Current Federal Tax Developments

Week of May 25, 2020

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF MAY 25, 2020

Published in 2020 by Kaplan Financial Education.

Printed in the United States of America.

Current Federal Tax Developments

Kaplan Financial Education

Contents

SECTION: PPP LOAN
FOREIGN AFFILIATES COUNT FOR PPP LOAN 500 EMPLOYEE TEST BUT APPLICANTS BEFORE MAY 5 QUALIFY FOR RELIEF

Citation: RIN 3245-AH44, "Business Loan Program Temporary Changes; Paycheck Protection Program – Treatment of Entities with Foreign Affiliates," Small Business Administration, 5/18/2020

The Small Business Administration has issued interim final rules clarifying how foreign affiliates affect a borrower's qualification to obtain a Payroll Protection Program (PPP) loan.[1]

The IFR deals with whether an applicant must count employees of foreign affiliates who will generally have residences outside the United States when determining if the entity has more than 500 employees and thus is not eligible for a PPP loan. The SBA concludes that the answer will be yes if the foreign entity fits the definitions found in the SBA's own affiliation rules.

The IFR states:

> **1. Treatment of Foreign Affiliates**
>
> Are employees of foreign affiliates included for purposes of determining whether a PPP borrower has more than 500 employees?
>
> Yes. The CARES Act specifies that an entity is eligible for a PPP loan only if it is (1) a small business concern, or (2) a business concern, nonprofit organization described in section 501(c)(3) of the Internal Revenue Code, veterans organization described in section 501(c)(19) of the Internal Revenue Code, or Tribal business concern described in section 31(b)(2)(C) of the Small Business Act that employs not more than the greater of 500 employees, or, if applicable, SBA's employee-based size standard for the industry in which the entity operates. SBA's affiliation regulations provide that to determine a concern's size, employees of the concern "and all of its domestic and foreign affiliates" are included. 13 C.F.R. 121.301(f). Therefore, to calculate the number of employees of an entity for purposes of determining eligibility for the PPP, an entity must include all employees of its

---

[1] RIN 3245-AH44, "Business Loan Program Temporary Changes; Paycheck Protection Program – Treatment of Entities with Foreign Affiliates," Small Business Administration, May 18, 2020, https://home.treasury.gov/system/files/136/Interim-Final-Rule-on-Treatment-of-Entities-with-Foreign-Affiliates.pdf (retrieved May 18, 2020)

> domestic and foreign affiliates, except in those limited circumstances where the affiliation rules expressly do not apply to the entity. Any entity that, together with its domestic and foreign affiliates, does not meet the 500-employee or other applicable PPP size standard is therefore ineligible for a PPP loan.

However, the SBA concludes that the agency's guidance prior to May 5 may have led a borrower to reasonably conclude that foreign affiliates could be excluded from the 500-employee test. Thus, the IFR provides relief for a borrower who applied before the issuance of the May 5 frequently asked questions (FAQ). The IFR continues:

> However, as an exercise of enforcement discretion due to reasonable borrower confusion based on SBA guidance (which was later resolved through a clarifying FAQ on May 5, 2020), SBA will not find any borrower that applied for a PPP loan prior to May 5, 2020 to be ineligible based on the borrower's exclusion of non-U.S employees from the borrower's calculation of its employee headcount if the borrower (together with its affiliates) had no more than 500 employees whose principal place of residence is in the United States. Such borrowers shall not be deemed to have made an inaccurate certification of eligibility solely on that basis. Under no circumstances may PPP funds be used to support non-U.S. workers or operations.

SECTION: PPP LOAN
§501(C)(12) ELECTRIC COOPERATIVES ARE ELIGIBLE FOR PPP LOANS

Citation: RIN 3245-AH43, "Business Loan Program Temporary Changes; Paycheck Protection Program – Eligibility of Certain Electric Cooperatives," Small Business Administration, 5/14/2020

The SBA issued a new interim final regulation that is focused on the qualification of certain electric cooperatives under the PPP loan program.[2]

The preamble explains the entities that this IFR applies to:

> Existing SBA regulations define a "business concern" as "a business entity organized for profit," subject to certain limitations. 13 CFR 121.105(a)(1). Generally, electric cooperatives are organizations that are owned and controlled by members who receive services from the cooperative. Electric cooperatives periodically return any excess of net

[2] RIN 3245-AH43, "Business Loan Program Temporary Changes; Paycheck Protection Program – Eligibility of Certain Electric Cooperatives," Small Business Administration, May 14, 2020, https://home.treasury.gov/system/files/136/Interim-Final-Rule-on-Eligibility-of-Certain-Electric-Cooperatives.pdf (retrieved May 14, 2020)

> operating revenues over their cost of operations – generally referred to as "savings" – to their member-owners. In addition, electric cooperatives meeting the description of section 501(c)(12) of the Code may be exempt from federal income taxation under section 501(a) of the Code. To qualify for the exemption, an electric cooperative must receive at least 85 percent of its income each year from its members. The 85 percent member income test is computed annually. An electric cooperative may be exempt in one year, lose exemption in another year if it does not derive at least 85 percent of its income from members, and become exempt in a third year. Because of their potential tax exemption under section 501(c)(12) of the Code, electric cooperatives have faced uncertainty about their eligibility to receive PPP loans.

