Current Federal Tax Developments

Week of July 6, 2020

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JULY 6, 2020
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Kaplan Financial Education

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SECTION: CARES
PAYROLL TAX DEFERRAL FAQ UPDATED TO REFLECT PPPFA CHANGES

Citation: "Deferral of employment tax deposits and payments through December 31, 2020," IRS website, 6/26/20

The IRS has updated its FAQ on the deferral of employment tax deposits and payments through December 31, 2020[1] to take into account changes made by the Paycheck Protection Program Flexibility Act (PPPFA).

The CARES Act provided that employers were allowed to defer the payment of the employer portion of old age, survivors and disability insurance (the 6.2% FICA tax) for payments due on or after March 27, 2020 and before January 1, 2021. The employer would then pay the tax in two installments, one half due on December 31, 2021 and the other half due on December 31, 2022.

Under the original CARES Act provision, if a taxpayer had a PPP loan forgiven, the taxpayer would no longer be allowed to defer the employer taxes. The PPPFA eliminated this restriction, so all employers, regardless of whether they have a PPP loan forgiven or not, are eligible to take advantage of this deferral through the end of 2020.

The IRS has an updated Question 4 to the FAQ to reflect this change. Question 4 provides:

> **4. May an employer that receives a loan under the Small Business Administration Act, as provided in section 1102 of the CARES Act (the Paycheck Protection Program (PPP)), defer the deposit and payment of the employer's share of Social Security tax even if the loan has been forgiven (or partially forgiven) in accordance with paragraph (g) of section 1106 of the CARES Act, as amended by section 3 of the Paycheck Protection Program Flexibility Act of 2020 (PPP Flexibility Act)? (updated June 26, 2020)**
>
> Yes. The PPP Flexibility Act, enacted on June 5, 2020, amends section 2302 of the CARES Act by striking the rule that would have prevented an employer from deferring the deposit and payment of the employer's share of Social Security tax after the employer receives a decision that its PPP loan was forgiven by the lender. Therefore, an employer that

[1] "Deferral of employment tax deposits and payments through December 31, 2020," IRS website, June 26, 2020, https://www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020 (retrieved June 26, 2020)

> receives a PPP loan is entitled to defer the payment and deposit of the employer's share of Social Security tax, even if the loan is forgiven.
>
> Prior to the enactment of the PPP Flexibility Act, an employer that received a PPP loan was not permitted to defer deposit and payment of the employer's share of Social Security tax after the receipt of the lender's decision forgiving all or a portion of the employer's PPP loan.

SECTION: 401
RELIEF GRANTED TO MAKE CERTAIN AMENDMENTS TO SAFE HARBOR RETIREMENT PLANS TO SUSPEND OR REDUCE SAFE HARBOR CONTRIBUTIONS

Citation: Notice 2020-52, 6/29/20

Relief has been granted to certain employers who sponsor safe-harbor 401(k) and §403(b) plans to amend their plans in 2020 to reduce certain contributions in Notice 2020-52.[2] The relief is provided in response to economic issues arising due to the COVID-19 pandemic.

The relief covers two cases:

- An employer makes a mid-year amendment to a safe harbor §401(k) or §401(m) plan that reduces only contributions for highly compensated employees (HCEs); or
- An employer is making certain mid-year amendments to a safe harbor §401(k) or §401(m) plan that reduces or suspends safe harbor contributions.

Safe harbor plans are granted an exemption from meeting the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests. The ADP and ACP tests impose limits on the ability of highly compensated employees (as defined at IRC §414(q)) to make contributions to the plan unless the non-highly compensated employees (NHCE) make sufficient contributions to the plan.

To gain this exemption, the plan must either make a qualifying safe harbor non-elective contribution for all covered employees (whether or not they make any deferral under the plan) or make a qualifying safe harbor matching contribution to the account of each participant that defers under the plan.

Under the law and regulations governing such plans prior to the issuance of this Notice, the plan can only be amended mid-year to reduce the safe harbor contributions if the following conditions are satisfied as outlined in the Notice:

> Under § 1.401(k)-3(g)(1)(i)(A) and (ii)(A), the employer must either (1) be operating at an economic loss (as described in § 412(c)(2)(A)) for

[2] Notice 2020-52, June 29, 2020, https://www.irs.gov/pub/irs-drop/n-20-52.pdf (retrieved June 29, 2020)

> the plan year, or (2) have included in the plan's safe harbor notice (as described in § 1.401(k)-3(d)) for the plan year a statement that the plan may be amended during the plan year to reduce or suspend safe harbor contributions and that the reduction or suspension will not apply earlier than 30 days after all eligible employees are provided notice of the reduction or suspension. Under § 1.401(k)-3(g)(1)(i)(C) and (ii)(C), the reduction or suspension of safe harbor contributions may be effective no earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice described in § 1.401(k)-3(g)(2). Under § 1.401(k)-3(g)(1)(i)(D) and (ii)(D), eligible employees must be given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor contributions to change their cash or deferred elections and, if applicable, their employee contribution elections.[3]

The IRS Notice indicates that, due to the economic impact of the pandemic, employers may need to reduce or suspend their safe harbor contributions in order to "satisfy payroll and other operating costs."[4]

Reduction of Safe Harbor Contributions on Behalf of HCEs Only

One potential option some employers are wishing to implement is described in the Notice as follows:

> One option that an employer maintaining a safe harbor plan may be considering is to reduce plan contributions made on behalf of HCEs. However, an employer may be uncertain as to whether an amendment that reduces only contributions made on behalf of HCEs is subject to the conditions for reducing or suspending safe harbor contributions set forth in §§ 1.401(k)-3(g) and 1.401(m)-3(h).[5]

The IRS Notice clarifies that such an amendment that only impacts HCEs will be considered acceptable if proper notice is given. The Notice provides:

> As described in section II.B of this notice, contributions made on behalf of HCEs are not included in the definition of safe harbor contributions. Accordingly, a mid-year change that reduces only contributions made on behalf of HCEs is not a reduction or suspension of safe harbor contributions described in §§ 1.401(k)-3(g) and 1.401(m)-3(h). However, a mid-year change that reduces only contributions made on behalf of HCEs would be a mid-year change to a plan's required safe harbor notice content for purposes of section III.B of Notice 2016-16. Therefore, in order to satisfy the notice and election opportunity conditions of section III.C of Notice 2016-16,

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[3] Notice 2020-52, Section II.C

[4] Notice 2020-52, Section II.D

[5] Notice 2020-52, Section II.D

> which apply generally to changes that affect required safe harbor notice content and are not reductions or suspensions of safe harbor contributions, an updated safe harbor notice and an election opportunity must be provided to HCEs to whom the mid-year change applies, determined as of the date of issuance of the updated safe harbor notice.[6]

Other Reduction or Suspension of Safe-Harbor Contributions

The other option considered by employers for which relief is granted is described in the Notice as follows:

> An employer may also be considering reducing or suspending a plan's safe harbor matching contributions or safe harbor nonelective contributions. However, an employer may be uncertain as to whether it is operating at an economic loss for the plan year and, due to the unexpected nature of the COVID-19 pandemic, the employer may not have foreseen the need to have included a statement in the plan's safe harbor notice that safe harbor contributions may be reduced mid-year. Further, in light of the COVID-19 pandemic, an employer may have difficulty satisfying the timing requirements for providing notice of reductions or suspensions of safe harbor contributions.[7]

In this case, the IRS offers two different relief provisions. The net impact of these rules is that plans offering either type of safe harbor contribution option may amend their plans between March 13, 2020 and August 31, 2020 to reduce or suspend such contributions, but those making use of the safe harbor matching contribution option will still need to give 30 days notice to participants before the reduction can take place.

Note, as well, these changes will quite often result in the plan no longer qualifying as a safe harbor plan for 2020. If that is the case, the plan will be subject to ADP and ACP testing and HCEs may find their contributions to the plan limited.

Temporary Relief Related to Mid-Year Reductions or Suspensions of Safe Harbor Matching or Safe Harbor Nonelective Contributions

All plans will be allowed to make the amendments to reduce or suspend contributions, so long as the amendment is adopted between March 13, 2020 and August 31, 2020:

> If a plan amendment that reduces or suspends safe harbor matching contributions or safe harbor nonelective contributions during a plan year is adopted between March 13, 2020, and August 31, 2020, then the plan will not be treated as failing to satisfy the requirement in §§ 1.401(k)-3(g)(1)(i)(A) and (ii)(A) and 1.401(m)-3(h)(1)(i)(A) and (ii)(A) that the employer either (1) is operating at an economic loss (as described in § 412(c)(2)(A)) for the plan year, or (2) has included in the

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[6] Notice 2020-52, Section III

[7] Notice 2020-52, Section II.D

> plan's safe harbor notice (as described in § 1.401(k)-3(d)) for the plan year a statement that (a) the plan may be amended during the plan year to reduce or suspend the safe harbor contributions and (b) the reduction or suspension will not apply until at least 30 days after all eligible employees are provided notice of the reduction or suspension.[8]

Temporary Relief Related to the Supplemental Notice Requirement for Mid-Year Reductions or Suspensions of Safe Harbor Nonelective Contributions

Even if an employer satisfied either the economic loss rule or gave notice before the beginning of the year that the plan might be amended to remove or suspend the safe harbor contribution, the regulations also required notice be given to employees when the employer adopted those changes during the year. This Notice provides relief from the notice requirements, but only for employers using the safe harbor non-elective contribution option. The relief provides:

> If a plan amendment that reduces or suspends safe harbor nonelective contributions during a plan year is adopted between March 13, 2020, and August 31, 2020, then the plan will not be treated as failing to satisfy the requirements of § 1.401(k)-3(g)(1)(ii) or § 1.401(m)-3(h)(1)(ii) merely because a supplemental notice is not provided to eligible employees at least 30 days before the reduction or suspension of safe harbor nonelective contributions is effective, provided that (1) the supplemental notice is provided to eligible employees no later than August 31, 2020, and (2) the plan amendment that reduces or suspends safe harbor nonelective contributions is adopted no later than the effective date of the reduction or suspension of safe harbor nonelective contributions.[9]

The IRS provides the following explanation in the Notice for why this relief does not extend to safe harbor matching contribution reductions or suspensions:

> This notice does not provide relief with respect to the timing of supplemental notices for a mid-year reduction or suspension of safe harbor matching contributions under § 1.401(k)-3(g)(1)(i) or 1.401(m)-3(h)(1)(i) because matching contribution levels communicated to employees directly affect employee decisions regarding elective contributions (and, if applicable, employee contributions).[10]

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[8] Notice 2020-52, Section IV.A

[9] Notice 2020-52, Section IV.B

[10] Notice 2020-52, Section IV.B

Application of the Notice to §403(b) Plans

§403(b) plans can apply the above rules if they meet the following conditions:

> Sections III and IV of this notice apply on similar terms to § 403(b) plans that apply the § 401(m) safe harbor rules pursuant to § 403(b)(12).[11]

SECTION: 664
IRS MEMORANDUM ADDRESSES ISSUES WITH MARKETED CRAT PROGRAM

Citation: Memorandum AM 2020-006, 6/26/20

In Memorandum AM 2020-006[12] the IRS looked at a marketed charitable remainder annuity trust structure which claimed to allow a taxpayer to completely avoid paying tax on large capital gains. The IRS was not impressed with the marketing materials they reviewed, finding the program failed to accomplish the goal implied by the materials.

