

Current Federal Tax Developments

Week of May 11, 2020

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ACCOUNTING
CONTINUING EDUCATION

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF MAY 11, 2020
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SECTION: ERC

IRS REVERSES COURSE, QUALIFYING EMPLOYERS PAYING ONLY HEALTH CARE COSTS CAN CLAIM EMPLOYEE RETENTION CREDIT

Citation: “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.¹

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

¹ “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)

percent. It pays wages to the employees only for the time the employees 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.

SECTION: ERC

SBA CONFIRMS THAT BORROWERS WHO TAKE ADVANTAGE OF MAY 14 EXTENSION TO REPAY GETS EMPLOYEE RETENTION CREDIT

Citation: “Paycheck Protection Program Loans Frequently Asked Questions (FAQs),” Small Business Administration, 5/6/20

The SBA published guidance² in its PPP loan FAQ that duplicates that provided by the IRS earlier, but confirms that a borrower who pays back their PPP loan by May 14 (the extended due date announced by the SBA) will qualify for claiming the Employee Retention Credit. The original IRS guidance providing the relief only mentioned the original May 7 due date for repaying the loan.

² “Paycheck Protection Program Loans Frequently Asked Questions (FAQs),” Small Business Administration, May 6, 2020 edition, https://www.sba.gov/sites/default/files/2020-05/Paycheck-Protection-Program-Frequently-Asked-Questions_05%2006%2020.pdf (retrieved May 6, 2020)

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The new question and answer 45 provides:

45. Question: Is an employer that repays its PPP loan by the safe harbor deadline (May 14, 2020) eligible for the Employee Retention Credit?

Answer: Yes. An employer that applied for a PPP loan, received payment, and repays the loan by the safe harbor deadline (May 14, 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 purposes of the credit.

SECTION: ERC BORROWERS WHO RETURN PPP LOANS UNDER SBA SAFE HARBOR WILL BE ALLOWED TO CLAIM EMPLOYEE RETENTION CREDIT

Citation: “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 now current Question 80 on the IRS’s page for “COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs,”³ the

³ “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)

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 Program—Requirements—Promissory Notes, Authorizations, Affiliation, and Eligibility (PDF).

It seems likely (but not assured) that the IRS will update this guidance to take into account the extension that the SBA has offered, but for now the page still contains the May 7 due date, referring solely to the April 28, 2020 interim final rules published by the SBA.

SECTION: ERC

CHAIRS OF TAXWRITING COMMITTEES ASK IRS TO RECONSIDER FAQ ON HEALTH INSURANCE AND EMPLOYEE RETENTION CREDIT

Citation: “Wyden, Grassley, Neal Request Retention Credit Eligibility for Employers Providing Health Insurance,” Senator Chuck Grassley website, 5/4/20

The Chairs of both Congressional tax writing committees (House Ways and Means Committee and Senate Finance Committee) and the Ranking Member of the Senate Finance Committee have sent a letter to Secretary of Treasury Mnuchin questioning the IRS’s position on the payment of health insurance benefits for employees no longer receiving payroll and the employee retention credit enacted as part of the CARES Act.⁴

The employee retention credit, found at Section 2301 of the CARES Act, provides employers who meet certain conditions a credit of up to 50% of amounts paid for certain payroll costs. The question the IRS sought to answer in the FAQ on the matter

⁴ “Wyden, Grassley, Neal Request Retention Credit Eligibility for Employers Providing Health Insurance,” Senator Chuck Grassley website, May 4, 2020, <https://www.grassley.senate.gov/news/news-releases/wyden-grassley-neal-request-retention-credit-eligibility-employers-providing> (retrieved May 5, 2020)

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is whether an employer could claim this credit if it was not currently paying wages to the employee but continued to pay for the employee's health insurance costs.

The IRS held in its FAQ that if no wages are paid to the employee, then no health care costs would qualify for inclusion in the employee retention credit. In the agency's FAQ on the ERC, the following is stated in question 64:

However, if the Eligible Employer lays off or furloughs its employees and continues the employees' health care coverage, but does not pay the employees any wages for the time they are not working, the employer may not treat any portion of the health plan expenses as qualified wages for purposes of the Employee Retention Credit because no portion of the health plan expenses would be allocable to wages paid to the employees.⁵

The IRS provides the following example in FAQ question 64 to illustrate this point:

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 may not treat any portion of its health plan expenses as qualified wages for purposes of the Employee Retention Credit.

While question 64 only deals with employers with 100 or fewer employees, the same language is found in question 65 which deals with employers with more than 100 employees.

The FAQ's position on the matter led to a letter signed by the following three members of Congress who hold the positions noted on the main tax writing committees:

- Senator Charles Grassley (R-IA), Chairman Senate Finance Committee
- Senator Ron Wyden (D-OR), Ranking Member Senate Finance Committee
- Representative Richard Neal (D-MA), Chairman House Ways & Means Committee

⁵ "COVID-19-Related Employee Retention Credits: Amount of Allocable Qualified Health Plan Expenses FAQ - Determining the Amount of Allocable Qualified Health Plan Expenses," IRS website, April 29, 2020 version, <https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-amount-of-allocable-qualified-health-plan-expenses-faqs> (retrieved May 5, 2020)

The letter was addressed to Treasury Secretary Mnuchin and voiced their displeasure with this position.

