

# Current Federal Tax Developments

Week of October 5, 2020

Edward K. Zollars, CPA  
(Licensed in Arizona)

ACCOUNTING  
CONTINUING EDUCATION

CURRENT FEDERAL TAX DEVELOPMENTS  
WEEK OF OCTOBER 5, 2020  
© 2020 Kaplan, Inc.  
Published in 2020 by Kaplan Financial Education.

Printed in the United States of America.

All rights reserved. The text of this publication, or any part thereof, may not be translated, reprinted or reproduced in any manner whatsoever, including photocopying and recording, or in any information storage and retrieval system without written permission from the publisher.



# Current Federal Tax Developments

Kaplan Financial Education

## Contents

Section: 274 Final Regulations Published for Meals and Entertainment Expenses .....	1
Section: 3405 Final Regulations on Withholding on Periodic Retirement and Annuity Payments Issued .....	21
Section: 951A S Corporations with Transition AE&P Allowed to Elect Entity Treatment for GILTI.....	23
Section: PPP Loan SBA Issues Notice Regarding Impact of Change of Ownership for PPP Borrower.....	32



## **SECTION: 274**

# **FINAL REGULATIONS PUBLISHED FOR MEALS AND ENTERTAINMENT EXPENSES**

### **Citation: TD 9925, 9/30/20**

The Treasury Department has released final regulations<sup>1</sup> relating to the changes to IRC §274 made as part of the Tax Cuts and Jobs Act.<sup>2</sup>

The Tax Cuts and Jobs Act (TCJA) repealed the rule that allowed a deduction for entertainment expenses if the taxpayer established that:

- The entertainment was directly related to the active conduct of the taxpayer's trade or business (*directly related exception*), or
- In the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the item was associated with the active conduct of the taxpayer's trade or business (*business discussion exception*).

Thus, following the TCJA, no deductions are allowed for entertainment expenses unless they meet one of the exceptions found at IRC §274(e).

Initially many were concerned it was not clear that meals had not been included as part of entertainment, since in prior acts Congress had treated meals as a subset of entertainment. But the IRS indicated in the preliminary guidance given in Notice 2018-76 that the agency did not believe the law barred deductions for most meals. The preamble to the proposed regulations confirm this treatment, stating:

While the TCJA eliminated the deduction for entertainment expenses, Congress did not amend the provisions relating to the deductibility of business meals. Thus, taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business, including meals consumed by employees on work travel. See H.R. Rep. No. 115-466, at 407 (2017) (Conf. Rep.). However, as before the TCJA, no deduction is allowed for the expense of any food or beverages unless (a) the expense is not lavish or extravagant under the circumstances, and (b) the taxpayer (or an employee of the taxpayer) is present at the furnishing of the food or beverages. See section 274(k).<sup>3</sup>

---

<sup>1</sup> TD 9925, September 30, 2020, <https://www.irs.gov/pub/irs-drop/td-9925.pdf> (retrieved September 30, 2020)

<sup>2</sup> REG-100814-19, February 21, 2020, <https://docs.google.com/document/d/1G5BQic54VUc4zqPqjYcvj-cqYzftVvYkIB0tkHnqPFQ/edit> (retrieved February 21, 2020)

<sup>3</sup> REG-100814-19, February 21, 2020, p. 5

## 2 Current Federal Tax Developments

As well, the preamble to the proposed regulations confirmed what many had noticed—there was no longer anything left in §274 that required the strict substantiation provisions for meals other than those related to travel. As the preamble continues:

Prior to amendment by the TCJA, section 274(d) provided substantiation requirements for deductions under section 162 or 212 for any traveling expense (including meals and lodging while away from home), and for any item with respect to an activity of a type considered to constitute entertainment, amusement, or recreation or with respect to a facility used in connection with such activity. Section 13304(a)(2)(A) of the TCJA repealed the substantiation requirements for entertainment expenditures. Traveling expenses (including meals and lodging while away from home), however, remain subject to the section 274(d) substantiation requirements. Food and beverage expenses are subject to the substantiation requirements under section 162 and the requirement to maintain books and records under section 6001.<sup>4</sup>

Note that this doesn't mean there is no substantiation required, but rather that the anti-*Cohan* rules of old IRC §274(d) no longer apply. So a taxpayer can now attempt to use the *Cohan* case to argue for a deduction for meals not related to travel even if there is minimal substantiation—but it is important to note that such attempts most often fail, due to a lack of evidence to enable a reasonable estimate for expenses in the past that have been eligible for the *Cohan* treatment.

The preamble to the proposed regulations also discussed the removal of the ability of employers to claim 100% of the amount paid for *de minimis* food and beverage fringes, instead subjecting them to the 50% disallowance rule of IRC §274(n)(2)(B). The preamble states:

Prior to amendment by the TCJA, section 274(n)(1) generally limited the deduction for food or beverage expenses to 50 percent of the amount that otherwise would have been allowable, subject to an exception in section 274(n)(2)(B) in the case of an expense for food or beverages that is excludable from the gross income of the recipient under section 132 by reason of section 132(e), relating to *de minimis* fringes. Section 132(e)(1) defines “*de minimis* fringe” as any property or service the value of which is, after taking into account the frequency with which similar fringes are provided by the employer to its employees, so small as to make accounting for it unreasonable or administratively impracticable. Section 132(e)(2) provides that the operation by an employer of any eating facility for employees is treated as a *de minimis* fringe if (1) the facility is located on or near the business premises of the employer, and (2) revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. Thus, under prior law, employers generally were allowed to fully deduct an expense for food or beverages provided to their employees if the amount was excludable from the gross income of the employee as a *de minimis* fringe. However, the TCJA repealed section

---

<sup>4</sup> REG-100814-19, February 21, 2020, p. 5

274(n)(2)(B), meaning that expenses for food or beverages that are *de minimis fringes* under section 132(e) are no longer excepted from section 274(n)(1). As a result, these expenses, like other food or beverage expenses generally, are subject to the 50 percent limitation unless one of the six exceptions to section 274(n) in section 274(e) applies.<sup>5</sup>

Some meals are allowed in full based on the exceptions found in IRC §274(e). Specifically, the preamble notes the following exceptions to the 50% disallowance of amounts paid for meals:

- Expenses for goods, services, and facilities to the extent that the expenses are treated as compensation to the recipient.<sup>6</sup>
- Expenses incurred by a taxpayer in connection with the performance of services for an employer or other person under a reimbursement or other expense allowance arrangement.<sup>7</sup>
- Expenses for recreational, social, or similar activities for employees.<sup>8</sup>
- Expenses for goods, services, and facilities made available to the general public.<sup>9</sup>
- Expenses for goods or services that are sold by the taxpayer in a bona fide transaction for adequate and full consideration in money or money's worth.<sup>10</sup>
- Expenses for goods, services, and facilities to the extent that the expenses are treated as income to a person other than an employee.<sup>11</sup>

The final regulations add two new regulations under IRC §274. Those regulations would be:

- Reg. §1.274-11: Dealing with entertainment expenditures paid or incurred after December 31, 2017 and
- Reg. §1.274-12: Dealing with food or beverage expenses under IRC §274(k) and §274(n) paid or incurred after December 31, 2017, including the application of the various exceptions under IRC §274(e) and business meals described in Notice 2018-76, as well as other meals including travel meals and employer provided meals.<sup>12</sup>

---

<sup>5</sup> REG-100814-19, February 21, 2020, pp. 7-8

<sup>6</sup> IRC §274(e)(2)

<sup>7</sup> IRC §274(e)(3)

<sup>8</sup> IRC §247(e)(4)

<sup>9</sup> IRC §274(e)(7)

<sup>10</sup> IRC §274(e)(8)

<sup>11</sup> IRC §274(e)(9)

<sup>12</sup> TD 9925, September 30, 2020

## 4 Current Federal Tax Developments

### ***Entertainment Expenditures (Reg. §1.274-11)***

The basic issue here is simple—no deduction is allowed, except as provided for in IRC §274(e), for

- Any entertainment expenditure,
- Expenditures related to a facility used in connection with an entertainment activity (including dues or fees paid to any social, athletic or sporting club or organization); or
- Amounts paid or incurred for membership in any club organized for business, pleasure, recreation or other social purpose.<sup>13</sup>

But the question is what exactly do those terms mean? Reg. §1.274-11(b) provides specific definitions for various terms.

