Current Federal Tax Developments

Week of August 10, 2020

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SECTION: PPP LOAN
FAQ ON PPP LOAN FORGIVENESS ISSUED BY SBA WITH SOME SURPRISES ON SHAREHOLDER-EMPLOYEE PAYROLL COSTS

Citation: Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness, Small Business Administration, 8/4/20

The SBA has resumed the issuance of FAQs on the Paycheck Protection Program, issuing a new FAQ on PPP Loan Forgiveness.[1] Presumably the SBA believed they should publish this document as they are approaching the date the agency announced they may be accepting applications for forgiveness that have been processed by lenders.

The FAQ is divided into four major categories:

- General Forgiveness FAQs
- Loan Forgiveness Payroll Costs FAQs
- Loan Forgiveness Nonpayroll Costs FAQs
- Loan Forgiveness Reductions FAQs.

Corporate shareholder-employees will find some good news in the FAQs, but those who were looking to attempt to pre-pay retirement or health benefits will not be happy with the guidance in the FAQs.

General Loan Forgiveness FAQs

The general category looks at issues that apply outside of the areas covered by the more detailed sections of the FAQ. The section begins by noting that sole proprietors with no employees should strongly consider filing the short form application for forgiveness (*Loan Forgiveness Application* Form 3508EZ or lender equivalent):

> **1. Question: Which loan forgiveness application should sole proprietors, independent contractors, or self-employed individuals with no employees complete?**
>
> Answer: Sole proprietors, independent contractors, and self-employed individuals who had no employees at the time of the PPP loan

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[1] Paycheck Protection Program Frequently Asked Questions (FAQs) on PPP Loan Forgiveness, Small Business Administration, August 4, 2020 version, August 4, 2020, https://home.treasury.gov/system/files/136/PPP--Loan-Forgiveness-FAQs.pdf (retrieved August 4, 2020)

application and did not include any employee salaries in the computation of average monthly payroll in the Borrower Application Form automatically qualify to use the Loan Forgiveness Application Form 3508EZ or lender equivalent and should complete that application.

The FAQ indicates a significant amount of flexibility on the part of the SBA in finding scanned forms and forms signed by electronic signatures as acceptable, though noting that other applicable non-SBA regulations may affect the issue:

> **2. Question: Can PPP lenders use scanned copies of documents, E-signatures, or E-consents for loan forgiveness applications and loan forgiveness documentation?**
>
> Answer: Yes. All PPP lenders may accept scanned copies of signed loan forgiveness applications and documents containing the information and certifications required by SBA Form 3508, 3508EZ, or lender equivalent. Lenders may accept any form of E-consent or E-signature that complies with the requirements of the Electronic Signatures in Global and National Commerce Act (P.L. 106-229).
>
> If electronic signatures are not feasible, then when obtaining a wet ink signature without in-person contact, lenders should take appropriate steps to ensure the proper party has executed the document.
>
> This guidance does not supersede signature requirements imposed by other applicable law, including by the lender's primary federal regulator.

The FAQ reminds all parties that no payments need to be made before the application for forgiveness is submitted so long as it is submitted timely (no more than 10 months after the end of the Applicable Period):

> **3. Question: If a borrower submits a timely loan forgiveness application, does the borrower have to make any payments on its loan prior to SBA remitting the forgiveness amount, if any?**
>
> Answer: As long as a borrower submits its loan forgiveness application within ten months of the completion of the Covered Period (as defined below), the borrower is not required to make any payments until the forgiveness amount is remitted to the lender by SBA. If the loan is fully forgiven, the borrower is not responsible for any payments. If only a portion of the loan is forgiven, or if the forgiveness application is denied, any remaining balance due on the loan must be repaid by the borrower on or before the maturity date of the loan. Interest accrues during the time between the disbursement of the loan and SBA remittance of the forgiveness amount. The borrower is responsible for paying the accrued interest on any amount of the loan that is not forgiven. The lender is responsible for notifying the borrower of remittance by SBA of the loan forgiveness amount (or that SBA determined that no amount of the loan is eligible for

forgiveness) and the date on which the borrower's first payment is due, if applicable.