Their letter notes:

As of this writing, more than one million Americans have contracted COVID-19, and more than 60,000 have perished. It is absolutely critical that American families have access to health care during this crisis. Allowing employees to retain their employer-provided health insurance, even while furloughed, is an important component in ensuring millions of Americans access to affordable health care.⁶

The letter goes on to ask Treasury to reverse this position and allow the credit to be used to subsidize such payment of medical insurance for furloughed employees:

We are, therefore, disappointed with the recent determination that an employer that is no longer paying regular wages but continues to provide full health benefits would not be able to treat any portion of those health benefits as qualifying wages eligible for the retention credit. We urge you to reconsider this determination in light of congressional intent and the importance of providing access to affordable health care during the ongoing health crisis.⁷

One interesting person who did not sign the letter is the Ranking Member of the House Ways & Means Committee, Rep. Kevin Brady (R-TX). His absence is important, especially if it is clear he does not endorse this position. Normally the IRS pays special attention to Congressional correspondence if the Chairs and Ranking Members of both tax writing committee write to the agency, since the implied threat is that there will be legislative action with broad support to overturn the agency's position if the agency doesn't reverse the position on its own.

For the moment all we have is an FAQ which is not legal authority on its own, but most taxpayers will be uneasy about taking a position that is contrary to the FAQ. While it is not authority, it likely expresses the position the agency is going to take in any examination on the issue, a position the agency will defend using the argument it gave to support the position in the FAQ—that the credit requires wages to allocate the health insurance costs to. A taxpayer would have to be able ultimately to persuade a court that the law does not require wages based on how the law is written, and that the law truly meant to allow the credit for such expenditures.

⁶ “Wyden, Grassley, Neal Request Retention Credit Eligibility for Employers Providing Health Insurance,” Senator Chuck Grassley website, May 4, 2020

⁷ “Wyden, Grassley, Neal Request Retention Credit Eligibility for Employers Providing Health Insurance,” Senator Chuck Grassley website, May 4, 2020

SECTION: PPP LOAN MORE INTERIM FINAL REGULATION GUIDANCE FOR PPP LOANS ISSUED ON NON-DISCRIMINATION PROVISIONS AND STUDENT WORKERS

Citation: RIN 3245-AH40, “Business Loan Program Temporary Changes; Paycheck Protection Program – Nondiscrimination and Additional Eligibility Criteria,” Small Business Administration, 5/5/20

Another interim final regulation on the PPP loan program has been issued by the Small Business Administration.⁸ The new guidance deals with non-discrimination rules and student workers.

Non-Discrimination Provisions

The non-discrimination provision is meant to address the following issue outlined by the SBA in the supplementary information portion of the IFR:

Prior to the CARES Act, nonprofit organizations were not eligible to participate in SBA’s 7(a) Loan Program (15 U.S.C. 636(a)). Section 1102 of the CARES Act expanded eligibility, limited to PPP, to include certain nonprofit organizations, among other organizations.

SBA regulations at 13 CFR part 113 impose regulatory requirements “to reflect to the fullest extent possible the nondiscrimination policies of the Federal Government as expressed in the several statutes, Executive Orders, and messages of the President dealing with civil rights and equality of opportunity.” 13 CFR 113.1(a). But because SBA’s loan programs previously served business entities, these regulations did not restate certain limitations and exemptions under federal law primarily pertinent to certain faith-based or nonprofit organizations. In particular, Title IX of the Education Amendments of 1972 permits single-sex admissions practices by preschools, non-vocational elementary or secondary schools, and private undergraduate higher education institutions. See 20 U.S.C. 1681(a)(1). Additionally, the Fair Housing Act of 1968 allows religious organizations to reserve housing for coreligionists, see 42 U.S.C. § 3607, and allows for single-sex emergency shelters that provide refuge to abused women (or abused men), see 24 CFR 5.106; see also *Johnson v. Dixon*, 786 F. Supp. 1, 4 (D.D.C. 1991) (“It is . . . doubtful [that] ‘emergency overnight

⁸ RIN 3245-AH40, “Business Loan Program Temporary Changes; Paycheck Protection Program – Nondiscrimination and Additional Eligibility Criteria,” Small Business Administration, May 5, 2020, <https://home.treasury.gov/system/files/136/IFR-Nondiscrimination-and-Additional-Eligibility-Criteria.pdf> (retrieved May 5, 2020)

shelter,’ . . . can be characterized as a ‘dwelling’ within the meaning of the [Fair Housing] Act.”). Finally, the Indian Child Welfare Act of 1978 requires certain placement preferences in the foster care and adoptions of Indian children. See 25 U.S.C. 1915. The broadly worded SBA regulations do not articulate these limitations on the application of the relevant nondiscrimination provisions.

