BEA. Section 2631(c). The effect of the increased BEA on the GST tax is beyond the scope of this rulemaking.
>
> A commenter requested confirmation and examples showing that allocations of the increased GST exemption made during the increased BEA period (whether to transfers made before or during that period) will not be reduced as a result of the sunset of the increased BEA. There is nothing in the statute that would indicate that the sunset of the increased BEA would have any impact on allocations of the GST

[1370] TD 9884, Summary of Comments and Explanation of Revisions, Section 3 exemption available during the increased BEA period. However, this request is beyond the scope of this project.

SECTION: 6677
TAXPAYER WHO WAS BOTH BENFECIARY AND OWNER OF FOREIGN TRUST ONLY LIABLE FOR OWNER PENALTY FOR FAILURE TO FILE FORM 3520

Citation: Wilson, et. al. v. United States, Case No. 2:19-cv-05037, US District Court, Eastern District of New York, 11/17/19

In the case of *Wilson, et. al. v. United States*, Case No. 2:19-cv-05037, US District Court, Eastern District of New York,[1371] the Court found that the sole owner/beneficiary of a trust could only be assessed the 5% penalty under §6677 as the owner. The Court denied the IRS's attempt to impose the 35% penalty under that section on distributions received.

The issue involves the requirement under IRC §6048 for information reporting by certain foreign trusts. If a party fails to file the required reports, penalties are imposed under IRC §6677.

Generally, IRC §6677 requires a beneficiary failing to report a distribution from the trust on Form 3520 to pay a penalty equal to 35% of the distribution amount. However, IRC §6677(b) modifies the penalty in the case of the owner of the trust who fails to file such a report, imposing a 5% penalty on the balance in the trust at year end when a report is not filed.

The case notes the following information about the facts of this case:

> …Joseph Wilson established an overseas trust in 2003. Wilson named himself the grantor of the trust and was its sole owner and beneficiary. The singular purpose of the trust was to "place assets beyond the reach of his then-wife, who he had reason to believe was preparing to file a divorce action against him." (She did.) Wilson funded the trust with approximately $9 million in U.S. Treasury bills, accruing annual interest of 5% or less. All principal had previously been taxed in the United States.
>
> From 2003-2007, Wilson filed "various income tax and information returns" with the IRS, reporting the trust's assets and the interest it accrued. In 2007, upon conclusion of the divorce proceedings, Wilson terminated the trust and transferred the assets — at that point $9,203,381 — back to his bank accounts in the United States.
>
> Despite general compliance with IRS requirements, Wilson was late in filing his Form 3520 for calendar year 2007. Form 3520 is an annual report disclosing

[1371] *Wilson, et. al. v. United States*, Case No. 2:19-cv-05037, US District Court, Eastern District of New York, https://ecf.nyed.uscourts.gov/doc1/123116103015 (Pacer registration required)

> distributions from a foreign trust, with different requirements for trust grantors/owners and for trust beneficiaries. After Wilson filed his 2007 Form 3520, the IRS assessed a late penalty of $3,221,183, representing 35% of the distributions from the trust during the 2007 calendar year. Because Wilson had transferred 100% of his trust's funds back to his own domestic accounts during 2007, the penalty also amounted to 35% of his total trust assets.[1372]

The taxpayer paid the penalty the IRS asked for, but filed a claim for refund on two separate bases:

- That there was reasonable cause for the taxpayer's untimely filing of Form 3520; and
- That, since Joseph Wilson was the owner of the trust, the proper penalty was the penalty for the owner failing to report the trust (the 5% penalty); not the penalty on unreported distributions of 35%.[1373]

The IRS agreed that the 5% penalty would apply to Joseph as the owner, but argued that the two penalties are separate and can be applied independently.[1374]

IRC §6048 clearly required the filing of the Form 3520 to report at least some information about the trust for 2007 and Joseph White had not filed that information return. The opinion summarized the law on the consequences of failing to file such an information return as follows:

> Penalties for violating the provisions of 26 U.S.C. § 6048 are codified under 26 U.S.C. § 6677. Subsection (a) of that statute prescribes the penalty for untimely filing "any notice or return required to be filed by section 6048." In relevant part, 26 U.S.C. § 6677(a)(1) states:
>
> > [T]he person required to file such notice or return shall pay . . . 35 percent of the gross reportable amount. . . . At such time as the gross reportable amount with respect to any failure can be determined by the Secretary, any subsequent penalty imposed under this subsection with respect to such failure shall be reduced as necessary to assure that the aggregate amount of such penalties do not exceed the gross reportable amount (and to the extent that such aggregate amount already exceeds the gross reportable amount the Secretary shall refund such excess to the taxpayer).
>
> That provision is modified by 26 U.S.C. § 6677(b)(2), which provides that "subsection (a) shall be applied by substituting '5 percent' for '35 percent'" for returns required to be filed by the owner of a foreign trust.[1375]

[1372] *Wilson, et. al. v. United States*, pp. 1-2

[1373] *Wilson, et. al. v. United States*, p. 3

[1374] *Wilson, et. al. v. United States*, pp. 9-10

[1375] *Wilson, et. al. v. United States*, pp. 9-10

The Court then starts its analysis of how the penalty rules are going to apply in this case where the taxpayer is both a beneficiary of the trust and the owner of the trust:

> At the outset, it is imperative to understand that a person in Wilson's situation — i.e. a sole grantor/owner and sole beneficiary of a foreign trust — would have only been required to file a *single* Form 3520 for fiscal year 2007. So the question then becomes, whether 26 U.S.C. § 6677 permits a single person untimely filing a single IRS form to be penalized as two different people — as an owner and as a beneficiary.

The opinion rejects the IRS's view that both penalties could apply in this situation, arguing such a holding is contrary to the plain language of the statute:

> A plain language reading of 26 U.S.C. § 6677 counsels that a trust owner cannot be penalized as a beneficiary for violating a provision of 26 U.S.C. § 6048(b). There is a clear instruction under 26 U.S.C. § 6677(b)(2) to "substitute" 5% for 35%, not to choose between the two or to simply apply a 5% assessment without reference to an otherwise applicable penalty. Therefore, the statute mandates that the 5% replace the 35% whenever there is a "case of a return required under section 6048(b)."
>
> When a foreign trust owner is required to file Form 3520, it falls under 26 U.S.C. § 6048(b)'s purview of "such information as the Secretary may prescribe with respect to" an owner of a foreign trust. Undeniably, then, a violation of that section should be treated under 26 U.S.C. § 6677(b)(2)'s substitution clause, which replaces "35 percent" with "5 percent." But even if this were not inescapably evident, "in case of doubt [in the interpretation of statutes levying taxes,] they are construed most strongly against the Government, and in favor of the citizen." *Gould v. Gould*, 245 U.S. 151, 153 (1917).
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> Moreover, the Government's argument, if accepted, would result in an irreconcilable textual conflict. Section 6677(a)(1) of Title 26 states that once the Secretary determines the gross reportable amount "with respect to any failure," the Secretary must ensure that the taxpayer's penalties under § 6677 "do not exceed the gross reportable amount." Although this language is primarily concerned with subsequent late fees, the underlying directive appears to limit all penalties for a violation to no more than the "gross reportable amount." Therefore, it follows that a taxpayer should not be liable for any two penalties if their combined assessment would add up to more than the gross reportable amount for any one violation.
>
> But that would be the case if the Government got its way. Because the gross reportable amount for an owner's untimely filing Form 3520 under § 6677(c)(2) is "the gross value of the portion of the trust's assets at the close of the year," Wilson's $0 in trust assets at the end of 2007 yields a $0 gross reportable amount. Any additional penalty resulting from the same "failure" would violate the statute. The Government seeks $3,221,183 above $0, which violates the statute.[1376]

[1376] *Wilson, et. al. v. United States*, pp. 11-12

And the Court finds in this case the proper penalty is 5% of the zero balance in the trust at the end of the tax year, noting:

> Plaintiffs next ask the Court for summary judgment as to whether "the 5% penalty should properly be based on the amount of the [trust's] account balances, if any, at the close of 2007, pursuant to [26 U.S.C. §] 6677(c)(2)." It should. Because Wilson is treated as the owner of the foreign trust for the purpose of his Form 3520 filing, he is liable for penalty under 26 U.S.C. § 6677(b) for a violation of 26 U.S.C. § 6048(b)(1). Under 26 U.S.C. § 6677(b), the proper assessment is "5% of the gross reportable amount." The gross reportable amount for "a failure relating to section 6048(b)(1)" is "the gross value of the portion of the trust's assets at the close of the year treated as owned by the United States person."[1377]

[1377] *Wilson, et. al. v. United States*, pp. 13-14

NOTES

Unit

18

IRS Practice and Procedure Developments

SECTION: 201
TAXPAYERS REMINDED OF EXPEDITED LETTER RULING OPTION FOR COVID-19 ISSUES AND ELECTRONIC SUBMISSION OF SUCH REQUESTS

Citation: IR-2020-212, 9/16/20

In News Release IR-2020-212[1378] the IRS reminded taxpayers of the option to request an expedited letter ruling request, and that COVID-19 issues can justify asking for such expedited processing.