Loan Forgiveness Payroll Cost FAQs

Some of what may be considered by most to be surprising guidance in this FAQ is found in the Loan Forgiveness Payroll Cost section.

The first few questions are not where the surprises lie—they rather confirm what some had found surprising in earlier guidance. The first question deals with payroll costs incurred during the Covered Period but not paid until shortly after the period ends.

> **1. Question: Are payroll costs that were incurred during the Covered Period1 or the Alternative Payroll Covered Period2 but paid after the Covered Period or the Alternative Payroll Covered Period eligible for loan forgiveness?**
>
> Answer: Yes, if the payroll costs are paid on or before the next regular payroll date after the Covered Period or Alternative Payroll Covered Period.

The FAQ continues with the following example:

EXAMPLE – LOAN FORGIVENESS PAYROLL COST FAQ Q1

A borrower received its loan before June 5, 2020 and elects to use a 24-week Covered Period. The borrower's Covered Period runs from Monday, April 20 through Sunday, October 4. The borrower has a biweekly payroll cycle, with a pay period ending on Sunday, October 4. However, the borrower will not make the corresponding payroll payment until the next regular payroll date of Friday, October 9. Under these circumstances, the borrower incurred payroll costs during the Covered Period and may seek loan forgiveness for the payroll costs paid on October 9 because the cost was incurred during the Covered Period and payment was made on the first regular payroll date after the Covered Period.

Similarly, costs incurred before the Covered Period but paid in the Covered Period are also counted as payroll costs:

> **2. Question: Are payroll costs that were incurred before the Covered Period but paid during the Covered Period eligible for loan forgiveness?**
>
> Answer: Yes.

The FAQ offers an example of this as well:

EXAMPLE – LOAN FORGIVENESS PAYROLL COST FAQ Q2

A borrower received its loan before June 5, 2020 and elects to use a 24-week Covered Period. The borrower's Covered Period runs from Monday, April 20 through Sunday, October 4. The borrower has a biweekly payroll cycle, with a payroll cycle ending on Saturday, April 18. The borrower will not make the corresponding payroll payment until Friday, April 24. While these

payroll costs were not incurred during the Covered Period, they were paid during the Covered Period and are therefore eligible for loan forgiveness.

The FAQ notes that taxpayers with bi-weekly or more frequent payroll cycles may be able to avoid calculating partial pay period payroll costs if they elect to use the Alternative Payroll Covered Period, but those with longer pay periods will have to deal with partial pay period costs.

> **3. Question: Are borrowers required to calculate payroll costs for partial pay periods?**
>
> Answer: If the borrower uses a biweekly or more frequent (e.g., weekly) payroll cycle, the borrower may elect to calculate eligible payroll costs using the eight-week (for borrowers that received their loans before June 5, 2020 and elect this Covered Period length) or 24-week period that begins on the first day of the first payroll cycle following the PPP Loan Disbursement Date (referred to as the Alternative Payroll Covered Period). However, if a borrower pays twice a month or less frequently, it will need to calculate payroll costs for partial pay periods. The Covered Period or Alternative Covered Period for any borrower will end no later than December 31, 2020.

Again, the agency offers up an example to illustrate the issue:

EXAMPLE – LOAN FORGIVENESS PAYROLL COST FAQ Q3

A borrower uses a biweekly payroll cycle. The borrower's 24-week Covered Period begins on Monday, June 1 and ends on Sunday, November 15. The first day of the borrower's first payroll cycle that starts in the Covered Period is June 7. The borrower may elect an Alternative Payroll Covered Period that starts on June 7 and ends on November 21 (167 days later). Payroll costs incurred (i.e., the pay was earned on that day) during this Alternative Payroll Covered Period are eligible for loan forgiveness if the last payment is made on or before the first regular payroll date after November 21.