In addition, there is a technical discrepancy between SBA’s religious employer exemption at 13 CFR 113.3-1(h) and Title VII of the Civil Rights Act, which allows religious employers to make hiring decisions according to their religious beliefs with respect to all “activities,” not just “religious activities.” See An Act to further promote equal employment opportunities for American workers, Pub. L. 92-261, 86 Stat. 103, 104 (1972), codified at 42 U.S.C. 2000e-1(a).

Given these various discrepancies, organizations have accordingly faced uncertainty about whether their participation in the PPP program would require them to substantially change their operations for a short period of months. These types of changes are impossible for some organizations, and impractical for many. This uncertainty risks frustrating the purpose of the CARES Act, which was to afford swift stopgap relief to Americans who might otherwise lose their jobs or businesses because of the economic hardships wrought by the response to the COVID-19 public health emergency. To provide certainty to applicants and recipients of loans and loan forgiveness under the PPP, and to address the large-scale burdens that SBA regulations may impose on recipients participating only on a short-term basis, this interim final rule provides guidance that for purposes of the PPP, nonprofits must meet their nondiscrimination obligations under existing Federal laws and Executive Orders. This interim final rule also provides guidance with respect to the religious employer exemption to ensure harmony with Section 702 of Title VII.

Thus, the interim final regulation provides the following:

1. Non-Discrimination

Are recipients of PPP loans entitled to exemptions on the grounds provided in Federal nondiscrimination laws for sex-specific admissions practices, sex-specific domestic violence shelters, coreligionist housing, or Indian tribal preferences in connection with adoption or foster care practices?

Yes. With respect to any loan or loan forgiveness under the PPP, the nondiscrimination provisions in the applicable SBA regulations incorporate the limitations and exemptions provided in corresponding Federal statutory or regulatory nondiscrimination provisions for sex-specific admissions practices at preschools, non-vocational elementary or secondary schools, and private undergraduate higher education institutions under Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.), for sex-specific emergency shelters and coreligionist housing under the Fair Housing Act of 1968 (42 U.S.C.

3601 et seq.), and for adoption or foster care practices giving child placement preferences to Indian tribes under the Indian Child Welfare Act of 1978 (25 U.S.C. 1901 et seq.).

In addition, for purposes of the PPP, SBA regulations do not bar a religious nonprofit entity from making decisions with respect to the membership or the employment of individuals of a particular religion to perform work connected with the carrying on by such nonprofit of its activities.

Student Workers

The regulation also provides an exclusion from the employee count for employees that are part of a work-study program. The interim final regulation provides:

2. Student Workers and PPP Loan Eligibility

Do student workers count when determining the number of employees for PPP loan eligibility?

Yes, student workers generally count as employees, unless (a) the applicant is an institution of higher education, as defined in the Department of Education’s Federal Work-Study regulations, 34 C.F.R. § 675.2, and (b) the student worker’s services are performed as part of a Federal Work-Study Program (as defined in those regulations) or a substantially similar program of a State or political subdivision thereof. Institutions of higher education must exclude work study students when determining the number of employees for PPP loan eligibility, and must also exclude payroll costs for work study students from the calculation of payroll costs used to determine their PPP loan amount. The Administrator, in consultation with the Secretary, has determined that this is a reasonable interpretation of section 1102(a) of the CARES Act’s reference to “individuals employed on a full-time, part-time, or other basis.” Such programs generally provide part-time jobs for students with financial need, and their services are incident to and for the purpose of pursuing a course of study. Work study students are excluded from the definition of employees in other areas of federal law. For example, in the regulations implementing the Affordable Care Act, Treasury defined an employee’s “hours of service” to exclude work study hours. Explaining this exclusion, the regulation’s preamble states that “[t]he federal work study program, as a federally subsidized financial aid program, is distinct from traditional employment in that its primary purpose is to advance education.” Similarly, student work is generally exempt from Federal Insurance Contribution Act (FICA) and Federal Unemployment taxes. For similar reasons, the Administrator, in consultation with the Secretary of the Treasury, has determined that a limited exception for work study is appropriate here. In particular, the Administrator recognizes that requiring institutions of higher education to count work study students towards employee headcount would result in an anomalous outcome in two respects. First, it would prevent some small educational institutions from receiving PPP loans due solely to their provision of financial aid to

students in the form of work study. Second, it would result in the exclusion of small educational institutions whose part-time work study headcount dwarfs their full-time faculty and staff headcounts. Educational institutions that filed loan applications prior to the issuance of the regulation are not bound by this interpretation but may rely on it. Lenders may continue to rely on borrower certifications as part of their good faith review process.