The SBA has decided that even though these organizations are tax exempt entities under a provision of §501 other than §501(c)(3), they should still qualify for participation in the PPP loan program:

> **1. Eligibility of Certain Electric Cooperatives**
>
> Are electric cooperatives that are exempt from federal income taxation under section 501(c)(12) of the Internal Revenue Code eligible for a PPP loan?
>
> Yes. Electric cooperatives provide utility services and distribute savings to their member-owners. Accordingly, for purposes of the PPP, the Administrator, in consultation with the Secretary, has determined that an electric cooperative that is exempt from federal income taxation under section 501(c)(12) of the Internal Revenue Code will be considered to be "a business entity organized for profit" for purposes of 13 CFR 121.105(a)(1). As a result, such entities are eligible PPP borrowers, as long as other eligibility requirements are met. To be eligible, an electric cooperative must satisfy the employee-based size standard established in the CARES Act, SBA's employee-based size standard corresponding to its primary industry, if higher, or both tests in SBA's "alternative size standard."1 The Administrator, in consultation with the Secretary, has determined that this treatment is appropriate to effectuate the purposes of the CARES Act to provide assistance to eligible PPP borrowers, including business concerns, affected by the COVID-19 emergency.

SECTION: PPP LOAN
SAFE HARBOR PPP LOAN REPAYMENT DATE EXTENDED TO MAY 18

Citation: "Paycheck Protection Program Loans Frequently Asked Questions (FAQs)," Small Business Administration, May 13, 2020 3rd version, 5/13/20

The SBA is now offering one more extension of time to repay a loan under the safe harbor that was originally set at May 7 in third iteration of the PPP loan FAQ issued on May 13.[3] Now the SBA has delayed the date for repayment to avoid a question regarding the certification of the need for the loan to May 18th. Of interest, though, is that this has been issued on the same day the SBA issued guidance that provided the question would not be asked on loans of less than $2 million, as well as providing a later safe harbor for repaying the loan if the SBA determines there was no need for the loan.

The one major reason left to repay the loan would be to obtain the right to claim the employee retention credit in the future, assuming the IRS will move the date to repay the loan and regain the right to claim the credit to May 18.

The new Q&A reads:

> 47. Question: An SBA interim final rule posted on May 8, 2020 provided that any borrower who applied for a PPP loan and repays the loan in full by May 14, 2020 will be deemed by SBA to have made the required certification concerning the necessity of the loan request in good faith. Is it possible for a borrower to obtain an extension of the May 14, 2020 repayment date?
>
> Answer: Yes, SBA is extending the repayment date for this safe harbor to May 18, 2020, to give borrowers an opportunity to review and consider FAQ #46. 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.

---

[3] "Paycheck Protection Program Loans Frequently Asked Questions (FAQs)," Small Business Administration, May 13, 2020 3rd version, https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf (retrieved May 13, 2020)

SECTION: PPP LOAN
SBA GIVES LIMITED OPTIONS FOR ADDITIONAL DISBURSEMENTS UNDER PPP LOANS

Citation: RIN 3245-AH42, "Business Loan Program Temporary Changes; Paycheck Protection Program – Loan Increases," 5/13/20

The Small Business Administration (SBA) has issued a set of interim final regulations on the PPP loan program entitled "Business Loan Program Temporary Changes; Paycheck Protection Program – Loan Increases."[4]

The preamble to the interim final regulations explains the need for this guidance, overriding the general rule that a borrower cannot receive multiple PPP loans:

> On April 14, 2020, SBA posted an interim final rule that, among other things, provided guidance for individuals with self-employment income (85 FR 21747). The interim final rule stated, "if you are a partner in a partnership, you may not submit a separate PPP loan application for yourself as a self-employed individual. Instead, the self-employment income of general active partners may be reported as a payroll cost, up to $100,000 annualized, on a PPP loan application filed by or on behalf of the partnership." On April 28, 2020, the Department of the Treasury posted an interim final rule that provided an alternative criterion for calculating the maximum loan amount for PPP loans issued to seasonal employers (85 FR 23917).
>
> Some PPP loans were approved to partnerships or seasonal employers before the additional guidance was issued and, as a result, those businesses may not have received PPP loans in the maximum amount for which they are eligible. This interim final rule authorizes all PPP lenders to increase existing PPP loans to partnerships or seasonal employers to include appropriate amounts to cover partner compensation in accordance with the interim final rule posted on April 14, 2020, or to permit the seasonal employer to calculate its maximum loan amount using the alternative criterion posted on April 28, 2020.
>
> In addition, although the interim final rule on disbursements posted on April 28, 2020, requires PPP loans to be disbursed in a single disbursement, if a PPP loan that is increased has already been disbursed, this interim final rule authorizes the lender to make an additional disbursement of the increased loan proceeds prior to

---

[4] RIN 3245-AH42, "Business Loan Program Temporary Changes; Paycheck Protection Program – Loan Increases," May 13, 2020, https://home.treasury.gov/system/files/136/Interim-Final-Rule-on-Loan-Increases.pdf (retrieved May 13, 2020)

> submission of the initial SBA Form 1502 that includes that loan. SBA Form 1502 is required to be submitted within 20 calendar days after a PPP loan is approved or, for loans approved before availability of the updated SBA Form 1502 reporting process, by May 22, 2020.

As is noted, this is not a general purpose rule that allows "fixing" loans where a lender failed to properly compute the maximum loan amount. Rather, this provision allows the issuance of an additional loan disbursement only for the specific partnership and seasonal employee issues discussed.