The FAQ also confirms that *gross* and not *net* payroll is used in the computation of payroll costs for forgiveness:

> **4. Question: For purposes of calculating cash compensation, should borrowers use the gross amount before deductions for taxes, employee benefits payments, and similar payments, or the net amount paid to employees?**
>
> Answer: The gross amount should be used when calculating cash compensation.

Repeating a holding found in earlier interim final rules, the FAQ confirms that amounts paid by an employer to cover an employee's lost tips, bonuses or other forms of incentive pay are considered acceptable payroll costs for forgiveness purposes:

> **5. Question: Are only salaries or wages covered by loan forgiveness, or can a borrower pay lost tips, lost commissions,**

bonuses, or other forms of incentive pay and have such costs qualify for loan forgiveness?

Answer: Payroll costs include all forms of cash compensation paid to employees, including tips, commissions, bonuses, and hazard pay. Note that forgivable cash compensation per employee is limited to $100,000 on an annualized basis.

The first warning against accelerating payments that relate to future periods into the Covered Period is found in the FAQ discussing health care benefits:

6. Question: What expenses for group health care benefits will be considered payroll costs that are eligible for loan forgiveness?

Answer: Employer expenses for employee group health care benefits that are paid or incurred by the borrower during the Covered Period or the Alternative Payroll Covered Period are payroll costs eligible for loan forgiveness. However, payroll costs do not include expenses for group health care benefits paid by employees (or beneficiaries of the plan) either pre-tax or after tax, such as the employee share of their health care premium. Forgiveness is not provided for expenses for group health benefits accelerated from periods outside the Covered Period or Alternative Payroll Covered Period.

If a borrower has an insured group health plan, insurance premiums paid or incurred during the Covered Period or Alternative Payroll Covered Period qualify as "payroll costs," as long as the premiums are paid during the applicable period or by the next premium due date after the end of the applicable period. As noted, only the portion of the premiums paid by the borrower for coverage during the applicable Covered Period or Alternative Payroll Covered Period is included, not any portion paid by employees or beneficiaries or any portion paid for coverage for periods outside the applicable period. Loan Forgiveness Payroll Costs FAQ 8 outlines the rules that apply to owner health insurance.

A similar warning against accelerating costs is found when the FAQ discusses retirement benefits as payroll costs:

7. Question: What contributions for retirement benefits will be considered payroll costs that are eligible for loan forgiveness?

Answer: Generally, employer contributions for employee retirement benefits that are paid or incurred by the borrower during the Covered Period or Alternative Payroll Covered Period qualify as "payroll costs" eligible for loan forgiveness. The employer contributions for retirement benefits included in the loan forgiveness amount as payroll costs cannot include any retirement contributions deducted from employees' pay or otherwise paid by employees. Forgiveness is not provided for employer contributions for retirement benefits accelerated from periods outside the Covered Period or Alternative Covered Period. Loan Forgiveness Payroll Costs FAQ 8 outlines the

> treatment of retirement benefits for owners, which are different from this general approach.

While some may be disappointed with this "anti-acceleration" guidance, the SBA had never issued any guidance that suggested such payments incurred *after* the Covered Period would be considered acceptable costs, even though the agency clearly allowed costs incurred *before* the Covered Period but paid during the Covered Period to be counted towards loan forgiveness.

However, the guidance on owner compensation does contain a few surprising pieces of guidance—and these surprises are generally good news for shareholder-employees compared to what most had inferred to be the rules given prior SBA guidance.

The SBA FAQ on owner compensation is broken down into separate discussions for different entity types. The FAQ begins with a generally applicable paragraph before looking at specific entity types.

> **8. Question: How is the amount of owner compensation that is eligible for loan forgiveness determined?**
>
> Answer: The amount of compensation of owners who work at their business that is eligible for forgiveness depends on the business type and whether the borrower is using an eight-week or 24-week Covered Period. In addition to the specific caps described below, the amount of loan forgiveness requested for owner-employees and self-employed individuals' payroll compensation is capped at $20,833 per individual in total across all businesses in which he or she has an ownership stake. For borrowers that received a PPP loan before June 5, 2020 and elect to use an eight-week Covered Period, this cap is $15,385. If their total compensation across businesses that receive a PPP loan exceeds the cap, owners can choose how to allocate the capped amount across different businesses. The examples below are for a borrower using a 24-week Covered Period.