SECTION: PPP LOAN

SBA EXTENDS DEADLINE TO REPAY PPP LOANS TO AVOID HAVING TO DEMONSTRATE GOOD FAITH CERTIFICATION LOAN IS NECESSARY BY ONE WEEK

Citation: “Payroll Protection Program Loans Frequently Asked Questions (FAQ),” May 5, 2020 version (2nd), 5/5/20

Two days before the May 7 due date to return PPP loan funds to gain the presumption that the borrower had made a good faith representation that the loan was necessary, the SBA has granted a one week extension on that deadline in an update to the Payroll Protection Program loan FAQ.⁹

When the SBA published Question 31 that emphasized that borrowers who had sufficient liquidity likely could not have correctly represented the loan was necessary for the business, the agency gave borrowers who had already obtained a loan until May 7 to repay the loan. While the relief says in that case it will be presumed the borrower made a good faith certification, in reality what it does is allow the borrower to avoid the risk of being asked to demonstrate the necessity of the loan and any potential sanctions that might arise if it is found that the certification was not made in good faith.

In Question 43 the SBA has now granted a one-week extension to make a safe harbor repayment:

43. Question: FAQ #31 reminded borrowers to review carefully the required certification on the Borrower Application Form that “[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.” SBA guidance and regulations provide that any borrower who applied for a PPP loan prior to April 24, 2020 and repays the loan in full by May 7, 2020 will be deemed by SBA to have made the

⁹ “Paycheck Protection Program Loans Frequently Asked Questions,” Small Business Administration website, May 5, 2020 version, May 5, 2020, <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf> (retrieved May 5, 2020)

required certification in good faith. Is it possible for a borrower to obtain an extension of the May 7, 2020 repayment date?

Answer: SBA is extending the repayment date for this safe harbor to May 14, 2020. Borrowers do not need to apply for this extension. This extension will be promptly implemented through a revision to the SBA's interim final rule providing the safe harbor. SBA intends to provide additional guidance on how it will review the certification prior to May 14, 2020.

SECTION: PPP LOAN ADDITIONAL PPP FAQ QUESTIONS ADDRESS BORROWER APPLICATION FORM ISSUES FOR SEASONAL EMPLOYERS AND §115 HOSPITALS

Citation: “Payroll Protection Program Loans Frequently Asked Questions (FAQ),” May 3, 2020 version (2nd), 5/3/20

A few hours after adding question 40, the Small Business Administration added another two questions and answers to the frequently asked questions (FAQ) for the payroll protection program loans late on a Sunday evening.¹⁰ These two questions deal with issues that arise for seasonal businesses and the certifications on the SBA Borrower Application Forms as well as whether hospitals exempt from tax under IRC §115 qualify to enter this program.

Seasonal Employers and the SBA Borrower Application Form

On April 27, 2020 the Small Business Administration issued an interim final rule that allowed seasonal businesses to use periods other than those specifically authorized in the law to compute their maximum loan amount. However, the SBA's Borrower Application Form has language that caused some borrowers to be concerned that if they used the optional measuring period, they either could not sign the form that currently exists or, if they did, they might face liability or even prosecution for having provided false information to a financial institution for the purpose of obtaining credit.

The applicant is required to certify to the following statement on the Borrower Application Form:

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

¹⁰ “Paycheck Protection Program Frequently Asked Questions (FAQs),” May 3, 2020 version (2nd), May 3, 2020, <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf> (retrieved May 4, 2020)

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 \$1,000,000.¹¹

On page 3 the form contains the following specific instructions to the borrower:

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, 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.*¹²

A seasonal business using the additional optional periods under the April 27, 2020 interim final rule would not be using the period required by the instructions to the Borrower Application Form.

Question 41 provides that the seasonal employer borrower is to ignore this instruction and refer to the interim final rule for purposes of completing the form. The question and answer reads:

41. Question: Can a seasonal employer that elects to use a 12-week period between May 1, 2019 and September 15, 2019 to calculate its maximum PPP loan amount under the interim final rule issued by Treasury on April 27, 2020, make all the required certifications on the Borrower Application Form?

Answer: Yes. The Borrower Application Form requires applicants to certify that “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.” On April 27, 2020, Treasury issued an interim final rule allowing seasonal borrowers to use an alternative base period for purposes of calculating the loan amount for which they are eligible under the PPP. An applicant that is otherwise in compliance with applicable SBA requirements, and that complies with Treasury’s interim final rule on seasonal workers, will be deemed

¹¹ SBA Form 2483, “Paycheck Protection Program Borrower Application Form,” U.S. Small Business Administration, April 2020, p. 2, <https://www.sba.gov/sites/default/files/2020-04/PPP%20Borrower%20Application%20Form.pdf> (retrieved May 4, 2020)

¹² SBA Form 2483, “Paycheck Protection Program Borrower Application Form,” U.S. Small Business Administration, April 2020, p. 3

eligible for a PPP loan under SBA rules. Instead of following the instructions on page 3 of the Borrower Application Form for the time period for calculating average monthly payroll for seasonal businesses, an applicant may elect to use the time period in Treasury's interim final rule on seasonal workers.