#### ***Entertainment***

Obviously, a key term to define is that of *entertainment*. The regulation defines entertainment generally as:

...any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family.<sup>14</sup>

The proposed regulation then goes on to describe three specific modifications to this definition:

- The described activities are treated as entertainment under this section, subject to the objective test, regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. Basically, you can't get around this rule by arguing the expenditure is otherwise an ordinary and necessary business expense, the broad rule applicable to most business expenses found at IRC §162. IRC §274 is a specific set of exceptions to the general rule found at IRC §162.
- The term *entertainment* may include an activity, the cost of which otherwise is a business expense of the taxpayer, which satisfies the personal, living, or family needs of any individual, such as a hotel suite or an automobile to a business customer or the customer's family. Thus, context is extremely important when evaluating an expenditure, not just the specific expenditure itself.
- Finally, the regulation limits the reach of *entertainment* by excluding activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as a hotel room maintained by an

---

<sup>13</sup> Reg. §1.274-11(a)

<sup>14</sup> Reg. §1.274-11(b)(1)(i)



employer for lodging of employees while in business travel status or an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. But the regulation notes that the providing of a hotel room or an automobile by an employer to an employee who is on vacation would constitute entertainment of the employee.<sup>15</sup>

### *Food and Beverages*

Food and beverages are not considered entertainment unless they are provided during or at an entertainment activity.<sup>16</sup> But even food provided during or at an entertainment activity may escape classification as entertainment. The regulation provides:

...[I]n the case of food or beverages provided during or at an entertainment activity, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.<sup>17</sup>

The “separate billing” rule first appeared in Notice 2018-76 and that basic rule is repeated in the proposed regulation. To meet the separate billing requirement the regulation provides:

The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue’s usual selling cost for those items if they were to be purchased separately from the entertainment, or must approximate the reasonable value of those items. Unless the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation can be made and the entire amount is a nondeductible entertainment expenditure.<sup>18</sup>

### *Objective Test*

Knowing that taxpayers and advisers would look long and hard for ways to claim their expenditure is different the IRS issues what the agency refers to as an *objective test*. Note that, in fact, the test is a subjective test, but one that the IRS is presumed to be correct in applying during an exam. The objective test provides:

An objective test is used to determine whether an activity is of a type generally considered to be entertainment. Thus, if an activity is generally considered to be entertainment, it will be treated as entertainment for purposes of this section and section 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This

---

<sup>15</sup> Reg. §1.274-11(b)(1)(i)

<sup>16</sup> Reg. §1.274-11(b)(1)(ii)

<sup>17</sup> Reg. §1.274-11(b)(1)(ii)

<sup>18</sup> Reg. §1.274-11(b)(1)(ii)

## 6 Current Federal Tax Developments

objective test precludes arguments that entertainment means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test the taxpayer's trade or business is considered. Thus, although attending a theatrical performance generally would be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in a professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce its products to a group of store buyers, the show generally would not be considered entertainment. However, if an appliance distributor sponsors a fashion show, the fashion show generally would be considered to be entertainment.<sup>19</sup>

The regulation reminds the reader that the exceptions under IRC §274(e) override the bar on the deduction of entertainment expenses.

### *Examples*

As with most regulations, the language of the regulation text only provides some clues about how the IRS is likely to approach specific situations. The examples that often accompany the regulations are important for the adviser to study to gain an insight in how the IRS expects to apply the specifics discussed in the regulations.

The four examples below apply the entertainment provisions of Reg. §1.274-11 to some situations encountered by taxpayers. In each of the examples neither the taxpayer nor the business associate is engaged in a trade or business that relates to the entertainment activity

#### **EXAMPLE 1, REG. §1.274-11(D)(1) – A BASEBALL GAME**

Taxpayer A invites, B, a business associate, to a baseball game to discuss a proposed business deal. A purchases tickets for A and B to attend the game. The baseball game is entertainment as defined in paragraph (b)(1) of this section and thus, the cost of the game tickets is an entertainment expenditure and is not deductible by A.

Now we modify the example to consider the case where the taxpayer buys hot dogs and drinks for himself and the associate once they are at the game:

#### **EXAMPLE 2, REG. §1.274-11(D)(2) – THE HOT DOGS AND DRINKS**

Assume the same facts as in paragraph (d)(1) of this section (Example 1), except that A also buys hot dogs and drinks for A and B from a concession stand. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expenditure and is not subject to the section 274(a)(1) disallowance. Therefore, A may

---

<sup>19</sup> Reg. §1.274-11(b)(1)(iii)

deduct 50 percent of the expenses associated with the hot dogs and drinks purchased at the game if they meet the requirements of section 162 and §1.274-12.

Now we look at the case where the taxpayer has access to a luxury suite for a basketball game where food and beverages are provided in a bundle covered by a single fee:

**EXAMPLE 3, REG. §1.274-11(D)(3)-HOT DOGS AND DRINKS AT THE SUITE**

Taxpayer C invites D, a business associate, to a basketball game. C purchases tickets for C and D to attend the game in a suite, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food or beverages. The basketball game is entertainment as defined in paragraph (b)(1) of this section and, thus, the cost of the game tickets is an entertainment expenditure and is not deductible by C. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages is an entertainment expenditure that is subject to the section 274(a)(1) disallowance. Therefore, C may not deduct the cost of the tickets or the food and beverages associated with the basketball game.

The answer changes when the food and beverage are separately stated on the invoice.

**EXAMPLE 4, REG. §1.274-11(D)(4), FOOD AND DRINKS SEPARATELY STATED ON INVOICE**

Assume the same facts as in paragraph (d)(3) of this section (Example 3), except that the invoice for the basketball game tickets separately states the cost of the food and beverages and reflects the venue's usual selling price if purchased separately. As in paragraph (d)(3) (Example 3), the basketball game is entertainment as defined in paragraph (b)(1) of this section and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expenditure and is not deductible by C. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expenditure and is not subject to the section 274(a)(1) disallowance. Therefore, C may deduct 50 percent of the expenses associated with the food and beverages provided at the game if they meet the requirements of section 162 and §1.274-12.

Note that these four examples are essentially the same examples, with the same results, as were found in Notice 2018-76.

***Food or Beverages (Reg. §1.274-12)***

The existing regulations under §274 did not always clearly differentiate between entertainment and meals. Now that the IRS has determined that the law Congress enacted does actually treat meals differently than entertainment, a comprehensive regulation on food and beverages is required, found at Reg. §1.274-12.

This regulation also contains the explanations of the exceptions found at IRC §274(e) that impact food and beverages.

The regulation begins with three rules that must be met in order for any deduction to be allowed for the provision of food and beverages as part of a business meal:

- The expense is not lavish or extravagant under the circumstances;

## 8 Current Federal Tax Developments

- The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
- The food or beverages are provided to the taxpayer or a business associate.<sup>20</sup>

Unless a specific exception applies, only 50% of the amount expended for food and beverages will be allowed as a deduction.<sup>21</sup>

In the preamble to the final regulations, the IRS provides the following response to a commenter who asked if a sole proprietor can deduct the cost of meals when working throughout the day:

As explained in the Background section of this preamble, section 274 limits or disallows deductions for certain meal and entertainment expenditures that otherwise would be allowable under chapter 1, primarily under section 162(a), which allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. The requirements imposed by section 274 are in addition to the requirements for deductibility imposed by other provisions of the Code. If a taxpayer intends to claim a deduction for an expenditure for meals or entertainment, the taxpayer must first establish that the expenditure is otherwise allowable as a deduction under chapter 1 before the provisions of section 274 become applicable. Therefore, the sole proprietor must first establish that the food or beverage expense is deductible under chapter 1 before section 274 would apply. For example, if the sole proprietor can establish that the food or beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business, the sole proprietor may deduct 50 percent of the food or beverage expenses under section 274(k) and (n) and §1.274-12(a) of the final regulations if: (1) the expenses are not lavish or extravagant; (2) the sole proprietor, or an employee of the sole proprietor, is present at the furnishing of the food or beverages; and (3) the food or beverages are provided to the sole proprietor or a business associate (as defined in §1.274-12(b)(3)).<sup>22</sup>

The IRS provides four examples to illustrate these rules. In neither case were the expenditures lavish or extravagant under the circumstances and are otherwise assumed to be ordinary and necessary expenses under IRC §162.

---

<sup>20</sup> Reg. §1.274-12(a)(1)

<sup>21</sup> Reg. §1.274-12(a)(2)

<sup>22</sup> TD 9925, SUPPLEMENTARY INFORMATION, Summary of Comments and Explanation of Revisions, 2. Food or Beverage Expenses, A. Business Meal Expenses

The first example is the traditional lunch with a client or customer.

**EXAMPLE 1, REG. §1.274-12(A)(3)(I), TAKING A CLIENT TO LUNCH**

Taxpayer A takes client B out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, A may deduct 50 percent of the food or beverage expenses.

Similarly, a lunch with an employee for a business purpose is also fine.

**EXAMPLE 2, REG. §1.274-12(A)(3)(II), EMPLOYEE' PERFORMANCE REVIEW**

Taxpayer C takes employee D out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, C may deduct 50 percent of the food or beverage expenses..

The final two examples deal with the treatment of expenses for food and beverages provided to attendees at a business meeting.

**EXAMPLE 3, REG. §1.274-12(A)(3)(II), BUSINESS MEETING WITH FOOD AND BEVERAGES PROVIDED**

Taxpayer E holds a business meeting at a hotel during which food and beverages are provided to attendees. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses.

**EXAMPLE 4, REG. §1.274-12(A)(3)(II), BUSINESS MEETING WITH FOOD AND BEVERAGES PROVIDED TO EMPLOYEES**

The facts are the same as in Example 3, except that all the attendees of the meeting are employees of E. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses. The exception in section 274(e)(5) does not apply to food and beverage expenses under section 274(k) and (n).

Meals incurred while on travel will remain subject to the substantiation rules of IRC §274(d).<sup>23</sup> Since §274(d) applies, the taxpayer must have the following in order to claim a deduction for meals incurred while traveling:

- The amount of such expense or other item,
- The time and place of the travel or the date and description of the gift,
- The business purpose of the expense or other item, and
- The business relationship to the taxpayer of the person receiving the benefit.<sup>24</sup>

<sup>23</sup> Reg. §1.274-12(a)(4)

<sup>24</sup> IRC §274(d)

## 10 Current Federal Tax Developments

Travel meal expenses of a spouse, dependent or other individual accompanying the taxpayer are not allowed unless the following criteria are met:

- The spouse, dependent, or other individual is an employee of the taxpayer;
- The travel of the spouse, dependent, or other individual is for a bona fide business purpose of the taxpayer; and
- The expenses would otherwise be deductible by the spouse, dependent or other individual.<sup>25</sup>

Although not officially labeled as an example, the IRS provides the following illustration of the application of the accompanying individual provision.