The Plan

The IRS describes the structure as follows:

> Taxpayer creates and funds a trust which is purported to qualify as a CRAT. The trust is funded with interests in a closely-held business, with farmland, and/or with the crops produced by farmland. The trust resembles the model CRAT described in the appropriate revenue procedure (for an inter vivos CRAT for one measuring life, this would be Rev. Proc. 2003-53, 2003-2 C.B. 230, which is cited in the promotional materials), with the following significant modifications:
>
> Article 5B provides that the trustee may provide for the annuity amount by purchasing one or more annuities (including without limitation one or more single premium immediate annuities (SPIAs)), with the total cost of such annuity or annuities to be less than 90% of the initial fair market value (FMV) of the trust property, which will guarantee to pay to the beneficiaries or beneficiaries' children as applicable, the annual annuity amount during the five year annuity period.
>
> Article 5F provides that in each taxable year of the trust, the trustee shall pay "to the beneficiary for during the [annuity period], during their lifetime for a period of five years," an annuity amount equal to

[11] Notice 2020-52, Section V

[12] Memorandum AM 2020-006, June 26, 2020, https://www.irs.gov/pub/lanoa/am-2020-006.pdf (retrieved July 2, 2020)

> the greater of (1) 10% of the initial FMV of all property transferred to the trust; or (2) the payments received by the trustee from one or more SPIAs purchased by the trustee as provided in Article 5B, provided however, that such annuity payments cannot exceed 49% of the initial FMV of the trust property valued as described above. Upon the death of the last surviving initial beneficiary prior to the end of the annuity period, the annuity amount shall be paid in equal shares, per stirpes and not per capita to the grantor's children for the remainder of the annuity period.
>
> Article 5L provides that in lieu of the remainder distribution to the charitable organization, the trustee, upon the availability of adequate funding in cash, may pay to the charitable organization a cash sum equal to 10% of the initial FMV of the trust property plus $100. The trustee shall not make a distribution in kind to satisfy this cash distribution.[13]

The marketing materials provided a series of descriptions of the tax implications of various transactions that were part of the marketed program:

- A single premium immediate annuity (SPIA) creates a stream of payments that are only partially taxable under the tax law, with each payment consisting of a portion that is a return of original investment and a portion that is income;[14]
- A charitable remainder annuity trust (CRAT) does not pay capital gain taxes when it sells the appreciated property initially transferred to fund the CRAT;[15]
- The CRAT's basis in an annuity it purchases is based on the funds it invests into the SPIA, not the grantor's basis in the donated asset;[16]
- In Revenue Procedure 2020-53 the IRS allowed for an early distribution to charity from a CRAT;[17] and
- CRATs are allowed to purchase SPIAs in lieu of purchasing other, more traditional investments.[18]

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[13] Memorandum AM 2020-006, pp. 2-3

[14] Memorandum AM 2020-006, p. 3

[15] Memorandum AM 2020-006, pp. 2-3

[16] Memorandum AM 2020-006, p. 3

[17] Memorandum AM 2020-006, p. 5

[18] Memorandum AM 2020-006, pp. 5-7

The memorandum does not take the position that any of those statements are incorrect. However, the promoter's materials go on to state or imply the following tax results based on those items.

- The beneficiary each year will pay tax only on the ordinary income portion of the annuity, with the portion allocated to investment in the contract becoming a wholly nontaxable distribution to the beneficiary;
- The capital gain will never be taxable to the beneficiary in any amount; and
- The structure qualifies as a CRAT, giving the taxpayer the immediate deduction benefit of a CRAT.

The memorandum does take the position that every one of those statements is false.

Arrangement is Not a Charitable Remainder Annuity Trust

The memorandum finds two key flaws cause this arrangement to fail to qualify for treatment as a charitable remainder annuity trust. If the arrangement is not a charitable remainder annuity trust, then there is not a tax exempt entity that would not initially pay tax on the gain on the sale of the capital asset and the grantor would not get a charitable contribution deduction for the partial interest gift.

The first objection is that the provision that calculates the payment as 10% of the original trust principal *or* the amount of the SPAI annual distribution (capped at 49% of the initial fair market value) means this does not qualify as a charitable remainder *annuity* trust as the payment stream is not the required sum certain annuity:

> Excessive authorized payments/Payment not a sum certain: Article 5F of the trust agreement described above provides that in each taxable year of the trust, the trustee shall pay to the beneficiary "during their lifetime for a period of five years" an annuity amount equal to the greater of (1) 10% of the initial FMV of all property transferred to the trust or (2) the payments received by the trustee from one or more SPIAs purchased by the trustee. Even if the trust was being correctly administered, this provision allowing a payment to the income beneficiary in excess of the amount determined at the funding of the trust based on a percentage of the initial FMV of the trust assets causes the trust to fail to qualify under § 664(d)(1)(B) since such excess payments are not described in § 664(d)(1)(A). This determination is not dependent on whether any excess payments are ever actually made. Additionally, Article 5F does not satisfy the "sum certain" requirement of § 1.664-2(a)(1)(i), as the amount payable could change if the trust purchases an SPIA.[19]

[19] Memorandum AM 2020-006, p. 11

While a charitable remainder *unitrust* is allowed to have a provision that provides for payment of the greater of the unitrust amount or trust income, such an income provision is not allowed in an annuity trust which must have a sum certain payout.