Hospitals Exempt from Tax Under IRC §115

Another concern addressed in the new questions is whether hospitals exempt from tax under IRC §115 can qualify for a PPP loan.

IRC §115 provides:

§ 115. Income of States, municipalities, etc.

Gross income does not include—

(1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or

(2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

While certain non-profit organizations qualify for PPP loans, the law did not provide that such was the case for entities exempt from tax under §115. However, it is possible that a §115 organization might also qualify for an exemption under §501(c)(3), but the organization would not have made an application for that exemption since it was rendered unnecessary by IRC §115. The question was whether such a hospital could qualify for a PPP loan?

Question 42 provides relief for §115 hospitals that are also entities described in §501(c)(3), allowing the hospital to qualify for a PPP loan:

42. Question: Do nonprofit hospitals exempt from taxation under section 115 of the Internal Revenue Code qualify as “nonprofit organizations” under section 1102 of the CARES Act?

Answer: Section 1102 of the CARES Act defines the term “nonprofit organization” as “an organization that is described in section 501(c)(3) of the Internal Revenue Code of 1986 and that is exempt from taxation under section 501(a) of such Code.” The Administrator, in consultation with the Secretary of the Treasury, understands that nonprofit hospitals exempt from taxation under section 115 of the Internal Revenue Code are unique in that many such hospitals may meet the description set forth in section 501(c)(3) of the Internal Revenue Code to qualify for tax exemption under section 501(a), but have not sought to be recognized by the IRS as such because they are otherwise fully tax-exempt under a different provision of the Internal Revenue Code.

Accordingly, the Administrator will treat a nonprofit hospital exempt from taxation under section 115 of the Internal Revenue Code as meeting the definition of “nonprofit organization” under section 1102 of the CARES Act if the hospital reasonably determines, in a written record maintained by the hospital, that it is an organization described in section 501(c)(3) of the Internal Revenue Code and is therefore within a category of organization that is exempt from taxation under section 501(a). The hospital’s certification of eligibility on the Borrower Application Form cannot be made without this determination. This approach helps accomplish the statutory purpose of ensuring that a broad range of borrowers, including entities that are helping to lead the medical response to the ongoing pandemic, can benefit from the loans provided under the PPP.

This guidance is solely for purposes of qualification as a “nonprofit organization” under section 1102 of the CARES Act and related purposes of the CARES Act, and does not have any consequences for federal tax law purposes. Nonprofit hospitals should also review all other applicable eligibility criteria, including the Interim Final Rules on Promissory Notes, Authorizations, Affiliation, and Eligibility (April 28, 2020) regarding an important limitation on ownership by state or local governments. 85 FR 23450, 23451.

A related footnote discusses details of the hospital’s determination that it is an organization described in §501(c)(3):

This determination need not account for the ancillary conditions set forth in section 501(r) of the Internal Revenue Code and elsewhere associated with securing the tax exemption under that section. Section 501(r) states that a hospital organization shall not be treated as described in section 501(c)(3) unless it meets certain community health and other requirements. However, section 1102 of the CARES Act defines the term “nonprofit organization” solely by reference to section 501(c)(3), and section 501(r) does not amend section 501(c)(3). Therefore, for purposes of the PPP, the requirements of section 501(r) do not apply to the determination of whether an organization is “described in section 501(c)(3).”

SECTION: PPP LOAN SBA OFFERS PPP LOAN FORGIVENESS RELIEF FOR EMPLOYERS WHOSE EMPLOYEES TURN OFFER OF REEMPLOYMENT

Citation: “Paycheck Protection Program Loans Frequently Asked Questions (FAQs),” May 3, 2020 version, 5/3/20

In its most recent addition to the questions and answers for the Payroll Protection Program loans,¹³ the SBA has given some protection on forgiveness for an employer that attempts to rehire an employee if the employee declines the offer of employment.

Question 40 provides:

Question: Will a borrower’s PPP loan forgiveness amount (pursuant to section 1106 of the CARES Act and SBA’s implementing rules and guidance) be reduced if the borrower laid off an employee, offered to rehire the same employee, but the employee declined the offer?

Answer: No. As an exercise of the Administrator’s and the Secretary’s authority under Section 1106(d)(6) of the CARES Act to prescribe regulations granting de minimis exemptions from the Act’s limits on loan forgiveness, SBA and Treasury intend to issue an interim final rule excluding laid-off employees whom the borrower offered to rehire (for the same salary/wages and same number of hours) from the CARES Act’s loan forgiveness reduction calculation. The interim final rule will specify that, to qualify for this exception, the borrower must have made a good faith, written offer of rehire, and the employee’s rejection of that offer must be documented by the borrower. Employees and employers should be aware that employees who reject offers of re-employment may forfeit eligibility for continued unemployment compensation.