The news release notes that normally letter ruling requests are processed in the order received, but there is a procedure in place for requesting expedited processing:

> As set forth in Rev. Proc. 2020-1, the IRS ordinarily processes requests for letter rulings in the order that they were received. A taxpayer with a compelling need to have a request processed more quickly may request expedited handling.[1379]

The news release continues to explain the procedure for making the request.

> The request for expedited handling must be made in writing, preferably in a separate letter submitted with the letter ruling request. Requests for expedited handling are granted at the discretion of the IRS and typically involve a factor outside of the taxpayer's control that creates a real business need to obtain a letter ruling before a

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[1378] "IRS reminds taxpayers and practitioners of expedited letter ruling procedures," IR-2020-212, September 16, 2020, https://www.irs.gov/newsroom/irs-reminds-taxpayers-and-practitioners-of-expedited-letter-ruling-procedures (retrieved September 16, 2020)

[1379] "IRS reminds taxpayers and practitioners of expedited letter ruling procedures," IR-2020-212, September 16, 2020

> certain date in order to avoid serious business consequences. Requests for expedited handling should be submitted as promptly as possible after the taxpayer has become aware of the deadline or compelling business need.[1380]

Section 7.02(4) of Revenue Procedure 2020-1 has the detailed information on expedited processing. That section provides the following additional information on the request:

> A taxpayer with a compelling need to have a request processed ahead of requests received before it may request expedited handling. This request must explain in detail the need for expedited handling. The request for expedited handling must be made in writing, preferably in a separate letter included with the request for the letter ruling or determination letter or provided soon after its filing. If the request for expedited handling is contained in the letter requesting the letter ruling or determination letter, the letter should state at the top of the first page "**Expedited Handling Is Requested. See page ___ of this letter.**"[1381]

The request for expedited handling will not be forwarded to a branch for action until the user fee is paid.[1382] For this reason, it is advisable to discuss the matter informally with the IRS employee who has been authoring rulings in the area before proceeding down this path if the ruling will only be useful if issued under the expedited program. Of course, that's advisable generally when a ruling request is being considered even if expedited processing is not being requested—it's best to know before the fee is paid if there is no chance of a favorable ruling.

The criteria the Service uses to make the decision on whether to expedite the ruling is described in Notice 2020-1:

> Whether a request for expedited handling will be granted is within the Service's discretion. The Service may grant the request when a factor outside a taxpayer's control creates a real business need to obtain a letter ruling or determination letter before a certain date to avoid serious business consequences. Examples include situations in which a court or governmental agency has imposed a specific deadline for the completion of a transaction, or where a transaction must be completed expeditiously to avoid an imminent business emergency (such as the hostile takeover of a corporate taxpayer), provided that the taxpayer can demonstrate that the deadline or business emergency, and the need for expedited handling, resulted from circumstances that could not reasonably have been anticipated or controlled by the taxpayer. To qualify for expedited handling in such situations, the taxpayer must also demonstrate that the taxpayer submitted the request as promptly as possible after becoming aware of the deadline or emergency. The extent to which the letter ruling or determination letter request complies with all of the applicable requirements of this revenue procedure, and fully and clearly presents the issues, is a

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1380 "IRS reminds taxpayers and practitioners of expedited letter ruling procedures," IR-2020-212, September 16, 2020

1381 Revenue Procedure 2020-1, Section 7.02(4)

1382 Revenue Procedure 2020-1, Section 7.02(4)

> factor in determining whether expedited treatment will be granted. When the Service agrees to process a request out of order, it cannot give assurance that any letter ruling or determination letter will be processed by the date requested.[1383]

The news release makes clear that the COVID-19 pandemic will qualify as an event out of the taxpayer's control:

> The COVID-19 pandemic is a factor outside of the taxpayer's control that can support a request for expedited handling under Rev. Proc. 2020-1. As a result, and consistent with Executive Order 13924 of May 19, 2020, taxpayers are encouraged to seek expedited handling if they face a compelling need related to COVID-19. Such requests will be handled as provided in Rev. Proc. 2020-1.[1384]

Notice 2020-1 does caution about issues that will *not* generally be found to justify expedited processing of the request:

> The scheduling of a closing date for a transaction or a meeting of the board of directors or shareholders of a corporation, without regard for the time it may take to obtain a letter ruling or determination letter, will not be considered a sufficient reason to process a request ahead of its regular order. Also, the possible effect of fluctuation in the market price of stocks on a transaction will not be considered a sufficient reason to process a request out of order.[1385]

Advisers will not want to list either of those as reasons justifying expedited processing, and may expect IRS inquiries if the information suggests these may be the real reason why the taxpayer is seeking expedited treatment.

The Revenue Procedure concludes reminding taxpayers of the fact that even a request that does meet the criteria for expedited processing needs to fully comply with the other requirements for a ruling request in order for the letter to be issued most rapidly:

> Because most requests for letter rulings and determination letters cannot be processed out of order, the Service urges all taxpayers to submit their requests well in advance of the contemplated transaction. In addition, to facilitate prompt action on letter ruling requests, taxpayers are encouraged to ensure that their initial submissions comply with all of the requirements of this revenue procedure (including the requirements of other applicable guidelines set forth in Appendix G of this revenue procedure), to prepare "two-part" requests described in section 7.02(3) of this revenue procedure when possible, and to promptly provide any additional information requested by the Service.[1386]

[1383] Revenue Procedure 2020-1, Section 7.02(4)

[1384] "IRS reminds taxpayers and practitioners of expedited letter ruling procedures," IR-2020-212, September 16, 2020

[1385] Revenue Procedure 2020-1, Section 7.02(4)

[1386] Revenue Procedure 2020-1, Section 7.02(4)

The ruling concludes by noting that letter ruling requests, including those asking for expedited treatment, can be submitted electronically under special procedures the IRS put in place in response to the COVID-19 pandemic:

> In addition, Rev. Proc. 2020-29, 2020-21 I.R.B. 859 (May 18, 2020)[1387], sets forth procedures for the electronic submission of letter ruling requests.

SECTION: 6011
IRS ADDS 6 MORE FORMS TO LIST THAT TEMPORARILY CAN BE SIGNED WITH DIGITAL SIGNATURES

Citation: "IRS adds six more forms to list that can be signed digitally; 16 now available," IR 2020-206, 9/10/20

The IRS has announced an additional six forms that will qualify for electronic signatures, in addition to the forms originally announced as eligible for this program on August 28.[1388]

The new forms added to the list are:

- Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 706-NA, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return;
- Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons;
- Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts; and
- Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.

These forms join the following forms originally on the list to qualify for electronic signatures:

- Form 3115, Application for Change in Accounting Method;
- Form 8832, Entity Classification Election;
- Form 8802, Application for U.S. Residency Certification;

[1387] Revenue Procedure 2020-29, https://www.irs.gov/irb/2020-21_IRB#REV-PROC-2020-29 (retrieved September 16, 2020)

[1388] "IRS adds six more forms to list that can be signed digitally; 16 now available," IR 2020-206, September 10, 2020, https://www.irs.gov/newsroom/irs-adds-six-more-forms-to-list-that-can-be-signed-digitally-16-now-available (retrieved September 10, 2020); Memorandum from Susan B. Lough, Issued August 28, 2020, modified September 10, 2020, "Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," https://www.irs.gov/pub/irs-utl/updated-dcse-web-signature-memorandum.pdf (retrieved September 10, 2020)

- Form 1066, U.S. Income Tax Return for Real Estate Mortgage Investment Conduit;
- Form 1120-RIC, U.S. Income Tax Return For Regulated Investment Companies;
- Form 1120-C, U.S. Income Tax Return for Cooperative Associations;
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts;
- Form 1120-L, U.S. Life Insurance Company Income Tax Return;
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return; and
- Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms.

These forms will be accepted with digital signatures so long as they are mailed on or before December 31, 2020.

The forms are ones that generally cannot be filed electronically and, thus, are normally mailed with the taxpayer's pen and ink signature.

The memorandum, which retained its August 28, 2020 date but was simply revised to add the new forms, has the following information regarding the types of electronic signature technologies that can be used for this program:

> Electronic and digital signatures appear in many forms when printed and may be created by many different technologies. No specific technology is required for this purpose during this temporary deviation.[1389]

[1389] Memorandum from Susan B. Lough, Issued August 28, 2020, modified September 10, 2020, "Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," Footnote 1

SECTION: 6011
IRS TEMPORARILY EXPANDS THE USE OF ELECTRONIC SIGNATURES FOR A LIMITED SET OF FORMS

Citation: Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," 8/27/20

The IRS announced a limited, temporary relaxation of rules regarding the use of electronic or digital signatures for certain tax forms in lieu of handwritten signatures.[1390] The relief will apply to forms signed and postmarked on or after August 28, 2020 through December 31, 2020.