This guidance does provide some additional clarity on the limits that apply when an individual has an ownership interest in multiple businesses that obtained PPP loans, allowing that the owners can choose how to spread the capped amount between the various businesses.

The FAQ then goes on to provide the rules for C corporation shareholder-employees:

> **C Corporations:** The employee cash compensation of a C-corporation owner-employee, defined as an owner who is also an employee (including where the owner is the only employee), is eligible for loan forgiveness up to the amount of 2.5/12 of his or her 2019 employee cash compensation, with cash compensation defined as it is for all other employees. Borrowers are also eligible for loan forgiveness for payments for employer state and local taxes paid by the borrowers and assessed on their compensation, for the amount paid by the borrower for employer contributions for their employee health insurance, and for employer retirement contributions to their employee retirement plans capped at the amount of 2.5/12 of the 2019

> employer retirement contribution. Payments other than for cash compensation should be included on lines 6-8 of PPP Schedule A of the loan forgiveness application (SBA Form 3508 or lender equivalent), for borrowers using that form, and do not count toward the $20,833 cap per individual.

Note that only *cash compensation* is subject to the limit on owner compensation and that the definition is the same as it is for other employees. Earlier guidance had been interpreted by many commentators to require that the caps be applied to all payroll costs of the shareholder-employee. These "extra" costs (certain benefits and taxes) go on line 6-8 of PPP Schedule A along with the similar costs of rank and file employees.

> **S Corporations:** The employee cash compensation of an S-corporation owner-employee, defined as an owner who is also an employee, is eligible for loan forgiveness up to the amount of 2.5/12 of their 2019 employee cash compensation, with cash compensation defined as it is for all other employees. Borrowers are also eligible for loan forgiveness for payments for employer state and local taxes paid by the borrowers and assessed on their compensation, and for employer retirement contributions to their employee retirement plans capped at the amount of 2.5/12 of their 2019 employer retirement contribution. Employer contributions for health insurance are not eligible for additional forgiveness for S-corporation employees with at least a 2% stake in the business, including for employees who are family members of an at least 2% owner under the family attribution rules of 26 U.S.C. 318, because those contributions are included in cash compensation. The eligible non-cash compensation payments should be included on lines 7 and 8 of PPP Schedule A of the Loan Forgiveness Application (SBA Form 3508), for borrowers using that form, and do not count toward the $20,833 cap per individual.

The difference for S corporation shareholders (and those subject to the family attribution rules) is that health insurance benefits are considered part of *cash compensation* and not allowed in addition to cash compensation as they are for a C corporation shareholder. But the amounts paid for certain payroll taxes and retirement plan payments are not subject to the owner-employee caps.

> **Self-employed Schedule C (or Schedule F) filers:** The compensation of self-employed Schedule C (or Schedule F) individuals, including sole proprietors, self-employed individuals, and independent contractors, that is eligible for loan forgiveness is limited to 2.5/12 of 2019 net profit as reported on IRS Form 1040 Schedule C line 31 (or 2.5/12 of 2019 net farm profit, as reported on IRS Form 1040 Schedule F line 34) (or for new businesses, the estimated 2020 Schedule C (or Schedule F) referenced in question 10 of "Paycheck Protection Program: How to Calculate Maximum Loan Amounts – By Business Type"3). Separate payments for health insurance, retirement, or state or local taxes are not eligible for additional loan forgiveness; health insurance and retirement expenses are paid out of their net self-employment income. If the borrower did not submit its 2019 IRS Form 1040 Schedule C (or F) to the Lender when the borrower

> initially applied for the loan, it must be included with the borrower's forgiveness application.

