Current Federal Tax Developments

Week of January 10, 2022

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CURRENT FEDERAL TAX DEVELOPMENTS
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SECTION: 41
IRS ISSUES ADDITIONAL INFORMATION RELATED TO AND MAKES UPDATES TO PROCEDURES FOR RESEARCH CREDIT CLAIMS

Citation: "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, 1/3/22

Following up on guidance issued in mid-October 2021 that the agency would be imposing new requirements on amended returns filed for research credit claims under IRC §41, the IRS has issued a memorandum to its employees on these new requirements[1] along with a web page of frequently asked questions (FAQ) on the issue.[2]

Contents of Original October 15 Advice

The original Field Advice[3] provided that the IRS would begin requiring specific information to be provided with each such claim and that if such information was not provided that the claim for refund would be rejected as invalid. Such a rejection would not be treated as the IRS formally denying the claim, as the Advice argued that such an invalid claim was not a proper claim for refund necessary to show that taxpayers had exhausted administrative remedies before pursuing a claim in court.

Thus, assuming the Advice's view of this issue is upheld when tested in actual litigation, taxpayers would need to submit an amended return that contained all information required in the proper form before the expiration of the statute of limitations for filing for such a claim.

The Field Advice provided that the IRS would phase in the program as follows:

- For claims postmarked on January 10, 2022 or after,[4] the IRS will provide taxpayers with a 30-day grace period to perfect claims that did not meet the requirements before the claim would be rejected as invalid

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[1] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022, https://www.irs.gov/pub/foia/ig/lbi-04-0122-0001.pdf (retrieved January 7, 2022)

[2] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS website, January 5, 2022 revision, https://www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions (retrieved January 7, 2022)

[3] Field Advice 20214101F, October 15, 2021

[4] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS website, January 5, 2022 revision

- One year later (thus, for claims beginning January 10, 2023) the IRS will no longer provide a grace period to perfect such claims, and would rather simply reject them as invalid.

We published an article on these developments when they took place in October of 2021.[5]

January 3 Memorandum

The January 3 memorandum provides revisions to the Internal Revenue Manual to implement these procedures.

While many of the details remain the same, the IRS did change one key item—the grace period has been extended to 45 days from the 30-day period found in the original Field Advice.

> (1) For claims that include a claim for credit for increasing research activities ("research credit claim") filed January 10, 2022 through January 9, 2023 (the transition period) taxpayers will be given 45 days to perfect the claim that is timely filed but does not provide the five foundational criteria in IRM 4.46.3.7.x.
>
> …
>
> (3) During the transition period, a claim that includes a claim for research credit that would otherwise be considered timely pursuant to IRC 6511(a) but does not meet the requirements of IRM 4.46.3.7.x, will be considered timely filed if perfected within the 45-day timeframe. Taxpayers that fail to provide the required information as listed in IRM 4.46.3.7.x will be notified with Letter 6428, Claim for Credit for Increasing Research Credit Activities — Additional Information Required. The 45-day perfect period will start from the date Letter 6428 is issued. All refund claims that include a claim for research credit filed on or after January 10, 2023, will be subject to the general rules of IRC 6511(a).

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[5] Ed Zollars, "Memorandum Outlines Minimum Information That Will Be Required for a Research Credit Refund Claim to Be Accepted," *Current Federal Tax Developments* website, October 15, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/10/15/memorandum-outlines-minimum-information-that-will-be-required-for-a-research-credit-refund-claim-to-be-accepted (retrieved January 7, 2022)

The memorandum contains the following table[6] of items that any claim for refund related to a research credit must contain:

Item #	Information Needed	Description
1	Identify all the business components that form the factual basis of the IRC § 41 research credit claim for the claim year.	Business components as defined in IRC § 41(d)(2)(B) must be identified.
2	All research activities performed by business component.	This must include a description of what the taxpayer did, and how they did it, by business component. It does not need to describe the four-part test under IRC § 41(d)(1) in detail. Language that simply restates the requirements under the Code or Treasury Regulations is insufficient.
3	All individuals who performed each research activity by business component.	This can be a list, table, or narrative but must include the first and last name or title/position of the person or persons engaged in the research by business component.

