Current Federal Tax Developments

Week of November 16, 2020

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ACCOUNTING
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KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF NOVEMBER 16, 2020
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Kaplan Financial Education

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SECTION: 162
GUIDANCE DENYING DEDUCTION FOR PPP FORGIVABLE EXPENSES EVEN IF FORGIVENESS NOT GRANTED BY YEAR END REPORTED TO BE ON THE WAY FROM TREASURY

Citation: Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," Tax Notes Today Federal, 11/14/20

An issue that has not yet been addressed directly by the IRS is the treatment of certain expenses paid after a taxpayer received a Paycheck Protection Program (PPP) loan when the taxpayer's tax year end concludes prior to either the filing of an application for or a grant of forgiveness.

The PPP loan program, established by the CARES Act signed into law in March of 2020[1], provided loans to eligible small businesses. If the borrower used the loan proceeds to pay certain eligible expenses, an amount of the loan up to such eligible expenses would be forgiven under the law[2] and such forgiveness would not be treated as taxable income to the borrower.[3]

In Notice 2020-32 the IRS ruled that IRC §265(a)(1) applies to such amounts. That provision reads:

> (a) General rule
>
> No deduction shall be allowed for—
>
> > (1) Expenses
> >
> > Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

Thus the ruling holds "the Code disallows any otherwise allowable deduction under any provision of the Code, including sections 162 and 163, for the amount of any payment of an eligible section 1106 expense to the extent of the resulting covered loan

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[1] CARES Act Section 1102

[2] CARES Act Section 1106

[3] CARES Act Section 1106(i)

forgiveness (up to the aggregate amount forgiven) because such payment is allocable to tax-exempt income."

Notice 2020-32 was issued in April of 2020. In June of 2020 Congress passed the Paycheck Protection Program Flexibility Act (PPPFA) which greatly extended the time period for borrowers to use their PPP loan proceeds to pay expenses from the proceeds of the loan and be granted forgiveness. As well, taxpayers were given 10 months after the end of the 24-week period over which to pay out such expenses to apply for forgiveness before any payments would need to be made on the loan.

Originally payments were only deferred for six months from the date the loan was received and the funds had to be spent within 8 weeks of the time the funds were received. In that situation, most borrowers would presumably have applied for and received forgiveness before the end of their applicable tax year, especially if that year was a calendar year. But, following the PPPFA revisions, it is becoming clear many borrowers will not have applied for forgiveness prior to their tax year end.

Year End Passes Without Forgiveness – Is the Expense Deductible?

Since the Notice referred to "resulting loan forgiveness" as being the issue that creates the disallowance of the expense, does that mean that a disallowance of the deduction awaits the formal forgiveness of the loan? And, thus, if that event had not yet occurred, does that mean the expenses are to be deducted in the year paid or accrued, with the taxpayer potentially facing reporting such items as income under the tax benefit rule in the year forgiveness is granted?

The AICPA has inquired about this issue with the United States Treasury, per an article published in *Tax Notes Today Federal* on November 11, 2020.[4] The article noted:

> Edward S. Karl of the American Institute of CPAs said Treasury officials told him they anticipated issuing more guidance before the end of the year, and possibly by the end of November, generally stating that if a borrower has a reasonable expectation of loan forgiveness, the expenses can't be deducted to the extent they're paid for with the loan. That's true regardless of when the loan is forgiven, Karl added.[5]

Mr. Karl gave the same information in a session he presented online at the Pacific Tax Conference of the Washington Society of CPAs on November 7, 2020.

[4] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, November 11, 2020,

2020 TNTF 218-1, https://www.taxnotes.com/tax-notes-today-federal/partnerships/ppp-borrowers-brace-potentially-problematic-irs-guidance/2020/11/11/2d5zd (subscription required, retrieve

[5] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, November 11, 2020

Another View – Reliance on the Bliss Dairy Case and the Tax Benefit Rule

Mr. Karl in his presentation to the conference noted that many advisers do not agree with this view, and that many cite the Supreme Court's holding in *Bliss Dairy* to justify a current deduction followed by recovery under the tax benefit rule in the subsequent year.[6]

Justice O'Connor outlined the facts in *Bliss Dairy* as follows:

> As a cash basis taxpayer, in the taxable year ending June 30, 1973, it deducted upon purchase the full cost of the cattle feed purchased for use in its operations, as permitted by Section 162 of the Internal Revenue Code, 26 U.S.C. Section 162. A substantial portion of the feed was still on hand at the end of the taxable year. On July 2, 1973, two days into the next taxable year, Bliss adopted a plan of liquidation, and, during the month of July, it distributed its assets, including the remaining cattle feed, to the shareholders. Relying on Section 336, which shields the corporation from the recognition of gain on the distribution of property to its shareholders on liquidation, Bliss reported no income on the transaction.[7]

Under the then available corporate liquidation provisions used in Bliss's situation, the feed effectively regained its basis in the hands of the shareholders in the liquidation who then were able to deduct the cost of this feed when it was used in the now unincorporated business.

