Current Federal Tax Developments

Week of April 5, 2021

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SECTION: 85
IRS ANNOUNCES MAY START OF AUTOMATIC REFUND PROGRAM FOR UNEMPLOYMENT BENEFITS

Citation: "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, 3/31/21

In News Release IR-2021-71[1] the IRS announced that it plans to begin issuing automatic refunds to taxpayers who filed returns that included 2020 unemployment compensation as taxable if the changes made by the American Rescue Plan Act (ARPA) of 2021 make the unemployment not taxable in 2020.

ARPA added IRC §85(c) which rendered a limited amount of unemployment received in 2020 nontaxable for taxpayers with a modified adjusted gross income of less than $150,000. But as the law was enacted on March 11, 2021, many taxpayers had already filed returns that treated their unemployment as taxable. But, as the release notes, now the law may exclude those benefits from tax:

> The legislation, signed on March 11, allows taxpayers who earned less than $150,000 in modified adjusted gross income to exclude unemployment compensation up to $20,400 if married filing jointly and $10,200 for all other eligible taxpayers. The legislation excludes only 2020 unemployment benefits from taxes.[2]

Refund Program

The IRS notes that the program will begin in May and run into the summer:

> Because the change occurred after some people filed their taxes, the IRS will take steps in the spring and summer to make the appropriate change to their return, which may result in a refund. The first refunds are expected to be made in May and will continue into the summer.[3]

The IRS outlines what the agency will do as follows:

> For those taxpayers who already have filed and figured their tax based on the full amount of unemployment compensation, the IRS will determine the correct taxable amount of unemployment compensation

[1] "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, IRS website, March 31, 2021, (https://www.irs.gov/newsroom/irs-to-recalculate-taxes-on-unemployment-benefits-refunds-to-start-in-may, retrieved March 31, 2021)

[2] "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, IRS website, March 31, 2021

[3] "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, IRS website, March 31, 2021

> and tax. Any resulting overpayment of tax will be either refunded or applied to other outstanding taxes owed.
>
> For those who have already filed, the IRS will do these recalculations in two phases, starting with those taxpayers eligible for the up to $10,200 exclusion. The IRS will then adjust returns for those married filing jointly taxpayers who are eligible for the up to $20,400 exclusion and others with more complex returns.[4]

But Taxpayers May Still Need/Want to Amend Their Returns

While the IRS discourages taxpayers generally from filing amended returns, the news release conceded that some taxpayers are going to need to do just that:

> There is no need for taxpayers to file an amended return unless the calculations make the taxpayer newly eligible for additional federal credits and deductions not already included on the original tax return.
>
> For example, the IRS can adjust returns for those taxpayers who claimed the Earned Income Tax Credit (EITC) and, because the exclusion changed the income level, may now be eligible for an increase in the EITC amount which may result in a larger refund. However, taxpayers would have to file an amended return if they did not originally claim the EITC or other credits but now are eligible because the exclusion changed their income.[5]

So, as a practical matter, advisers will likely want to verify that the IRS refund represents the entire reduction in tax the taxpayer is entitled to.

And Then There's the States

While the IRS may be automating the process for most taxpayers at the federal level, state returns are another issue entirely. The IRS does note the state issue, but gives no details:

> These taxpayers may want to review their state tax returns as well.[6]

State issues will include:

- Will the state follow the federal law? While some states have rolling conformity statutes that will automatically follow this law change without legislative action, many others have static conformity rules requiring the state legislature to take action if the state wishes to retroactively conform to these rules.

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[4] "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, IRS website, March 31, 2021

[5] "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, IRS website, March 31, 2021

[6] "IRS to recalculate taxes on unemployment benefits; refunds to start in May," IR-2021-71, IRS website, March 31, 2021

- Even if a state does decide it will not tax such unemployment, there's no guarantee that the state revenue departments will follow the lead of the IRS and issue automatic refunds to affected taxpayers.

SECTION: 7508A IRS FORMALIZES EXTENSION OF APRIL 15 FORM 1040 DUE DATE TO MAY 17, CLARIFIES OTHER ISSUES RELATED TO THE EXTENSION

Citation: Notice 2021-21, 3/29/21

Twelve days after announcing the agency planned to push back the April 15 filing deadline for calendar year 2020 Forms 1040 to May 17, the IRS made it official in IRS News Release IR-2021-67[7] and Notice 2021-21.[8]

Use of §7508A to Extend Time

As most had suspected, the IRS again turned to IRC §7508A, the same provision used one year ago, to extend due dates, but this time doing so in a much more limited fashion than was used for 2019 returns.