Partnership Additional Loan

The IFR for partnership additional loans reads as follows:

> **1. Loan Increases**
>
> *a. If a partnership received a PPP loan that did not include any compensation for its partners, can the loan amount be increased to include partner compensation?*
>
> Yes. If a partnership received a PPP loan that only included amounts necessary for payroll costs of the partnership's employees and other eligible operating expenses, but did not include any amount for partner compensation, the lender may electronically submit a request through SBA's E-Tran Servicing site to increase the PPP loan amount to include appropriate partner compensation, even if the loan has been fully disbursed, provided that the lender's first SBA Form 1502 report to SBA on the PPP loan has not been submitted. After the initial SBA Form 1502 report on the PPP loan has been submitted to SBA, or after the date the first SBA Form 1502 was required to be submitted to SBA, the loan cannot be increased. In no event can the increased loan amount exceed the maximum loan amount allowed under the PPP Program, which is $10 million for an individual borrower or $20 million for a corporate group. Additionally, the borrower must provide the lender with required documentation to support the calculation of the increase.
>
> The interim final rule posted on April 14, 2020, describes how partnerships, rather than individual partners are eligible for a PPP loan. The interim final rule further explained that the self-employment income of general active partners could be reported as a payroll cost, up to $100,000 annualized, on a PPP loan application filed by or on behalf of the partnership. Guidance describing how to calculate partnership PPP loan amounts and defining the self-employment income of partners was posted on April 24, 2020 (see How to Calculate Maximum Loan Amounts, Question 4 at https://www.sba.gov/sites/default/files/2020-04/How-toCalculate-Loan-Amounts.pdf).

Footnote 2 to Section 1.a. above provides:

> As set forth in the interim final rule posted on April 14, 2020, a partner in a partnership may not submit a separate PPP loan

> application as a self-employed individual. Instead, the self-employment income of general active partners may be reported as a payroll cost, up to $100,000 annualized, on a PPP loan application filed by or on behalf of the partnership.

Note, as well, that this does not authorize the additional funds forever—just until the bank submits the SBA Form 1502 (*Guaranty Loan Status & Lender Remittance Form*).

Seasonal Employers Additional Loan

A similar rule is provided for seasonal employers. Section 1.b. provides:

> *If a seasonal employer received a PPP loan before the alternative criterion for determining the maximum loan amount for seasonal employers became available, can the loan amount be increased based on a revised calculation using the alternative criterion?*
>
> Yes. If a seasonal employer received a PPP loan before the alternative criterion for such employers was posted on April 28, 2020, and would be eligible for a higher maximum loan amount under the alternative criterion, the lender may electronically submit a request through SBA's E-Tran Servicing site to increase the PPP loan amount, even if the loan has been fully disbursed, provided that the lender's first SBA Form 1502 report to SBA on the PPP loan has not been submitted. After the initial SBA Form 1502 report has been submitted to SBA, or after the date the initial SBA Form 1502 report was required to be submitted to SBA, the loan cannot be increased. In no event can the increased loan amount exceed the maximum loan amount allowed under the PPP Program, which is $10 million for an individual borrower or $20 million for a corporate group. Additionally, the borrower must provide the lender with required documentation to support the calculation of the increase.

Interim Final Rule for Lenders on Disbursements and 1502 Reporting on Increased PPP Loans.

The interim final rule provides the following guidance to lenders on disbursements and reporting under this IFR.

Section 2.a. provides:

> *If a borrower's PPP loan has already been fully disbursed, can the lender make an additional disbursement for the increased loan proceeds?*
>
> Yes. Notwithstanding the requirement set forth in paragraph 1.a. of the interim final rule on disbursements posted on April 28, 2020, i.e., that lenders make a one-time, full disbursement of the PPP loan within ten calendar days of loan approval, if a PPP loan is increased under paragraphs 1.a. or b. above, the lender may make a single additional disbursement of the increased loan proceeds prior to submission of the initial SBA Form 1502 report for that loan.

Reporting on Form 1502 by the lender in this situation is described in Section 2.b. of the IFR:

> *How do lenders report disbursements on PPP loans that are increased and does the increase in the loan delay the timeframe to report the loan on the SBA Form 1502?*
>
> SBA set forth in the interim final rule on disbursements and 1502 reporting posted on April 28, 2020, the process lenders must follow to electronically upload SBA Form 1502 information on PPP loans. The interim final rule provided that lenders must submit the SBA Form 1502 information within 20 calendar days after a PPP loan is approved or, for loans approved before availability of the updated SBA Form 1502 reporting process, by May 18, 2020. In its interim final rule posted on May 8, 2020, SBA revised that date from May 18, 2020 to May 22, 2020. Lenders must comply with the initial 1502 reporting deadline. SBA may review at any time an increase submitted by the lender to confirm that the increase was submitted within the required timeframe; increases submitted outside the required timeframe will not be forgiven and no processing fee will be earned on such amounts. Additionally, lenders are not entitled to processing fees on increases submitted outside of the required timeframe.

SECTION: PPP LOAN
SBA ANNOUNCES PPP LOANS TO UNAFFILIATED BORROWERS OF LESS THAN $2 MILLION WILL NOT HAVE GOOD FAITH CERTICATION QUESTIONED

Citation: "Payroll Protection Program Loans Frequently Asked Questions," Small Business Administration, May 13, 2020 edition, 5/13/20

In an FAQ[5] updated on May 13, 2020, the SBA appears to have mostly backed off the threat to review PPP loans of less than $2 million for improperly certifying their loan was necessary.

On April 29, 2020, Treasury Secretary Mnunchin and SBA Administrator Jovita Carranza issued a Joint Statement that read, in part:

> To further ensure PPP loans are limited to eligible borrowers, the SBA has decided, in consultation with the Department of the Treasury, that it will review all loans in excess of $2 million, <u>in addition to other loans</u>

[5] "Payroll Protection Program Loans Frequently Asked Questions," Small Business Administration, May 13, 2020 edition, https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf (retrieved May 13, 2020)

> as appropriate, following the lender's submission of the borrower's loan forgiveness application. Regulatory guidance implementing this procedure will be forthcoming.[6]

The statement specifically was issued discussing the review of loans and repayment before the then May 7 deadline to avoid having questions raised regarding the correctness of a borrower's certification that a loan was necessary.