In the case of the sole proprietor, the limit is what had been expected from prior guidance. Since all of the "extra" payroll costs (retirement benefits, health benefits and state taxes) for the proprietor are not allowed as deductions in computing Schedule C or F income, the SBA takes the position that such costs are part of the net earnings shown on Schedule C or F from which the limitation is computed.

> **General Partners:** The compensation of general partners that is eligible for loan forgiveness is limited to 2.5/12 of their 2019 net earnings from self-employment that is subject to self-employment tax, which is computed from 2019 IRS Form 1065 Schedule K-1 box 14a (reduced by box 12 section 179 expense deduction, unreimbursed partnership expenses deducted on their IRS Form 1040 Schedule SE, and depletion claimed on oil and gas properties) multiplied by 0.9235. Compensation is only eligible for loan forgiveness if the payments to partners are made during the Covered Period or Alternative Payroll Covered Period. Separate payments for health insurance, retirement, or state or local taxes are not eligible for additional loan forgiveness. If the partnership did not submit its 2019 IRS Form 1065 K-1s when initially applying for the loan, it must be included with the partnership's forgiveness application.

This treatment also is in line with what most commentators had expected based on prior guidance.

The SBA this time decided to indirectly comment on the reduction of self-employment income of general partners by using the 0.9235 factor in a footnote to the FAQ. That footnote reads:

> This treatment follows the computation of self-employment tax from IRS Form 1040 Schedule SE Section A line 4 and removes the "employer" share of self-employment tax, consistent with how payroll costs for employees in the partnership are determined.

While that statement is true, most who have questioned its inclusion have noted that the same reduction applies to self-employment income from Schedule C and E on Form 1040, but the SBA did not reduce proprietor's income by this factor for PPP loan purposes.

> **LLC owners:** LLC owners must follow the instructions that apply to how their business was organized for tax filing purposes for tax year 2019, or if a new business, the expected tax filing situation for 2020.

The LLC section may provide some guidance for cases where the LLC made a change in its check the box election for 2020—the borrower must use the rules for the type of tax entity the LLC was treated as for 2019. However, that still leaves unanswered questions about how such compensation would be paid to the owners.

Loan Forgiveness Nonpayroll Costs FAQs

The nonpayroll cost FAQ starts with a similar pair of questions dealing with the "paid and incurred" status of nonpayroll costs, with answers provided that are similar to those given for payroll costs.

1. Question: Are nonpayroll costs incurred prior to the Covered Period, but paid during the Covered Period, eligible for loan forgiveness?

Answer: Yes, eligible business mortgage interest costs, eligible business rent or lease costs, and eligible business utility costs incurred prior to the Covered Period and paid during the Covered Period are eligible for loan forgiveness.

EXAMPLE – LOAN FORGIVENESS NONPAYROLL COST FAQ Q1

A borrower's 24-week Covered Period runs from April 20 through October 4. On May 4, the borrower receives its electricity bill for April. The borrower pays its April electricity bill on May 8. Although a portion of the electricity costs were incurred before the Covered Period, these electricity costs are eligible for loan forgiveness because they were paid during the Covered Period.

2. Question: Are nonpayroll costs incurred during the Covered Period, but paid after the Covered Period, eligible for loan forgiveness?

Answer: Nonpayroll costs are eligible for loan forgiveness if they were incurred during the Covered Period and paid on or before the next regular billing date, even if the billing date is after the Covered Period.

EXAMPLE – LOAN FORGIVENESS NONPAYROLL COST FAQ Q2

A borrower's 24-week Covered Period runs from April 20 through October 4. On October 6, the borrower receives its electricity bill for September. The borrower pays its September electricity bill on October 16. These electricity costs are eligible for loan forgiveness because they were incurred during the Covered Period and paid on or before the next regular billing date (November 6).

The FAQ clarifies that while a borrower may elect an Alternative Payroll Covered Period, that does not affect the beginning and ending of the Covered Period for nonpayroll costs:

3. Question: If a borrower elects to use the Alternative Payroll Covered Period for payroll costs, does the Alternative Payroll Covered Period apply to nonpayroll costs?