In 2019 all returns due during the period of relief, and a number of other required actions, were delayed by the ruling. This time the IRS much more narrowly defines the taxpayers affected by the COVID-19 emergency, covering those filing 1040 series forms on April 15, 2021 and a limited number of other filings:

> The Secretary has determined that any person with a Federal income tax return filed on Form 1040, Form 1040-SR, Form 1040-NR, Form 1040-PR, Form 1040-SS, or Form 1040(SP) (Form 1040 series), or a Federal income tax payment reported on one of these forms, that absent this notice would be due April 15, 2021, is affected by the COVID-19 emergency for purposes of the relief described in this section III (Affected Taxpayer). In addition, persons who are required to file and furnish Form 5498, IRA Contribution Information, Form 5498-ESA, Coverdell ESA Contribution Information, and Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information (Form 5498 series) that absent this notice would generally be due June 1, 2021, are Affected Taxpayers.[9]

The use of IRC §7508A to provide the extension triggers a provision in the American Rescue Plan Act of 2021. The Act added IRC §6428B to provide for 2021 recovery rebates and advance payments of the same. At IRC §6428B(5)(B) the act provides that

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[7] "IRS extends additional tax deadlines for individuals to May 17," IRS News Release IR-2021-67, March 29, 2021 (https://www.irs.gov/newsroom/irs-extends-additional-tax-deadlines-for-individuals-to-may-17, retrieved March 29, 2021)

[8] Notice 2021-21, March 29, 2021, (https://www.irs.gov/pub/irs-drop/n-21-21.pdf, retrieved March 29, 2021)

[9] Notice 2021-21, March 29, 2021, Section III.A

a taxpayer that was paid an advance payment on the 2021 recovery rebate based on the taxpayer's 2019 return can qualify for an additional payment that the taxpayer would have qualified for based on the 2020 return if that return is processed by the IRS by a date that is no more than 90 days after the calendar year 2020 filing deadline, taking into account any extensions of that date granted under IRC §7508A.

Thus, 2020 returns processed by the IRS through August 15, 2021 that are from taxpayers that had their initial 2021 recovery rebate computed based on 2019 numbers will now be considered by the IRS to see if the taxpayer qualifies for a larger advance payment.

Claims for Refunds

The Notice also provides relief for expiring time periods to file a claim for refund or credit, creating another class of Affected Taxpayers:

> The Secretary has also determined that any individual with a period of limitations to file a claim for credit or refund of Federal income tax that absent this notice would expire on or after April 15, 2021, and before May 17, 2021 (for example, certain individual taxpayers with claims for credit or refund in respect of their 2017 taxable years), is an Affected Taxpayer.[10]

General Delay to May 17

The Notice provides the following general relief for the filing of Forms 1040 and a limited set of other forms due on April 15, 2021:

> For an Affected Taxpayer, the due date for filing Federal income tax returns in the Form 1040 series and making Federal income tax payments in connection with one of these forms having an original due date of April 15, 2021, is automatically postponed to May 17, 2021. Affected Taxpayers do not have to file any form, including Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, to obtain this relief. This relief includes the filing of all schedules, returns, and other forms that are filed as attachments to the Form 1040 series or are required to be filed by the due date of the Form 1040 series, including, for example, Schedule H and Schedule SE, as well as Forms 965-A, 3520, 5329, 5471, 8621, 8858, 8865, 8915-E, and 8938. Finally, elections that are made or required to be made on a timely filed Form 1040 series (or attachment to such form) will be timely made if filed on such form or attachment, as appropriate, on or before May 17, 2021.[11]

[10] Notice 2021-21, March 29, 2021, Section III.A

[11] Notice 2021-21, March 29, 2021, Section III.B

The Notice provides that interest and penalties will also not apply for that period of time for Affected Taxpayers:

> As a result of the postponement of the due date for Affected Taxpayers to file Federal income tax returns and make Federal income tax payments from April 15, 2021, to May 17, 2021, the period beginning on April 15, 2021, and ending on May 17, 2021, will be disregarded in the calculation of any interest, penalty, or addition to tax for failure to file the Federal income tax returns or to pay the Federal income taxes postponed by this notice. Interest, penalties, and additions to tax with respect to such postponed Federal income tax filings and payments will begin to accrue on May 18, 2021.[12]