In the end, the Supreme Court found that the corporation was to report income in the following year under the tax benefit rule, as the non-recognition of gain provision for the liquidation was inconsistent with the deduction that took place in a prior year.

While not directly addressed by the Court, those seeing *Bliss Dairy* as applicable here note that even though Bliss Dairy almost certainly was aware that a liquidation would occur two days into the following year and had occurred by the time the prior year tax return was prepared, the Court did not find that a denial of the deduction in the prior year would have been the proper treatment. Rather, Bliss Dairy was to pick up the income in the subsequent year, as that was the year when the event occurred that was inconsistent with the original deduction.[8]

Thus, supporters of this view would argue, if no forgiveness has been granted by year end, the event inconsistent with a deduction (the creation of tax-exempt forgiveness income) had not occurred at that time. As with the taxpayer in *Bliss Dairy*, taxpayers who had not received forgiveness by their tax year end would initially deduct the expenses. When the forgiveness occurs, the taxpayer would recognize income under the tax benefit rule.

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[6] *Hillsborough National Bank v. Commissioner*, *United States v. Bliss Dairy*, 460 U.S. 370 (1983), March 7, 1983

[7] *United States v. Bliss Dairy*, 460 U.S. 370 (1983)

[8] *United States v. Bliss Dairy*, 460 U.S. 370 (1983)

That is, until the taxpayer obtains forgiveness there is no tax-exempt income. And tax-exempt income is required before IRC §265(a)(1) denies a deduction.

While the argument is rather persuasive, the adviser should note that nothing in the opinion suggests that the IRS had put forward an argument for denying the initial deduction rather than invoking the tax benefit rule in the following year. Thus, the adviser may find the IRS arguing that the case did not deal with the year of deduction of the expense—and that had that issue been raised, the Supreme Court might have preferred the denial of the deduction in a situation where the taxpayer clearly foresaw the upcoming liquidation. Of course, the Court could have used this logic to resolve the case and, the adviser can argue, it's such an obvious option that, presumably, the Court decided against going that route.

The Other IRS Argument for Denying a Deduction

Although cited almost as an afterthought in Notice 2020-32, the IRS did offer up a second rationale for denying taxpayers a deduction for these forgivable expenses—one that specifically deals with a situation where the taxpayer pays an expense prior to the event that would make the payment nondeductible.

The IRS provides the following description of this rationale:

> The deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement. See, e.g., *Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966); *Wolfers v. Commissioner*, 69 T.C. 975 (1978); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 31; Rev. Rul. 80-173, 1980-2 C.B. 60.[9]

Nathan T. Smith of CBIZ, Inc. is quoted as arguing that the two IRS rationales would lead to a different answer on deductibility when forgiveness is not granted by year end. The article states the following from Mr. Smith:

> Because the government offered two different positions for nondeductible treatment, the ancillary question about timing must be addressed discretely under each of those positions, Smith said. And as it turns out, the answer to the timing question appears to be different depending on which of the two positions from Notice 2020-32 a taxpayer chooses to follow, he added.
>
> The primary and the alternative positions in Notice 2020-32 are distinct because receiving tax-exempt income isn't the same as receiving an expense reimbursement, Smith said. He pointed to a few court decisions that held that expense reimbursements aren't tantamount to gross income, and other cases showing instead that the reimbursement reduces the amount of the deduction. The rationale for

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[9] Notice 2020-32

that conclusion is that the taxpayer hasn't made an expenditure or cost outlay, Smith said.

"On the other hand, the primary position that relies on section 265 relies on the existence of tax-exempt income — in this case loan forgiveness income," Smith said. "So pick your poison — either tax-exempt income (income exists) or expense reimbursement (no income exists). Two different timing answers, depending on which one you pick."[10]

What is An Adviser to Do?