[6] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

Item #	Information Needed	Description
4	All the information each individual sought to discover by business component.	This can be a list, table, or narrative providing the information each individual sought to discover.
5	The total qualified 1) employee wage expenses, 2) supply expenses, and 3) contract research expenses.	The claim should provide the total amount of each of these expense types. If the Form 6765 or its equivalent is properly completed, that will satisfy this item.

The memorandum also provides that:

> …a declaration signed under the penalties of perjury verifying that the facts provided are accurate is required. In most cases, the signature on Forms 1040X or 1120X serves this function.[7]

The memorandum directs employees who receive an invalid claim to provide the following warning to the taxpayer submitting that claim when it is rejected as invalid:

> If during an examination, the taxpayer submits a deficient claim for refund or raises an affirmative issue that does not meet the criteria for a claim for refund, examiners should advise the taxpayer to file a valid claim for refund (before the RSED expires) if they want to protect their opportunity to recover a refund related to the issue. LB&I examiners must refer to IRM 4.46.3.7.2.2, Claims Not Meeting the Standards of Treas. Reg. 301.6402-2. SB/SE examiners may generally consider the issues in a deficient claim.[8]

As the analysis in the original Field Advice concluded that the IRS had previously lost the ability to argue no valid claim had been filed to challenge a court filing by having

[7] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

[8] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

worked the case, the memorandum warns IRS employees to avoid taking any actions involving considering the claim:

> **Exception:** For a deficient research credit claim, the claim issues must not be considered. See IRM 4.10.11.2.1.1.1 and IRM 4.46.3.7.X for additional information.
>
> (3) Examiners must not use claim letters or claim for refund language in reports (e.g., references to "disallowing the claim") for examinations where a deficient claim was raised; such language could be deemed as waiving the defects of the deficient claim.[9]

Claims Filed in the One Year from January 10, 2022 to January 9, 2023

The memorandum provides specific procedures IRS employees are to follow during the one-year transition period for claims:

- Evaluate the claim for the five criteria outlined in IRM 4.46.3.7.x and verify that it is signed under penalties of perjury to determine validity and document the results of the evaluation in the case file. This determination should generally be completed within 30 days after received in the field examination team.
- If the claim is determined to be valid, examiners will follow appropriate risking procedures and determine if an examination of the claim is warranted.
- If a claim is determined to be deficient, examiners will first issue Letter 6428, Claim for Credit for Increasing Research Credit Activities — Additional Information Required, allowing 45 days to perfect. If information that meets the requirements of IRM 4.46.3.7.x is received within the 45 days provided, the examiner will continue under normal risking procedures. If sufficient information to perfect the claim is not received pursuant to the process set forth in the letter, the claim will be considered deficient, and taxpayers will be issued Letter 6430, No Consideration, Section 41 Claim. Management (i.e. Territory Manager) and counsel must concur that the claim does not meet the criteria outlined in IRM 4.46.3.7.x prior to issuing Letter 6430.
- If the claim is deficient, do not consider the claim issues or include claim language in a report. In addition to providing the taxpayer Letter 6430, a Form 3870, Request for Adjustment, is required to reverse the transaction code posted to the

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[9] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

master file and to remove freeze code "-A." EEFax Form 3870 to CCP to input a TC 290 for zero to release the freeze code. efer to IRM 21.5.6.4.2, -A Freeze.[10]

Procedures for Claims Received on or After January 10, 2023

Following the end of the one-year transition period, the memorandum provides the following procedures for IRS employees to follow:

- Evaluate the claim for the five criteria outlined in IRM 4.46.3.7.x and verify that it is signed under penalties of perjury to determine validity and document the results of the evaluation in the case file. This determination should generally be completed within 30 days after received in the field examination team.
- If the claim is determined to be valid, examiners will follow appropriate risking procedures and determine if an examination of the claim is warranted.
- If the claim is determined to be deficient, examiners will issue Letter 6430, No Consideration, Section 41 Claim to the taxpayer. Management (i.e., Territory Manager) and counsel must concur that the claim does not meet the criteria outlined in IRM 4.46.3.7.x prior to issuing Letter 6430.
- If the claim is deficient, do not consider the claim issues or include claim language in a report. In addition to providing the taxpayer Letter 6430, a Form 3870, Request for Adjustment, is required to reverse the transaction code posted to the master file and to remove freeze code "-A." EEFax Form 3870 to CCP to input a TC 290 for zero to release the freeze code. Refer to IRM 21.5.6.4.2, -A Freeze.[11]

SECTION: 85
TAXPAYERS ALLOWED TO KEEP FUNDS RECEIVED FROM IRS ERROR IN DETERMINING EXCLUDABLE 2020 UNEMPLOYMENT COMPENSATION

Citation: "IRS updates 2020 unemployment compensation FAQs," FS-2022-01, 1/7/22

The IRS updated the 2020 unemployment compensation exclusion FAQ to allow certain taxpayers to keep an erroneous reduction of their federal taxes when the IRS corrected their 2020 Form 1040 to compute the excludable unemployment

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[10] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

[11] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

compensation following changes made in the American Rescue Plan Act.[12] The issue affects certain married taxpayers filing joint returns in non-community property states who received unemployment compensation in 2020.

Most advisers are aware the IRS faced a number of challenges beginning in 2020 that carried into 2021. The enactment of the American Rescue Plan Act which made certain retroactive changes to the law that applied to 2020 didn't help, especially not coming just over two months after Congress made a number of late year changes to 2020 tax law at the very end of 2020.

The IRS has now disclosed one particular error the agency made trying to deal with the American Rescue Plan Act's changes to the taxation of unemployment compensation. The error resulted in the IRS computing an erroneously low total federal tax for certain taxpayers on their 2020 income tax return. The agency has now announced those taxpayers will not be required to amend their 2020 tax return or pay the additional tax that they should have paid.

The IRS added question 10 to Topic G (Receiving a Refund, Letter or Notice) of the FAQ to add a new question and answer. The added question and answer reads:

> **Q10. I'm married, do not live in a community property state and filed a joint 2020 tax return with my spouse. We received a notice stating the IRS corrected our return to allow the unemployment compensation exclusion, but we believe the exclusion amount is too much. Do we need to file an amended return or pay back all or some of the refund we received? (added January 7, 2022)**
>
> A10. The IRS moved quickly to implement the provisions of the American Recovery Plan Act (ARPA) of 2021. ARPA allows eligible taxpayers to exclude up to $10,200 of unemployment compensation on their 2020 income tax return. For married taxpayers, separate exclusions can apply to the unemployment compensation paid to each spouse. In some cases, when Form 1099-G, Certain Government Payments, information was not available, the IRS automatically allowed an exclusion amount of up to $20,400 for married individuals who live in a non-community property state and who filed a joint 2020 tax return when:
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> - The total unemployment compensation was $10,201 or more;
> - The modified adjusted gross income of the taxpayers was less than $150,000; and

[12] "IRS updates 2020 unemployment compensation FAQs," FS-2022-01, January 7, 2022, https://www.irs.gov/pub/newsroom/fs-2022-01.pdf (retrieved January 7, 2022)

- Form 1099-G data was not available at the time when the IRS completed the correction.

If the IRS determined you qualified for the exclusion based on the criteria above and as a result you received a refund, then you are not required to pay back all or part of the refund.

There is no need to contact the IRS or to file an amended return.

If you're married and live-in community property state, refer to Q4 under Topic A: I'm married and live in a community property state. Am I eligible for the exclusion?[13]

While married taxpayers living in the 9 community property states who received unemployment of over $10,200, filed a joint return and who had modified adjusted gross income of under $150,000 might initially be miffed about how they missed out, they actually didn't. In community property states, the total unemployment compensation received by both spouses was community income (treated as ½ assigned to each spouse even if all was paid to a single spouse) and, thus, they would have received the same treatment as if they had lived in a non-community property state and were impacted by this glitch. The only difference is that the community property couple's tax was properly computed in that case.