Answer: No. The Alternative Payroll Covered Period applies only to payroll costs, not to nonpayroll costs. The Covered Period always starts on the date the lender makes a disbursement of the PPP loan. Nonpayroll costs must be paid or incurred during the Covered Period to be eligible for loan forgiveness. For payroll costs only, the borrower

may elect to use the Alternative Payroll Covered Period to align with its biweekly or more frequent payroll schedule.

As well, the FAQ points out that interest on unsecured debt is not an eligible nonpayroll cost:

> **4. Question: Is interest on unsecured credit eligible for loan forgiveness?**
>
> Answer: No. Payments of interest on business mortgages on real or personal property (such as an auto loan) are eligible for loan forgiveness. Interest on unsecured credit is not eligible for loan forgiveness because the loan is not secured by real or personal property. Although interest on unsecured credit incurred before February 15, 2020 is a permissible use of PPP loan proceeds, this expense is not eligible for forgiveness.

The FAQ clarifies that even though a lease may have expired after February 15, 2020, if the borrower renewed that same lease after that date the payments will continue to qualify as nonpayroll costs:

> **5. Question: Are payments made on recently renewed leases or interest payments on refinanced mortgage loans eligible for loan forgiveness if the original lease or mortgage existed prior to February 15, 2020?**
>
> Answer: Yes. If a lease that existed prior to February 15, 2020 expires on or after February 15, 2020 and is renewed, the lease payments made pursuant to the renewed lease during the Covered Period are eligible for loan forgiveness. Similarly, if a mortgage loan on real or personal property that existed prior to February 15, 2020 is refinanced on or after February 15, 2020, the interest payments on the refinanced mortgage loan during the Covered Period are eligible for loan forgiveness.

EXAMPLE – LOAN FORGIVENESS NONPAYROLL COST FAQ Q5

A borrower entered into a five-year lease for its retail space in March 2015. The lease was renewed in March 2020. For purposes of determining forgiveness of the borrower's PPP loan, the March 2020 renewed lease is deemed to be an extension of the original lease, which was in force before February 15, 2020. As a result, the lease payments made under the renewed lease during the Covered Period are eligible for loan forgiveness.

Question 6 will surprise many readers. The original IFR for self-employed individuals had indicated a very broad reading of transportation utility costs, but the FAQ seems to have greatly restricted that category:

> **6. Question: Covered utility payments, which are eligible for forgiveness, include a "payment for a service for the distribution**

> **of . . . transportation" under the CARES Act. What expenses does this category include?**
>
> Answer: A service for the distribution of transportation refers to transportation utility fees assessed by state and local governments. Payment of these fees by the borrower is eligible for loan forgiveness.

In a footnote the FAQ directs readers to https://www.fhwa.dot.gov/ipd/value_capture/defined/transportation_utility_fees.aspx for information on Transportation Utility Fees. That page describes transportation utility fees as follows:

> Transportation utility fees are a financing mechanism that treats the transportation system like a utility in which residents and businesses pay fees based on their use of the transportation system rather than taxes based on the value of property they occupy. The fees are not subject to voter approval and are based on the number of trips generated by different land uses. Utility fee rates may be determined by the number of parking spaces, square footage, or gross floor area. This approach links the costs of maintaining transportation infrastructure with the benefits derived from the mobility a transportation system provides.
>
> The first transportation utility fees in the United States were implemented in Oregon in the 1980s. Since then they have been used successfully in smaller cities in Washington, Idaho, Utah, Colorado, Texas, Missouri, and Florida. The fees are used primarily by local governments to fund roadway maintenance. They are also known as street maintenance fees, road use fees, street utility fees, and pavement maintenance utility fees.
>
> Transportation utility fees differ from other types of impact fees in that they are levied on all property occupants - owners and renters alike - rather than on property owners alone. They are also paid on an ongoing monthly basis like a utility bill and not in annual or quarterly installments the way real estate taxes are collected. Given that use of the transportation system is not metered in the way that home electricity or sewer utilization is, the fee is calculated on estimated trip generation rates for different land uses. Most transportation utility fee programs in the United States use of trip generation rates prepared by the Institute of Transportation Engineers (ITE).[2]