Mr. Karl advised in his Pacific Tax Conference presentation that advisers need to discuss the options with their clients regarding whether or not to claim a deduction for these expenses if a return is being filed where no forgiveness was granted by year end. Ultimately, the taxpayer needs to decide which course of action best fits their risk tolerance and preferences on tax positions, based on those positions that the advisers believes have enough support to enable the adviser to sign the return.

As well, consideration should be given to disclosing the basis relied upon for the treatment on the tax return, especially if the IRS has issued guidance prior to the filing of the return and the taxpayer's treatment is at odds with what the IRS indicates is the proper treatment.

Finally, it is possible that Congress will act to provide for a deduction for such payments, with the relief being retroactive to the date the CARES Act was enacted. Such bills have been proposed by the chairs of both tax-writing committees and have sponsors from both parties. This possibility has led some advisers to suggest that, if possible, these returns should be placed on extension to hopefully provide time for such a bill to become law. Such a change in the law would render this entire question of dealing with a return when forgiveness had not been granted by year end no longer relevant.

SECTION: 164
PASSTHROUGH TAXES CREATED BY STATES AS SALT WORKAROUNDS WILL BE ALLOWED AS DEDUCTION WITHOUT REGARD TO ANY SALT LIMITATIONS

Citation: Notice 2020-75, 11/9/20

The IRS has now released guidance that proposed regulations will be released that will allow partnerships and S corporations to deduct state and local income taxes imposed

[10] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, November 11, 2020

on the entity.[11] This development resolves an issue that has been around since Connecticut enacted the first passthrough tax following the passage of the Tax Cuts and Jobs Act.

The IRS notes the following:

> Certain jurisdictions described in section 164(b)(2) have enacted, or are contemplating the enactment of, tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion. The Treasury Department and the IRS are aware that there is uncertainty as to whether entity-level payments made under these laws to jurisdictions described in section 164(b)(2) other than U.S. territories must be taken into account in applying the SALT deduction limitation at the owner level.[12]

The IRS begins by announcing that they will be issuing proposed regulations to allow this deduction:

> .01 Purpose and scope. The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. Based on the statutory and administrative authorities described in section 2 of this notice, the forthcoming proposed regulations will clarify that Specified Income Tax Payments (as defined in section 3.02(1) of this notice) are deductible by partnerships and S corporations in computing their non-separately stated income or loss.[13]

The Notice provides the following with regard to the deduction of such payments:

> (2) Deductibility of Specified Income Tax Payments. If a partnership or an S corporation makes a Specified Income Tax Payment during a taxable year, the partnership or S corporation is allowed a deduction for the Specified Income Tax Payment in computing its taxable income for the taxable year in which the payment is made.[14]

The term *Specified Income Tax Payment* is defined as follows:

> For purposes of section 3.02 of this notice, the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the

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[11] Notice 2020-75, November 9, 2020, https://www.irs.gov/pub/irs-drop/n-20-75.pdf (retrieved November 9, 2020)

[12] Notice 2020-75, Section 2.02(3)

[13] Notice 2020-75, Section 3.01

[14] Notice 2020-75, Section 3.02(2)

> District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation. This definition does not include income taxes imposed by U.S. territories or their political subdivisions.[15]

One area of concern that some had with regard to the entity level passthrough taxes imposed by states was that some were imposed at the election of the entity. Would the fact that an entity has elected to pay the tax eliminate the treatment as a tax imposed on the entity? The IRS has decided that is not an issue. Similarly, the fact that a partner ends up with a benefit against his/her tax liability also is not a problem for such taxes.

> For this purpose, a Specified Income Tax Payment includes any amount paid by a partnership or an S corporation to a Domestic Jurisdiction pursuant to a direct imposition of income tax by the Domestic Jurisdiction on the partnership or S corporation, without regard to whether the imposition of and liability for the income tax is the result of an election by the entity or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the partnership or S corporation to satisfy its income tax liability under the Domestic Jurisdiction's tax law and which reduces the partners' or shareholders' own individual income tax liabilities under the Domestic Jurisdiction's tax law.[16]

The tax will *not* be a separately stated item, but rather will be part of the non-separately stated income or loss from the partnership or S corporation:

> Any Specified Income Tax Payment made by a partnership or an S corporation during a taxable year does not constitute an item of deduction that a partner or an S corporation shareholder takes into account separately under section 702 or section 1366 in determining the partner's or S corporation shareholder's own Federal income tax liability for the taxable year. Instead, Specified Income Tax Payments will be reflected in a partner's or an S corporation shareholder's distributive or pro-rata share of nonseparately stated income or loss reported on a Schedule K-1 (or similar form).[17]