The key points to note are the requirement for the employer to issue a written offer to rehire the employee and that the employer must document the rejection of the offer. While not explicitly stated, the final sentence regarding the loss of unemployment benefits suggests that it is reasonably possible the SBA may forward the evidence of the offer of employment and documentation of the rejection of the offer to the appropriate state agency for action if the employee did not volunteer that he/she had turned down employment.

¹³ “Payroll Protection Program Loans Frequently Asked Questions (FAQ),” May 3, 2020 version, <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf> (retrieved May 3, 2020)

That may cause some employers concern that they may effectively face the choice of losing the forgiveness of the debt or facing the consequences of employee relation issues for what will be likely be viewed as the threat of turning in the employee.

As well, we must also wait to see if the SBA will still limit forgiveness to the amounts expended, so that the borrower may need to return the funds it was unable to pay. The relief is that the borrower will be given a benefit in not reducing the forgiveness that otherwise would exist based on the funds actually expended due to the loss of FTEs from employees turning down the job offer or failing to meet the 75% of prior quarter earnings for the employee that declined to be rehired.

It seems likely the borrower will still need to pay back funds if the employer is unable to expend sufficient funds in the 8 week period. That also could create problems if the employer does not reserve back the funds it was unable to spend on covered expenses, including a potential sanction for using the funds for unauthorized purposes if the borrower cannot document spending the funds on other covered expenses before June 30, 2020 (which would be not long after the end of the 8-week period for an employer receiving the loan at this point).

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.¹⁴ 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.

¹⁴ 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) Section 67(e) deductions.

(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.¹⁵

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)-4.¹⁶

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

¹⁵ Proposed Reg. §1.642(h)-2(b)(1)

¹⁶ Proposed Reg. §1.642(h)-2(b)(2)

to inform beneficiaries of the nature of the expenses after the allocation of expenses against income.

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 make up 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.¹⁷

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.¹⁸

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

¹⁷ Reg. §1.652(b)-3(a)

¹⁸ Reg. §1.652(b)-3(a)

deductions are attributable to the tax-exempt interest, they may not be allocated to either the rents, taxable interest, or dividends.¹⁹

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.²⁰

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

¹⁹ Reg. §1.652(b)-3(d)

²⁰ Reg. §1.652(b)-3(b)

capital gains are excluded from the computation of distributable net income under section 643(a)(3).²¹

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

*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,

²¹ Reg. §1.652(b)-3(b)

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).²²

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.²³ So even in 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: 265

TAX 101 REVISITED: THREE KEY TAXWRITERS PROTEST IRS POSITION ON DEDUCTION OF PPP EXPENSES, STATE THE RULING IS CONTRARY TO BOTH CONGRESSIONAL INTENT AND CONTROLLING AUTHORITIES

Citation: Letter to U.S. Treasury Secretary Mnuchin from Senator Chuck Grassley, Representative Richard Neal and Senator Ron Wyden on Notice 2020-32, 5/5/20

Key members of the Congressional tax-writing committees have, for the second straight day, sent a letter to Treasury Secretary Mnuchin, voicing their displeasure with IRS guidance on a CARES Act issue and requesting that the agency reverse this

²² Proposed Reg. §1.642(h)-5(b)(2)

²³ "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."

guidance.²⁴ This time the letter, signed by Senate Finance Committee Chair Chuck Grassley (R-IA), Ranking Member Ron Wyden (D-OR) and House Ways & Means Committee Chair Richard Neal (D-MA), raises issues with the guidance in Notice 2020-23.

Notice 2020-23 provided that amounts expended that were used to justify the forgiveness of a PPP loan would not be deductible by the taxpayer in computing federal taxable income. The Treasury Secretary had defended that guidance specifically in an interview with Fox News on May 4. Tax Analysts, in a May 5, 2020 story, provided the following quotes from the Fox News Interview:

“The money coming in the PPP is not taxable,” Mnuchin said May 4 in an interview on Fox Business. “So if the money that's coming is not taxable, you can't double dip.”

...

Mnuchin said the IRS guidance is correct, adding, “I have reviewed this personally. This is basically Tax 101.”²⁵

The authors of the letter clearly do not agree with the Secretary's view of the Tax 101 answer. The letter cites the intent of Congress in enacting the exclusion—that the most obvious reason to include the language was to give those receiving forgiveness a better tax result than they would have obtained had the language not been in the bill:

Section 1106(i) was specifically included in the CARES Act to exclude from income loan forgiveness, which would otherwise be taxable, to provide a tax benefit to small businesses that received the PPP loan. Had we intended to provide neutral tax treatment for loan forgiveness, Section 1106(i) would not have been necessary. In that case, loan forgiveness generally would have been added to the borrower's taxable income, and the expenses covered by the PPP loan would be deductible, reducing taxable income by an offsetting amount and resulting in no additional net income. Notice 2020-32 effectively renders Section 1106(i) meaningless. That, clearly, is contrary to the intent of Section 1106(i) and the CARES Act more generally.