2020 IRA, HSA, MSA and ESA Contributions

The Notice also provides that contributions to IRAs, HSAs, MSAs, and ESAs for 2020 which normally would have been required to be made no later than April 15, 2021 will now be allowed to be made through May 17, 2021:

> The postponement of the due date for filing these Federal income tax returns to May 17, 2021, also automatically postpones to the same date the time for Affected Taxpayers to make 2020 contributions to their individual retirement arrangements (IRAs and Roth IRAs), health savings accounts (HSAs), Archer Medical Savings Accounts (Archer MSAs), and Coverdell education savings accounts (Coverdell ESAs).[13]

Due Date for Tax on Premature Distributions Under IRC §72

The Notice also clarifies that the additional tax imposed by IRC §72 on premature distributions from retirement plans will also not be due until May 17, 2021:

> This postponement also automatically postpones to May 17, 2021, the time for reporting and payment of the 10-percent additional tax on amounts includible in gross income from 2020 distributions from IRAs or workplace-based retirement plans.[14]

Delay in Date for Filing Form 5498

A slightly different delay is provided for those filing Form 5498, pushing the due date back to June 30, 2021:

> Forms in the Form 5498 series must be filed with the IRS and furnished to participants and beneficiaries by the due date specified in General Instructions for Certain Information Returns (Forms 1096, 1097, 1098, 1099, 3921, 3922, 5498, and W2G). Because filers of Form 5498 series are Affected Taxpayers, the due date for filing and

[12] Notice 2021-21, March 29, 2021, Section III.B

[13] Notice 2021-21, March 29, 2021, Section III.B

[14] Notice 2021-21, March 29, 2021, Section III.B

> furnishing the Form 5498 series is postponed to June 30, 2021. The period beginning on the original due date of those forms and ending on June 30, 2021, will be disregarded in the calculation of any penalty for failure to file those forms. Penalties with respect to such a postponed filing will begin to accrue on July 1, 2021.[15]

Items Not Receiving Relief

The IRS makes clear in Notice 2021-21 that this year the relief is much more limited than last year's broad grant of relief. The Notice provides:

> Businesses and any other type of taxpayer who file Federal income tax returns on forms outside of the Form 1040 series are not Affected Taxpayers for purposes of the relief described in this section III.B.
>
> No extension is provided in this notice for the payment or deposit of any other type of Federal tax, including Federal estimated income tax payments, or for the filing of any Federal return other than the Form 1040 series and the Form 5498 series for the 2020 taxable year.[16]

Thus, still due on April 15, 2021 are, among other forms:

- First quarter individual estimated income tax payments;
- Trust and estate income tax returns (calendar year); and
- C corporation tax returns (calendar year).

In the accompanying News Release, the IRS puts an emphasis on the requirement for individuals to file first quarter estimated tax payments by April 15:

> **Estimated tax payment due April 15**
>
> Notice 2021-21, issued today does not alter the April 15, 2021, deadline for estimated tax payments; these payments are still due on April 15. Taxes must be paid as taxpayers earn or receive income during the year, either through withholding or estimated tax payments. In general, estimated tax payments are made quarterly to the IRS by people whose income isn't subject to income tax withholding, including self-employment income, interest, dividends, alimony or rental income. Most taxpayers automatically have their taxes withheld from their paychecks and submitted to the IRS by their employer.[17]

[15] Notice 2021-21, March 29, 2021, Section III.B

[16] Notice 2021-21, March 29, 2021, Section III.B

[17] "IRS extends additional tax deadlines for individuals to May 17," IRS News Release IR-2021-67, March 29, 2021

Claims for Refund

The Notice also provides relief for 1040 related claims for refund, essentially making any claim whose last date for filing the claim falls between April 15, 2021 and May 16, 2021 timely filed so long as it is filed by May 17, 2021:

> Individuals with a period of limitations to file a claim for credit or refund of Federal income tax expiring on or after April 15, 2021, and before May 17, 2021, have until May 17, 2021, to file those claims for credit or refund. This postponement is limited to claims for credit or refund properly filed on the Form 1040 series or on a Form 1040-X.
>
> As a result of the postponement of the time for individuals to file claims for credit or refund of Federal income tax where the period to file that claim expires on or after April 15, 2021, and before May 17, 2021, the period beginning on April 15, 2021, and ending on May 17, 2021, will be disregarded in determining whether the filing of those claims is timely.[18]