In the interim many small borrowers began worrying that they might face this scrutiny and a number went ahead and took advantage of the SBA's safe harbor repayment date (which was extended until May 14) out of concern the SBA might decide their loan wasn't necessary.

Now the SBA has effectively reversed course and, on the day before the repayment deadline, held that any loans totaling less than $2 million for a borrower and any affiliates will be deemed to have certified their need for the loan in good faith.

The new Q&A 46 reads:

> **Question: How will SBA review borrowers' required good-faith certification concerning the necessity of their loan request?**
>
> Answer: When submitting a PPP application, all borrowers must certify in good faith that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." SBA, in consultation with the Department of the Treasury, has determined that the following safe harbor will apply to SBA's review of PPP loans with respect to this issue: Any borrower that, together with its affiliates, received PPP loans with an original principal amount of less than $2 million will be deemed to have made the required certification concerning the necessity of the loan request in good faith.
>
> SBA has determined that this safe harbor is appropriate because borrowers with loans below this threshold are generally less likely to have had access to adequate sources of liquidity in the current economic environment than borrowers that obtained larger loans. This safe harbor will also promote economic certainty as PPP borrowers with more limited resources endeavor to retain and rehire employees. In addition, given the large volume of PPP loans, this approach will enable SBA to conserve its finite audit resources and focus its reviews on larger loans, where the compliance effort may yield higher returns.
>
> Importantly, borrowers with loans greater than $2 million that do not satisfy this safe harbor may still have an adequate basis for making the

---

[6] "Joint Statement by Secretary Steven T. Mnuchin and Administrator Jovita Carranza on the Review Procedure for Paycheck Protection Program Loans," U.S. Department of the Treasury website, April 28, 2020, https://home.treasury.gov/news/press-releases/sm991 , retrieved April 29, 2020

> required good-faith certification, based on their individual circumstances in light of the language of the certification and SBA guidance. SBA has previously stated that all PPP loans in excess of $2 million, and other PPP loans as appropriate, will be subject to review by SBA for compliance with program requirements set forth in the PPP Interim Final Rules and in the Borrower Application Form. If SBA determines in the course of its review that a borrower lacked an adequate basis for the required certification concerning the necessity of the loan request, SBA will seek repayment of the outstanding PPP loan balance and will inform the lender that the borrower is not eligible for loan forgiveness. If the borrower repays the loan after receiving notification from SBA, SBA will not pursue administrative enforcement or referrals to other agencies based on its determination with respect to the certification concerning necessity of the loan request. SBA's determination concerning the certification regarding the necessity of the loan request will not affect SBA's loan guarantee.

In a footnote, the SBA reminds the reader where to find the affiliates rules for this safe harbor:

> For purposes of this safe harbor, a borrower must include its affiliates to the extent required under the interim final rule on affiliates, 85 FR 20817 (April 15, 2020).

It is also important to note that, in the final paragraph of the answer, the SBA is also toning down the threats to borrowers who had larger loans, stating that they would be given a chance to repay the loan before any enforcement action or referrals to other agencies (such as the Justice Department) would take place if the SBA concludes their loan request was not necessary.

SECTION: 83
MEMORANDUM DISCUSSES IRS VIEW ON TIMING FOR PAYROLL PURPOSES OF INCOME INCLUSION FOR STOCK OPTIONS, STOCK-SETTLED SARS AND STOCK-SETTLED RSUS

Citation: AM-2020-004, 5/22/20

Many employers offer some form of stock-based compensation to employees. In AM-2020-004[7] the IRS has issued guidance related to the computation of payroll and withholding taxes on certain types of such compensation, as well as the timing of payroll tax deposits related to such compensation.

---

[7] AM-2020-004, May 22, 2020, https://www.irs.gov/pub/lanoa/am-2020-004.pdf (retrieved May 22, 2020)

The guidance deals with three different programs:

- Nonqualified stock options
- Stock-settled stock appreciation rights (SARs)
- Stock-settled restricted stock unit (RSU)

The ruling poses an example situation for each of these types of compensation, and looks to resolve the following issue:

> When does (i) income inclusion and application of FICA taxes and federal income tax withholding and (ii) the employer's obligation to deposit withheld employment taxes occur with respect to each of the following stock-settled awards?[8]

The memorandum does caution that it is not addressing the impact of the deferral of employer OASDI under CARES Act §2302 for the period from March 27, 2020 through December 31, 2020.

A key complication in dealing with these programs is the inherent short delay between the time an employee exercises the right or, in the case of RSUs, vests in the shares and when the shares are deposited into the employee's brokerage account. Especially in times when the market is volatile, there can be a substantial difference in the value of the underlying stock between the date the employee exercises the option or vests, and the date the stock is deposited into the brokerage account established to hold the stock.