²⁴ Letter to U.S. Treasury Secretary Mnuchin from Senator Chuck Grassley, Representative Richard Neal and Senator Ron Wyden on Notice 2020-32, May 5, 2020, [https://www.finance.senate.gov/imo/media/doc/2020-05-05%20CEG,%20RW,%20RN%20to%20Treasury%20\(PPP%20Business%20Deductions\).pdf](https://www.finance.senate.gov/imo/media/doc/2020-05-05%20CEG,%20RW,%20RN%20to%20Treasury%20(PPP%20Business%20Deductions).pdf) (retrieved May 5, 2020)

²⁵ Jad Chamseddine, “Tax 101: Mnuchin Defends Nondeductibility of PPP Expenses,” *Tax Notes Today Federal*, May 5 2020, 2020 TNTF 87-2, <https://www.taxnotes.com/tax-notes-today-federal/exemptions-and-deductions/tax-101-mnuchin-defends-nondeductibility-ppp-expenses/2020/05/05/2ch77> (retrieved May 6, 2020)

The Chairs and the Ranking Member of the Senate Finance Committee go on to give the Secretary their own lesson in proper interpretation of tax law, apparently not arriving at the same “Tax 101” conclusion as the Secretary:

In addition to disregarding congressional intent, we believe Notice 2020-32 is flawed in its analysis of the applicability of Section 265(a) of the Internal Revenue Code. Section 265(a)(1) applies to deny a deduction only if the deduction is allocable to a class of income that is “wholly exempt from the taxes imposed by this subtitle [of the Internal Revenue Code].” In this case, the deduction is not allocable to the exempt income resulting from the forgiven loan. The deductions for expenses that make a borrower eligible for loan forgiveness are attributable to the conduct of its business. Accordingly, they are properly allocable to the income produced by the business, not to the PPP loan forgiveness. Moreover, the loan forgiveness is not a class of income that is “wholly exempt from the taxes imposed by this subtitle.” The loan may or may not be forgiven, and the amount of the forgiveness is limited by a number of factors. Therefore, even putting aside clear congressional intent, we believe Section 265(a) should not be read to deny ordinary and necessary business deductions in this case.

The letter adds a footnote to the paragraph:

Similarly, such intent is a distinguishing factor and a key consideration in the case law cited in Notice 2020-32.

While the letter did not say that Congress would pass legislation to override the ruling if it was not reversed by Treasury, Tax Analysts reported Senator Grassley has now stated that legislation to reverse this ruling is in the works for his Committee in the Senate. Representative Neal had made a similar commitment immediately following the release of Notice 2020-23 to bring forth legislation in the House to reverse the ruling.²⁶

²⁶ Jad Chamseddine, “Top Taxwriters Urge IRS to Reconsider PPP Tax Deduction Stance,” *Tax Notes Today Federal*, May 6, 2020, 2020 TNTF 88-2, <https://www.taxnotes.com/tax-notes-today-federal/exemptions-and-deductions/top-taxwriters-urge-irs-reconsider-ppp-tax-deduction-stance/2020/05/06/2chdp> (retrieved May 6, 2020)

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 2020-52²⁷ 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 any items except costs of good 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.²⁸

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;

²⁷ *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)

²⁸ Reg. §1.471-3(b)

- Direct labor; and
- Indirect production costs, including an appropriate portion of management costs.²⁹

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 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% downpayment when the product was brought in and paid the

²⁹ Reg. §1.471-3(c)

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.³⁰

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

³⁰ *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, pp. 3-7

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 212.³¹

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”).

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.³²

³¹ *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, p. 16

³² *Richmond Patients Group v. Commissioner*, TC Memo 2020-52, pp. 16-17

SECTION: 6428

DECEASED TAXPAYERS' ESTATES REQUIRED TO RETURN ECONOMIC IMPACT PAYMENTS, GIVEN INSTRUCTIONS ON HOW TO RETURN THE FUNDS

Citation: “Economic Impact Payment Information Center,” IRS website, 5/6/20

The IRS has added information to their “Economic Impact Payment Information Center”³³ on their website dealing with payments made to deceased taxpayers.

Shortly after the IRS began issuing economic impact payments (EIP) to taxpayers, reports began coming up of amounts being paid to deceased taxpayers. While the Treasury Secretary indicated that such payments were made in error and should be returned to the government, no specific guidance was issued by the IRS until May 6.

The new guidance both makes clear the IRS position on when the payment will need to be returned and also the mechanics of returning the payment. The May 6 changes also contain information about EIPs related to resident aliens and incarcerated individuals.

Payments to a Deceased Individual

Question 10 answers the question about exactly what the cut-off for the date of death is that would trigger the return of an EIP. The IRS requires the taxpayer be alive when the payment is *received*.

The guidance states:

Q10. Does someone who has died qualify for the Payment? (added May 6, 2020)

A10. No. A Payment made to someone who died before receipt of the Payment should be returned to the IRS by following the instructions about repayments. Return the entire Payment unless the Payment was made to joint filers and one spouse had not died before receipt of the Payment, in which case, you only need to return the portion of the Payment made on account of the decedent. This amount will be \$1,200 unless adjusted gross income exceeded \$150,000.