SECTION: ERC
UPDATED GUIDANCE ISSUED FOR EMPLOYEE RETENTION TO APPLY TO PROGRAM VERSION THAT RUNS FROM JANUARY TO JUNE 2021

Citation: Notice 2021-23, 4/2/21

The IRS released guidance on the version of the Employee Retention Credit (ERC) contained in the Taxpayer Certainty and Disaster Relief Act (TCDRA) of 2020 that is in effect for the first two quarters of 2021 in Notice 2021-23.[19]

As with Notice 2021-20, which was issued to cover the revised 2020 Employee Retention Credit, this Notice only updates the original Notice for issues related to the January-June 2021 version of the credit, and later guidance will be released governing new IRC §3134 that was added by the American Rescue Plan Act of 2021 and will apply from July-December 2021.

Expansion to Certain Governmental Entities

While the original ERC was not available to governmental entities, the TCDRA version created a limited exception:

> …[A]mended section 2301(f)(2)(A) provides an exception for any organization described in section 501(c)(1) of the Code and exempt from tax under section 501(a) of the Code, and amended section 2301(f)(2)(B) provides an exception for any governmental entity if the

[18] Notice 2021-21, March 29, 2021, Section III.C

[19] Notice 2021-23, April 2, 2021, https://www.irs.gov/pub/irs-drop/n-21-23.pdf (retrieved April 2, 2021)

> entity is a college or university or the principal purpose or function of the entity is providing medical or hospital care. The flush language of amended section 2301(f)(2) provides that in the case of any governmental entity that is a college or university, or the principal purpose or function of which is providing medical or hospital care, the entity shall be treated as satisfying the trade or business requirement in section 2301(c)(2)(A)(i). Accordingly, these entities may be eligible employers for the first and second calendar quarters of 2021, assuming they satisfy the other requirements to be eligible employers.[20]

The Notice provides definitions of a *college and university* and *an entity with the principal purpose or function of providing health care*:

> The Treasury Department and the IRS have determined that, for purposes of amended section 2301(f)(2)(B) of the CARES Act, a college or university means an educational organization as defined in section 170(b)(1)(A)(ii) of the Code and Treas. Reg. § 1.170A-9(c)(1) that is a college or university, and an entity that has the principal purpose or function of providing medical or hospital care means an entity that has the principal purpose or function of providing medical or hospital care within the meaning of section 170(b)(1)(A)(iii) of the Code and Treas. Reg. § 1.170A-9(d)(1).[21]

Prior Quarter Election for Decline in Gross Receipts Test

Under the TCDRA version of the ERC, a new election was added to allow an employer to choose to use either the current quarter or the immediately prior one to test for a decline in gross receipts. The Notice provides specific guidance for the first and second quarters of 2021 on this issue:

> Accordingly, for the first calendar quarter of 2021, an employer may elect to use its gross receipts for the fourth calendar quarter of 2020 compared to those for the fourth calendar quarter of 2019 to determine if the decline in gross receipts test is met. If an employer was not in existence as of the beginning of the fourth calendar quarter of 2019, then the alternative quarter election will not be available for the first calendar quarter of 2021.
>
> For the second calendar quarter of 2021, an employer may elect to use its gross receipts for the first calendar quarter of 2021 compared to those for the first calendar quarter of 2019 to determine if the decline in gross receipts test is met. If an employer was not in existence as of the beginning of the first calendar quarter of 2019, then that employer may elect to measure the decline in gross receipts for the second calendar quarter of 2021 using its gross receipts for the first calendar

[20] Notice 2021-23, Section III.B

[21] Notice 2021-23, Section III.B

> quarter of 2021 compared to those for the first calendar quarter of 2020.[22]

The Notice appears to provide that the employer will not necessarily be telling the IRS which quarter it tested on the Form 941, but rather must keep records that include showing which quarter was used to justify the ability to claim the credit:

> Eligible employers must maintain documentation to support the determination of the decline in gross receipts, including which calendar quarter an eligible employer elects to use in measuring the decline. An election to use an alternative quarter to calculate gross receipts is made by claiming the employee retention credit for the quarter using the alternative quarter to calculate gross receipts.[23]

Maximum Amount of Employee Retention Credit per Employee

The Notice points out the larger amount of credit that employers can qualify for per employee under the early 2021 version of the ERC. For 2020 an employer's maximum credit was $5,000 per employee for the year, being 50% of no more than $10,000 of qualified wages (including health care costs) paid during 2020 per employee. The maximums for the first and second quarter of 2021 are outlined in the Notice:

> For the first and second calendar quarters of 2021, section 2301(a) of the CARES Act, as amended by section 207(b) of the Relief Act, provides that the employee retention credit equals 70 percent of qualified wages (including allocable qualified health plan expenses) that an eligible employer pays in a calendar quarter. Section 2301(b)(1) of the CARES Act, as amended by section 207(c) of the Relief Act, limits the amount of qualified wages (including allocable qualified health plan expenses) with respect to any employee that may be taken into account under section 2301(a) of the CARES Act to $10,000 for any calendar quarter; thus the maximum credit for qualified wages (including allocable qualified health plan expenses) paid to an employee is $7,000 for each of the first and second calendar quarters in 2021 (for a total of $14,000).[24]

Increase in the Size of Small Employers

Under the 2020 ERC, employers whose average number of full-time employees during 2020 was 100 or fewer could claim the credit paid during eligible periods for all employees of the employer paid during that period. For employers where the average was greater than 100 employees, the credit was only allowed to be claimed for employees who did not provide services.

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[22] Notice 2021-23, Section III.C

[23] Notice 2021-23, Section III.C

[24] Notice 2021-23, Section III.D

Under the 2021 ERC more employers will now meet the small employer test, allowing those employers to claim the credit for employees regardless of whether or not they are performing services during that period:

> Section 2301(c)(3)(A)(i) of the CARES Act, as amended by section 207(e)(1) of the Relief Act, provides that large eligible employers are eligible employers for which the average number of full-time employees during 2019 was greater than 500 (2021 large eligible employers). Section 2301(c)(3)(A)(ii) of the CARES Act, as amended by section 207(e)(1) of the Relief Act, provides that small eligible employers are eligible employers for which the average number of full-time employees during 2019 was not greater than 500 (2021 small eligible employers).[25]

Advance Payment Rules

The IRS provides a series of details about the advance payment rules for the first and second quarter of 2021. The Notice begins by noting that in the 2020 version of the ERC, all employers could receive an advance payment and there were no limits on that advance:

> Section III.J. of Notice 2021-20 provides various rules related to claiming the employee retention credit, including the circumstances under which an eligible employer may request an advance payment of the employee retention credit. For calendar quarters in 2020 there was no restriction on the types of eligible employers that could claim an advance, nor was there a maximum advance amount other than the amount of the employee retention credit eligible to be claimed, subject to the requirement that an eligible employer reduce deposits in anticipation of the credit before requesting an advance.[26]

However, the Notice provides that in the 2021 version of the ERC, advance payments are only available to certain employers and are limited in amount:

> Section 2301(j) of the CARES Act, as amended by section 207(g) of the Relief Act, prohibits the advance payment of the employee retention credit except to 2021 small eligible employers. Section 2301(j)(2) of the CARES Act, as amended, provides that 2021 small eligible employers may elect to receive an advance payment of the employee retention credit in an amount not to exceed 70 percent of the average quarterly wages paid in calendar year 2019 (the 70 percent advance rule). The requirement to reduce deposits in anticipation of the credit before requesting an advance continues to apply to 2021 small eligible employers.[27]

[25] Notice 2021-23, Section III.E

[26] Notice 2021-23, Section III.F

[27] Notice 2021-23, Section III.F

The Notice contains information on computing the average quarterly wages limit:

> Section 2301 of the CARES Act does not define the term "average quarterly wages." The Treasury Department and the IRS have determined that for purposes of the 70 percent advance rule the term "average quarterly wages" generally means the average of wages (as defined in section 3121(a) of the Code), or compensation (as defined in section 3231(e) of the Code), both determined without regard to the social security wage base, paid in each calendar quarter in 2019. The aggregation rules described in section III.B. of Notice 2021-20 apply to the determination of an eligible employer's average quarterly wages. Accordingly, the average quarterly wages for the 70 percent advance rule are calculated based on the quarterly wages paid by all members of the aggregated group.[28]

The Notice begins by describing the calculation for employers who file the quarterly Form 941:

> For 2021 small eligible employers who file Form 941, Employer's Quarterly Federal Tax Return, average quarterly wages for the 70 percent advance rule are calculated by averaging the amount required to be reported on Line 5c, "Taxable Medicare wages & tips," on all Forms 941 required to be filed by a small eligible employer for wages paid in 2019.[29]