The arrangement also violates the CRAT requirements in the view of the memorandum by the method it uses to implement a prepayment of the charitable contribution:

> Prepayment: Article 5L provides that in lieu of the remainder distribution to the charitable organization, the trustee may pay to the charitable organization a cash sum equal to 10% of the initial FMV of the trust property plus $100. This provision and the description of the structure in the promotional materials indicate that after a payment of 10% of the initial FMV of the trust assets to charity, the charity has no further rights under the trust and will not receive the remainder at the end of the trust term. Under § 664(d)(1)(C), the payment of the remainder to charity is a mandatory definitional requirement for a CRAT. A trust which does not require such payment is disqualified without regard to any actual distributions which it may make to charity during or at the end of its term. Section 664(d)(1)(D) provides that the value of the remainder calculated at the creation of the trust must be at least 10% of FMV; it neither states nor implies that a current payment of that amount to charity vitiates the requirement to also pay the remainder at the end of the term. The cited publications, such as Rev. Proc. 2003-53 and PLR 200124010, do not support the promoters' contentions, as the provisions described therein clearly authorize payments to charity in addition to, not in lieu of, the payment of the remainder, such additional payments being consistent with § 664(d)(1)(B) and explicitly authorized by § 1.664-2(a)(4).[20]

Clearly, the promoter's idea in most cases would be to immediately give the 10% plus $100 to the charity, and then have a trust that had no additional obligation to pay the charity, allowing the entire proceeds of the annuity to go to the beneficiary. But, as the memorandum notes, that structure would appear to invalidate the CRAT.

Annuity Distributions and the §644 Layers

The IRS memorandum, noting that the above failures would remove the arrangement's tax benefits, goes on to note that even if, for the sake of argument, you assume the trust does qualify as a CRAT, the claimed tax treatment misapplies the rules of §72 for taxation of annuities and §644 for taxation of charitable remainder trust distributions to beneficiaries.

The memorandum begins by citing the proper tax treatment of such a CRT that sells an asset, purchases a SPIA, and then makes distributions while receiving payments from the SPIA:

> Amounts received under an immediate annuity that meets certain requirements and is described under § 72(u)(3)(E), which the annuities

[20] Memorandum AM 2020-006, pp. 11-12

> purchased as part of this structure appear to be, are taxed under the general rules of §§ 72(a)(1) and 72(b)(1). That is, each payment under the annuity will consist of an ordinary income portion and an excluded portion representing return of investment, until such time as the entire investment has been recovered. See, generally, § 1.72-1. A CRT is exempt from ordinary income taxation itself, but its distributions to the annuity or unitrust recipients, as the case may be, are taxable to the extent that those distributions are treated as coming from the potentially taxable tiers in § 664(b): current and accumulated ordinary income and current and accumulated capital gain. Note that the promoters' paraphrase of § 664(b) quoted above omits the "accumulated" element of each of these tiers.
>
> Applying the rules of § 664 and § 72 together to the standard facts described in the promoters' materials, in which the appreciated asset is contributed to the CRAT, sold shortly thereafter, and the proceeds used to purchase the SPIA, would result in annual ordinary income being added to the § 664(b)(1) tier each year from the annuity, and a large one-time amount being added to the § 664(b)(2) tier from the sale of the asset (assuming the asset is of a kind to produce capital gain). Assuming no other activity, the annual annuity distributions would take out current and any accumulated ordinary income from the annuity and then accumulated capital gain from the sale, only reaching non-taxable corpus to the extent these two accounts have been exhausted.[21]

The IRS notes the misleading implications created by the promoter's materials regarding Notice 2008-99 and PLR 9237030 in a footnote, stating:

> The promoters' citation to Notice 2008-99 is simply misleading in that they quote it for the correct statement that a CRT is exempt from ordinary income taxation and has a cost basis in purchased assets, without noting that the gain on assets sold will be added to the § 664 tiers and thus preserved for taxation to the income beneficiaries as distributions are made. Similarly, they draw a false implication from the accurate summary of the § 72 rules regarding immediate annuities in PLR 9237030, that those rules somehow override the § 664 tier structure in cases where a CRT holds such an annuity.[22]

That is, the promotional materials left out significant details (like the tier structure), thus inviting the reader to "fill in" conclusions that are erroneous without a memorandum ever actually making the statements in question. So technically, there's no actual falsehood in the statements—but that doesn't mean the materials are not misleading.