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[2] "Transportation Utility Fees," Center for Innovative Finance Support, Federal Highway Administration, US Department of Transportation, https://www.fhwa.dot.gov/ipd/value_capture/defined/transportation_utility_fees.aspx (retrieved August 4, 2020)

However, the FAQ does allow that both electricity supply charges and electricity distribution charges are nonpayroll costs, even if they are separately stated on an invoice:

> **7. Question: Are electricity supply charges eligible for loan forgiveness if they are charged separately from electricity distribution charges?**
>
> Answer: Yes. The entire electricity bill payment is eligible for loan forgiveness (even if charges are invoiced separately), including supply charges, distribution charges, and other charges such as gross receipts taxes.

Loan Forgiveness Reductions FAQs

The final section of the FAQ discusses loan forgiveness reduction issues.

The first question deals with employees who refuse an offer to return to work.

> **1. Question: Will a borrower be subject to a reduction to its forgiveness amount due to a reduction in FTE employees during the Covered Period if the borrower offered to rehire one or more laid off employees but the employees declined?**
>
> Answer: In calculating its loan forgiveness amount, a borrower may exclude any reduction in FTE employees if the borrower is able to document in good faith the following: (1) an inability to rehire individuals who were employees of the borrower on February 15, 2020 and (2) an inability to hire similarly qualified individuals for unfilled positions on or before December 31, 2020. Borrowers are required to inform the applicable state unemployment insurance office of any employee's rejected rehire offer within 30 days of the employee's rejection of the offer. The documents that borrowers should maintain to show compliance with this exemption include the written offer to rehire an individual, a written record of the offer's rejection, and a written record of efforts to hire a similarly qualified individual.

One key issue to note here is the need to have written evidence of an attempt to rehire a similarly qualified individual. Merely having an employee refuse to return to work isn't enough to eliminate that employee's FTE in computing a reduction unless the employer attempts to replace that employee.

The second question gives guidance to seasonal employers on the proper reference period to use.

> **2. Question: If a seasonal employer elects to use a 12-week period between May 1, 2019 and September 15, 2019 to calculate its maximum PPP loan amount, what period in 2019 should be used as the reference period for calculating any reductions in the loan forgiveness amount?**

> Answer: A seasonal employer that elects to use a 12-week period between May 1, 2019 and September 15, 2019 to calculate its maximum PPP loan amount must use the same 12-week period as the reference period for calculation of any reduction in the amount of loan forgiveness.

Question 3 clarifies that even employees who have annualized income in excess of $100,000 must still be counted in determining if there is an FTE reduction:

> **3. Question: When calculating the FTE Reduction Exceptions in Table 1 of the PPP Schedule A Worksheet on the Loan Forgiveness Application (SBA Form 3508 or lender equivalent), do borrowers include employees who made more than $100,000 in 2019 (those listed in Table 2 of the PPP Schedule A Worksheet)?**
>
> Answer: Yes. The FTE Reduction Exceptions apply to all employees, not just those who would be listed in Table 1 of the Loan Forgiveness Application (SBA Form 3508 or lender equivalent). Borrowers should therefore include employees who made more than $100,000 in the FTE Reduction Exception line in Table 1 of the PPP Schedule A Worksheet.

Question 4 goes into significant detail on the calculations used in computing the reduction in salary/wages:

> **4. Question: How do borrowers calculate the reduction in their loan forgiveness amount arising from reductions in employee salary or hourly wage?**
>
> Answer: Certain pay reductions during the Covered Period or the Alternative Payroll Covered Period may reduce the amount of loan forgiveness a borrower will receive. If the salary or hourly wage of a covered employee is reduced by more than 25% during the Covered Period or the Alternative Payroll Covered Period, the portion in excess of 25% reduces the eligible forgiveness amount unless the borrower satisfies the Salary/Hourly Wage Reduction Safe Harbor (as described in the Loan Forgiveness Application (SBA Form 3508 or lender equivalent)). The examples below assume that each employee is a "covered employee."