For employers that file an annual federal employment tax return, the Notice provides:

> For 2021 small eligible employers that file an annual federal employment tax return, "average quarterly wages" for the 70 percent advance rule are calculated by dividing the amount required to be reported on the following forms and lines, as applicable, by four:
>
> - Line 4, "Total wages subject to Medicare tax," on the 2019 Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*;
>
> - Line 4c, "Taxable Medicare wages and tips," on the 2019 Form 944, *Employer's Annual Federal Tax Return*;
>
> - The sum of the amounts in the "Compensation" columns of Line 2, "Tier 1 Employer Medicare Tax – Compensation (other than tips and sick pay)," and Line 9, "Tier 1 Employer Medicare Tax – Sick Pay," on the 2019 Form CT-1, *Employer's Annual Railroad Retirement Tax Return*.

[28] Notice 2021-23, Section III.F

[29] Notice 2021-23, Section III.F

Special rules are described for computing this average wage amount for seasonal employers:

> Section 2301(j)(2) of the CARES Act provides special rules for determining average quarterly wages for 2021 small eligible employers that are seasonal employers and 2021 small eligible employers not in existence in 2019. Under section 2301(j)(2)(B), 2021 small eligible employers that employ seasonal workers (as defined in section 45R(d)(5)(B) of the Code) may elect to determine the average quarterly wages based on the wages for the calendar quarter in 2019 which corresponds to the calendar quarter to which the election relates rather than the average quarterly wages paid in calendar year 2019. A 2021 small eligible employer that employs seasonal workers elects to use the special rule by requesting an advance based on the amount of wages for the calendar quarter in 2019 corresponding to the calendar quarter to which the election relates. Under section 2301(j)(2)(C), 2021 small eligible employers not in existence in 2019 may look to the average quarterly wages paid in 2020 for purposes of applying the 70 percent advance rule. A 2021 small eligible employer that was not in existence in 2019 elects to use the special rule by requesting an advance based on the average quarterly wages paid in 2020.[30]

Advance payments are not available for employers who come into existence in 2021:

> The special rules provided by section 2301(j)(2) of the CARES Act do not provide a method for determining average quarterly wages for a 2021 small eligible employer that comes into existence in 2021. Accordingly, 2021 small eligible employers that come into existence in 2021 are ineligible to receive advance payment of the employee retention credit; however, these 2021 small eligible employers, like all eligible employers, may reduce their deposits of employment taxes in anticipation of claiming the employee retention credit on Form 941 (or other applicable federal employment tax return) in accordance with Notice 2020-22.[31]

Finally, the Notice concludes with guidance for employers in existence for only part of 2019 or 2020:

> If an eligible employer was in existence for some, but not all, calendar quarters of 2019 or 2020, average quarterly wages should be determined by dividing the sum of the wages paid in 2019 or 2020, as applicable, by the number of calendar quarters in 2019 or 2020, as applicable, in which that eligible employer existed. For example, an eligible employer that existed in only the second, third, and fourth calendar quarters of 2019 would add the wages paid in each of those calendar quarters and divide the total by 3. If an eligible employer existed for only part of a calendar quarter, that eligible employer should estimate the wages paid in the entire calendar quarter based on

[30] Notice 2021-23, Section III.F

[31] Notice 2021-23, Section III.F

the wages paid in the portion of the calendar quarter in which it existed using any reasonable method. For example, if an eligible employer existed for two out of three months in a calendar quarter, that eligible employer may multiply the wages paid in those two months by 1.5 before averaging the wages for that quarter with the wages for the other calendar quarters. If an eligible employer filing a Form 943, 944, or CT-1 existed for only part of 2019 or 2020, that eligible employer may use any reasonable method to annualize the wages paid (or compensation for Form CT-1 filers) prior to dividing the amount by four.[32]

SECTION: ERC
TAX ADVISERS' AREA 51 - EMPLOYEE RETENTION CREDIT AND MAJORITY SHAREHOLDERS

Citation: CARES Act 2301 and Later Revisions, 3/11/21

Area 51 is that mysterious area in the Nevada desert under the control of the United States Air Force. But it turns out that Area 51 is not the only mysterious 51 related to the United States federal government. Tax advisers have been exploring their own "area 51," this time found at IRC Section 51(i)(1) that is cross-referenced for limiting the application of the employee retention credit.