The relief is limited only to the forms specifically listed in the memorandum. Those listed are:

- Form 3115, Application for Change in Accounting Method;
- Form 8832, Entity Classification Election;
- Form 8802, Application for U.S. Residency Certification;
- Form 1066, U.S. Income Tax Return for Real Estate Mortgage Investment Conduit;
- Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies;
- Form 1120-C, U.S. Income Tax Return for Cooperative Associations;
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts;
- Form 1120-L, U.S. Life Insurance Company Income Tax Return;
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return; and
- Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms.[1391]

The memorandum seems to allow virtually any e-signature system to be used for the purposes of this specific relief:

[1390] Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," August 27, 2020 https://www.irs.gov/pub/irs-utl/osee_e_wet_signature-deviation_8_27_2020.pdf (retrieved August 28, 2020)

[1391] Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," August 27, 2020, pp. 1-2

> Electronic and digital signatures appear in many forms when printed and may be created by many different technologies. No specific technology is required for this purpose during this temporary deviation.[1392]

Since the individual electronic filing authorization Form 8879 is in the list, this presumably means that, until December 31, 2020, the requirement to use an e-signature system with knowledge based authentication (KBA) has been suspended. Previously issued guidance allowed the use of e-signature systems by taxpayers electronically signing this authorization form only when the taxpayers' identity could be confirmed, normally by use of KBA.

The IRS explains the reason this relief was provided as follows:

> As part of our response to the COVID-19 situation, we have taken steps to protect employees, taxpayers and their representatives by minimizing the need for in-person contact. Taxpayer representatives have expressed concerns with securing handwritten signatures during these times for forms that are required to be filed or maintained on paper. To alleviate these concerns while promoting timely filing, we are implementing a temporary deviation with this memorandum that allows taxpayers and representatives to use electronic or digital signatures when signing the following forms that currently require a handwritten signature…[1393]

The list of forms allowed to be signed in this manner is far from a complete list. The IRS explains why it is only allowing this option for this list of forms:

> We recognize that this list of forms does not represent the full universe of forms filed or retained on paper that taxpayers and their representatives would like to see covered by this deviation guidance. However, while we seek to maximize remote capabilities for taxpayers and their representatives during this time, we know that the acceptance of electronic/digital signatures presents elements of risk. Therefore, this temporary deviation is limited to the list of forms set forth above. These forms cannot be filed electronically and the IRS can accept the associated risks with these forms at this time in a limited duration under these circumstances.[1394]

The memorandum closes with a reminder that this current relief is limited, but the agency does indicate it will consider the status of e-signatures based on the experience the agency has with this program:

[1392] Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," August 27, 2020, p. 1 Footnote 1

[1393] Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," August 27, 2020, p. 1

[1394] Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," August 27, 2020, p. 2

> This memorandum is effective for the forms listed above, that are signed and postmarked beginning on or after August 28, 2020, through December 31, 2020. After the expiration of this temporary deviation, we will evaluate the full impact of this change to inform the future path for handwritten signatures, balancing flexibility for taxpayers and their representatives with ensuring that we do not introduce downstream risks for tax administration.[1395]

SECTION: 6109
PTIN FEES TO RESUME FOR 2021, SET AT $21 PLUS CONTRACTOR FEE OF $14.95

Citation: TD 9903, 7/17/20

The IRS has finalized regulations to set the PTIN fee at $21 plus a $14.95 third-party contractor fee as the agency begins to resume collection of this annual fee from paid tax preparers.[1396] The final regulations retain the same fees as were found in the proposed regulations originally announced on April 15, 2020.

The IRS had ceased collection of the PTIN user fee following an initial loss in the US District Court for the District of Columbia in the case of *Steele v. United States*, 260 F. Supp. 3d 52 (D.D.C. 2017)[1397] that found the IRS did not have the authority to charge such a fee. However, the Court of Appeals for District of Columbia found that the IRS did have the authority to charge such a fee, reversing that earlier decision of the lower court in *Montrois v. United States*, 916 F.3d 1056 (D.C. Cir. 2019).[1398]

Although litigation continues over the amount of the fee the IRS may charge, the injunction against imposing the fee was lifted and the IRS has decided to begin collection of the fee again for those preparing returns in 2021.[1399]

The fee is set at $21 in addition to a fee charged by the contractor.[1400] The contractor fee was announced by the IRS in IR-2020-159 as $14.95.[1401]

[1395] Sunita Lough, Deputy Commissioner for Services and Enforcement, IRS, "Memorandum for All Services and Enforcement Employees: Temporary Deviation from Handwritten Signature Requirement for Limited List of Tax Forms," August 27, 2020, p. 2

[1396] TD 9903, July 17, 2020, https://s3.amazonaws.com/public-inspection.federalregister.gov/2020-15446.pdf (retrieved July 16, 2020)

[1397] TD 9903, Summary of Comments, C.

[1398] TD 9903, Summary of Comments, C.

[1399] TD 9903, Summary of Comments, C.

[1400] Reg. §301.13(b)

[1401] "IRS announces 2021 PTIN fees for tax return preparers," IR 2020-159, July 15, 2020, https://www.irs.gov/newsroom/irs-announces-2021-ptin-fees-for-tax-return-preparers (retrieved July 16, 2020)

SECTION: 6501
STATUTE OF LIMITATIONS BEGINS TO RUN ON DATE FIRST RETURN IS FILED, NOT DATE SUPERSEDING RETURN IS FILED

Citation: CCA 202026002, 6/26/2020

In Chief Counsel Advice 202026002[1402] the IRS looks at whether the filing of a superseding return following the filing of the first tax return that was placed on extension changes the starting date for the statute of limitations on the assessment of tax or claiming a refund.

Superseding Returns

A *superseding return* is a term that has been coined to describe a change made to a tax return after a return has already been filed, but before the due date of the return (including extensions if requested). If the return was placed on extension before the first return was filed, the superseding return can be filed up to the extended due date of the return, otherwise the superseding return would be due by the original due date of the return.

A superseding return is a special category of amended returns. The key difference is that, for many purposes, the superseding return replaces the return originally filed, allowing, for instance, a taxpayer to make an election that can only be made on an original tax return. The CCA describes the history of the doctrine, arising from the case of *Haggar v. Helvering*, 308 U.S. 389 (1940):

> In *Haggar*, for purposes of a new capital stock tax, the taxpayer was required to declare the value of its stock on what the statute referred to as the "first return." The taxpayer could declare any value of capital stock for its first taxable year, but the declared value for the first year was a controlling factor for the computation of excess profits tax for later years. The statute provided that the declaration once made could not be amended.
>
> On a timely filed return, Haggar mistakenly reported the par value, as distinguished from actual value, of its issued capital stock. Before the due date, it filed a superseding return declaring the actual value. The Commissioner, refusing to accept the value of the capital stock declared in the superseding return, gave notice of a deficiency in excess profits tax calculated upon what was declared in the first return. Noting that the government was not prejudiced, that the purpose of the statute was not thwarted, and that there was a longstanding administrative practice of accepting superseding returns in other contexts, the Court observed:
>
>> "First return" thus means a return for the first year in which the taxpayer exercises the privilege of fixing its capital stock value for tax purposes, and

[1402] Chief Counsel Advice 202026002, Internal Revenue Service, June 26, 2020, https://www.irs.gov/pub/irs-wd/202026002.pdf (retrieved June 27, 2020)

> includes a timely amended return[1403] for that year. A timely amended return is as much a "first return" for the purpose of fixing the capital stock value in contradistinction to returns for subsequent years, as is a single return filed by the taxpayer for the first tax year.
>
> *Haggar*, 308 U.S. at 395–96.

> Over the years, Haggar has come to stand for the proposition that a superseding return, whether filed on extension or not, is effective for most purposes. For example, courts have held that many elections required to be made on a timely return can be made or changed on a superseding return. See, e.g., *National Lead Co. v. Commissioner*, 336 F.2d 134 (2d Cir. 1964) (inventory accounting relief provision); *Charles Leich & Co. v. United States*, 329 F.2d 649 (Ct. Cl. 1964) (excess profits tax election); *Wilson v. United States*, 267 F. Supp. 89 (E.D. Mo. 1967) (partnership tax year); Cf. *J.E. Riley Investment Co. v. Comm'r*, 311 U.S. 55 (1940) ("[Haggar] would compel the conclusion that had the amended return been filed within the period allowed for filing the original return, it would have been a first return [for purposes of determining percentage depletion election]. . . .") (citations omitted).

Superseding returns have gotten some additional discussion since the Bipartisan Budget Act of 2015 partnership audit rules began to apply—while generally a partnership cannot amend its return if it is covered by the BBA rules (rather having to go through the complex administrative adjustment request process for a BBA partnership), a superseding return can still be filed up to the due date or extended due date of the partnership return. The superseding return allows the change to be simply passed out to the partners for use on their individual returns for the year in question.

Statute of Limitations and Superseding Returns

But while a superseding return supplants the original return for purposes of elections and the like, does it also move the date of filing of the return for purposes of starting the statute of limitations running under IRC §6501 (for the IRS to assess additional tax) or §6511 (for a taxpayer to file a claim for refund)?