As the memorandum notes:

> When a service provider exercises a stock award (such as a stock option or a stock-settled SAR) or the service recipient initiates payment under a stock award (such as a stock-settled RSU), the service recipient or a securities broker (broker) makes a request to the service recipient's transfer agent to transfer shares held in the service recipient's account with the transfer agent to the broker's account with the transfer agent. The broker then holds the shares on behalf of the service provider until the service provider decides to sell the shares. If, at the time of exercise, the service provider elects to sell shares to pay the exercise price or satisfy the tax withholding obligations, then the broker instructs the transfer agent to sell those shares.
>
> Due to Securities and Exchange Commission (SEC) regulations that apply to transfer agents and securities brokers, there is generally a short delay (settlement cycle) between the exercise of the option and settlement of the option exercise (delivery of the shares to the service provider's brokerage account or sale of the shares to cover the exercise price/withholding taxes). This same settlement cycle applies to the exercise of a stock-settled SAR as well as the payment under a stock-settled RSU. With respect to a stock-settled RSU, the short delay

---

[8] AM-2020-004, p. 1

> occurs between initiation of payment by the service recipient and delivery of the shares to the service provider's brokerage account. Prior to September 5, 2017, the settlement cycle could not exceed three days. On March 22, 2017, the SEC amended the settlement cycle regulations to provide that the settlement cycle could not exceed two days effective September 5, 2017. 17 C.F.R. § 240.15c6-1(a).

Nonqualified Stock Options

The memorandum gives the following definition of a stock option for purposes of this ruling:

> A stock option is a contractual right to purchase one or more shares of stock from a corporation by virtue of an offer of the corporation continuing for a stated period of time, whether or not irrevocable, to sell such stock at a specified price.[9]

The fact situation posed in the memorandum for the stock option is as follows:

> On January 2, 2020, Employer (a publicly traded corporation) grants Employee a nonstatutory stock option to purchase 10 shares of Employer stock. The exercise price is $10 per share, which is the fair market value of each share on the date of grant. On the date of grant, the stock option has no readily ascertainable fair market value as defined in Treas. Reg. § 1.83-7(b). The stock option does not provide for a deferral of compensation under I.R.C. § 409A and Treas. Reg. § 1.409A-1(b)(5)(i)(A). The stock option vests and becomes exercisable with respect to all 10 shares of Employer on January 2, 2021. Employee can exercise the stock option at any time from January 2, 2021 through January 2, 2024. The shares delivered upon exercise of the option are substantially vested as defined in Treas. Reg. § 1.83-3(b). On December 29, 2021, Employee exercises the option to purchase the shares. On the date of exercise, the fair market value of each share is $15. On December 31, 2021, the shares are delivered to Employee's brokerage account. On the delivery date, the fair market value of each share is $14.[10]

The memorandum holds that the employee obtains ownership via beneficial interest on the date the option is exercised, even if the actual delivery is not the same day. The memorandum states:

> An employee acquires a beneficial interest in the underlying shares of stock upon exercising a stock option. For example, in Walter, the Tax Court ruled that, upon the exercise of a stock option, the employee became the beneficial owner of the underlying stock because, upon exercise, the employee incurred the risk that the value of the stock would decline. *Walter*, TC Memo 2007-2, at 7. Rev. Rul. 70-335, 1970-

---

[9] AM-2020-004, p. 1

[10] AM-2020-004, pp. 1-2

> 1 C.B. 111, holds that stock is considered transferred on the date the employee delivers to the grantor corporation written notice of the stock option exercise with full payment even though the plan provides that the employee has no interest in the stock until issuance of the stock certificates. In both *Walter* and Rev. Rul. 70-335, the employee incurred the risk that the value of the stock would decline and thus acquired beneficial ownership of the stock upon exercise of the stock option. When the employee exercises a stock option (thus initiating the process pursuant to which the employer transfers the stock), the number of shares and fair market value of the stock received by the employee are fixed and determinable, even though the value of the stock may decrease or increase prior to actual delivery of the shares (for example, during the period of delay between exercise and delivery of the shares to the employee's brokerage account). The employee's ability to (1) pledge the stock as collateral for a loan to exercise the option, and (2) direct the sale of shares to repay the loan or to satisfy the tax withholding obligation upon exercising the stock award are also indications of beneficial ownership. Accordingly, for purposes of I.R.C. § 83, the transfer of shares of stock occurs on December 29, 2021, the date on which Employee exercises the stock option.[11]

In a footnote, the memorandum expands on the reasoning the court used in *Walter* to determine there was beneficial ownership at the exercise date:

> In concluding that an employee acquired a beneficial ownership of shares of stock on the date of exercising the stock options, the court in *Walter* also explained that the employee's exercise of the stock options constituted an "unconditional acceptance of [the employer's] offer under the stock option grants and created a contract between [the employer] and petitioner for the sale of the exercised shares of stock." *Walter*, TC Memo 2007-2, at 6. In other words, an employee acquires a beneficial ownership in stock under a stock option when the employee is contractually obligated to purchase the underlying shares. This is consistent with the definition of transfer in Treas. Reg. § 1.83-3(a) and the Ninth Circuit's description of *Theophilos* in *Pahl*.[12]

The taxation of the stock option is governed by IRC §83. The IRS continues the analysis in the memorandum to determine the amount of the income inclusion:

> When an employee exercises a stock option, I.R.C. § 83 applies to the transfer of stock pursuant to the exercise and compensation is realized upon such transfer at the time and in the amount determined under I.R.C. § 83(a). See Treas. Reg. § 1.83-7(a). To determine the amount of compensation realized, I.R.C. § 83(a) provides, in relevant part, that the excess of the fair market value of the transferred property over the amount (if any) paid for such property shall be included in the gross income of the person who performed such services. In other words,