### **ILLUSTRATION, REG. §1.274-12(A)(4)(III)(D), TRAVEL WITH SPOUSE**

Taxpayer E and Taxpayer E's spouse travel from New York to Boston to attend a series of business meetings. E's spouse is not an employee of E, does not travel to Boston for a bona fide business purpose of E, and the expenses would not otherwise be deductible. While in Boston, E and E's spouse go out to dinner. Under section 274(m)(3) and paragraph (a)(4)(iii) of this section, the expenses associated with the food and beverages consumed by E's spouse are not deductible. Therefore, the cost of E's spouse's dinner is not deductible. E may deduct 50 percent of the expense associated with the food and beverages E consumed while on business travel if E meets the requirements in sections 162 and 274, including section 274(k) and (d).

### *Food or Beverage*

The regulations provide the following definition of a food or beverage:

Food or beverages means all food and beverage items, regardless of whether characterized as meals, snacks, or other types of food and beverages, and regardless of whether the food and beverages are treated as de minimis fringes under section 132(e).<sup>26</sup>

Food or beverage expenditures are also defined in the regulation:

Food or beverage expenses mean the full cost of food or beverages, including any delivery fees, tips, and sales tax. In the case of employer-provided meals furnished at an eating facility on the employer's business premises, food or beverage expenses do not include expenses for the operation of the eating facility such as salaries of employees preparing and serving meals, and other overhead costs.<sup>27</sup>

---

<sup>25</sup> Reg. §1.274-12(a)(4)(a)(iii)

<sup>26</sup> Reg. §1.274-12(b)(1)

<sup>27</sup> Reg. §1.274-12(b)(2)

### *People at the Meal or for the Exceptions*

The proposed regulation also looks at definitions for those who need to be at the meal to be deductible or to qualify for one of the exceptions under IRC §274(e).

The first definition is that of a *business associate*:

Business associate means a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective.<sup>28</sup>

Next up is the definition of an *independent contractor*:

For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, independent contractor means a person who is not an employee of the payor.<sup>29</sup>

The definition of a *client or customer* is as follows:

For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(i) of this section, client or customer means a person who receives services from an independent contractor and enters into a reimbursement or other expense allowance arrangement with the independent contractor.<sup>30</sup>

The *payor* is defined as:

For purposes of the reimbursement or other expense allowance arrangements described in paragraph (c)(2)(ii) of this section, payor means a person that enters into a reimbursement or other expense allowance arrangement with an employee and may include an employer, its agent, or a third party.<sup>31</sup>

The *general public* is defined as:

For purposes of paragraph (c)(2)(iv) of this section, the general public includes, but is not limited to, customers, clients, and visitors. The general public does not include employees, partners or independent contractors of the taxpayer. Also, an exclusive list of guests is not the general public.

---

<sup>28</sup> Reg. §1.274-12(b)(3)

<sup>29</sup> Reg. §1.274-12(b)(4)

<sup>30</sup> Reg. §1.274-12(b)(5)

<sup>31</sup> Reg. §1.274-12(b)(6)

## 12 Current Federal Tax Developments

### *Reimbursement Arrangement*

For some of the exceptions, a reimbursement arrangement is involved. The IRS defines a reimbursement arrangement as follows:

- An arrangement under which an employee receives an advance, allowance, or reimbursement from a payor (the employer, its agent, or a third party) for expenses the employee pays or incurs; and
- An arrangement under which an independent contractor receives an advance, allowance, or reimbursement from a client or customer for expenses the independent contractor pays or incurs if either--
  - A written agreement between the parties expressly states that the client or customer will reimburse the independent contractor for expenses that are subject to the limitations on deductions in paragraph (a) of this section; or
  - A written agreement between the parties expressly identifies the party subject to the limitations.<sup>32</sup>

### ***§274(e) Exceptions for Food and Beverages***

The regulation concludes with guidance on the various exceptions to the general rules found in IRC §274(e).

### *Expenses Treated as Compensation*

One option to avoid the 50% limit is to treat food and beverage as compensation to the employee. This includes items that involve the special requirements for meals while traveling. This exception is available if the expense is treated by the taxpayer:

- On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and
- As wages to the employee for purposes of withholding under chapter 24 of the Code, relating to collection of income tax at source on wages.<sup>33</sup>

The compensation rule can apply to independent contractors in addition to employees, but an additional restriction applies. The amount in question must be included in a Form 1099 issued to the contractor if the contractor is one to whom a 1099 would be required to be issued. For this purpose, the Form 1099 must be issued even if the Form 1099 wouldn't be required to be issued because the amounts are less than \$600. However, if other rules eliminate the need to file it (such as the payee is a corporation), then not issuing a Form 1099 is not fatal to the deduction.<sup>34</sup>

---

<sup>32</sup> Reg. §1.274-12(b)(7)

<sup>33</sup> Reg. §1.274-12(c)(2)

<sup>34</sup> Reg. §1.274-12(c)(2)(ii)(B)



In the preamble to the proposed regulations the IRS indicated that they were providing examples to deal with specific fact patterns that some commentators had raised concerns about.<sup>35</sup> Thus, advisers who have situations such as those addressed in the regulation's examples need to pay close attention to these examples.

The first pair of examples are found in this area where the amounts are included as compensation.

The first example deals with the provision of food to employees at a company cafeteria where the employer treats the meals as compensation and thus preserves a full deduction for the expense.

**EXAMPLE 1, REG. §1.274-12(C)(2)(D)(1), CAFETERIA FOOD IN THE PAYCHECK**

Employer F provides food and beverages to its employees without charge at a company cafeteria on its premises. The food and beverages do not meet the definition of a *de minimis fringe* under section 132(e). F treats the food and beverage expenses as compensation and wages, and determines the amount of the inclusion under §1.61-21. Under section 274(e)(2) and paragraph (c)(2)(i) of this section, the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitations in paragraph (a) of this section. Thus, F may deduct 100 percent of the food and beverage expenses.

But the next example notes that if the meals are excluded from the employee's wages under IRC §119 because they are provided for the convenience of the employer, the employer will have to reduce the deduction by 50% of the expense incurred.

**EXAMPLE 2, REG. §1.274-12(C)(2)(D)(2), MEALS EXCLUDED FROM WAGES**

Employer G provides meals to its employees without charge. The meals are properly excluded from the employees' income under section 119 as meals provided for the convenience of the employer. Under §1.61-21(b)(1), an employee must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount, if any, paid for the benefit by or on behalf of the recipient, and the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Code. Because the entire value of the employees' meals is excluded from the employees' income under section 119, the fair market value of the fringe benefit does not exceed the amount excluded from gross income under subtitle A of the Code, so there is nothing to be included in the employees' income under §1.61-21. Thus, the exception in section 274(e)(2) and paragraph (c)(2)(i) of this section does not apply and G may only deduct 50 percent of the expenses for the food and beverages provided to employees.

### *Reimbursed Expenses*

If the service recipient is reimbursing the business related meals expenses of the service provider, one or the other party (but not both) is going to have to bear the burden of the 50% deduction disallowance.<sup>36</sup>

<sup>35</sup> REG-100814-19, February 21, 2020, p. 15

<sup>36</sup> Reg. §1.274-12(c)(2)(ii)(A)

## 14 Current Federal Tax Developments

If the reimbursement arrangement involves an employee, the regulation provides:

- The disallowance applies to the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid to the employee and treats the amount as wages subject to withholding. Note that due to the disallowance of deductions for miscellaneous itemized deductions found in IRC §67(g) that was added by TCJA, in reality the employee will most often get no deduction for the meals expense.
- The disallowance applies to the payor if the amount is not treated as wages by the payor. However, if the payor itself is reimbursed by a customer for those meals, then we look to the rules for reimbursing persons that are not employees discussed next.<sup>37</sup>

If the reimbursement occurs to a nonemployee, such as in the case of a payment to an independent contractor, the limits apply to the party specified in the agreement as bearing the burden of the loss of the deduction, assuming such a designation is made in the contract or other arrangement.<sup>38</sup> If the agreement does not provide a designation, the deduction limit applies to:

- The independent contractor if the contractor does not account to the client or customer the amounts paid as such accounting is defined under the anti-*Cohan* rules of IRC §274(d).
- The client or customer if such an accounting is provided by the independent contractor. Such accounting will generally occur by separately stating the billing for the food and providing documentation of the same.<sup>39</sup>

The IRS provides four examples dealing with the reimbursement rules.

### **EXAMPLE 1, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT**

Employee I performs services under an arrangement in which J, an employee leasing company, pays I a per diem allowance of \$10x for each day that I performs services for J's client, K, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food or beverages that I pays in performing services as an employee. J enters into a written agreement with K under which K agrees to reimburse J for any substantiated reimbursements for travel expenses, including meal expenses, that J pays to I. The agreement does not expressly identify the party that is subject to the limitations on deductions in paragraph (a) of this section. I performs services for K while traveling away from home for 10 days and provides J with substantiation that satisfies the requirements of section 274(d) of \$100x of meal expenses incurred by I while traveling away from home. J pays I \$100x to reimburse those expenses pursuant to their arrangement. J delivers a copy of I's substantiation to K. K pays J \$300x, which includes \$200x compensation for services and

---

<sup>37</sup> Reg. §1.274-12(c)(2)(ii)(B)

<sup>38</sup> Reg. §1.274-12(c)(2)(ii)(C)

<sup>39</sup> Reg. §1.274-12(c)(2)(ii)(C) and (D)

\$100x as reimbursement of J's payment of I's travel expenses for meals. Neither J nor K treats the \$100x paid to I as compensation or wages.