In the fact pattern under consideration in this memorandum, the taxpayer had filed for an extension of time to file a corporate income tax return. Prior to the expiration of the extension period, the taxpayer had filed its tax return. However, the taxpayer noticed an error on the return and, again prior to the extended due date, filed a superseding return.

More than three years after the first return was filed, but less than three years after the superseding return was filed, the taxpayer filed a claim for refund.

The fact the returns were filed on extension made this an issue. If the returns had been filed before the regular due dates with no extension, neither statute would have begun to run until that due date

[1403] Some CPAs seem to believe that, in order to get superseding treatment, the revision cannot be filed on an amended return form. Clearly, the case from the Supreme Court that created this treatment has no such arrives—so in that case it wouldn't matter which return triggered the beginning of the statute because the result would be the same. Any assessment or claim must be raised prior to three years following that original due date.

But with returns on extension, the statute begins running on the date the return is filed. So, in this case, if the original return's filing date is used to determine the date when the statute begins to run, the claim was not filed timely. As the CCA explains:

> If both returns are filed before the original due date, this ambiguity has no effect on when the statute of limitations begins because a return filed before the last day prescribed for filing is deemed filed on the last day. See I.R.C. §§ 6501(b)(1) and 6513(a). Thus, in that situation, regardless of which return is "the return," the statute will begin on the original due date for the return. But a return filed on extension is treated as filed on the day it is received. See, e.g., *First Charter Financial Corp. v. United States*, 669 F.2d 1342 (9th Cir. 1982) (finding that return filed during automatic extension period was filed when received for purposes of statute of limitation on assessment). So where the first return is filed before the last date prescribed for filing (original or extended), and a second return is subsequently filed during the extension period, the statute would begin running on different dates, depending on which return is "the return" for purposes of section 6501(a) or 6511(a).

The memorandum argues that it is the first filed return, and not the superseding one, that triggers the beginning of the running of the statute. The memorandum looks to the cases of *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934) and *National Paper Products Co. v. Helvering*, 293 U.S. 183 (1934) to justify this conclusion.

> In these two related cases, the issue before the Supreme Court was substantially the same, but the facts were slightly different. In both cases, new statutes were enacted after two companies had already timely filed their tax returns. Each statute affected income tax and was effective retroactively. In response to the new law, "[National Paper] filed an additional return, supplementing the original one by a statement of the additional taxes due." *Nat'l Paper*, 293 U.S. at 186. Zellerbach Paper, on the other hand, "did not make a new or supplemental return correcting the computation in the one on file." *Zellerbach*, 293 U.S. at 175. In both cases, the Commissioner issued a notice of deficiency after the limitation period for assessment had run from the original returns' filing date.
>
> The taxpayers argued that the notices of deficiency were untimely. The government's position was that, since the original returns did not incorporate the changes under the statute, the original return in both cases was a nullity, so the statute of limitations on assessment had not begun to run with the filing of the original returns. The Court disagreed. Discussing what is now known as the *Beard* test, the Court found the original returns filed by both Zellerbach Paper Company and National Paper met that test and started the statute of limitations for assessment. Thus, the notices of deficiency were untimely.

> The court disagreed with the government's argument that starting the period of limitation for assessment with the original return unfairly curtails the government's time for audit and assessment:
>
>> [A] second return, reporting an additional tax, is an amendment or supplement to a return already upon the files, and being effective by relation does not toll a limitation which has once begun to run. . . . Supplement and correction in such circumstances will not take from a taxpayer, free from personal fault, the protection of a term of limitation already running for his benefit.
>
> *Id*. at 180.2 In coming to this conclusion, the *Zellerbach* Court deemed a loss of four months for audit insignificant, *Id*. at 181, and it apparently did not find a loss of ten months alone to be a factor that would change its decision in *National Paper*. *Nat'l Paper*, 293 U.S. at 185.

Although the returns in *Zellerbach* and *National Paper* were not superseding returns, the memorandum concludes that this would not have an impact on the holding:

> The reasoning of *Zellerbach* also applies with equal force to superseding returns filed on extension. In both superseding- and amended-return situations, if the second return were to restart the limitations period, the taxpayer would lose the protection of the assessment statute for the period between the dates the two returns were filed. This is unfair to the taxpayer and thwarts the purpose of the statute of limitations, which, in the tax context, is "to cut off rights that might otherwise be asserted. . . ." See *Kavanagh v. Noble*, 332 U.S. 535, 539 (1947) (citing *Rosenman v. United States*, 323 U.S. 658, 661 (1945)), reh'g denied, 333 U.S. 850 (1948). This purpose is served best when the original return starts the period of limitations.
>
> The loss of time to audit the superseding return, even if the superseding return were filed at the end of a six-month automatic extension period, does not influence our conclusion that an original return, despite its inaccuracy, is the return for purposes of the statute of limitations on assessment, and the filing of a superseding return during an extension period does not restart the period of limitations. See *Zellerbach* and *National Paper* (Court was unmoved by losses of four and ten months, respectively).

But doesn't *Haggar* tell us that the superseding return is treated as the original return? In the memorandum's view not for purposes of restarting the statute once the second return is filed. The memorandum reasons:

> Nonetheless, *Haggar* does not compel a conclusion that a superseding return is "the return" for purposes of the statute of limitations. It has never been applied in that context; nor should it be because the purpose of the statute of limitations is distinct from the purpose of the statute in *Haggar* and from the purposes of the statutes covering elections and penalties to which *Haggar* has been applied. While *Haggar* has been applied to statutes aimed at determining what substantively is included in

> the return, the statute of limitations is a mechanical rule with the purpose of cutting off rights, as discussed above.

The IRS also argues that there is no conflict between the *Haggar* and *Zellerbach* decisions:

> Furthermore, *Haggar* does not conflict with *Zellerbach*. A superseding return modifies or supersedes an original return under Haggar and still relates back to the date of the original return for timing purposes under *Zellerbach*. *Zellerbach* recognizes that a second return, although it does not restart the limitation period, is still "an amendment or supplement to a return already upon the files, and . . . [is] effective by relation." *Zellerbach*, 293 U.S. at 180; see also *Wilson*, 267 F. Supp. at 91 (suggesting that the question *Haggar* addresses is "whether or not an amendment is *part of* a first return") (emphasis added); *Barber v. Comm'r*, 64 T.C. 314, 317 (1975) (noting that if the amended return had been timely filed, then under Haggar, "[the amended] return might then be treated as part of the original return").

The IRS view is that the superseding return is simply treated as if it had been in the return that was first filed. Thus, the date of filing of the original return remains the same, and only the contents of that return are treated as being modified.

EXAMPLE

Wanda filed for an extension of time to file her 2018 income tax return. She filed a return on June 30, 2019. Later Wanda discovered she had failed to make an election that was required to be made on her original return, so she files a superseding return on October 1, 2019.

Even though the superseding return was filed on October 1, 2019, the statute for Wanda to file a claim for refund will still end on June 30, 2022. The same is true for the time the IRS has to assess tax on Wanda's 2018 return. The original return filing date of June 30, 2019 is treated as the date on which both statutes begin to run.

SECTION: 7502
USE OF UNAPPROVED PRIVATE DELIVERY SERVICE CAUSES TAXPAYER'S PETITION TO BE TREATED AS NOT FILED TIMELY

Citation: Organic Cannabis Foundation, LLC, et al, v. Commissioner, CA9, Nos. 17-72874, 17-72877, affirming 153 TC No. 4 (2019), 6/18/20

Small details can be crucial in certain portions of tax practice, and in the case of *Organic Cannabis Foundation, LLC, et al, v. Commissioner*[1404] the problem involved the use of a particular delivery option available from FedEx that was not on the list of IRS approved delivery services. That fact, combined with the inability of FedEx to make delivery on its initial attempt, combined to deny the taxpayers the ability to contest their issue in the United States Tax Court, their petition being found to have been filed a day late.

[1404] *Organic Cannabis Foundation, LLC, et al, v. Commissioner,* CA9, Nos. 17-72874, 17-72877, *affirming* 153 TC No. 4 (2019), June 18, 2020, https://cdn.ca9.uscourts.gov/datastore/opinions/2020/06/18/17-72874.pdf (retrieved June 19, 2020)

Timely Mailing Rule

The main issue goes back to IRC §7502. Per IRC §7502(a)(1), if a document is postmarked on or before the final date for filing certain documents (such as tax returns and, as in this case, Tax Court petitions) the date mailed shall be treated as the date of delivery when determining if an item has been filed timely.

In order to prove the date of the postmark, IRC §7502 and the regulations under it provide for a limited set of options which can be used to establish the postmark date. These options are to file the document using:

- Registered mail;[1405]
- Certified mail;[1406] or
- Specified private delivery services designated by the IRS.[1407]

These options represent the only methods allowed under the regulations for a taxpayer to prove a timely postmark was applied to a document.[1408]

The IRS provides a list of specific approved private delivery services and taxpayers must select from this list. At the time of the case in question, the approved list was found in Notice 2004-83. As of the date this article was written, the current approved list is found in Notice 2016-30.[1409]

Use of an Unapproved FedEx Service

In the case in question, the law firm representing the taxpayer sought to file a Tax Court petition to challenge the IRS's notices of deficiency. The last date to file the petition was April 22, 2015.