[11] AM-2020-004, pp. 12-13

[12] AM-2020-004, p. 12

> the amount of compensation realized is the excess of the fair market value of the stock on the date of exercise over the exercise price. In accordance with Treas. Reg. § 1.83-7(a), such compensation is included in gross income upon exercise of the option because that is when the transfer of the underlying stock occurs for purposes of I.R.C. § 83. Accordingly, on December 29, 2021, $50 [10 shares x ($15 FMV on date of exercise – $10 exercise price)] is includible in Employee's gross income.[13]

The IRS cites to additional authority in a footnote to this analysis which provides:

> See also Rev. Rul. 67-257, 1967-2 C.B. 359, which holds that because the employees have an unconditional right to receive stock upon payment of the exercise price, the excess of the fair market value of the stock on the date of exercise over the option price is compensation includible in the employee's gross income at the time the option is exercised.[14]

Finally, the IRS concludes that the option is valued based on the higher value at the date of exercise, providing:

> Even though the fair market value of each share is $14 on December 31, 2021 when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83 nor the wage amount subject to FICA taxes or federal income tax withholding. At the time Employee exercised the stock option on December 29, 2021, when the fair market value of the stock was $15 per share, Employee incurred the risk that the value of the stock would decline.
>
> On December 29, 2021, when Employee exercises the option to purchase the shares, Employee has beneficial ownership of the stock. Furthermore, when Employee exercises the option, the stock was made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time. Therefore, on December 29, 2021, the $50 stock payment constitutes wages that have actually or constructively been received by the Employee and is subject to FICA taxes and federal income tax withholding at that time.[15]

---

[13] AM-2020-004, p. 13

[14] AM-2020-004, p. 13

[15] AM-2020-004, p. 13

In a footnote, the IRS also references Rev. Rul. 67-257. *Cf.* Rev. Rul. 78-185 and Rev. Rul. 79-305 in support of the position that the exercise makes the stock available to the employee.[16]

The analysis concludes by looking at the payroll tax deposit date implications of this transaction—and, again, the date of exercise governs when the employer treats the payroll tax liability as having been incurred (and thus the date by which a deposit must be made). The memorandum states:

> If, in conjunction with other wage payments, Employer has accumulated $100,000 or more in employment taxes upon the $50 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.[17]

Stock-Settled Stock Appreciation Rights (SARs)

In the memorandum the IRS defines a stock-settled SAR as:

> A stock-settled SAR is a right to stock based on the appreciation in value of a specified number of shares of stock during a specified period (such as a period beginning on the date of grant or some other specified date and the date of exercise of such right). Although less typical, the terms of the SAR may also provide that the stock will be paid on a specified date and not require the service provider to exercise the SAR. These facts do not contemplate or address the situation in which the SAR is settled only in cash.[18]

As the explanation notes, most often such rights are *not* settled in stock and, thus, the analysis does not apply to the more typical situation where the SAR is settled in cash.

The facts in the situation to be discussed in this memorandum are as follows:

> On January 2, 2020, Employer (a publicly traded corporation) grants Employee 10 stock-settled SAR's. The 10 stock-settled SAR's vest and become exercisable on January 2, 2021. Employee can exercise the SAR's at any time from January 2, 2021 through January 2, 2024. Each SAR entitles Employee to receive upon exercise a number of shares of the common stock of Employer equal to the excess of the fair market value of a share of Employer common stock on the date Employee exercises the SAR over the fair market value of a share of such stock

---

[16] AM-2020-004, p. 13

[17] AM-2020-004, p. 13-14

[18] AM-2020-004, p. 2

> on the date of grant, divided by the fair market value of a share of such stock on the date of exercise. The SAR's do not provide for a deferral of compensation under I.R.C. § 409A and Treas. Reg. § 1.409A1(b)(5)(i)(B). The shares received upon exercise of the SAR are substantially vested as defined in Treas. Reg. § 1.83-3(b). On January 2, 2020, the fair market value per share of the Employer common stock was $10. On December 29, 2021, when the fair market value of each share of Employer stock is $25, Employee exercises all of the SAR's. On December 31, 2021, the shares are delivered to Employee's brokerage account. On the delivery date, the fair market value of each share is $24.[19]

In this case, the analysis is similar to that of the stock option:

> A stock-settled SAR is, in substance, a stock option without an exercise price. Upon exercising the stock-settled SAR, an employee acquires a beneficial ownership in the underlying shares of stock because the employee incurs the risk that the value of the stock would decline. Accordingly, the transfer of shares of stock occurs on December 29, 2021, the date on which Employee exercises the stock-settled SAR. Therefore, on December 29, 2021, $150 [10 SAR's x ($25 FMV per share on date of exercise — $10 FMV per share on date of grant)], which is the fair market value of 6 shares on the date of exercise ($150 total FMV/$25 FMV per share on date of exercise = 6 shares), is includible in Employee's gross income.
>
> Even though the fair market value of each share is $24 on December 31, 2021 when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into account in determining the amount of compensation income includible under I.R.C. § 83 nor the wage amount subject to FICA taxes or federal income tax withholding. At the time Employee exercised the stock option on December 29, 2021, when the fair market value of the stock was $25 per share, Employee incurred the risk that the value of the stock would decline.[20]

The result for the employee is much the same as it was for the stock option:

> On December 29, 2021, when Employee exercises the stock settled SAR, Employee has beneficial ownership of the stock. Furthermore, when Employee exercises the option, the stock was made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time. Therefore, on December 29, 2021, the $150 stock payment constitutes wages that have been actually or constructively received by the Employee and is

[19] AM-2020-004, p. 2

[20] AM-2020-004, p. 14

> subject to FICA taxes and federal income tax withholding at that time.[21]

As well, the payroll tax deposit rules are similar to the result for the stock option:

> If, in conjunction with other wage payments, Employer has accumulated $100,000 or more in employment taxes upon the $150 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.[22]

Stock Settled Restricted Stock Unit (RSU)

The memorandum describes a stock-settled RSU as follows:

> A stock-settled RSU is an unsecured and unfunded promise by the service recipient to pay one or more shares of stock to the service provider at a future date following a specified vesting condition. The terms of a RSU typically provide that the payment of the stock will occur upon or within a short period of time following the satisfaction of the vesting condition. If payment occurs no later than two and a half months after the end of the taxable year in which the vesting condition was satisfied, then the payment is not considered deferred compensation. See Treas. Reg. § 1.409A-1(b)(4). If the payment occurs more than two and a half months after the end of the taxable year in which the vesting condition was satisfied, then the RSU provides for a deferral compensation and is subject to the requirements of I.R.C. § 409A. See Treas. Reg. § 1.409A-1(b)(1). These facts do not contemplate or address the situation in which the RSU is settled only in cash.[23]

As the description notes, unlike the first two structures mentioned, most often RSUs are considered deferred compensation, subjecting them to the special rules for determining when the value is subject to payroll taxes, as well as potentially running into §409A issues (though those are not really relevant to the memorandum).

The facts in this example are as follows:

> On January 2, 2020, Employer (a publicly traded corporation) grants Employee a stock-settled RSU that entitles Employee to 10 shares of Employer's common stock if Employee continues to provide services

---

[21] AM-2020-004, p. 14

[22] AM-2020-004, p. 14

[23] AM-2020-004, p. 3

> to Employer until December 29, 2021. The terms of the RSU provide that payment of the shares will occur on the date the vesting condition is satisfied. The shares received upon payment of the RSU are not subject to a substantial risk of forfeiture. On December 29, 2021, Employee satisfies the vesting condition and Employer initiates payment of the 10 shares of stock. The fair market value of each share of stock is $25 on December 29, 2021. On December 31, 2021, the shares are delivered to Employee's brokerage account. On the delivery date, the fair market value of each share is $24.

However, despite being a deferred compensation program in most cases, the final result is similar to the result for the other programs. The applicable law is discussed in the memorandum as the memo states:

> When the employer initiates payment under the RSU, the employee acquires a beneficial ownership in the underlying stock. When the employer initiates payment, the number of shares of stock to be transferred and the fair market value of the stock become fixed and determinable. At this time, the employee incurs the risk that the stock's fair market value may decrease or increase prior to actual delivery of the shares (for example, during the period of delay between the time the employer initiates payment and delivery of the shares to the employee's brokerage account). The employee's ability to direct the sale of stock to satisfy the tax withholding obligation is another indication of beneficial ownership. Thus, upon initiation of the payment, the employee is considered a beneficial owner of the stock and the stock is considered transferred for purposes of I.R.C. § 83. Accordingly, the transfer of shares of stock occurs on December 29, 2021, the date on which Employer initiates payment of the 10 shares of stock.17
>
> I.R.C. § 83(a) determines the amount of compensation realized upon the transfer and provides, in relevant part, that the excess of the fair market value of the transferred property over the amount (if any) paid for such property shall be included in the gross income of the person who performed such services. If the employee did not pay for the stock issued under the RSU, then the amount of compensation included in the employee's gross income is the fair market value of the stock on the date that the employer or broker initiates the payment. Accordingly, because Employee paid nothing for the shares, on December 29, 2021, $250 (10 shares x $25 FMV on date of transfer) is includible in Employee's gross income.[24]

The result for the employee is also very similar to the result in the case of the stock option and stock-settled SAR:

> Even though the fair market value of each share is $24 on December 31, 2021, when the shares are delivered to Employee's brokerage account, the value of the shares on the delivery date is not taken into

[24] AM-2020-004, p. 15

> account in determining the amount of compensation income includible under I.R.C. § 83. At the time Employer initiated payment on December 29, 2021, when the fair market value of the stock was $25 per share, Employee incurred the risk that the value of the stock would decline.[25]

However, since this is a deferred compensation program, the explanation for the result for the employer and payroll tax deposits is different, though it arrives at much the same result:

> I.R.C. § 3121(v)(2) determines the FICA tax treatment of NQDC plans. A RSU award is not a stock value right and therefore provides for the deferral of compensation. Amounts paid pursuant to the settlement of an RSU award are NQDC for FICA purposes and are subject to FICA taxes as of the later of (1) the date on which the services creating the right to the amount are performed, or (2) the date on which the right to the amount is no longer subject to a substantial risk of forfeiture. On December 29, 2021, when Employer initiates payment, the Employee's right to the shares of stock transferred is no longer subject to a substantial risk of forfeiture. Thus, the fair market value of the shares of stock transferred in the amount of $250 is an amount paid subject to FICA taxes at that time.
>
> As stated above, on December 29, 2021, when Employer initiates payment, Employee has beneficial ownership of the stock. Furthermore, when Employer initiates payment, the stock is made available to the Employee without any substantial limitation or restriction and was available to be used by the Employee at any time. Therefore, on December 29, 2021, the $250 stock payment constitutes wages that have been actually or constructively received by the Employee and is subject to federal income tax withholding at that time.
>
> If, in conjunction with other wage payments, Employer has accumulated $100,000 or more in employment taxes upon the $250 stock payment date of December 29, 2021, then pursuant to the One-Day rule, Employer has an obligation to deposit such employment taxes by the close of the next day, December 30, 2021. If the Employer does not deposit such employment taxes by December 30, 2021, then under the Code the IRS may impose an FTD penalty upon the Employer unless it is shown that such failure is due to reasonable cause and not due to willful neglect.[26]

---

[25] AM-2020-004, p. 15

[26] AM-2020-004, p. 16

SECTION: 125
MAXIMUM FSA CARRYOVER SET TO 20% OF MAXIMUM DEFERRAL AND CHANGE IN TIMING FOR REIMBURSEMENT FOR INDIVIDUAL PREMIUM PROVIDED FOR IN IRS NOTICE

Citation: Notice 2020-33, 5/12/2020

In Notice 2020-23[27] 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 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

---

[27] Notice 2020-23, May 12, 2020, https://www.irs.gov/pub/irs-drop/n-20-33.pdf (retrieved May 12, 2020)

> 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.