As well, the amounts paid will not be taken into account for the individual SALT limitation:

> Any Specified Income Tax Payment made by a partnership or an S corporation is not taken into account in applying the SALT deduction limitation to any individual who is a partner in the partnership or a shareholder of the S corporation.[18]

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[15] Notice 2020-75, Section 3.02(1)

[16] Notice 2020-75, Section 3.02(1)

[17] Notice 2020-75, Section 3.02(3)

[18] Notice 2020-75, Section 3.02(4)

The applicability date allows taxpayers to deduct taxes paid on such taxes generally for years ending after December 31, 2017:

> The proposed regulations described in this notice will apply to Specified Income Tax Payments made on or after November 9, 2020. The proposed regulations will also permit taxpayers described in section 3.02 of this notice to apply the rules described in this notice to Specified Income Tax Payments made in a taxable year of the partnership or S corporation ending after December 31, 2017, and made before November 9, 2020, provided that the Specified Income Tax Payment is made to satisfy the liability for income tax imposed on the partnership or S corporation pursuant to a law enacted prior to November 9, 2020. Prior to the issuance of the proposed regulations, taxpayers may rely on the provisions of this notice with respect to Specified Income Tax Payments as described in this section 4.[19]

SECTION: 408
TAXPAYER'S ATTEMPT TO USE CONTROLLED SMLLC TO INVEST IRA FUNDS IN LOANS FAILS

Citation: Ball v. Commissioner, TC Memo 2020-152, 11/10/20

A taxpayer attempted to argue that an LLC into which he had Chase distribute funds from his SEP-IRA was part of a "conduit agency arrangement" via which he had the funds invested in loans on behalf of the IRA in the case of *Ball v. Commissioner*, T.C. Memo 2020-152.[20] Unfortunately, the Tax Court found that he had full control of the funds at all times, making the entire $209,600 a taxable premature distribution to Mr. Ball.

The transactions began when Mr. Ball had funds transferred from his Chase IRA account to an account in the name of an LLC he had formed:

> During 2012 and 2013, petitioner participated in a SEP-IRA the custodian of which was JP Morgan Chase Bank, N.A (Chase). On two occasions in 2012, petitioner requested and received distributions from the SEP-IRA account, of $170,000 and $39,600, respectively (collectively, distributions). On each occasion, to effect the distribution, petitioner executed a Traditional IRA Withdrawal Request form that requested that Chase pay him the designated amount. He checked a box on each form indicating that the withdrawal was an early distribution with no known exceptions to being taxable. He further instructed Chase to make the distribution into a Chase business

[19] Notice 2020-75, Section 4

[20] *Ball v. Commissioner*, TC Memo 2020-152, 11/10/20, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12353 (retrieved November 14, 2020)

> checking account that he had opened in the name of a Nevada limited liability company, The Ball Investment Account, LLC (Ball LLC).
>
> Petitioner was the sole owner of Ball LLC and its managing member. The Ball LLC checking account (Ball LLC account) was not a retirement account.[21]

Immediately upon each transfer of funds to the LLC, Mr. Ball had the funds transferred out to fund two loans. Both loans were titled to indicate the lender was the Ball SEP Account.[22]

As the loans were paid off, Mr. Ball deposited the funds into the Chase IRA account, indicating that the amounts represented rollover contributions or, in some cases, current year contributions.

At the end of 2012 Mr. Ball received a Form 1099-R from Chase indicating he had received a distribution from his IRA account of $209,600 that was an early distribution for which no known exception applied. As well, the Form 5498 that Chase issued for 2012 showed as the balance in the IRA amounts excluding the remaining balances on the loans.[23]

Mr. Ball reported $209,600 of gross IRA distributions on his 2012 individual income tax return, with none of the distributions treated as taxable distributions on his return.[24]

The IRS noticed that Mr. Ball's reporting on his return did not match up with the information returns they had received and issued a Notice CP 2000, notifying Mr. Ball that he owed additional tax of $67,031 and a substantial underpayment penalty of $13,406.[25]

The taxpayer disputed the IRS's view that he had received a distribution at all, arguing that the funds remained as part of his IRA. As the opinion describes the taxpayer's defense:

> He argues that "the essential question in this case" is whether the movement of funds from the SEP-IRA through the Ball LLC account to, and then back from, Development LLC and Svarga LLC described a "conduit agency arrangement." Under that theory, Ball LLC acted as a mere facilitator, transferring funds between the SEP-IRA and the two other LLCs.[26]

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[21] *Ball v. Commissioner*, TC Memo 2020-152, pp. 3-4
[22] *Ball v. Commissioner*, TC Memo 2020-152, p. 4
[23] *Ball v. Commissioner*, TC Memo 2020-152, p. 5
[24] *Ball v. Commissioner*, TC Memo 2020-152, p. 5
[25] *Ball v. Commissioner*, TC Memo 2020-152, p. 6
[26] *Ball v. Commissioner*, TC Memo 2020-152, p. 8

The opinion notes that the concept of a conduit agency arrangement has been upheld by the Court in the past, but only if certain conditions are met:

> This Court has previously found in certain circumstances that an otherwise taxable IRA distribution was not includible in a taxpayer's gross income when the taxpayer was acting as an agent or conduit on behalf of the IRA's custodian to carry out an investment. See, e.g., *Ancira v. Commissioner*, 119 T.C. 135, 138 (2002); *McGaugh v. Commissioner*, T.C. Memo. 2016-28. But we have also found that, when a distributee had unfettered control over an IRA distribution, he could not claim that he was acting as a mere conduit or an agent for the IRA custodian with respect to the distributed funds. *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29.[27]

But the opinion finds that Mr. Ball's situation does not meet the requirements to be a conduit agency relationship:

> Our difficulty with petitioner's argument is that we cannot conclude that Ball LLC was acting as an agent or conduit on behalf of Chase (as custodian of the SEP-IRA) when Ball LLC received and made use of the distributions. Chase had no knowledge of the disposition of the $209,600 that it deposited into the Ball LLC account other than that it made the deposits at petitioner's direction. Petitioner controlled Ball LLC, and nothing in the record convinces us that he did not have unfettered control over the $209,600 Ball LLC received from Chase. Yes, petitioner caused Ball LLC to lend the distributions nominally for the benefit of "The Ball SEP Account", but he could just as well have made the loans in Ball LLC's name or in his own name. The facts of this case are closer to those of *Vanderbosch* than to those of *Ancira* and *McGaugh*. Ball LLC was not a conduit or agent for Chase.[28]

To put it simply, Chase's lack of knowledge or approval of what Mr. Ball was doing makes it difficult to accept the idea he was acting as an agent of Chase. Nothing in this case indicates he made any effort to inform Chase of what he was doing or that he sought their approval to act for them—an approval it's unlikely Chase would have given, presuming the account was being held as a standard consumer IRA account rather than via a specialized trust arrangement (with significantly higher fees than would be charged for an account holding Chase bank accounts and/or publicly traded securities).

Having lost on this issue, the taxpayer tries to argue that the amounts shouldn't be taxable to him since none of the checks were deposited into his personal accounts. But the Court found that where he deposited the checks Chase sent to him wasn't a relevant fact in determining if he owed tax on the distribution:

> Alternatively, petitioner argues that because the funds were deposited into the Ball LLC account, rather than petitioner's own checking account, the distributions were not income to him. We disagree.

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[27] *Ball v. Commissioner*, TC Memo 2020-152, pp. 8-9

[28] *Ball v. Commissioner*, TC Memo 2020-152, p. 9

Amounts paid or distributed out of an IRA are "included in gross income by the payee or distributee * * * in the manner provided under section 72." Sec. 408(d)(1). And while neither the statute nor the regulations define the terms "payee or distributee", we have said: "Generally, the payee or distributee of an IRA is the participant or beneficiary who is eligible to receive funds from the IRA." *Roberts v. Commissioner*, 141 T.C. 569, 576 (2013). In some cases the general rule is inapplicable. See, e.g., *id*. at 582 (holding that a taxpayer is not a payee or distributee within meaning of section 408(d)(1) with respect to improper withdrawals from his IRA account without his knowledge by his soon-to-be divorced spouse). However: "[T]he mere fact that the distribution is made by the plan administrator to A rather than to B does not make A the distributee." *Darby v. Commissioner*, 97 T.C. 51, 58 (1991). Petitioner was the distributee, and that is sufficient for us to conclude that the distributions were an item of gross income to him for 2012 even though he directed the distributions be deposited into the Ball LLC account.[29]

[29] *Ball v. Commissioner*, TC Memo 2020-152, pp. 9-10