The Ninth Circuit panel describes what happened when the law firm sought to send the petition to the Tax Court:

> As the petitions were being finalized on the late afternoon of April 21 — the day before they were due — one of the firm's attorneys asked a secretary to prepare a FedEx shipping envelope addressed for overnight delivery to the Tax Court in Washington, D.C. After logging into her account on the FedEx website, the secretary entered the necessary addressing information and then reviewed the delivery options. She selected the "FedEx 'First Overnight'" delivery option because, "given the attorneys' obvious concerns about meeting the filing deadlines, [she] felt [she] should select the delivery method that would guarantee the earliest possible delivery." After preparing the appropriately labeled FedEx package, the secretary

[1405] IRC §7502(c)(1)

[1406] IRC §7502(c)(2), Reg. §301.7502-1(c)(2)

[1407] IRC §7502(f), Reg. §301.7502-1(c)(3)

[1408] Reg. §301.7501-1(a), (e)

[1409] Notice 2016-30, April 11, 2016, https://www.irs.gov/pub/irs-drop/n-16-30.pdf (retrieved June 19, 2020) gave it to one of the attorneys and went home. A paper receipt from the FedEx office in nearby Rancho Cordova states that the single package (which contained both Appellants' petitions) was dropped off at 8:04 P.M. Pacific time on April 21.

The original FedEx label prepared by the secretary stated that the shipping date was "21APR15" and that the package was to be delivered "WED — 22 APR 8:30A" by "FIRST OVERNIGHT." At some point in processing the package, however, FedEx apparently prepared a new label that bears a notation indicating it was created on "04/22" and that redesignates the package for delivery on "THU — 23 APR 8:30A" by "FIRST OVERNIGHT." This new label was affixed directly over the prior label, and the package arrived in that form at the Tax Court on the morning of April 23. The limited FedEx tracking information that was later available concerning the package no longer listed any of the details of the package's transit while being handled by FedEx; instead, it merely stated that the "Ship date" was "Wed 4/22/2015" and that the package was delivered at "7:35 am" on "4/23/2015 — Thursday."

On the morning of April 22 (the due date for the petitions), one of the attorneys asked the secretary who had prepared the FedEx package to check on its status. The secretary checked her email and saw that she had not received the usual automatic notice from FedEx confirming its delivery. She called the Tax Court Clerk's Office and "was told something to the effect that the package had not been received." She then called FedEx's customer service number and spoke with a representative to whom she provided the package's tracking number. As the secretary later described it, the FedEx representative responded that "the driver's delivery notes stated the driver had tried to deliver but could not because . . . he or she could not get to the door for some plausible reason like construction, or some sort of police action (perhaps the representative said the access was blocked off because of a safety threat)." The record does not indicate that the law firm took any further action that day. When the secretary arrived at the firm the next morning, April 23, she saw that she had an email in her inbox confirming that the package had been delivered that morning at 7:35 a.m. Eastern time.[1410]

At the time of the mailing, Notice 2004-83 listed the following services provided by FedEx as qualifying for protection under §7502(f):

- FedEx Priority Overnight,
- FedEx Standard Overnight,
- FedEx 2 Day,
- FedEx International Priority, and

[1410] *Organic Cannabis Foundation, LLC, et al, v. Commissioner,* CA9, Nos. 17-72874, 17-72877, pp. 7-8

- FedEx International First.[1411]

Although FedEx First Overnight did offer the earliest overnight delivery of the overnight options FedEx offered, it was not a service that was on the 2004 approved list, presumably being first offered after that list was finalized.[1412]

The Ninth Circuit points out that the law enabling the use of private delivery services restricted the protection only to services approved by the IRS:

> Unlike Federal Rule of Appellate Procedure 25(a)(2)(ii), which applies a mailbox rule to the timely delivery of a brief to "a third-party commercial carrier," § 7502 does not allow taxpayers to use the services of any bona fide commercial courier. Instead, the statute specifies that a particular "delivery service provided by a trade or business" will count as a "designated delivery service" only "if such service is designated by the Secretary for purposes of this section." I.R.C. § 7502(f)(2). The term "Secretary" means "the Secretary of the Treasury or his delegate," id. § 7701(a)(11)(B), and here that delegate is the Commissioner (or his further delegate). In addition to requiring a formal designation, the statute states that the IRS may designate a delivery service "only if [it] determines that such service" meets four enumerated statutory criteria designed to ensure that the delivery service is at least as adequate as the U.S. mail. Id. § 7502(f)(2). Specifically, these criteria require that a service be "available to the general public"; that it be "at least as timely and reliable on a regular basis as the United States mail"; that it employ specified methods for showing "the date on which such item was given to such trade or business for delivery"; and that it meet "such other criteria" as the IRS may prescribe. Id. § 7502(f)(2)(A)–(D).[1413]

The Court then noted that the IRS had taken steps to designate such approved services:

> The year after § 7502(f) was added, the IRS published Revenue Procedure 97-19, which outlined the additional criteria that a delivery service must meet before it can be designated under that section. See Rev. Proc. 97-19, § 4, 1997-1 C.B. 644, 645. This document also made clear that private couriers seeking designation under § 7502(f) would not receive a blanket designation for every service they offered; rather, the IRS announced that "[d]esignation will be determined with respect to each type of delivery service offered by a [courier] (e.g., next business morning delivery, next business day delivery, etc.)." Id. § 3.03. Beginning with Notice 97-26 in 1997, see 1997-1 C.B. 413, the IRS has published lists in the Internal Revenue Bulletin of those services that it has designated under § 7502(f). At the time of the delivery at issue in this case, the operative list of designated services was set forth in IRS Notice 2004-83, which designated particular delivery services offered by only

[1411] Notice 2004-83

[1412] The service is on the current approved list found in Notice 2016-30 and, in fact, was added to the list of approved services in Notice 2015-38, issued shortly after the petition in this case was filed.

[1413] *Organic Cannabis Foundation, LLC, et al, v. Commissioner,* CA9, Nos. 17-72874, 17-72877, p. 16

> three companies, FedEx, DHL, and UPS. See 2004-2 C.B. 1030. As to FedEx, the notice designated five particular delivery services under § 7502(f), including "FedEx Priority Overnight" and "FedEx Standard Overnight," but not "FedEx First Overnight." *Id.*[1414]

But the taxpayer countered that, given the facts of what the service offered, this should be deemed to be the same as the approved overnight FedEx offerings found in Notice 2004-83. The Ninth Circuit did not agree:

> Appellants contend that "FedEx First Overnight" should be deemed to be essentially the same delivery service as "FedEx Priority Overnight" and "FedEx Standard Overnight," and that therefore the service Appellants used here is actually covered by the then-existing designations in Notice 2004-83. Alternatively, Appellants argue that, because FedEx First Overnight was indisputably eligible for designation on the day they used it, and was formally designated just two weeks later, Appellants should be deemed to have substantially complied with § 7502(f)'s mailbox rule. These arguments cannot be squared with the language of the statute.
>
> Congress did not merely require that a private delivery service meet certain functional criteria concerning the operation of that delivery service; it also pointedly insisted that the service must be "designated by the Secretary for purposes of this section." I.R.C. § 7502(f)(2) (emphasis added). Given the wide range of documents that are eligible for § 7502(f)'s mailbox rule and the need for clear-cut rules on questions of timeliness, Congress understandably elected to establish a quality-control regime in which the IRS would vet each such service in advance and then issue bright-line designations as to which services are subject to the mailbox rule and which are not. The statutory language also makes clear that there must be separate designations for each "service" offered by a private courier — and not merely a designation of the courier itself — because § 7502(f) expressly distinguishes between the "trade or business" that engages in delivery of packages (e.g., FedEx) and the various "delivery service[s]" by which it does so (e.g., FedEx Priority Overnight). See id. (Secretary may designate a "delivery service provided by a trade or business" if, inter alia, the service records "the date on which [an] item [to be delivered] was given to such trade or business for delivery" (emphasis added)). This additional requirement of separate formal designations of each "service" offered by a given "trade or business" would be read out of the statute if we were to accept Appellants' invitation to stretch the existing designations to cover other similar services offered by a particular courier. And the same would be true if we accepted Appellants' argument that use of a non-designated service should be deemed to substantially comply with the statute.[1415]

[1414] *Organic Cannabis Foundation, LLC, et al, v. Commissioner,* CA9, Nos. 17-72874, 17-72877, pp. 16-17

[1415] *Organic Cannabis Foundation, LLC, et al, v. Commissioner,* CA9, Nos. 17-72874, 17-72877, pp. 17-19

Thus, the date of actual delivery by FedEx would apply in this case—and all parties agreed it had actually been delivered on the day *after* the last day for filing the petition. Thus, the panel concluded, the Tax Court had been correct in finding it had no jurisdiction to hear the case.