SECTION: 1368
IRS DRAFT 2021 S RETURN INSTRUCTIONS PROVIDE THAT EXPENSES PAID WITH PPP LOAN PROCEEDS REDUCE OTHER ADJUSTMENTS ACCOUNT

Citation: "2021 Instructions for Form 1120-S," December 22, 2021 draft, 12/22/21

A potential problem for S corporations that received PPP loan forgiveness who had accumulated earnings and profits involved the proper classification of the expenses paid with the PPP loan proceeds in the computation of the accumulated adjustments account (AAA). A post by Dan Chodan, CPA on Twitter on January 3, 2022 pointed out that the IRS had now given guidance on this issue.[14]

The issue arose after Congress, in the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act* signed into law on December 27, 2020, provided that expenses paid that led to the forgiveness of the PPP loan would be deductible for federal

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[13] "IRS updates 2020 unemployment compensation FAQs," FS-2022-01, January 7, 2022, https://www.irs.gov/pub/newsroom/fs-2022-01.pdf (retrieved January 7, 2022)

[14] https://twitter.com/danchodan/status/1478074397579694081?s=20 , January 3, 2021

tax purposes, overriding IRS Notice 2020-32 that provided such expenses would not be deductible for federal tax purposes.

The problem arose when taxpayers went to compute their Accumulated Adjustments Account on Schedule M-2 of Form 1120-S. While the 2020 instructions told taxpayers to omit tax-exempt income from the calculation of AAA, AAA was to be reduced by all deductible expenses.[15] Tax software, following those instructions would move the tax exempt income to the Other Adjustments Account column but would normally not make any adjustment to move the expenses paid with the PPP loans into this account and out of the AAA account. This was true even though those instructions did state this account was to be adjusted for "tax-exempt income (*and related expenses*)…(emphasis added)."[16]

Under IRC §1368(e)(1)(A) and the instructions, a taxpayer's basis would be increased by the PPP loan forgiveness per the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act*, but the corporation's AAA would not be increased as the income was exempt from tax. But IRC §1368(e)(1)(A) specifically provided that "no adjustment shall be made for income (and related expenses) which is exempt from tax under this title…".

Some advisers, this one included, believed that the treatment of this by most tax software was in error, noting that IRC §1368(e)(1)(A) provided that expenses related to tax-exempt income also did not reduce AAA, and that provision in the Code would override any language in the instructions that might appear contrary to that treatment. Such advisers pointed out that the 2020 instructions did refer to expenses related to tax exempt income being an item to be reported in OAA.[17]

Such expenses had been labeled by the IRS in Notice 2020-32 as expenses related to the exempt PPP forgiveness income to justify the IRS position that such expenses could not be deducted prior to the late 2020 law change. While the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act* provided that such expenses could be deducted, it did not override the IRS conclusion that such expenses were related to the tax-exempt income—it was simply silent on that issue.

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[15] "2020 Instructions for Form 1120-S," p. 45, https://www.irs.gov/pub/irs-pdf/i1120s.pdf (retrieved January 3, 2022)

[16] "2020 Instructions for Form 1120-S," p. 45

[17] "2020 Instructions for Form 1120-S," p. 45

In the draft instructions for the 2021 Form 1120-S, the IRS has now stated their position—and it agrees that such expenses do not reduce the accumulated adjustments account. Page 45 of the 2021 draft Form 1120-S instructions provides:

> An S corporation should include tax-exempt income from the forgiveness of PPP loans on line 3 and report expenses paid with PPP loans that are forgiven on line 5 in column (d) of the Schedule M-2.[18]

Thus, returns prepared using the default treatments provided by most tax software will have understated AAA and overstated OAA for S corporations who received PPP loans and have treated the loan as forgiven when filing the 2020 S Corporation income tax return.