Some parts of this 51-item are relatively clear. We know the employee retention credit (ERC) isn't allowed for the various relatives of a control owner under CARES Act Section 2301(e) and its later updated versions. But what has become as obscure to some as Area 51 is whether this provision will work to also eliminate the ability of most shareholders owning more than 50% of the stock of a corporation to obtain the employee retention credit on their own wages.

Tax Area 51 – The Limitation Cross-References for the Employee Retention Credit

CARES Act Section 2301(e) provides that "rules similar to the rules of sections 51(i)(1)" shall apply to the employee retention credit. And that language has survived unchanged through the two revisions (to date) we've been through each time the ERC has been extended and modified.

IRC Section 51 defines the work opportunity tax credit (WOTC) and was around long before the CARES Act and the employee retention credit. Part of that section looked to limit the ability to claim the WOTC on compensation paid to certain parties related to anyone who directly or indirectly controlled the employer. That limiting provision is found at IRC §51(i)(1).

[32] Notice 2021-23, Section III.F

IRC §51(i)(1) provides, in part:

> No wages shall be taken into account under subsection (a) with respect to an individual who—
>
> > (A) bears any of the relationships described in subparagraphs (A) through (G) of section 152(d)(2) to the taxpayer, or, if the taxpayer is a corporation, to an individual who owns, directly or indirectly, more than 50 percent in value of the outstanding stock of the corporation, or, if the taxpayer is an entity other than a corporation, to any individual who owns, directly or indirectly, more than 50 percent of the capital and profits interests in the entity (determined with the application of section 267(c)), …

The key issues that will cause us concern in that paragraph are:

- The reference to IRC §152(d)(2)(A)-(G) for a list of relatives impacted by these rules;
- The reference to directly or, more importantly, *indirectly* controlling the employer and
- The use of IRC §267(c) to determine that direct or indirect ownership.

Barred Relationships

Before getting into the indirect problem, let's first look at just who would be the related parties on which claiming the ERC will be barred under this provision. Any compensation paid to a person holding a relationship listed in §152(d)(2) to any person who *directly or indirectly* is found to own more than 50% of the stock of the corporation will not be wages on which the ERC can be claimed.

Section 152(d)(2)(A)-(G) gives the list of barred relationships. Anyone who has the listed relationship to any person with more than 50% control of the corporation could not be paid wages on which the ERC could be claimed:

> (2) Relationship
>
> For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if the individual is any of the following with respect to the taxpayer:
>
> > (A) A child or a descendant of a child.
> >
> > (B) A brother, sister, stepbrother, or stepsister.
> >
> > (C) The father or mother, or an ancestor of either.
> >
> > (D) A stepfather or stepmother.
> >
> > (E) A son or daughter of a brother or sister of the taxpayer.

(F) A brother or sister of the father or mother of the taxpayer.

(G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

A simple example would hold that if I own 100% of a corporation, wages paid to my son or daughter could not be treated as wages on which the corporation could claim the employee retention credit. So far this is pretty straight-forward. While you might argue it's unfair in many cases, it certainly isn't unclear.

But in that case the employee is the child of a person who actually is holding the shares in question. How would we determine if some other employee is going to be taken out of the pool of ERC eligible employees due to holding an impermissible relationship to a party that *indirectly* owns more than 50% of the corporation?

Indirect Ownership for Purposes of the Employee Retention Credit

Section 51 does give us some guidance on how to determine indirect ownership with the parenthetical reference at the end of IRC §51(i)(1)(A) to IRC §267(c) being applied to determine ownership.

IRC §267(c) defines constructive ownership of stock. Thus, it would seem, constructive ownership of stock under §267(c) would constitute indirect ownership of stock for purposes of §51 and, going all the way back up the chain, to the various employee retention credits beginning with the first one added in the CARES Act.

IRC §267(c) provides:

(c) Constructive ownership of stock

For purposes of determining, in applying subsection (b), the ownership of stock—

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying

> paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock."

Let's try a simple example—if I hire my brother's sister-in-law, my corporation won't be able to claim the credit on her wages. While she is not my sister-in-law, my brother under IRC §267(c)(2) is considered to *indirecty* own 100% of the S corporation and my employee has the impermissible sister-in-law relationship to this indirect owner.

Splash-Back Problem

So far, so good. But now we get to the crux of the matter.

As we noted earlier, my brother cannot be paid wages and have my corporation claim the credit on those wages since he's in the list at §152(d)(4). Again, this much is crystal clear.