EXAMPLE

Mary received her EIP electronically in her bank account on April 20. She dies on April 21. Mary’s estate is not required to return the EIP payment. However, had Mary died on April 19,

³³ “Economic Impact Payment Information Center,” IRS website, May 6, 2020 edition, <https://www.irs.gov/coronavirus/economic-impact-payment-information-center> (retrieved May 6, 2020)

then the estate would be required to return the payment since it was not received by Mary prior to her death.

As is noted in the example, if the payment relates to a married couple, only the amount allocable to the deceased spouse must be returned.

Resident Aliens

While non-resident aliens do not qualify for an EIP per the law, resident aliens can qualify. Question 11 provides:

Q11. Does someone who is a resident alien qualify for the Payment? (added May 6, 2020)

A11. A person who is a non-resident alien in 2020 is not eligible for the Payment. A person who is a qualifying resident alien with a valid SSN is eligible for the Payment only if he or she is a qualifying resident alien in 2020 and could not be claimed as a dependent of another taxpayer for 2020. Aliens who received a Payment but are not qualifying resident aliens for 2020 should return the Payment to the IRS by following the instructions about repayments.

Incarcerated Individuals

The IRS news for incarcerated individuals is not good—they do not qualify for an EIP and need to return it if they have received one. Question 12 provides:

Q12. Does someone who is incarcerated qualify for the Payment? (added May 6, 2020)

A12. No. A Payment made to someone who is incarcerated should be returned to the IRS by following the instructions about repayments. A person is incarcerated if he or she is described in one or more of clauses (i) through (v) of Section 202(x)(1)(A) of the Social Security Act (42 U.S.C. § 402(x)(1)(A)(i) through (v)). For a Payment made with respect to a joint return where only one spouse is incarcerated, you only need to return the portion of the Payment made on account of the incarcerated spouse. This amount will be \$1,200 unless adjusted gross income exceeded \$150,000.

Returning an Erroneous Payment

The page concludes with instructions on how an erroneous EIP should be returned to the government. Question 41 provides:

Q41. What should I do to return an Economic Impact Payment (EIP)? (added May 6, 2020)

A41. You should return the payment as described below.

If the payment was a paper check:

- Write “Void” in the endorsement section on the back of the check.
- Mail the voided Treasury check immediately to the appropriate IRS location listed below.
- Don’t staple, bend, or paper clip the check.
- Include a note stating the reason for returning the check.

If the payment was a paper check and you have cashed it, or if the payment was a direct deposit:

- Submit a personal check, money order, etc., immediately to the appropriate IRS location listed below.
- Write on the check/money order made payable to “U.S. Treasury” and write 2020EIP, and the taxpayer identification number (social security number, or individual taxpayer identification number) of the recipient of the check.
- Include a brief explanation of the reason for returning the EIP.

The IRS provides a table with the address to return the check to based on the state on the webpage. The locations are:

Maine, Maryland, Massachusetts, New Hampshire, Vermont

Andover Refund Inquiry Unit
1310 Lowell St Mail
Stop 666A
Andover, MA 01810

Georgia, Iowa, Kansas, Kentucky, Virginia

Atlanta Refund Inquiry Unit
4800 Buford Hwy
Mail Stop 112
Chamblee, GA 30341

Florida, Louisiana, Mississippi, Oklahoma, Texas

Austin Refund Inquiry Unit
3651 S Interregional Hwy 35
Mail Stop 6542
Austin, TX 78741

New York

Brookhaven Refund Inquiry Unit
5000 Corporate Ct.
Mail Stop 547
Holtsville, NY 11742

Alaska, Arizona, California, Colorado, Hawaii, Nevada, New Mexico, Oregon, Utah, Washington, Wisconsin, Wyoming

Fresno Refund Inquiry Unit
5045 E Butler Avenue
Mail Stop B2007
Fresno, CA 93888

Arkansas, Connecticut, Delaware, Indiana, Michigan, Minnesota, Missouri, Montana, Nebraska, New Jersey, Ohio, West Virginia

Kansas City Refund Inquiry Unit
333 W Pershing Rd
Mail Stop 6800, N-2
Kansas City, MO 64108

Alabama, North Carolina, North Dakota, South Carolina, South Dakota, Tennessee

Memphis Refund Inquiry Unit
5333 Getwell Rd Mail
Stop 8422
Memphis, TN 38118

District of Columbia, Idaho, Illinois, Pennsylvania, Rhode Island

Philadelphia Refund Inquiry Unit
2970 Market St
DP 3-L08-151
Philadelphia, PA 19104

A foreign country, U.S. possession or territory, or use an APO or FPO address, or file Form 2555 or 4563, or are a dual-status alien.

Austin Refund Inquiry Unit
3651 S Interregional Hwy 35
Mail Stop 6542 AUSC
Austin, TX 78741