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[21] Memorandum AM 2020-006, pp. 12-13

[22] Memorandum AM 2020-006, p. 12

Specifically, the memorandum goes on to say:

> Instead, the promoters are treating the capital gains as being trapped in the CRAT, with the income beneficiaries only taxed on the ordinary annuity income each year as if they were themselves the owners of the SPIA, rather than it being an asset of the CRAT funding their annuity payments from the trust. To reach this result, they are misinterpreting the cited TAM and PLRs. In those documents discussing a CRT holding an annuity contract, it is clear that the annuity income is included in the income of the trust, thus entering the § 664(b) tiers, not bypassing the trust and appearing directly on the income beneficiaries' returns. Put differently, the annuity is a funding mechanism for the CRT's required payments to the income beneficiaries, not an income stream of the beneficiaries in lieu of such payments.[23]
>
> … Promoters cite two of these rulings for the indisputable proposition that a CRT may purchase an annuity, but then do not explain that the trust will be the owner of the annuity contract and the income therefrom. Moreover, none of these rulings address the taxation of any distributions from the CRAT to the individual beneficiaries. Thus, none of cited authorities in the promotional materials support taxing the payments under the annuity contract solely under § 72 without running them through the § 664(b) tier system. Rather, the taxable portions of the annuity payments are income to the trust, which would mechanically fall into the first tier as ordinary income, with distributions from the trust first coming from ordinary income before dipping into the other tiers, including capital gain, until the entire distribution is accounted for.[24]

The IRS then posits two potential alternative treatments for imposing tax on a taxpayer who is taking an incorrect reporting position based on the implications of the promotional materials. First, the annuities could be treated as distributed to the beneficiaries by the CRAT upon purchase:

> The first alternative is to treat the CRAT as actually having distributed the entire annuity contract to the individual beneficiaries. CRTs may make in-kind distributions to satisfy their income distribution requirements, but the value of the policy would far exceed the beneficiaries' required annuity payment for the year and thus would violate the prohibition of § 1.664-2(a)(4) that no amount other than the annuity amount may be paid to or for the use of any person other than charity. This and any subsequent failure to make annuity payments would be operational failures disqualifying the CRAT

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[23] Memorandum AM 2020-006, p. 13

[24] Memorandum AM 2020-006, p. 14

> retroactively under the rule of *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd* 309 F.3d 1290 (11th Cir. 2002).[25]

The IRS notes that some of the structures attempt to block this result by having the CRAT listed as the owner of the annuity, with the beneficiaries listed as the annuitants receiving the benefits. But the memorandum finds this just changes the problems that the CRAT faces:

> To the extent that the trusts argue that their record ownership of the annuity contracts prevents the Service from asserting that the CRATs made in-kind distributions of the annuity contracts to the income beneficiaries, we note that it could create a new set of hazards for them. If the trusts have retained a right to change the recipient of the annuity, then the CRTs will be disqualified for not meeting the requirements of §§ 1.664-2(a)(3)(i) and (ii). Under § 1.664-2(a)(3)(i), individual beneficiaries must be living at the time of trust creation, but the trust's retained power to substitute annuitants would allow it to direct the annuity payments to beneficiaries who were born after the creation of the trust. Under § 1.664- 2(a)(3)(ii), no person can retain a power which would cause the trust to be a grantor trust; the retained power to change the annuity recipient would generally create a grantor trust as a power to control "beneficial enjoyment" of the trust under § 674(a) and none of the exceptions provided in §§ 674(b), (c), and (d) appear to apply. Additionally, distributions of trust assets to individuals other than those named in the trust instrument would be another *Atkinson* operational failure.[26]

Alternatively, the IRS could argue to treat it as if it was a valid CRAT and tax the distributions under those rules:

> The second alternative is simply to treat the payments under the annuity contract as if they had been correctly routed through the CRAT, taking out the tiers. Assuming that in any given case, the contributed assets are highly appreciated and are sold shortly after contribution, this would result in the distributions consisting of a thin layer of ordinary income with the balance being current or (in years after the year of sale) accumulated capital gain. We understand that some examinations have conceded the validity of the CRAT under § 664, in which cases this alternative would become the primary argument. Even if the CRATs are valid, this does not validate the attempt to trap the capital gains at the entity level.[27]

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[25] Memorandum AM 2020-006, p. 14

[26] Memorandum AM 2020-006, p. 15

[27] Memorandum AM 2020-006, p. 15

Memorandum's Recommendation to Agents

The IRS memorandum concludes with the following recommendation to agents when they encounter one of these structures:

> In all cases using this structure, the validity of the CRAT should be challenged both on the basis of disqualifying terms in the instrument and subsequent operational failures, with the result under both theories being (1) the disallowance of any charitable deductions claimed for the value of the remainder and (2) the treatment of the trust as a taxable entity from its creation, causing the sale of any appreciated donated assets to be currently taxable to the trust (or its beneficiaries, if the gain is included in DNI) in the year of sale. In appropriate cases, an assignment of income argument should be made to tax the gain of the sale of assets by the trust to the grantors or to assert SECA tax liability against the trust grantors. A whipsaw argument should also be included that if the trust is a qualified CRAT, the beneficiaries have reported incorrectly by only including the § 72 ordinary income on the annuity contract and not current or accumulated capital gain on the sale of the assets as part of their § 664(b) distribution.[28]

SECTION: 6501
STATUTE OF LIMITATIONS BEGINS TO RUN ON DATE FIRST RETURN IS FILED, NOT DATE SUPERSEDING RETURN IS FILED

Citation: CCA 202026002, 6/26/2020

In Chief Counsel Advice 202026002[29] the IRS looks at whether the filing of a superseding return following the filing of the first tax return that was placed on extension changes the starting date for the statute of limitations on the assessment of tax or claiming a refund.