Revising this calculation should not require formally amending the 2020 S Corporation return, since the amount of AAA at the beginning of 2021 is not required to agree with that shown on the 2020 return by any provision of the IRC. Rather, the IRC simply requires that the S corporation use the proper amount of AAA to determine the tax status of any distributions.

If distributions in 2021 did not exceed AAA this adjustment would be all that is necessary to correct the reporting.

However, this change in treatment may require amending Forms 1099-DIV that might have been issued for 2020 when distributions exceeded AAA for S corporations that had accumulated earnings and profits. Similarly, the 2020 returns for shareholders who received those Forms 1099-DIV would need to be amended.

Failing to amend those returns could create later issues for the shareholder, since the IRS position would be that these distributions were not dividend distributions, and thus would have reduced the shareholder's basis in his/her shares. Thus, even though the shareholder had reported the distribution as income, they would end up with a basis reduction regardless—so it's best to get the tax that was paid in error (in the IRS's view) refunded to the taxpayer.

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[18] "2021 Instructions for Form 1120-S," December 22, 2021 draft, p. 45, https://www.irs.gov/pub/irs-dft/i1120s--dft.pdf (retrieved January 3, 2022)

SECTION 7701: IRS INFORMATION LETTER ADDRESSES CASES WHERE A CONTROLLER IS AND IS NOT A PAID PREPARER OF RETURNS

Citation: INFO 2021-0029, 12/30/21

In IRS Information Letter 2021-0029[19] the agency addresses an issue that CPAs employed as a controller in small, closely held businesses with various related businesses run into. If they are asked to prepare a number of returns for individuals and other related entities that aren't their employer, at what point does the controller become a paid preparer with regard to some or all of those returns.

The letter addresses this specific concern of the party to whom the letter is addressed:

> As we understand the facts provided, you prepare a number of income tax returns for your employer, an S-Corporation, for whom you have been employed for over seven years. The entities you prepare returns for include partnerships and individuals. You state that these partnerships are Limited Liability Companies related to your employer, and that these individuals are employed by the taxpayer. You ask whether you are required to sign these returns as a tax preparer.[20]

The letter first addresses the general rule governing such situations:

> The definition of "tax return preparer" found in section 7701(a)(36)(A) of the Internal Revenue Code (Code) includes any person who prepares a return for compensation. Section 7701(a)(36)(B) of the Code states that a person is not a preparer merely because they prepare returns for an employer for whom they are continuously employed. This exception includes persons who prepare returns for officers and other employees of the employer.[21]

The letter then provides detailed information on how the party to whom the letter is addressed can resolve his/her situation:

> Treasury Regulation § 301.7701-15(f)(1)(ix) states that individuals preparing returns for an employer, including returns prepared for an

[19] INFO 2021-0029, December 30, 2021, https://www.irs.gov/pub/irs-wd/21-0029.pdf (retrieved January 7, 2022)

[20] INFO 2021-0029, December 30, 2021

[21] INFO 2021-0029, December 30, 2021

> officer, general partner, member, shareholder, or employee, are not considered tax return preparers.

Thus, if the individuals for whom the controller is preparing a return fits one of those categories, the controller is not a paid preparer for that return. But if an individual does not fit into one of those categories, then the controller would be a paid preparer for that return.

The letter continues to look at related *corporations* where an employee of one will be considered an employee of the other:

> Treasury Regulation § 301.7701-15(f)(4) further states that the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well. Treasury Regulation § 301.7701-15(f)(1)(ix) therefore applies to an employee preparing a return for an entity described in Treasury Regulation § 301.7701-15(f)(4) as well.[22]

As noted above, Treasury Regulation § 301.7701-15(f)(1)(ix) would allow preparing returns for an officer, general partner, member, shareholder, or employee of those organizations as well. But note that the regulation only refers to related corporations. This would appear to make the limited liability companies taxed as partnerships entities not covered by this exception, making the controller a paid preparer with regard to returns for those entities under the general rule found at Treasury Regulation § 301.7701-15(a) which states:

> A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code (Code).[23]

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[22] INFO 2021-0029, December 30, 2021

[23] Treasury Regulation §301.7701-15(a)