Under paragraph (b)(7)(i) of this section, I and J have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(B) of this section. Because the reimbursement payment is not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(B)(1) of this section, I is not subject to the limitations on deductions in paragraph (a) of this section. Instead, under paragraph (c)(2)(ii)(B)(2) of this section, J, the payor, is subject to limitations on deductions in paragraph (a) of this section unless J can meet the requirements of section 274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section.

Because the agreement between J and K expressly states that K will reimburse J for substantiated reimbursements for travel expenses that J pays to I, under paragraph (b)(7)(ii)(A) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. J accounts to K for K's reimbursement in the manner required by section 274(d) by delivering to K a copy of the substantiation J received from I. Therefore, under section 274(e)(3)(B) and paragraph (c)(2)(ii)(C)(2) of this section, K and not J is subject to the deduction limitations in paragraph (a) of this section.

The IRS then changes this employee leasing example slightly. The employee now accounts for the meals expense to the customer of the leasing company, and that customer then pays the reimbursement.

**EXAMPLE 2, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING  
REIMBURSEMENT BY CUSTOMER DIRECTLY TO EMPLOYEE**

The facts are the same as Example 1 except that, under the arrangements between I and J and between J and K, I provides the substantiation of the expenses directly to K, and K pays the per diem directly to I.

Under paragraph (b)(7)(i) of this section, I and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because I substantiates directly to K and the reimbursement payment was not treated as compensation and wages paid to I, under section 274(e)(3)(A) and paragraph (c)(2)(ii)(C)(1) of this section I is not subject to the limitations on deductions in paragraph (a) of this section. Under paragraph (c)(2)(ii)(C)(2) of this section, K, the payor, is subject to the limitations on deductions in paragraph (a) of this section.

Now the IRS modifies the example to provide that limits apply to the employee leasing company.

**EXAMPLE 3, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING  
REIMBURSEMENT COVERED BY AGREEMENT**

The facts are the same as in Example 1 except that the written agreement between J and K expressly provides that the limitations of this section will apply to K.

Under paragraph (b)(7)(ii)(B) of this section, J and K have established a reimbursement or other expense allowance arrangement for purposes of paragraph (c)(2)(ii)(C) of this section. Because the agreement provides that the 274 deduction limitations apply to K, under section

274(e)(3)(B) and paragraph (c)(2)(ii)(C) of this section, K and not J is subject to the limitations on deductions in paragraph (a) of this section.

The final example looks at the case where there is no agreement to reimburse expenses.

**EXAMPLE 4, REG. §1.274-12(C)(2)(II)(E), EMPLOYEE LEASING REIMBURSEMENT COVERED BY AGREEMENT**

The facts are the same as in Example 1 except that the agreement between J and K does not provide that K will reimburse J for travel expenses.

The arrangement between J and K is not a reimbursement or other expense allowance arrangement within the meaning of section 274(e)(3)(B) and paragraph (b)(7)(ii) of this section. Therefore, even though J accounts to K for the expenses, J is subject to the limitations on deductions in paragraph (a) of this section.

Note that without an agreement that the contractor will be reimbursed for covered expenses, even with an accounting the contractor will be stuck with the 50% disallowance.

*Recreational Expenses for Employees*

Expenses paid for food or beverages by a taxpayer for recreational, social or similar activities primarily for the benefit of employees is not subject to the 50% disallowance. However, special rules apply to the extent that some of the employees being provided the food are highly compensated employees.<sup>40</sup>

The regulation provides that it applies to “expenses paid or incurred for events such as holiday parties, annual picnics, or summer outings.”<sup>41</sup> However, it cannot be used to cover expenses that are excluded from the employees’ wages because they actually represent meals paid for the convenience of the employer per IRC §119.<sup>42</sup>

The exclusion only applies to food or beverages made primarily for the benefit of employees other than the following highly compensated employees:

- Officers;
- Shareholders or other owners who own a 10% or greater interest in the business (counting interests owned by members of the family within the meaning of IRC §267(c)(4) as owned by that person); or
- Other highly compensated employees.<sup>43</sup>

---

<sup>40</sup> Reg. §1.274-13(c)(2)(iii)(A)

<sup>41</sup> Reg. §1.274-13(c)(2)(iii)(A)

<sup>42</sup> Reg. §1.274-13(c)(2)(iii)(A)

<sup>43</sup> Reg. §1.274-13(c)(2)(iii)(B)

This does not mean this “tainted group” cannot attend the function in question, but rather that the function must be primarily for the benefit of the rank and file. As the proposed regulation notes:

An expense for food or beverages is not to be considered outside of the exception of this paragraph (c)(2)(iii) merely because, due to the large number of employees involved, the provision of food or beverages is intended to benefit only a limited number of employees at one time, provided the provision of food or beverages does not discriminate in favor of officers, shareholders, other owners, or highly compensated employees.<sup>44</sup>

The IRS gives five examples of the recreational expense exception.

**EXAMPLE 1, REG. §1.274-13(C)(2)(III)(C), HOLIDAY PARTY AT A HOTEL**

Employer L invites all employees to a holiday party in a hotel ballroom that includes a buffet dinner and an open bar. Under section 274(e)(4), this paragraph (c)(2)(iii), and §1.274-11(c), the cost of the party, including food and beverage expenses, is not subject to the deduction limitations in paragraph (a) of this section because the holiday party is a recreational, social, or similar activity primarily for the benefit of non-highly compensated employees. Thus, L may deduct 100 percent of the cost of the party.

The fact that the party did not discriminate in favor of the highly compensated employees was key in having this program qualify for a full deduction. Contrast the result with that in the second IRS example.

**EXAMPLE 2, REG. §1.274-13(C)(2)(III)(C), HOLDING PARTY FOR HIGHLY COMPENSATED EMPLOYEES ONLY WITH FOOD SEPARATELY INVOICED**

The facts are the same as in Example 1 except that Employer L invites only highly-compensated employees to the holiday party, and the invoice provided by the hotel lists the costs for food and beverages separately from the cost of the rental of the ballroom. The costs reflect the venue’s usual selling price for food or beverages. The exception in this paragraph (c)(2)(iii) does not apply because L invited only highly-compensated employees to the holiday party. However, under §1.274-11(b)(1)(ii), the food and beverage expenses are not treated as entertainment. L may deduct 50 percent of the food and beverage costs that are separately stated on the invoice under paragraph (a)(2) of this section.

The IRS next moves on to snacks in the break room—and the IRS decides those foods will be subject to the 50% limitation.

**EXAMPLE 3, REG. §1.274-13(C)(2)(III)(C), SNACKS IN THE BREAK ROOM**

Employer M provides free coffee, soda, bottled water, chips, donuts, and other snacks in a break room available to all employees. The expenses associated with the food and beverages are subject to the deduction limitations in paragraph (a) of this section because the break room is not a recreational, social, or similar activity primarily for the benefit of the employees. Thus, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not

<sup>44</sup> Reg. §1.274-13(c)(2)(iii)(B)

apply and M may only deduct 50 percent of the expenses for food and beverages provided in the break room.

As well, if there is a job related reason to provide the food and drink for the convenience of the employer, the full 50% disallowance will apply.

**EXAMPLE 4, REG. §1.274-13(C)(2)(III)(C), MEALS FURNISHED TO KEEP EMPLOYEES ON SITE**

Employer N has a written policy that employees in a certain medical services-related position must be available for emergency calls due to the nature of the position that requires frequent emergency response. Because these emergencies can and do occur during meal periods, N furnishes food and beverages to employees in this position without charge in a cafeteria on N's premises. N excludes food and beverage expenses from the employees' income as meals provided for the convenience of the employer excludable under section 119. Because these food and beverages are furnished for the employer's convenience, and therefore are not primarily for the benefit of the employees, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even if some socializing related to the food and beverages provided occurs. Thus, N may only deduct 50 percent of the expenses for food and beverages provided to employees in the cafeteria.

Similarly, the IRS decides that this exception can't be combined with a business meal even if a social celebration takes place with the employee during that meal.

**EXAMPLE 5, REG. §1.274-13(C)(2)(III)(C), BIRTHDAY DESERT AT A BUSINESS MEAL**

Employer O invites an employee and a client to dinner at a restaurant. Because it is the birthday of the employee, O orders a special dessert in celebration. Because the meal is a business meal, and therefore not primarily for the benefit of the employee, the exception in section 274(e)(4) and this paragraph (c)(2)(iii) does not apply, even though an employee social activity in the form of a birthday celebration occurred during the meal. Thus, O may only deduct 50 percent of the meal expenses.

The last two examples likely were added to make clear the IRS is not inclined to be very tolerant about "creative" attempts to expand the recreational rule to cover other situations as taxpayers attempt to get a full deduction. The event must be purely recreational in nature, not "maybe" recreational (if there was no medical emergency during the meal) or partially recreational (the birthday cake at the end of the business meal).

*Food or Beverage Made Available to the Public*

If the food or beverage is made available to the general public, then the 50% disallowance of the deduction does not apply to the expenditure. This is true even if that food or beverage is also available to employees of the employer, so long as the same types of food or beverages are provided to and primarily consumed by the general public.<sup>45</sup>

---

<sup>45</sup> Reg. §1.274-12(c)(2)(iv)(A)

The IRS provides four examples of what constitutes such items available to the general public.

**EXAMPLE 1, REG. §1.274-12(C)(2)(IV)(B), OPEN HOUSE OF REAL ESTATE AGENT**

Employer P is a real estate agent and provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by P's employees, potential buyers of the property, and other real estate agents. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations in paragraph (a) of this section if over 50 percent of the food and beverages are primarily consumed by potential buyers and other real estate agents. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

The last sentence of the example is a key one—the taxpayer must show the food and beverages were primarily consumed by the general public (in this case, other real estate agents and potential buyers), rather than by the employees of the employer.