Delivery Failure Due to Tax Court Being Inaccessible

The taxpayers argued that even if they had used the wrong service, the fact that FedEx had attempted delivery on the last date for filing but that the driver had tried but failed to make the delivery should offer relief from the fact that actual delivery took place a day later.

The Tax Court's rules do provide that if the Court is closed or otherwise inaccessible on the last day for filing, that items delivered the next day will be timely. But the question that the panel looked at was whether the taxpayer had proven the Tax Court was truly inaccessible at the deadline for filing.

The panel found that, even if they accept what the secretary testified FedEx had told her at face value (that there was "some plausible reason" the FedEx driver had for being unable to deliver at the time the driver arrived), that did not show that the Tax Court's inaccessibility continued for the entire day. The panel's opinion notes:

> But that says nothing about whether the Tax Court's Clerk's Office could have been reached later, during the remainder of the business day. As the Tax Court noted, the nature of the obstacle that FedEx claimed to have encountered was not one that, like "inclement weather, government closings, or other reasons," would be expected to make it impracticable to reach the clerk's office for the "entire day." Nor did Appellants suggest that the clerk's office was officially closed on April 22; indeed, the Tax Court took judicial notice that "the Court's Clerk's Office was open during its normal business hours" that day. A temporary obstacle that is encountered earlier in the day does not, without more, render the clerk's office "inaccessible" on "the last *day* for filing." Fed. R. Civ. P. 6(a)(3) (emphasis added). Rule 6(a)(4) states that, for filing by non-electronic means, "the last day ends . . . when the clerk's office is *scheduled* to close." Fed. R. Civ. P. 6(a)(4) (emphasis added). To render the clerk's office inaccessible for the "last day," therefore, an obstacle to access must exist for at least a significant portion of the final period of time preceding the point at which "the clerk's office is scheduled to close." Id. Appellants' evidence made no such showing that the Tax Court Clerk's Office remained inaccessible for the several hours that followed after FedEx's unsuccessful attempt to deliver the package. *Cf. Justice v. Town of Cicero*, 682 F.3d 662, 664 (7th Cir. 2012) (suggesting, in dicta, that if a court's e-filing system crashed during the last hour of the day, the clerk's office would be "inaccessible" under Rule 6(a)(3)).
>
> …We therefore hold that, for non-electronic filings (such as those at issue here), a clerk's office is "inaccessible" on the "last day" of a filing period only if the office cannot practicably be accessed for delivery of documents during a sufficient period of time up to and including the point at which "the clerk's office is scheduled to close." Fed. R. Civ. P. 6(a)(3), (4)(B). Because, as the Tax Court noted, Appellants presented no evidence to show that the clerk's office could not be accessed during

the substantial remaining portion of the day after FedEx's unsuccessful earlier delivery attempt, the extension in Rule 6(a)(3) did not apply.[1416]

SECTION: 7502
PETITION TO TAX COURT FOUND TO BE TIMELY MAILED DESPITE LACK OF POSTMARK

Citation: Seely v. Commissioner, TC Memo 2020-6, 1/14/20

A topic that regularly comes up year after year in Tax Court cases is the issue of whether a document meets the requirements for protection under the timely mailed, timely filed rule found in IRC §7502(a). In the case of *Seely v. Commissioner*, TC Memo 2020-6,[1417] we have one of the infrequent taxpayer victories when faced with such a challenge.

IRC §7502(a) provides:

> (a) General rule
>
> (1) Date of delivery
>
> If any return, claim, statement, or other document required to be filed, or any payment required to be made, within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws is, after such period or such date, delivered by United States mail to the agency, officer, or office with which such return, claim, statement, or other document is required to be filed, or to which such payment is required to be made, the date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.
>
> (2) Mailing requirements
>
> This subsection shall apply only if—
>
>> (A) the postmark date falls within the prescribed period or on or before the prescribed date—
>>
>>> (i) for the filing (including any extension granted for such filing) of the return, claim, statement, or other document, or
>>>
>>> (ii) for making the payment (including any extension granted for making such payment), and

[1416] *Organic Cannabis Foundation, LLC, et al, v. Commissioner,* CA9, Nos. 17-72874, 17-72877, pp. 13-15

[1417] *Seely v. Commissioner*, TC Memo 2020-6, January 13, 2020, https://www.ustaxcourt.gov/USTCInOP/OpinionViewer.aspx?ID=12146 (retrieved January 14, 2020)

> (B) the return, claim, statement, or other document, or payment was, within the time prescribed in subparagraph (A), deposited in the mail in the United States in an envelope or other appropriate wrapper, postage prepaid, properly addressed to the agency, officer, or office with which the return, claim, statement, or other document is required to be filed, or to which such payment is required to be made.

Of course, the key problem with this provision is that it all depends on a few things happening—first, the postmark being applied to the envelope by the United States Postal Service (USPS), second, the postmark showing the proper date and third, that letter and postmark making it into the hands of the IRS. The case today involves a failure with the first issue—the postmark did not get applied to the envelope by the United States Postal Service.

The facts, as detailed by the Court, are as follows:

> On March 28, 2017, respondent mailed petitioners, by certified mail to their last known address, a notice of deficiency for tax years 2013, 2014, and 2015. The notice of deficiency advised petitioners that they had 90 days from the date of the notice to file a petition in the Tax Court for a redetermination of the deficiency. The notice of deficiency also stated that the last day to petition the Tax Court was June 26, 2017.
>
> Petitioners' attorney, Scott Boyce, prepared a petition seeking a redetermination of the deficiencies and mailed it to the Tax Court. The Court received the petition on July 17, 2017, 111 days after the mailing of the notice of deficiency. The envelope in which the petition was mailed was properly addressed to the Tax Court. The envelope bears U.S. postage stamps and thus appears to have been delivered by the U.S. Postal Service (USPS). However, the envelope bears no discernable postmark and has no other markings affixed by the USPS.[1418]

The Court notes that taxpayers aren't necessarily out of luck when no postmark is visible on the envelope. Rather, the Court looks to the following for evidence of when the letter likely made it to the USPS:

> When a postmark is missing, our caselaw instructs us to deem the postmark illegible and permit the introduction of extrinsic evidence to ascertain the mailing date. See *Sylvan v. Commissioner*, 65 T.C. 548, 553-555 (1975); see also *Mason v. Commissioner*, 68 T.C. 354, 356 (1977). The burden is on the party who invokes section 7502 to present "convincing evidence" of timely mailing. Mason v. Commissioner, 68 T.C. at 356-357; see sec. 301.7502-1(c)(1)(iii)(A), Proced. & Admin. Regs. (providing that, if a USPS postmark "is not legible, the person * * * [invoking section 7502] has the burden of proving the date that the postmark was made").

1418 *Seely v. Commissioner*, pp. 2-3

> When confronted with illegible or missing postmarks, we have considered various types of extrinsic evidence, including testimony from the person claiming to have mailed the envelope. See *Mason v. Commissioner*, 68 T.C. at 357. We also look to evidence regarding the normal delivery time from the place of origin to our Court in Washington, D.C. See id.; *Selter v. Commissioner*, T.C. Memo. 2000-316, 2000 Tax Ct. Memo LEXIS 373, at *11; *Robinson v. Commissioner*, T.C. Memo. 2000-146, 2000 Tax Ct. Memo LEXIS 176, at *5. We may examine the envelope to see whether any markings indicate that the letter had been "misplaced, missent, or inadvertently lost or damaged". *Robinson v. Commissioner*, 2000 Tax Ct. Memo LEXIS 176, at *3 (noting the testimony of a post office employee that, in the event of misdelivery or damage, "there should be some sort of marking on * * * [the envelope] 'to let you know exactly what has happened to that letter'").
>
> The envelope that contained the petition in this case is not damaged and has no marking of any kind suggesting that it was misdirected or misplaced. The envelope, however, does not bear any postmark. Therefore, the issue turns on whether petitioners have presented convincing evidence establishing that they timely mailed their petition. We allowed both parties to present extrinsic evidence to establish the petition's mailing date. See *Sylvan v. Commissioner*, 65 T.C. at 553-555.[1419]

The taxpayers produced a declaration from their attorney regarding when the document was mailed:

> …[P]etitioners' attorney supplied a declaration (Mr. Boyce's declaration) under penalty of perjury in which he states that "on June 22, 2017 * * * [he] deposited into the [USPS] collection receptacle located at 690 Gage Blvd, Richland, Washington 99352, the tax court petition of Michael and Nancy Seely".[1420]

Since that date was before the last day for mailing the petition, if the Court accepted that statement as true then the taxpayers' petition was timely. Since the taxpayer must present *convincing* evidence, the Court looked to other evidence to either confirm or bring into doubt the assertion that the document was mailed on June 22, 2017.