But, as just noted as well, my brother is also someone covered by IRC §267(c)(2) and (4), so he is deemed to own *indirectly* 100% of the stock of the corporation as well since he's deemed to indirectly own every share I own.

Well, that now means his brother (meaning *me*, the 100% shareholder) is now also someone who cannot receive wages for which the ERC credit is claimed by my S corporation since I bear the barred §152(d)(4) relationship to my brother and he indirectly controls the corporation via my stock.

I can repeat that same logic with my parents, children, grandchildren, etc. So only if I have no one who will be deemed to own my stock indirectly under the family rules of IRC §267(c) could I get the ERC under a literal interpretation of the law.

Joint Committee on Taxation Seemed to Believe This Was Obvious in 2015

This issue has been discussed nonstop since the ERC was opened up to PPP borrowers among a group of tax geeks (myself included) on Twitter. During one of those conversations, Tony Nitti messaged me to point out one case where the Joint Committee on Taxation appears to have actually discussed the specific issue of whether "splash back" blocks the controlling shareholder from having the corporation claim a credit limited by IRC §51(i)(1).

In the *Technical Explanation of The Protecting Americans From Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029* the Joint Committee on Taxation was describing the Work Opportunity Credit which had been extended and modified by the PATH Act. As part of describing the impact of the Act, the JCT discussed portions of the Act that, while not changed by the Act, need to be understood to understand the impact of passing the bill, as these existing rules would apply to the WOTC as modified.

One part of that document talked about "Other Rules" and stated, in part "The work opportunity tax credit is not allowed for wages paid to a relative or dependent of the taxpayer. *No credit is allowed for wages paid to an individual who is a more than fifty-percent owner of the entity*."[33]

As no part of IRC §51 directly states that a more than 50% owner can't qualify for the credit, presumably this sentence is referring to the overwhelmingly likely possibility that the individual in control will have his/her ownership attributed to a person under IRC §267(c) to which he/she will bear one of the impermissible relationships listed at IRC §152(d)(2)(A)-(G).

Note that the sentence is very matter of fact in its presentation, as if the answer should be clear to anyone reading the law.

So Are Owners Out of Luck?

When you follow the cross-references, it certainly doesn't look good for claiming the credit on the majority shareholder's wages based on a literal reading of the IRC provisions in question.

But it does seem like an odd way to arrive at this result. For instance, the JCT's statement appears overly broad, even if it would be correct in an overwhelming number of real world cases. That is, if I had no living direct ancestors, as well as no living brother or sister and no children or other lineal descendants, there would be no indirect owners that would end up causing my wages to not be eligible for the credit in my corporation.

As well, Congress tends to start with such a direct bar on benefits to owners and then expand out when writing such provisions. Barring owners from getting benefits meant to be given only if they benefit the rank and file is not something Congress usually obscures in laws they pass.

But despite all of that, as courts have ruled in the past, Congress can pass absurd laws if that absurdity is caused by the plain language of the statute. Absurd but unambiguous is fine by the Courts.

Could the IRS Rescue the Credit for Owners?

One possible way the IRS could conclude the credit is available on the wages of majority shareholders would be to focus on the theory that there are to be rules "similar to" those found at IRC §51(i)(1). That phrase might, if the IRS was feeling particularly generous, be enough ambiguity to allow the agency to write rules allowing for such wages to qualify without necessarily ruling that owners could also qualify for the work opportunity credit.

While the IRS might be stretching their authority if they did that, there's also the simple fact that it would be hard to conceive of a situation where someone could take the IRS

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[33] Joint Committee on Taxation, *Technical Explanation of The Protecting Americans From Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029,* JCX-144-15, December 17, 2015, p. 59

to court to challenge that holding (ignoring the fact that not many would want to do so).

Congressional Action

The simplest way to clear the path for controlling shareholder wages to qualify for the credit would be for Congress to change the law if, in fact, Congressional intent was to allow the credit in such cases. But there are a couple of complications in that path.

First, Congress has trouble passing virtually any legislation these days due to partisan battling. Even though the provision in question passed with a bipartisan vote in the CARES Act, that doesn't mean that the parties would non insist on additional provisions being attached to any bill introduced to obtain this result.

Second, it's not clear that denying the credit to controlling shareholders is contrary to Congressional intent. After all, sole proprietors and partners do not qualify for any such subsidy for their needs no matter how you read CARES Act Section 2301 or its successors.