The same caveat is repeated in the second example, this one involving an automotive service center waiting room.

**EXAMPLE 2, REG. §1.274-12(C)(2)(IV)(B), AUTO REPAIR WAITING AREA**

Employer Q is an automobile service center and provides refreshments in its waiting area. The refreshments are consumed by Q's employees and customers. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations provided for in paragraph (a) of this section if over 50 percent of the food and beverages are primarily consumed by customers. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

The next example deals with meals provided at a summer camp.

**EXAMPLE 3, REG. §1.274-12(C)(2)(IV)(B), SUMMER CAMP**

Employer R operates a summer camp open to the general public for children and provides breakfast and lunch, as part of the fee to attend camp, both to camp counselors, who are employees, and to camp attendees, who are customers. There are 20 camp counselors and 100 camp attendees. The same type of meal is available to each counselor and attendee, and attendees consume more than 50 percent of the food and beverages. Under section 274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the food and beverages are not subject to the deduction limitations in paragraph (a) of this section, because over 50 percent of the food and beverages are primarily consumed by camp attendees. Thus, R may deduct 100 percent of the food and beverage expenses.

Note that the customers are treated as the general public in this case, though with the caveat that the camp is open to the general public. That suggests that there might be a point where restrictions on who could be a customer might lead to not treating customers as the general public.

As well, the example explicitly provides for a greater than 50% consumption test to determine if the food and beverages are primarily consumed by the general public. The next example emphasizes that the opposite is true—if more than 50% is consumed by employees, this exception won't work.

**EXAMPLE 4, REG. §1.274-12(C)(2)(IV)(B), COMPANY CAFETERIA**

Employer S provides food and beverages to its employees without charge at a company cafeteria on its premises. Occasionally, customers or other visitors also eat without charge in the cafeteria. The occasional consumption of food and beverages at the company cafeteria by customers and visitors is less than 50 percent of the total amount of food and beverages consumed at the cafeteria. Therefore, only the costs attributable to the food and beverages provided to the general public are excepted under section 274(e)(7) and this paragraph (c)(2)(iv).

*Goods or Services Sold to Customers*

Food and beverages purchased for eventual sale to customers generally are also exempted from the 50% disallowance of a deduction. But the transaction must be one for adequate and full consideration in money or money's worth.<sup>46</sup>

The regulation provides that if a transaction fails that test, it will not qualify, stating:

However, money or money's worth does not include payment through services provided. Under this paragraph (c)(2)(v), a restaurant or catering business may deduct 100 percent of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are also consumed at the worksite by employees who work in the employer's restaurant or catering business. In addition, for purposes of this paragraph (c)(2)(v), the term customer includes anyone, including an employee of the taxpayer, who is sold food or beverages in a bona fide transaction for an adequate and full consideration in money or money's worth.<sup>47</sup>

The IRS provides the following single example for this provision.

**EXAMPLE, REG. §1.274-12(C)(2)(V)(B), RESTAURANT**

Employer T operates a restaurant. T provides food and beverages to its food service employees before, during, and after their shifts for no consideration. Under section 274(e)(8) and this paragraph (c)(2)(v), the expenses associated with the food and beverages provided to the employees are not subject to the 50 percent deduction limitation in paragraph (a) of this section because the restaurant sells food and beverages to customers in a bona fide

---

<sup>46</sup> Reg. §1.274-12(c)(

<sup>47</sup> Reg. §1.274-12(c)(



transaction for an adequate and full consideration in money or money's worth. Thus, T may deduct 100 percent of the food and beverage expenses.

### ***Effective Date***

These regulations are proposed to apply to taxable years that begin on or after the date of their publication as final regulations. However, prior to the issuance of the final regulations, taxpayers can rely on these regulations for expenses incurred after December 31, 2017. As well, until the regulations are finalized, taxpayers can continue to rely on Notice 2018-76.<sup>48</sup>

## **SECTION: 3405 FINAL REGULATIONS ON WITHHOLDING ON PERIODIC RETIREMENT AND ANNUITY PAYMENTS ISSUED**

### **Citation: TD 9920, 9/28/20**

Prior to the Tax Cuts and Jobs Act, those receiving periodic payments from pensions, annuities and certain other deferred income had withholding computed by default at the rate imposed on a married wage earner claiming 3 exemptions. As the Tax Cuts and Jobs Act revisions eliminated the prior method of wage withholding, IRC §3405(a) was modified to change this default withholding, providing for methods to be determined by the IRS.

The IRS has now issued final regulations<sup>49</sup> to provide for withholding on such retirement distributions. The regulations apply to payments made after December 31, 2020. For 2020 payments, the IRS had issued guidance found in Notice 2020-03, issued in December 2019.

The IRS adds new Reg. §31.3405-1, Questions and answers relating to Federal income tax withholding on periodic retirement and annuity payments, to outline the new withholding provisions on such payments. The regulation is written in question and answer format, with two provisions with detailed rules and a final question to outline the effective date.

---

<sup>48</sup> REG-100814-19, February 21, 2020, p. 22

<sup>49</sup> TD 9920, September 28, 2020, <https://www.irs.gov/pub/irs-drop/td-9920.pdf> (retrieved September 28, 2020)

### ***How Income Will Be Withheld from a Periodic Payment***

The first question discusses how Federal income tax will be withheld from periodic retirement and annuity payments:

(b)(1) Q-1: How will Federal income tax be withheld from a periodic payment?

(2) A-1: In the case of a periodic payment that is subject to withholding under section 3405(a), amounts are withheld as if the payment were a payment of wages by an employer to the employee for the appropriate payroll period. If the payee has not furnished a withholding certificate, the amount to be withheld is determined in the manner described in the applicable forms, instructions, publications, and other guidance prescribed by the Commissioner. The rules for withholding when the payee has not furnished a withholding certificate apply regardless of whether the payor is aware of the payee's actual marital status or actual Federal income tax filing status.

Note that the IRS has moved the default withholding amounts out of the regulations, and rather allows the rate to be set in forms, instructions, publications and other guidance prescribed by the agency.

### ***Similar Rules to Those for Wage Withholding***

The second question provides that rules similar to those for withholding certificates for wages will apply to these payments:

(c)(1) Q-2: Do rules similar to those for wage withholding apply to the furnishing of a withholding certificate for periodic payments?

(2) A-2: Yes. Unless the rules of section 3405 specifically conflict with the rules of section 3402, the rules for withholding on periodic payments that are not eligible rollover distributions will parallel the rules for wage withholding. Thus, if a withholding certificate is furnished by a payee, it will generally take effect in accordance with section 3402(f)(3) and as provided in applicable forms, instructions, publications, and other guidance prescribed by the Commissioner. If no withholding certificate is furnished, the amount withheld must be determined in the manner described in the applicable forms, instructions, publications, and other guidance prescribed by the Commissioner for withholding on periodic payments when no withholding certificate is furnished.

## **SECTION: 951A**

### **S CORPORATIONS WITH TRANSITION AE&P ALLOWED TO ELECT ENTITY TREATMENT FOR GILTI**

#### **Citation: Notice 2020-69, 9/1/20**

In Notice 2020-69<sup>50</sup> the IRS outlined items that will be contained in to be issued proposed regulations related to S corporations with accumulated earnings and profits impacted by IRC §§951 and 951A. The revisions are meant to address the proposed and then modified final regulations on GILTI and FDII issued by the IRS previously. The IRS's change of direction from handling the S corporation as an entity for GILTI to treating it under an aggregate approach can lead to problems in getting shareholders the cash to pay the tax if the S corporation has accumulated earnings and profits. The Notice and eventual regulations seeks to address that issue.

#### ***GILTI in General***

The Notice begins by discussing the provisions in general that will be impacted by the Notice:

Section 951(a) of the Code generally requires a United States shareholder (as defined in § 951(b)) (U.S. shareholder), to include in its gross income its pro rata share of subpart F income (as defined in § 952) of a controlled foreign corporation (as defined in § 957) (CFC) and the amount determined under § 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under § 959(a)(2)) (subpart F inclusion).

Section 951A(a) requires a U.S. shareholder of any CFC for any taxable year to include in gross income the shareholder's GILTI for such taxable year (GILTI inclusion amount). The U.S. shareholder's GILTI inclusion amount is calculated based on certain items — such as tested income, tested loss, and QBAI — of each CFC owned by the U.S. shareholder (tested items). See § 1.951A-1(c) of the Income Tax Regulations. In general, a U.S. shareholder's GILTI inclusion amount is determined by reference to the U.S. shareholder's pro rata share of the tested items based on the stock of all the CFCs that the U.S. shareholder owns within the meaning of § 958(a). See § 951A(e)(1) (cross referencing § 951(a)(2)). The GILTI provisions in § 951A, enacted in § 14201(a) of the TCJA, apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See § 14201(d) of the TCJA.