The IRS objected that the letter did not arrive at the Tax Court within the normal time it would take for a letter to make it to the Court. As the Court notes:

> At the hearing respondent alleged that it takes 8 to 15 business days for the USPS to deliver a piece of mail to a Government agency located in Washington, D.C., from any location in the United States. Petitioners do not dispute this contention, and we deem it conceded. If the petition was mailed on June 26, 2017, the last day to file a petition, then the petition's delivery date would have fallen within the 15-day window. In a sworn declaration Mr. Boyce declared that he deposited the petition in the U.S. mail several days earlier, on June 22, 2017. Respondent argues that if the petition had in fact been mailed on June 22, 2017, then it would have been delivered to the Tax Court no later than July 14, 2017, which was a Friday. The

[1419] *Seely v. Commissioner*, pp. 5-6

[1420] *Seely v. Commissioner*, p. 3

> petition, however, arrived on Monday, July 17, 2017. Because the petition arrived at the Court later than it should have (16 business days after the alleged mailing date rather than 15), respondent contends that Mr. Boyce's declaration is not convincing evidence.[1421]

But the Tax Court found the IRS's evidence wasn't persuasive that the letter wasn't mailed when claimed:

> First, we note that the petition arrived at the Court only one business day late. We also note that the Fourth of July holiday fell between the date of the alleged mailing and the delivery date. In prior cases holiday conditions at the post office (e.g., holiday closures, unusually large volumes of mail, or inefficiencies attributable to temporary staff) have been found to be a possible explanation for short delays in delivery. *Rotenberry v. Commissioner*, 847 F.2d 229 (5th Cir. 1988) (finding that holiday conditions could explain a three-day delay in ordinary delivery time for a letter mailed on December 23); see also *Mason v. Commissioner*, 68 T.C. at 357 (noting the testimony of a post office employee that, because of the Bicentennial celebrations being conducted in Washington, D.C., over the Fourth of July weekend, "it is possible that mail going * * * [to Washington, D.C.] at about that time could have been delayed"). We are thus unpersuaded by respondent's argument that Mr. Boyce's declaration is not reliable because the petition's alleged mailing date does not square with its actual delivery date.[1422]

Thus, the Court found that it was more likely than not that the petition was mailed when the attorney stated it was mailed, and thus the filing was timely.

SECTION: FBAR REPORTING

TAXPAYER GETS HIT WITH WILLFUL FAILURE TO FILE FBAR PENALTIES AFTER VOLUNTARILY WITHDRAWING FROM OVDI PROGRAM

Citation: United States v. Ott, US DC SD Michigan, Case No. 2:18-cv-12174, 2/26/20

A taxpayer's decision to voluntarily withdraw from the IRS's Offshore Voluntary Disclosure Initiative (OVDI) program and instead argue a reasonable cause defense for the failure to file Foreign Bank Account Reporting forms did not end well. In the case of *United States v. Ott*, US DC SD Michigan, Case No. 2:18-cv-12174 the taxpayer ended up with almost $1 million in penalties when the Court determined that he had acted willfully in failing to file annual FBAR reports on his Canadian accounts.

[1421] *Seely v. Commissioner*, p. 7

[1422] *Seely v. Commissioner*, p. 8

The Court describes the history of his Canadian accounts as follows:

> In 1993, Defendant opened two brokerage accounts with McDermid St. Lawrence Ltd. ("McDermid"), a Canadian financial institution, and deposited $50,000 into those accounts.
>
> In 1994, Ott's Canadian financial advisor, Donna Balaski ("Balaski"), moved brokerage firms from McDermid to Thomson Kernaghan & Co. Ltd. ("Thomson"), a Canadian financial institution. Following his broker, Ott closed his accounts with McDermid and transferred the contents of those accounts into the Thomson accounts.
>
> Between 1993 and 1998, Defendant made additional deposits into the foreign accounts. The additional deposits totaled $71,478.
>
> Balaski moved her employment again to Desjardins Securities ("Desjardins"), a Canadian financial institution. On May 2, 2002, Defendant subsequently transferred the contents of his accounts with Thomson to Desjardins, following Balaski.
>
> On or about July 3, 2003, Ott opened two bank accounts with TD Canada Trust, a Canadian financial institution.
>
> On July 1, 2006, Ott opened two financial accounts with Octagon Capital Corporation ("Octagon") in Toronto, Ontario, with account numbers ending in 589-E and 589-F (the "Canadian Accounts"), and transferred the contents of the accounts with Desjardins to the Octagon accounts.
>
> Ott has a sister with a Canadian home address. Soon after the Octagon accounts were opened, Ott listed his sister's home address for receipt of mailings and correspondence from the Octagon firm. At all relevant times, the address associated with the Canadian Accounts was Ott's sister's Canadian address.
>
> Octagon sent mail to the address listed on Ott's account, his sister's Canadian address, which included information regarding potential income tax obligations with respect to the Octagon accounts.
>
> With rare exception, Ott's sister did not transmit mailings from the Octagon firm to Ott.
>
> Ott had regular contact with his securities broker at Octagon throughout the years 2007 to 2009.
>
> During the 2007, 2008, and 2009 calendar years, the balance of the Canadian Accounts exceeded $10,000.
>
> The highest aggregate balance of the Canadian Accounts in 2007 was $1,903,477. The highest aggregate balance of the Canadian Accounts in 2008 was at least

> $770,000. The highest aggregate balance of the Canadian Accounts in 2009 was $1,766,129.

Mr. Ott had a CPA prepare his returns for the years before the Court. The CPA did not inquire regarding whether Mr. Ott had bank accounts outside the United States. While the CPA did not actually make an entry in his tax software regarding whether Mr. Ott did or did not have a foreign bank account, his software defaulted to checking the boxes "No" on Schedule B.

In 2010 Mr. Ott transferred his accounts to a different Canadian banking institution. When he transferred and liquidated the accounts, he disclosed them to his CPA. The CPA referred him to a tax attorney.

Initially, the attorney recommended that Mr. Ott enter the OVDI program and voluntarily disclose his accounts. In doing so he provided the IRS with

- Copies of his original and amended individual income tax returns;
- Statements for his Canadian accounts; and
- Copies of his FBAR reports he was filing late.

Mr. Ott also voluntarily paid the tax due on income that had not been previously reported.

After he entered the program, the IRS offered participants the option to voluntarily withdraw from the program if they believed the penalties they would face for their failures would be less than that under the OVDI program Mr. Ott had entered. That would generally be true if Mr. Ott could show that his failures to file were not willful. His attorney counseled to withdraw and instead submit evidence to show he had not willfully failed to file. Mr. Ott followed his counsel's advice and withdrew from the program. He submitted the required statement of reasonable cause defenses to the FBAR penalties to the government.

The IRS audited Mr. Ott's returns for the years in question and they did not accept his reasonable cause defenses, asserting willful failure to file penalties.

The IRS position was that Mr. Ott was constructively aware of his FBAR reporting obligations by signing the return with the Schedule B questions referring to FBAR as part of the form. As well, his use of his sister's address represented evidence of an attempt to conceal the accounts. And the balances in the account meant the income from these accounts were a huge proportion of Mr. Ott's income for the years in question, showing a reckless disregard for his reporting responsibilities.

The District Court sided with the IRS. First, the Court found that failing to read the return was not a valid reason for not filing the FBAR form, noting:

> Here, the Defendant stated in both his deposition and trial testimony that he did not review the substance of his tax returns beyond "the bottom line," meaning "what [he] owed or received back" for each year in question. ECF No. 45, PageID.550-555. Ott further testified that no interest, dividends, or capital gains from the foreign Canadian accounts were reflected in his tax returns during this

> time. Id. at PageID.554-555. In *Mohney*, the Sixth Circuit upheld the defendant's conviction for willfully filing false returns, affirming that a taxpayer's "signature is prima facie evidence that the signer knows the contents of the return." 949 F. 2d at 1407 (finding that "knowledge may be inferred from the signature along with the surrounding facts and circumstances. . .").
>
> A sister district court undertook a thorough analysis of the constructive knowledge doctrine, agreeing with the Sixth Circuit and refusing "to excuse [the defendant's] liability and knowledge of a plainly evident duty because he failed to read what he was signing." *McBride*, 908 F. Supp. 2d at 1207 (D. Utah 2012). Given that McBride was not shielded from liability for failure to read the content of his tax returns, Ott should not be able to claim protection here under that same argument. Ott signed a return each year, under penalty of perjury — regardless of whether he actually read the return — certifying that he did not have an interest in foreign accounts. Accordingly, constructive knowledge of the requirement to file the FBAR is imputed to Ott, supporting a finding of willfulness here. See id. at 1208.

He also could not rely on the fact that his accountant hadn't asked him about foreign accounts—it's not reasonable to think it never occurred to him that it *might* be relevant. At best, he was attempting to remain willfully ignorant of any reporting responsibilities:

> The Defendant's failure to discuss his foreign investments with his long-time accountant Weide, for example, indicates "a conscious effort to avoid learning about reporting requirements." Id. at 529 (citing *U.S. v. Williams*, 489 Fed. Appx. 655, 658 (4th Cir. 2012)). Ott's lack of experience in tax accounting suggests that he knew, or should have known, that relying solely on advice he received as a young adult, without consulting his accountant, was reckless conduct in disregard of potential reporting requirements. At the very least, Ott's failure to disclose hundreds of thousands of dollars in a foreign Canadian account to his tax preparer demonstrates that he should have known there was a risk of noncompliance, and yet he failed to take any investigative or corrective action. *McBride*, 908 F. Supp. 2d at 1209. Therefore, Ott's claim that he relied on his own beliefs as to his legal reporting obligations, without verifying those beliefs with his long-time tax preparer, supports a finding of recklessness here.