Superseding Returns

A *superseding return* is a term that has been coined to describe a change made to a tax return after a return has already been filed, but before the due date of the return (including extensions if requested). If the return was placed on extension before the first return was filed, the superseding return can be filed up to the extended due date of

[28] Memorandum AM 2020-006, p. 17

[29] Chief Counsel Advice 202026002, Internal Revenue Service, June 26, 2020, https://www.irs.gov/pub/irs-wd/202026002.pdf (retrieved June 27, 2020)

the return, otherwise the superseding return would be due by the original due date of the return.

A superseding return is a special category of amended returns. The key difference is that, for many purposes, the superseding return replaces the return originally filed, allowing, for instance, a taxpayer to make an election that can only be made on an original tax return. The CCA describes the history of the doctrine, arising from the case of *Haggar v. Helvering*, 308 U.S. 389 (1940):

> In *Haggar*, for purposes of a new capital stock tax, the taxpayer was required to declare the value of its stock on what the statute referred to as the "first return." The taxpayer could declare any value of capital stock for its first taxable year, but the declared value for the first year was a controlling factor for the computation of excess profits tax for later years. The statute provided that the declaration once made could not be amended.
>
> On a timely filed return, Haggar mistakenly reported the par value, as distinguished from actual value, of its issued capital stock. Before the due date, it filed a superseding return declaring the actual value. The Commissioner, refusing to accept the value of the capital stock declared in the superseding return, gave notice of a deficiency in excess profits tax calculated upon what was declared in the first return. Noting that the government was not prejudiced, that the purpose of the statute was not thwarted, and that there was a longstanding administrative practice of accepting superseding returns in other contexts, the Court observed:
>
>> "First return" thus means a return for the first year in which the taxpayer exercises the privilege of fixing its capital stock value for tax purposes, and includes a timely amended return[30] for that year. A timely amended return is as much a "first return" for the purpose of fixing the capital stock value in contradistinction to returns for subsequent years, as is a single return filed by the taxpayer for the first tax year.
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>> *Haggar*, 308 U.S. at 395–96.
>
> Over the years, Haggar has come to stand for the proposition that a superseding return, whether filed on extension or not, is effective for most purposes. For example, courts have held that many elections required to be made on a timely return can be made or changed on a superseding return. See, e.g., *National Lead Co. v. Commissioner*, 336 F.2d 134 (2d Cir. 1964) (inventory accounting relief provision); *Charles Leich & Co. v. United States*, 329 F.2d 649 (Ct. Cl. 1964) (excess profits tax election); *Wilson v. United States*, 267 F. Supp. 89 (E.D. Mo. 1967)

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[30] Some CPAs seem to believe that, in order to get superseding treatment, the revision cannot be filed on an amended return form. Clearly, the case from the Supreme Court that created this treatment has no such

> (partnership tax year); Cf. *J.E. Riley Investment Co. v. Comm'r*, 311 U.S. 55 (1940) ("[Haggar] would compel the conclusion that had the amended return been filed within the period allowed for filing the original return, it would have been a first return [for purposes of determining percentage depletion election]. . . .") (citations omitted).

Superseding returns have gotten some additional discussion since the Bipartisan Budget Act of 2015 partnership audit rules began to apply—while generally a partnership cannot amend its return if it is covered by the BBA rules (rather having to go through the complex administrative adjustment request process for a BBA partnership), a superseding return can still be filed up to the due date or extended due date of the partnership return. The superseding return allows the change to be simply passed out to the partners for use on their individual returns for the year in question.

Statute of Limitations and Superseding Returns

But while a superseding return supplants the original return for purposes of elections and the like, does it also move the date of filing of the return for purposes of starting the statute of limitations running under IRC §6501 (for the IRS to assess additional tax) or §6511 (for a taxpayer to file a claim for refund)?

In the fact pattern under consideration in this memorandum, the taxpayer had filed for an extension of time to file a corporate income tax return. Prior to the expiration of the extension period, the taxpayer had filed its tax return. However, the taxpayer noticed an error on the return and, again prior to the extended due date, filed a superseding return.

More than three years after the first return was filed, but less than three years after the superseding return was filed, the taxpayer filed a claim for refund.

The fact the returns were filed on extension made this an issue. If the returns had been filed before the regular due dates with no extension, neither statute would have begun to run until that due date arrives—so in that case it wouldn't matter which return triggered the beginning of the statute because the result would be the same. Any assessment or claim must be raised prior to three years following that original due date.

But with returns on extension, the statute begins running on the date the return is filed. So, in this case, if the original return's filing date is used to determine the date when the statute begins to run, the claim was not filed timely. As the CCA explains:

> If both returns are filed before the original due date, this ambiguity has no effect on when the statute of limitations begins because a return filed before the last day prescribed for filing is deemed filed on the last day. See I.R.C. §§ 6501(b)(1) and 6513(a). Thus, in that situation, regardless of which return is "the return," the statute will begin on the original due date for the return. But a return filed on extension is treated as filed on the day it is received. See, e.g., *First Charter Financial Corp. v. United States*, 669 F.2d 1342 (9th Cir. 1982) (finding that return filed during automatic extension period was filed when received for purposes of statute of limitation on assessment). So where the first return is filed before the last date prescribed for filing (original or extended), and a second return is subsequently filed during the

> extension period, the statute would begin running on different dates, depending on which return is "the return" for purposes of section 6501(a) or 6511(a).