Section 951(b) defines a U.S. shareholder, with respect to any foreign corporation, as a United States person (U.S. person) that owns (within

---

<sup>50</sup> Notice 2020-69, September 1, 2020, <https://www.irs.gov/pub/irs-drop/n-20-69.pdf> (retrieved September 30, 2020)

the meaning of § 958(a)), or is considered as owning by applying the ownership rules of § 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such corporation or 10 percent or more of the value of all shares of all classes of stock of the foreign corporation. See also § 1.951-1(g). Section 957(c) generally defines a U.S. person for purposes of subpart F by reference to § 7701(a)(30), which defines a U.S. person as a citizen or resident of the United States, a domestic partnership, a domestic corporation, and certain estates and trusts.<sup>51</sup>

Partnerships and S corporations pose a problem for this regime, since they aren't themselves taxable entities generally. The tax law sometimes views the partnership or S corporation as an entity (say for selecting the overall method of accounting) while other times looking through the structure to apply rules at the individual level (such as if a §1231 gain will be ultimately taxed at capital gain rates) applying an aggregate test. That is, the passthrough was viewed as simply an aggregation of the various owners.

As the Notice indicates, IRC §1373(a) provides that an S corporation will be treated like a partnership for purposes of Subpart A and F of Part III and Part V of Subchapter N of the IRC. The Notice points out that, prior to TCJA, domestic partnerships and S corporations were treated as entities for the then applicable Subpart F inclusion for CFC. Thus, the test for the existence of a U.S. shareholder took place at the partnership/S corporation level, with the equity holder having to take into account his/her share of the Subpart F inclusion amount even if the equity holder was not him/herself a holder of enough of an interest in the CFC (even counting their proportionate share held by the partnership or S corporation) to be a U.S. shareholder of the CFC.

Foreign partnerships were treated differently, however. For those, the partners were each deemed to own proportionately the stock of the CFC held by the foreign partnership.

The original 2018 proposed regulations implementing the new GILTI provisions took a hybrid approach, borrowing from both the entity and aggregate view. As the Notice provides:

On October 10, 2018, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-104390-18) in the Federal Register (83 FR 51072) under § 951A (2018 proposed regulations). Section 1.951A-5 of the 2018 proposed regulations (proposed § 1.951A-5) provided a "hybrid approach" to a domestic partnership that is a U.S. shareholder (U.S. shareholder partnership) of a CFC (partnership-owned CFC). Under the hybrid approach, a U.S. shareholder partnership would determine its GILTI inclusion amount, and the partners of the partnership that were not also U.S. shareholders of the partnership-owned CFC would take into account their distributive share of the partnership's GILTI inclusion amount. See proposed § 1.951A-5(b). Partners that also were U.S. shareholders

---

<sup>51</sup> Notice 2020-69, Section 2.01

of a partnership-owned CFC would not take into account their distributive share of the partnership's GILTI inclusion amount. Instead, such partners would be treated as proportionately owning the stock of the partnership-owned CFC within the meaning of § 958(a) as if the domestic partnership were a foreign partnership. See proposed § 1.951A-5(c).

Because § 1373(a) treats S corporations as partnerships for purposes of subpart F, the hybrid approach in the 2018 proposed regulations also applied to S corporations that held stock of a CFC. For example, proposed § 1.951A-5(g)(5) (Example 5) applied entity treatment (outlined in section 2.02(1) of this notice) to an S corporation shareholder that was not a U.S. shareholder of a CFC owned by the S corporation (S corporation-owned CFC), and aggregate treatment (outlined in section 2.02(2) of this notice) to an S corporation shareholder that was a U.S. shareholder of the S corporation-owned CFC.<sup>52</sup>

However, this approach was not taken in the 2019 final regulations. Those regulations shifted entirely to the aggregate view that previously applied to foreign partnerships for Subpart F income. The partnership itself is not tested to see if it is a U.S. shareholder—rather, each partner looks at his/her overall ownership interest in the CFC, including the equity holder's proportionate share of the entity's holdings, to determine if he/she will be treated as a U.S. shareholder:

On June 21, 2019, the Treasury Department and the IRS published final regulations (T.D. 9866) in the Federal Register (84 FR 29288) under § 951A (final regulations). The final regulations did not adopt the hybrid approach included in the 2018 proposed regulations and instead adopted aggregate treatment for domestic partnerships. Accordingly, under the final regulations, a domestic partnership does not have a GILTI inclusion amount, and therefore no partner of the partnership has a distributive share of a GILTI inclusion amount. See § 1.951A-1(e)(1). Rather, for purposes of determining the GILTI inclusion amount of any partner of a domestic partnership, each partner is treated as proportionately owning the stock of a CFC owned by the partnership within the meaning of § 958(a) in the same manner as if the domestic partnership were a foreign partnership. Because only a U.S. person that is a U.S. shareholder can have a GILTI inclusion amount, a partner that is not a U.S. shareholder of a partnership-owned CFC does not have a GILTI inclusion amount determined by reference to the partnership-owned CFC. Section 1.951A-1(e)(1) applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. See § 1.951A-7.<sup>53</sup>

---

<sup>52</sup> Notice 2020-69, Section 2.02(3)

<sup>53</sup> Notice 2020-69, Section 2.02(4)

The Notice describes the resulting Subpart F and GILTI tax treatment for a partner under proposed regulations issued with the final regulations:

On June 21, 2019, concurrent with the final regulations, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-101828-19) in the Federal Register (84 FR 29114) under § 958 (2019 proposed regulations). Section 1.958-1 of the 2019 proposed regulations (proposed § 1.958-1) mirrored the aggregate treatment of domestic partnerships for purposes of GILTI inclusions as set forth in the final regulations, and also extended it to apply for purposes of subpart F inclusions. See proposed § 1.958-1(d)(1). Accordingly, subject to certain exceptions in proposed § 1.958-1(d)(2), for purposes of §§ 951 and 951A and any other provision that applies by reference to § 951 or 951A, the 2019 proposed regulations provided that a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of § 958(a); instead, a domestic partnership is treated in the same manner as a foreign partnership for purposes of determining the persons that own stock of the foreign corporation within the meaning of § 958(a). See proposed § 1.958-1(d)(1). Under proposed § 1.958-1(d)(2), a domestic partnership is treated as an entity for purposes of determining whether any U.S. person (including the domestic partnership) is a U.S. shareholder, whether any U.S. shareholder is a controlling domestic shareholder (as defined in § 1.964-1(c)(5)), or whether any foreign corporation is a CFC.

Consistent with the final regulations with respect to GILTI, under the 2019 proposed regulations a partner that is not a U.S. shareholder with respect to a partnership-owned CFC does not take into account a subpart F inclusion or GILTI inclusion amount by reference to the partnership-owned CFC.

The 2019 proposed regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date of publication of the Treasury decision adopting the rules as final regulations in the Federal Register. See proposed § 1.958-1(d)(4). Subject to a consistency requirement, however, the 2019 proposed regulations provide that a domestic partnership may apply the regulations, once finalized, to taxable years of a foreign corporation beginning after December 31, 2017, and to taxable years of the domestic partnership in which or with which such taxable years of the foreign corporation end. See *id.*<sup>54</sup>

### ***Impact of the Rules on S Corporation Distributions***

The new aggregate approach creates issues with distributions from an S corporation. Under current regulations, an S corporation shareholder who now has an income inclusion under the aggregate approach on his/her personal return would not see a

---

<sup>54</sup> Notice 2020-69, Section 2.02(5)

corresponding increase in AAA at the S corporation level, as that is a corporate account.

The Notice explains:

The aggregate treatment provided in the final regulations, as applied to S corporations with AE&P, does not result in a positive adjustment of AAA because the GILTI inclusion amount arises at the shareholder level, rather than at the S corporation level. See § 1.951A-1(e). If an S corporation with AE&P distributes property to its shareholders, for example, to provide its shareholders with funds to pay the resulting federal income tax arising from their GILTI inclusion amount with respect to stock of CFCs owned by the S corporation, the S corporation would need an amount of AAA equal to the amount of that distribution to prevent the distribution from being included in such shareholders' gross income to the extent of AE&P. See generally § 1368(c). Although the S corporation could generate additional AAA as needed through a distribution from a CFC, comments have asserted that such an approach could result in foreign withholding taxes or undesired reductions in working capital that otherwise would be devoted to the CFC's businesses.

As stated in section 2.02(7) of this notice, § 1368(c)(1) provides that tax-free distribution treatment to shareholders of an S corporation with AE&P results only to the extent the S corporation has sufficient AAA to support the distribution. In the absence of enough AAA, § 1368(c)(2) requires the distribution to be taxed as a dividend (as defined in § 316) to the S corporation's shareholders to the extent of the S corporation's AE&P. In other words, if an S corporation has no AAA, the amount of the adjusted basis in a shareholder's S corporation stock — including any positive basis adjustment under § 961(a) resulting from a shareholder's GILTI inclusion — does not affect dividend treatment. Once the S corporation exhausts its AE&P, distributions are once again applied to shareholder stock basis. Comments regarding the application of the final regulations to S corporations and their shareholders focused on these interactions between the aggregate treatment and the distribution rules for AE&P under subchapter S.<sup>55</sup>

Thus, S corporations with shareholders who are seeing a GILTI inclusion amount may find they are paying tax on a distribution made to allow them to pay the tax if there is not a corresponding distribution from the CFC—a distribution that may not make sense for various reasons. The issue will only arise if the S corporation has accumulated earnings and profits (AE&P) since in that case the distributions will become tax dividends to shareholders once the corporate level AAA is exhausted.

---

<sup>55</sup> Notice 2020-69, Section 2.02(8)

### ***Election for S Corporation with AE&P to be Treated Under the Entity Method***

The Notice announces that the IRS plans to address this problem in new regulations to be released under IRC §958. The Notice states:

The Treasury Department and the IRS intend to issue the forthcoming S corporation regulations under § 958 of the Code to ease the transition of S corporations with AE&P on September 1, 2020 from the historic entity treatment and the hybrid treatment under proposed §1.951A-5 (and illustrated in § 1.951A-5(g)(5) (Example 5)) to the aggregate treatment required under the final regulations (transition rules). The forthcoming S corporation regulations will ensure that distributions of income already taxed to S corporation shareholders will be tax-free, and AE&P generated by a former C corporation will be taxed as dividends when distributed.