SECTION: 125
COVID-19 RELIEF PROVIDED FOR §125 PLANS AND PARTICIPANTS

Citation: 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.[28] 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

[28] Notice 2020-29, May 12, 2020, https://www.irs.gov/pub/irs-drop/n-20-29.pdf (retrieved May 12, 2020)

- Allowing retroactive relief to January 1, 2020 for issues related to high deductible health plans and telepath services.

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.

SECTION: 139
TAX TREATMENT OF CARES PAYMENTS TO STUDENTS DISCUSSED BY IRS IN FAQ

Citation: "FAQs: Higher Education Emergency Relief Fund and Emergency Financial Aid Grants under the CARES Act," IRS website, 5/7/20

In yet another set of Frequently Asked Questions on the IRS website, the IRS clarified the tax treatment of funds received by students under provisions of the CARES Act that allows the use of certain funds allocated by the Department of Education to support students.[29]

---

[29] "FAQs: Higher Education Emergency Relief Fund and Emergency Financial Aid Grants under the CARES Act," IRS website, May 7, 2020,

The IRS cites IRC §139 provisions to support the tax treatments outlined. This provides additional indirect support for those looking to potentially take advantage of §139 to provide tax free relief payments to employees and other parties, as this implicitly finds that the COVID-19 emergency meets the definition of a disaster that is covered by §139.

CARES Act Provisions Covered by the FAQ

The FAQ describes each of the CARES Act provisions as follows:

> Section 3504 of the CARES Act allows higher education institutions to use additional supplemental educational opportunity grant funds they receive through the Higher Education Act to award emergency financial aid grants to support graduate and undergraduate students experiencing "unexpected expenses and unmet financial need" as the result of the COVID-19 pandemic.
>
> Section 18004 of the CARES Act directs the Secretary of Education to allocate funds out of the Higher Education Relief Fund to higher education institutions to directly support students facing urgent needs related to the COVID-19 pandemic, and to support institutions as they cope with the immediate effects of the COVID-19 pandemic, including school closures. These funds may be used (1) to defray the institutions' expenses, including lost revenues and payroll for employees and (2) for "emergency financial aid grants to students for expenses related to the disruption of campus operations due to the COVID-19 pandemic (including eligible expenses under a student's cost of attendance, such as food, housing, course materials, technology, health care, and child care)." Recipient higher education institutions must pay no less than 50 percent of these funds to students as emergency financial aid grants.
>
> Section 18008 of the CARES Act directs the Secretary of Education to allocate additional funds to Howard University and Gallaudet University to directly support students facing urgent needs related to the COVID-19 pandemic, and to support these institutions as they cope with the immediate effects of the COVID-19 pandemic, including school closures. These funds may be used (1) by the institutions to help defray their expenses and (2) for "grants to students for expenses directly related to" the COVID-19 pandemic and for expenses "caused by the disruption of university operations" resulting from the COVID-19 pandemic.

---

https://www.irs.gov/newsroom/faqs-higher-education-emergency-relief-fund-and-emergency-financial-aid-grants-under-the-cares-act (retrieved May 12, 2020)

Income Tax Treatment of Funds Received by the Student

The IRS has determined that funds received by a student under these programs represents qualified disaster relief payments under IRC §139, and thus are not includable in income. Q&A 1 provides:

> **Q1: I am a student who received an emergency financial aid grant under section 3504, 18004, or 18008 of the CARES Act for unexpected expenses, unmet financial need, or expenses related to the disruption of campus operations on account of the COVID-19 pandemic. Is this grant includible in my gross income?**
>
> A1: No. Emergency financial aid grants under the CARES Act for unexpected expenses, unmet financial need, or expenses related to the disruption of campus operations on account of the COVID-19 pandemic, such as unexpected expenses for food, housing, course materials, technology, health care, or childcare, are qualified disaster relief payments under section 139 of the Internal Revenue Code. This grant is not includible in your gross income.

Tax Benefits Claimed for Items Reimbursed By CARES Act Payments

However, the IRS has decided that students are not able to claim a tax deduction or increased tax credits based on expenses paid for under this program. Q&A 2 provides:

> **Q2: I received an emergency financial aid grant under the CARES Act and used some of it to pay for course materials that are now required for online learning because my college or university campus is closed. Can I claim a tuition and fees deduction for the cost of these materials, or treat the cost of these materials as a qualifying education expense for purposes of claiming the American Opportunity Credit or the Lifetime Learning Credit?**
>
> A2: No. Because the emergency financial aid grant is not includible in your gross income, you cannot claim any deduction or credit for expenses paid with the grant including the tuition and fees deduction, the American Opportunity Credit, or the Lifetime Learning Credit. See section 139(h) of the Internal Revenue Code.

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.[30]

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.

[30] Revenue Procedure 2020-32, May 20, 2021, https://www.irs.gov/pub/irs-drop/rp-20-32.pdf (retrieved May 21, 2020)