The memorandum argues that it is the first filed return, and not the superseding one, that triggers the beginning of the running of the statute. The memorandum looks to the cases of *Zellerbach Paper Co. v. Helvering*, 293 U.S. 172 (1934) and *National Paper Products Co. v. Helvering*, 293 U.S. 183 (1934) to justify this conclusion.

> In these two related cases, the issue before the Supreme Court was substantially the same, but the facts were slightly different. In both cases, new statutes were enacted after two companies had already timely filed their tax returns. Each statute affected income tax and was effective retroactively. In response to the new law, "[National Paper] filed an additional return, supplementing the original one by a statement of the additional taxes due." *Nat'l Paper*, 293 U.S. at 186. Zellerbach Paper, on the other hand, "did not make a new or supplemental return correcting the computation in the one on file." *Zellerbach*, 293 U.S. at 175. In both cases, the Commissioner issued a notice of deficiency after the limitation period for assessment had run from the original returns' filing date.
>
> The taxpayers argued that the notices of deficiency were untimely. The government's position was that, since the original returns did not incorporate the changes under the statute, the original return in both cases was a nullity, so the statute of limitations on assessment had not begun to run with the filing of the original returns. The Court disagreed. Discussing what is now known as the *Beard* test, the Court found the original returns filed by both Zellerbach Paper Company and National Paper met that test and started the statute of limitations for assessment. Thus, the notices of deficiency were untimely.
>
> The court disagreed with the government's argument that starting the period of limitation for assessment with the original return unfairly curtails the government's time for audit and assessment:
>
> > [A] second return, reporting an additional tax, is an amendment or supplement to a return already upon the files, and being effective by relation does not toll a limitation which has once begun to run. . . . Supplement and correction in such circumstances will not take from a taxpayer, free from personal fault, the protection of a term of limitation already running for his benefit.
>
> *Id.* at 180.2 In coming to this conclusion, the *Zellerbach* Court deemed a loss of four months for audit insignificant, *Id.* at 181, and it apparently did not find a loss of ten months alone to be a factor that would change its decision in *National Paper*. *Nat'l Paper*, 293 U.S. at 185.

Although the returns in *Zellerbach* and *National Paper* were not superseding returns, the memorandum concludes that this would not have an impact on the holding:

> The reasoning of *Zellerbach* also applies with equal force to superseding returns filed on extension. In both superseding- and amended-return situations, if the second return were to restart the limitations period, the taxpayer would lose the protection of the assessment statute for the period between the dates the two returns were filed. This is unfair to the taxpayer and thwarts the purpose of the statute of limitations, which, in the tax context, is "to cut off rights that might otherwise be asserted. . . ." See *Kavanagh v. Noble*, 332 U.S. 535, 539 (1947) (citing *Rosenman v. United States*, 323 U.S. 658, 661 (1945)), reh'g denied, 333 U.S. 850 (1948). This purpose is served best when the original return starts the period of limitations.
>
> The loss of time to audit the superseding return, even if the superseding return were filed at the end of a six-month automatic extension period, does not influence our conclusion that an original return, despite its inaccuracy, is the return for purposes of the statute of limitations on assessment, and the filing of a superseding return during an extension period does not restart the period of limitations. See *Zellerbach* and *National Paper* (Court was unmoved by losses of four and ten months, respectively).

But doesn't *Haggar* tell us that the superseding return is treated as the original return? In the memorandum's view not for purposes of restarting the statute once the second return is filed. The memorandum reasons:

> Nonetheless, *Haggar* does not compel a conclusion that a superseding return is "the return" for purposes of the statute of limitations. It has never been applied in that context; nor should it be because the purpose of the statute of limitations is distinct from the purpose of the statute in *Haggar* and from the purposes of the statutes covering elections and penalties to which *Haggar* has been applied. While *Haggar* has been applied to statutes aimed at determining what substantively is included in the return, the statute of limitations is a mechanical rule with the purpose of cutting off rights, as discussed above.

The IRS also argues that there is no conflict between the *Haggar* and *Zellerbach* decisions:

> Furthermore, *Haggar* does not conflict with *Zellerbach*. A superseding return modifies or supersedes an original return under Haggar and still relates back to the date of the original return for timing purposes under *Zellerbach*. *Zellerbach* recognizes that a second return, although it does not restart the limitation period, is still "an amendment or supplement to a return already upon the files, and . . . [is] effective by relation." *Zellerbach*, 293 U.S. at 180; see also *Wilson*, 267 F. Supp. at 91 (suggesting that the question *Haggar* addresses is "whether or not an amendment is ***part of*** a first return") (emphasis added); *Barber v. Comm'r*, 64 T.C. 314, 317 (1975) (noting that if the amended return had been

> timely filed, then under Haggar, "[the amended] return might then be treated as part of the original return").

The IRS view is that the superseding return is simply treated as if it had been in the return that was first filed. Thus, the date of filing of the original return remains the same, and only the contents of that return are treated as being modified.

EXAMPLE

Wanda filed for an extension of time to file her 2018 income tax return. She filed a return on June 30, 2019. Later Wanda discovered she had failed to make an election that was required to be made on her original return, so she files a superseding return on October 1, 2019.

Even though the superseding return was filed on October 1, 2019, the statute for Wanda to file a claim for refund will still end on June 30, 2022. The same is true for the time the IRS has to assess tax on Wanda's 2018 return. The original return filing date of June 30, 2019 is treated as the date on which both statutes begin to run.