The Treasury Department and the IRS intend the transition rules to assist S corporations with AE&P and their shareholders by allowing them to recognize the GILTI inclusion amount at the entity level so it is treated as an item of income, thereby increasing its AAA before allocation to the shareholders. This increase in AAA will allow S corporations to distribute property to shareholders and avoid dividend treatment. To achieve this result, the Treasury Department and the IRS expect to provide rules and examples consistent with those set forth in sections 3.02 and 3.03, respectively, of this notice. These transition rules are expected to apply solely to S corporations with “transition AE&P,” as defined in section 3.02(3) of this notice.<sup>56</sup>

To address this issue, the Notice provides the S corporation and its shareholders with an option to use the entity treatment for the GILTI inclusion amount:

With respect to a taxable year, an S corporation is subject to entity treatment if (a) it (and its shareholders, if applicable) makes an election described in section 3.02(2) of this notice, (b) it has elected S corporation status before June 22, 2019, (c) it would be treated as owning stock of a CFC on June 22, 2019, within the meaning of § 958(a) if entity treatment applied, (d) it has transition AE&P (as defined in section 3.02(3) of this notice) on September 1, 2020, or on the first day of any subsequent taxable year, and (e) it maintains records to support the determination of the transition AE&P amount. Entity treatment means that an S corporation that owns stock of a CFC is treated as owning within the meaning of § 958(a) the CFC stock for purposes of applying § 951A. Thus, the S corporation determines its GILTI inclusion amount, and its shareholders take into account their distributive share of that GILTI inclusion amount. See section 2.02(1) of this notice.<sup>57</sup>

---

<sup>56</sup> Notice 2020-69, Section 3.01

<sup>57</sup> Notice 2020-69, Section 3.02(1)



The Notice outlines the following rules for making this election:

With respect to the first taxable year ending on or after September 1, 2020, an S corporation may irrevocably elect to apply entity treatment on a timely filed (including extensions) original Form 1120-S, U.S. Income Tax Return for an S Corporation. For taxable years of an S corporation ending before September 1, 2020 and after June 21, 2019, the S corporation and all of its shareholders may irrevocably elect the entity treatment provided in section 3.02(1) of this notice on timely filed (including extensions) original returns or on amended returns filed by March 15, 2021, by attaching a statement thereto.

The election is made by attaching a statement to the Federal tax return. The election statement must identify the election being made, include the amount of transition AE&P as described in section 3.02(3) of this notice, and, where applicable, be signed by a person authorized to sign the return required to be filed under § 6037. Form 1120-S, Schedules K-1 (Form 1120-S), and Form 8892, *U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*, must be prepared consistent with the S corporation's election for shareholders to comply with § 6037(c).<sup>58</sup>

### ***Transition AE&P – A Requirement for the Election and Treatment***

As was explained earlier, an S corporation that has no accumulated earnings and profits does not face a problem with making distributions to help pay the tax generated by GILTI inclusion by shareholders in the aggregate method found in the regulations. So the Notice limits the election only to those S corporations with AE&P existing at the transition date (“Transition AE&P”) and only for the period the corporation continues to have such AE&P.

Transition AE&P is defined in the Notice as:

For purposes of this notice, the term “transition AE&P” means, with respect to an S corporation and its shareholders, the amount of AE&P of the S corporation calculated as of September 1, 2020, reduced as described in section 3.02(5) of this notice. Transition AE&P is not increased as a result of transactions occurring (or entity classification elections described in § 301.7701-3 filed) after September 1, 2020.<sup>59</sup>

The Notice provides that Transition AE&P is not transferrable—what would be transferred is “standard” AE&P.

For purposes of this notice, transition AE&P of an S corporation is not transferrable to another person under any provision of the Code (for example, under §§ 312(h) or 381 by reason of § 1371(a)). In other

---

<sup>58</sup> Notice 2020-69, Section 3.02(2)

<sup>59</sup> Notice 2020-69, Section 3.02(3)

words, the transferee of the transition AE&P would receive AE&P not transition AE&P.<sup>60</sup>

The Notice also points out that AE&P is only to be reduced by distributions (presumably either actual distributions or elective deemed distributions of S corporation earnings and profits):

An S corporation with transition AE&P is treated as having no transition AE&P if, beginning after September 1, 2020, the S corporation distributes in one or more distributions a cumulative amount of AE&P equal to or greater than the amount of the S corporation's transition AE&P as of September 1, 2020.<sup>61</sup>

The Notice provides that the entity status continues until transition AE&P is exhausted:

Except as provided in Notice 2019-46, aggregate treatment applies to an S corporation if the S corporation has not made an election described in section 3.02(1) of this notice to apply the transition rules. In the case of an S corporation that has made an election to apply entity treatment as described in section 3.02(1) of this notice, aggregate treatment applies beginning with the S corporation's first taxable year for which the S corporation has no transition AE&P on the first day of that year, and to each subsequent taxable year of the S corporation. For purposes of this section 3.02(6), aggregate treatment means the treatment of an S corporation provided under § 1.951A-1(e).<sup>62</sup>

### Examples

The Notice has two examples of applying this election.

#### **EXAMPLE 1, NOTICE 2020-69**

*S corporation with transition AE&P*

(a) Facts. Individual A and Individual B, each U.S. citizens, respectively own 5% and 95% of the single class of stock of SCX, an S corporation. SCX's sole asset is 100% of the single class of stock of FC, a CFC, which SCX has held since June 1, 2019. Neither Individual A or Individual B own shares, directly or indirectly, in any other CFC. Individual A, Individual B, SCX, and FC all use the calendar year as their taxable year. On January 1, 2021, SCX has transition AE&P of \$100x and AAA of \$0. SCX elects to apply the transition rules under section 3.02(1) of this notice. During the 2021 taxable year, FC has \$200x of tested income (within the meaning of § 1.951A-2(b)(1)) and \$0 of QBAI (within the meaning of § 1.951A-3(b)).

(b) Analysis — (i) S corporation-level. As an S corporation with transition AE&P on the first day of the taxable year (here, January 1, 2021), SCX is treated as owning (within the meaning of § 958(a)) all the stock of FC for purposes applying § 951A. Accordingly, SCX, a U.S. shareholder of FC, determines its GILTI inclusion amount under § 1.951A-1(c)(1) for its 2021 taxable year.

<sup>60</sup> Notice 2020-69, Section 3.02(4)

<sup>61</sup> Notice 2020-69, Section 3.02(5)

<sup>62</sup> Notice 2020-69, Section 3.02(6)

SCX's pro rata share of FC's tested income is \$200x, and its pro rata share of FC's QBAI is \$0. SCX's net CFC tested income (within the meaning of § 1.951A-1(c)(2)) is \$200x, and its net deemed tangible income return (within the meaning of § 1.951A-1(c)(3)) is \$0. As a result, SCX's GILTI inclusion amount for 2021 is \$200x. At the end of 2021, SCX increases its AAA by \$200x to reflect the GILTI inclusion amount. Because SCX computes its income as an individual under § 1363(b), it cannot take a § 250 deduction for any GILTI inclusion amount. See § 1.250(a)-1(c)(1).

(ii) S corporation shareholder-level. Neither Individual A nor Individual B is treated as owning the stock in FC within the meaning of § 958(a). Accordingly, Individual A and Individual B include in gross income their pro rata shares of SCX's GILTI inclusion amount as described in § 1366(a), which is \$10x ( $\$200x \times 5\%$ ) for Individual A and \$190x ( $\$200x \times 95\%$ ) for Individual B.

### **EXAMPLE 2, NOTICE 2020-69**

#### *Effect of distribution on transition AE&P*

(a) Facts. The facts are the same as in Example 1 of this section 3.03, except that, on December 31, 2021, SCX distributes \$300x to its shareholders. In addition, FC has an additional \$200x of tested income (within the meaning of § 1.951A-2(b)(1)) and \$0 of QBAI (within the meaning of § 1.951A-3(b)) during the 2022 taxable year.

(b) Analysis — (i) Determination of transition AE&P. Before taking into account the distribution on December 31, 2021, the results for taxable year 2021 are the same as set forth in paragraphs (b)(i) and (b)(ii) of Example 1 of this section 3.03. \$200x, the portion of SCX's \$300x distribution that does not exceed AAA, is subject to § 1368(c)(1). The remaining distribution of \$100x is treated as a dividend under § 316 to the extent of SCX's AE&P. As of January 1, 2022, SCX has \$0 of transition AE&P under section 3.02(5) of this notice because the cumulative amount of SCX's distributions out of AE&P after September 1, 2020 equals or exceeds the amount of SCX's transition AE&P as of September 1, 2020.

(ii) S corporation-level. Because SCX has no transition AE&P as of January 1, 2022, aggregate treatment applies to SCX for its taxable year 2022 and for each subsequent taxable year. As a result, for purposes of determining a GILTI inclusion amount in its taxable year 2022, SCX is not treated as owning (within the meaning of § 958(a)) the FC stock; instead, SCX is treated in the same manner as a foreign partnership for purposes of determining the FC stock owned by Individual A and Individual B under § 958(a)(2). See § 1.951A-1(e)(1). Accordingly, SCX does not have a GILTI inclusion amount for its 2022 taxable year (or for any subsequent taxable year) and therefore will not increase its AAA as a result of its ownership of FC stock for its taxable year 2022 (or for any subsequent taxable year).