The Court also found the use of his sister's address was an act of concealment of the account, further evidence of willfulness:

> Here, instead of receiving the mail associated with his foreign accounts at his Michigan address, Ott provided the bank with his sister's Canadian address. During the 2011 Offshore Voluntary Disclosure Program process, Ott stated under penalty of perjury that: ". . . I opened a bank account at TD Canada Trust . . . I used my name and address but also used my sister's address in Toronto for ease of mailing statements." Gov't Trial Ex. 3, Page 5. During his trial testimony, however, Ott stated that he had no part in the address change and his broker, by herself, changed the mailing address to Ott's sister's address in Canada. ECF No. 44, PageID.439.

> Considering the eight-year difference between Ott's conflicting statements as well as the arguments during trial, the Court finds it improbable and lacking in credibility that the Defendant took no part in changing his mailing address to a foreign Canadian address. Using an address that matched the country of the foreign bank accounts suggests that Ott sought to avoid the detection of his account ownership. Further, sending everything to his sister allowed Ott to avoid seeing any statements concerning reporting responsibilities, including the language: "These transactions are to be reported on your annual return of income." ECF No. 44, PageID.459. This failure to review any of the mail sent to his sister from the brokerages constitutes an act of concealment and "conduct marked by careless disregard whether or not one has the right so to act," therefore meeting the civil recklessness standard. *Safeco Ins.*, 551 U.S. at 57.

The opinion also noted that he spoke with the broker frequently about the account, making clear he was very aware of the accounts' existence—this was not a "little account" that he simply failed to recall. And that's because it was clearly not insignificant. The opinion notes:

> …Ott consistently monitored his foreign account balances online during the years in question. He testified that he looked at the account statements online "maybe monthly" so that he "could see the value of my account." ECF No. 44, PageID.458, 460. In other words, Ott had online access to monitor his accounts with balances at or exceeding a million dollars at their highest aggregate points. This is in stark contrast to the income amounts Ott provided on his tax returns, which ranged between twenty and forty thousand dollars for the years in question. See Gov't Trial Ex. 13-15. The amounts on Ott's tax returns are significantly disproportionate to the foreign accounts' million-dollar balances. Further, bank records and Ott's answers to the Government's interrogatories indicate that in-person cash withdrawals and numerous checks were written on the Canadian accounts. See Gov't Ex. 28, Page 1, Gov't Ex. 44, Page 5. These amounts totaled thousands of dollars in withdrawals and checks. Id. At trial, the Defendant was largely unable to remember when those withdrawals occurred or what the money was spent on. ECF No. 44, PageID.515. This Court agrees with the Government that it is neither credible nor believable that Ott, who claimed an income level near the poverty line, would be unable to recall taking out thousands of dollars from his Canadian accounts.

The opinion concludes by noting "[t]he Government has met its burden by a preponderance of the evidence that Ott acted recklessly and with willful blindness by failing to report his foreign accounts."

SECTION: JUDICIAL ESTOPPEL
IRS NOT BARRED FROM CHALLENGING ITEM AGREED TO IN PRIOR SETTLEMENTS

Citation: Audio Technica U.S., Inc. v. United States, Case No. 19-3469, CA6, 6/26/20

The Sixth Circuit Court of Appeals overturned a District Court ruling in favor of the taxpayer in the case of *Audio Technica U.S., Inc. v. United States*, Case No. 19-3469.[1423] The District Court had ruled that the IRS had conceded a specific-fixed rate percentage in prior years Tax Court settlements, which prevented the IRS from challenging that same percentage in the current year's dispute. But the Sixth Circuit did not agree that the prior agreements prevented the IRS from raising that issue.

The Sixth Circuit summarized the prior years as follows:

> In addition to the 2006-2010 tax years at issue here, Audio Technica also claimed the credit for the 2002-2005 tax years, as well as the 2011 tax year. The IRS disagreed and issued Audio Technica a notice of deficiency, essentially saying that it was not entitled to the credit amounts it claimed, and so Audio Technica filed a petition for review with the United States Tax Court.
>
> Rather than litigate the Tax Court proceedings through trial, Audio Technica and the government reached agreements to settle those cases, which were approved by the Tax Court. These settlements did not address the details of the parties' dispute; rather, they (1) listed the dollar amounts of the agreed-upon deficiencies by tax year, in the case of the 2002-2005 dispute, or (2) stated the total dollar amount of Audio Technica's research credit, in the case of the 2011 dispute. But according to Audio Technica, these amounts were determined by the parties through their "specific agreement" as to Audio Technica's fixed-base percentage, namely.92%.

For the year before the Circuit Court panel, the taxpayer decided, rather than again take the dispute to the Tax Court, to pay the tax and sue for a refund in the U.S. District Court. One of the issues that IRS had raised was to question the fixed based percentage that Audio Technica had used which was that same .92 amount.

Audio Technica objected to the IRS raising that issue, and the trial judge agreed:

> As the case was about to proceed to trial, Audio Technica filed a motion in limine arguing that the government was judicially estopped from claiming that the.92% fixed-base percentage did not apply in this case. Specifically, Audio Technica said that the IRS had "twice previously agreed to stipulated settlements recognizing that [Audio Technica's] fixed base percentage of.92% for the 1984 to 1988 base period

[1423] *Audio Technica U.S., Inc. v. United States*, Case No. 19-3469, CA6, June 26, 2020, https://www.opn.ca6.uscourts.gov/opinions.pdf/20a0193p-06.pdf (retrieved June 27, 2020)

> was correct." (Mem. in Support of Mot. in Limine, R. 80-1 at PageID #1127.) Because of this, Audio Technica said, "the doctrines of judicial estoppel and general principles of equity and fairness" required that the government "be estopped from introducing any evidence or asserting a position different than it agreed to with regard to the Fixed Base Percentage in the instant matter." (Id.) With respect to the requested remedy, the motion asked for an order prohibiting any argument or reference to the jury "that the 80's base calculation or fixed base percentage should be any alternative amount other than the amounts claimed by Plaintiff or [that] were accepted in the prior 2010 litigation between Plaintiff and Defendant." (Mot. in Limine, R. 80 at PageID #1122-23.)
>
> The district court granted this motion, holding that because the government "agreed to settlements with results derived through a stipulated, fixed base percentage of.92%," and because these settlements were "accepted and signed by the Tax Court," the government was barred from arguing that another percentage might apply in this case. (Order Granting Mot. in Limine, R. 114 at PageID #1345-46.) And while the government had argued that the.92% figure "was a compromise position" reached through negotiation, the court found that it had "consistently allowed this same basis of.92% to be used to resolve similar tax issues in dispute here," meaning that judicial estoppel applied. (Id. at #1346.)

The Circuit Court opinion notes that the doctrine of judicial estoppel, which the District Court had used as a justification of its decision, prevents a party to litigation from taking a position opposite of one the party had put forward in earlier litigation and which that court had agreed with. But the panel did not agree that was what had happened here.

In this case, the IRS had simply entered into a settlement agreement that both parties agreed to (so presumably was a compromise position), which is different from having a court rule on an issue the IRS had advanced in that case:

> Judicial estoppel cannot apply in this case because the Tax Court litigation was resolved through a settlement, meaning there was no judicial acceptance of the government's position. "Settlements, even in the form of an agreed order, ordinarily do not constitute judicial acceptance of whatever terms they contain." *Teledyne*, 911 F.2d at 1219. This is because judicial estoppel turns on the estopped party's having successfully convinced the earlier court that it was right. But "[i]f the initial proceeding results in settlement, the position cannot be viewed as having been successfully asserted." Edwards, 690 F.2d at 599; see also *City of Kingsport v. Steel Roof Structure, Inc.*, 500 F.2d 617, 620 (6th Cir. 1974) ("[B]ecause of the settlement of plaintiffs' case, the defense of the bar of the statute of limitations was never decided, and therefore no estoppel can possibly exist.").

As well, the specific fixed rate percentage was not listed in the settlement documents in question—so the Tax Court clearly didn't make any sort of decision on that number being appropriate:

> Furthermore, even if the settlements could have allowed for judicial estoppel, the Tax Court never relied upon or adopted the agreed-upon fixed-base percentage

when it approved the settlements in this case. Neither of the stipulated decisions filed with the court includes the .92% fixed-base percentage or any other reference to the proper calculation of the tax credit. Rather, those agreements listed only total dollar amounts, either that Audio Technica owed the IRS in deficiencies or that the IRS owed Audio Technica in credits.

Even if the parties, working behind the scenes, came up with these settlement figures by using the.92% rate, the Tax Court was none the wiser. Accordingly, the Tax Court could not have accepted the.92% fixed-base percentage as part of those proceedings, and so the government cannot be judicially estopped from arguing that Audio Technica failed to show this percentage is correct.

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