SECTION: 7508A
IRS NEWS RELEASE STATES THERE WILL BE NO ADDITIONAL DELAY OF THE 2020 DUE DATE PAST JULY 15

Citation: IR-2020-134, "Taxpayers should file by July 15 tax deadline; automatic extension to Oct. 15 available," IRS website, 6/29/20

In a news release the IRS announced that there will not be a second postponement of the tax filing deadline past July 15.[31] Treasury Secretary Mnuchin had been quoted recently as saying that the Treasury had not yet ruled out extending the deadline a second time, but now it appears that decision has been made.

The announcement states:

> The Department of the Treasury and IRS today announced the tax filing and payment deadline of July 15 will not be postponed. Individual taxpayers unable to meet the July 15 due date can request an automatic extension of time to file until Oct. 15.

The news release reminds taxpayers that they can file for an extension of time to file their return by July 15 by filing Form 4868. The news release notes that this extension

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[31] IR-2020-134, "Taxpayers should file by July 15 tax deadline; automatic extension to Oct. 15 available," IRS website, June 29, 2020, https://www.irs.gov/newsroom/taxpayers-should-file-by-july-15-tax-deadline-automatic-extension-to-oct-15-available (retrieved June 30, 2020)

does not serve to extend the time to pay taxes, at least without paying interest and penalties. The release continues:

> The IRS urges people who owe taxes, even if they have a filing extension, to carefully review their situation and pay what they can by July 15 to avoid penalties and interest. For people facing hardships, including those affected by COVID-19, who cannot pay in full, the IRS has several options available to help. To avoid interest and penalties, the IRS encourages them to pay what they can and consider a variety of payment options available for the remaining balance.
>
> "The IRS understands that those affected by the coronavirus may not be able to pay their balances in full by July 15, but we have many payment options to help taxpayers," said IRS Commissioner Chuck Rettig. "These easy-to-use payment options are available on IRS.gov, and most can be done automatically without reaching out to an IRS representative."

While the release does not mention the status of other obligations delayed by Notice 2020-23 to July 15, 2020, it is unlikely the agency will take any action to provide additional time for these other actions while not providing additional time to file Form 1040.

SECTION: 7508A
CALENDAR YEAR 2018 FORMS 1045 AND 1139 DUE ON JULY 15, 2020, NOT JUNE 30, 2020

Citation: "Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," Questions 19 and 20, IRS website, 6/29/20

The IRS has posted two additional questions to the FAQ page that deals with Forms 1139 and 1045, one of which clarifies that the June 30, 2020 deadline to file either of the forms is moved to July 15, 2020 by application of Notice 2020-23.[32]

Due Date for Forms 1139 and 1045 for Losses from Calendar Year 2018 Filings

The IRS in Notice 2020-23, issued on April 9, 2020, granted taxpayers additional time to take certain actions otherwise required to take place between April 1, 2020 and July 14, 2020, treating those actions as timely if completed by July 15, 2020. On the same day the IRS issued Notice 2020-26, providing relief for filing 2018 loss carrybacks on

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[32] "Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," Questions 19 and 20, IRS website, June 29, 2020, https://www.irs.gov/newsroom/temporary-procedures-to-fax-certain-forms-1139-and-1045-due-to-covid-19 (retrieved June 29, 2020)

Forms 1139 and Forms 1045, making such filings timely if filed within 18 months of the end of the year that generated the net operating loss. The notice contained a parenthetical example in Section 3 that provided the form must be filed "no later than June 30, 2020, for a taxable year ending December 31, 2018."[33]

But a question remained—since June 30, 2020 is within the time period for which relief is granted under Notice 2020-23, does that due date relief apply to this separate relief published on the same date? Or did the IRS rule provided in Notice 2020-26, being issued at the same time, govern the due date in this case?

The day before June 30, 2020 the IRS added question 20 to the FAQ on the temporary procedures to file Forms 1045 and 1139 to resolve that matter. The question provides:

> **20. If the last date to file my Form 1139/1045 was extended six months under Notice 2020-26, and the extended due date is a date on or after April 1, 2020, and before July 15, 2020, will I also receive relief under Notice 2020-23?**
>
> Yes. Notice 2020-26 granted a six-month extension to file Form 1139 or Form 1045 with respect to the carryback of a net operating loss that arose in any taxable year that began during calendar year 2018 and that ended on or before June 30, 2019. If a taxpayer, including a taxpayer that filed a consolidated return and/or had a short tax year for the applicable loss year, satisfies the requirements of Notice 2020-26, the taxpayer will have 18 months rather than the normal 12 months, after the end of the loss year, to file Form 1139 or Form 1045. Notice 2020-23 granted affected taxpayers until July 15, 2020, to perform specified time-sensitive actions, including filing Forms 1139 and 1045. *Under Notice 2020-23, a taxpayer filing a Form 1139 or Form 1045 which is due on or after April 1, 2020, and before July 15, 2020, including as a result of the relief provided in Notice 2020-26, is an affected taxpayer performing a specified time-sensitive action, and will have until July 15, 2020, to file the relevant form.* **(added June 29, 2020)**[34]

Consolidated Groups

The IRS also added question 19 to the FAQ, this time simply clarifying that the relief applied to consolidated group filings as well:

> **19. Does the extension granted by Notice 2020-26 apply to consolidated groups?**
>
> Yes. **(added June 29, 2020)**

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[33] Notice 2020-26, Section 3

[34] "Temporary procedures to fax certain Forms 1139 and 1045 due to COVID-19," Question 20, IRS website, June 29, 2020