(iii) S corporation shareholder-level — (A) Individual A. For purposes of determining the GILTI inclusion amount of Individual A for taxable year 2022, Individual A is treated as owning 5% of the FC stock under § 958(a). Individual A is not, however, a U.S. shareholder of FC because Individual A owns (within the meaning of § 958(a) and (b)) less than 10% (that is, only 5%) of the FC stock. Accordingly, Individual A does not have a GILTI inclusion amount for taxable year 2022.

(B) Individual B. For purposes of determining the GILTI inclusion amount of Individual B for taxable year 2022, Individual B is treated as owning 95% of the FC stock under § 958(a). In addition, Individual B is a U.S. shareholder of FC because Individual B owns (within the meaning of § 958(a) and (b)) at least 10% (that is, 95%) of the FC stock. Accordingly, Individual B's pro rata share of FC's tested income is \$190x ( $\$200x \times 0.95$ ), and Individual B's pro rata share of FC's QBAI is \$0. Individual B's net CFC tested income is \$190x, and Individual

B's net deemed tangible income return is \$0. As a result, Individual B's GILTI inclusion amount for taxable year 2022 is \$190x.

## **SECTION: PPP LOAN**

### **SBA ISSUES NOTICE REGARDING IMPACT OF CHANGE OF OWNERSHIP FOR PPP BORROWER**

#### **Citation: SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, 10/2/20**

The Small Business Administration has issued guidance related to PPP loans when there is a change in ownership of the borrowing business.<sup>63</sup> The notice provides for the required procedures when there is a change in ownership.

The notice defines a *change in ownership* as when any of the following take place:

- At least 20 percent of the common stock or other ownership interest of a PPP borrower (including a publicly traded entity) is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity,
- The PPP borrower sells or otherwise transfers at least 50 percent of its assets (measured by fair market value), whether in one or more transactions, or
- A PPP borrower is merged with or into another entity.<sup>64</sup>

The SBA clarifies the need to look at all transfers to determine if there has been a change of ownership:

For purposes of determining a change of ownership, all sales and other transfers occurring since the date of approval of the PPP loan must be aggregated to determine whether the relevant threshold has been met. For publicly traded borrowers, only sales or other transfers that result in one person or entity holding or owning at least 20% of the common stock or other ownership interest of the borrower must be aggregated.<sup>65</sup>

Even with a change in ownership, the borrower still remains responsible for:

- The performance of all obligations under the PPP loan,

---

<sup>63</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, <https://www.sba.gov/sites/default/files/2020-10/5000-20057.pdf> (retrieved October 2, 2020)

<sup>64</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

<sup>65</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

- The certifications made in connection with the PPP loan application, including the certification of economic necessity, and
- Compliance with all other applicable PPP requirements.<sup>66</sup>

As well, the SBA notes:

Additionally, the PPP borrower remains responsible for obtaining, preparing, and retaining all required PPP forms and supporting documentation and providing those forms and supporting documentation to the PPP lender or lender servicing the PPP loan (referred to as the “PPP Lender” in this Notice) or to SBA upon request.<sup>67</sup>

### ***Notification Requirement***

Borrowers should take note of the need to inform a lender of a change of ownership. The notice states:

Prior to the closing of any change of ownership transaction, the PPP borrower must notify the PPP Lender in writing of the contemplated transaction and provide the PPP Lender with a copy of the proposed agreements or other documents that would effectuate the proposed transaction.<sup>68</sup>

### ***Procedures Upon Change of Ownership***

The SBA notes that, depending on the circumstances, different procedures will be required for a change of ownership transaction.

#### ***PPP Loan is Fully Satisfied***

The SBA provides the following information related to an ownership change if the PPP loan is fully satisfied:

There are no restrictions on a change of ownership if, prior to closing the sale or transfer, the PPP borrower has:

- a. Repaid the PPP Note in full; or

---

<sup>66</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

<sup>67</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 1

<sup>68</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 2

b. Completed the loan forgiveness process in accordance with the PPP requirements and:

- i. SBA has remitted funds to the PPP Lender in full satisfaction of the PPP Note; or
- ii. The PPP borrower has repaid any remaining balance on the PPP loan.<sup>69</sup>

*PPP Note is Not Fully Satisfied – Cases Where SBA Approval is Not Required*

If the note is not fully satisfied, the SBA outlines that in some cases SBA approval will be required before the ownership change takes place, while in other cases no approval is required.

The SBA provides for the following case where no approval is required:

**i. Change of ownership is structured as a sale or other transfer of common stock or other ownership interest or as a merger.** An individual or entity may sell or otherwise transfer common stock or other ownership interest in a PPP borrower without the prior approval of SBA only if:

- a) The sale or other transfer is of 50% or less of the common stock or other ownership interest of the PPP borrower; or
- b) The PPP borrower completes a forgiveness application reflecting its use of all of the PPP loan proceeds and submits it, together with any required supporting documentation, to the PPP Lender, and an interest-bearing escrow account controlled by the PPP Lender is established with funds equal to the outstanding balance of the PPP loan. After the forgiveness process (including any appeal of SBA’s decision) is completed, the escrow funds must be disbursed first to repay any remaining PPP loan balance plus interest.

In any of the circumstances described in a) or b) above, the procedures described in paragraph #2.c. below must also be followed.<sup>70</sup>

The “paragraph 2.c” items, which apply to all loans not already paid off, will be described after the next section.

The “no prior approval needed” rules continue as follows:

**ii. Change of ownership is structured as an asset sale.** A PPP borrower may sell 50 percent or more of its assets (measured by fair

---

<sup>69</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 2

<sup>70</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, pp. 2-3

market value) without the prior approval of SBA only if the PPP borrower completes a forgiveness application reflecting its use of all of the PPP loan proceeds and submits it, together with any required supporting documentation, to the PPP Lender, and an interest-bearing escrow account controlled by the PPP Lender is established with funds equal to the outstanding balance of the PPP loan. After the forgiveness process (including any appeal of SBA's decision) is completed, the escrow funds must be disbursed first to repay any remaining PPP loan balance plus interest. The PPP Lender must notify the appropriate SBA Loan Servicing Center of the location of, and the amount of funds in, the escrow account within 5 business days of completion of the transaction.<sup>71</sup>

### *PPP Note is Not Fully Satisfied – Cases Where SBA Approval is Required*

In other cases, the approval of the SBA will be required. The note continues:

If a change of ownership of a PPP borrower does not meet the conditions in paragraph #2.a. above, prior SBA approval of the change of ownership is required and the PPP Lender may not unilaterally approve the change of ownership.

To obtain SBA's prior approval of requests for changes of ownership, the PPP Lender must submit the request to the appropriate SBA Loan Servicing Center. The request must include:

- i. the reason that the PPP borrower cannot fully satisfy the PPP Note as described in paragraph #1 above or escrow funds as described in paragraph #2.a above;
- ii. the details of the requested transaction;
- iii. a copy of the executed PPP Note;
- iv. any letter of intent and the purchase or sale agreement setting forth the responsibilities of the PPP borrower, seller (if different from the PPP borrower), and buyer;
- v. disclosure of whether the buyer has an existing PPP loan and, if so, the SBA loan number; and
- vi. a list of all owners of 20 percent or more of the purchasing entity.

If deemed appropriate, SBA may require additional risk mitigation measures as a condition of its approval of the transaction.

---

<sup>71</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, p. 3

SBA approval of any change of ownership involving the sale of 50 percent or more of the assets (measured by fair market value) of a PPP borrower will be conditioned on the purchasing entity assuming all of the PPP borrower's obligations under the PPP loan, including responsibility for compliance with the PPP loan terms. In such cases, the purchase or sale agreement must include appropriate language regarding the assumption of the PPP borrower's obligations under the PPP loan by the purchasing person or entity, or a separate assumption agreement must be submitted to SBA.

SBA will review and provide a determination within 60 calendar days of receipt of a complete request.<sup>72</sup>

### ***Rules Applicable for all Ownership Changes, Regardless of Whether Approval is Needed***

The notice provides the following steps that will apply to all ownership transfers:

In the event of a sale or other transfer of common stock or other ownership interest in the PPP borrower, or a merger of the PPP borrower with or into another entity, the PPP borrower (and, in the event of a merger of the PPP borrower into another entity, the successor to the PPP borrower) will remain subject to all obligations under the PPP loan. In addition, if the new owner(s) use PPP funds for unauthorized purposes, SBA will have recourse against the owner(s) for the unauthorized use.

If any of the new owners or the successor arising from such a transaction has a separate PPP loan, then, following consummation of the transaction: (1) in the case of a purchase or other transfer of common stock or other ownership interest, the PPP borrower and the new owner(s) are responsible for segregating and delineating PPP funds and expenses and providing documentation to demonstrate compliance with PPP requirements by each PPP borrower, and (2) in the case of a merger, the successor is responsible for segregating and delineating PPP funds and expenses and providing documentation to demonstrate compliance with PPP requirements with respect to both PPP loans.

The PPP Lender must notify the appropriate SBA Loan Servicing Center, within 5 business days of completion of the transaction, of the:

- i. identity of the new owner(s) of the common stock or other ownership interest;
- ii. new owner(s)' ownership percentage(s);

---

<sup>72</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, pp. 3-4



iii. tax identification number(s) for any owner(s) holding 20 percent or more of the equity in the business; and

iv. location of, and the amount of funds in, the escrow account under the control of the PPP Lender, if an escrow account is required.<sup>73</sup>

---

<sup>73</sup> SBA Procedural Notice, Paycheck Protection Program Loans and Changes of Ownership, October 2, 2020, pp. 4-5