In a footnote the SBA clarifies who is a *covered employee* for these purposes:

> A "covered employee" is an individual who: (1) was employed by the borrower at any point during the Covered Period or Alternative Payroll Covered Period and whose principal place of residence is in the United States; and (2) received compensation from the borrower at an annualized rate less than or equal to $100,000 for all pay periods in 2019 or was not employed by the borrower at any point in 2019.

The question continues with the following illustrative examples:

EXAMPLE 1, LOAN FORGIVENESS REDUCTION FAQS, Q4

A borrower received its PPP loan before June 5, 2020 and elected to use an eight-week covered period. Its full-time salaried employee's pay was reduced during the Covered Period from $52,000 per year to $36,400 per year on April 23, 2020 and not restored by December 31, 2020. The employee continued to work on a full-time basis with a full-time equivalency (FTE) of 1.0. The borrower should refer to the "Salary/Hourly Wage Reduction" section under the "Instructions for PPP Schedule A Worksheet" in the PPP Loan Forgiveness Application Instructions. In Step 1, the borrower enters the figures in 1.a, 1.b, and 1.c, and because annual salary was reduced by more than 25%, the borrower proceeds to Step 2. Under Step 2, because the salary reduction was not remedied by December 31, 2020, the Salary/Hourly Wage Reduction Safe Harbor is not met, and the borrower is required to proceed to Step 3. Under Step 3.a., $39,000 (75% of $52,000) is the minimum salary that must be maintained to avoid a penalty. Salary was reduced to $36,400, and the excess reduction of $2,600 is entered in Step 3.b. Because this employee is salaried, in Step 3.e., the borrower would multiply the excess reduction of $2,600 by 8 (if it had instead selected a 24-week Covered Period, it would multiply by 24) and divide by 52 to arrive at a loan forgiveness reduction amount of $400. The borrower would enter on the PPP Schedule A Worksheet, Table 1, $400 as the salary/hourly wage reduction in the column above box 3 for that employee.

EXAMPLE 2, LOAN FORGIVENESS REDUCTION FAQS, Q4

A borrower received its PPP loan before June 5, 2020 and elected to use a 24-week Covered Period. An hourly employee's hourly wage was reduced from $20 per hour to $15 per hour during the Covered Period. The employee worked 10 hours per week between January 1, 2020 and March 31, 2020. The borrower should refer to the "Salary/Hourly Wage Reduction" section under the "Instructions for PPP Schedule A Worksheet" in the PPP Loan Forgiveness Application Instructions. Because the employee's hourly wage was reduced by exactly 25% (from $20 per hour to $15 per hour), the wage reduction does not reduce the eligible forgiveness amount. The amount on line 1.c would be 0.75 or more, so the borrower would enter $0 in the Salary/Hourly Wage Reduction column for that employee on the PPP Schedule A Worksheet, Table 1.

If the same employee's hourly wage had been reduced to $14 per hour, the reduction would be more than 25%, and the borrower would proceed to Step 2. If that reduction were not remedied as of December 31, 2020, the borrower would proceed to Step 3. This reduction in hourly wage in excess of 25% is $1 per hour. In Step 3, the borrower would multiply $1 per hour by 10 hours per week to determine the weekly salary reduction. The borrower would then multiply the weekly salary reduction by 24 (because the borrower is using a 24-week Covered Period). The borrower would enter $240 in the Salary/Hourly Wage Reduction column for that employee on the PPP Schedule A Worksheet, Table 1. If the borrower applies for forgiveness before the end of the 24-week Covered Period, it must account for the salary reduction (the excess reduction over 25%, or $240) for the full 24-week Covered Period.

EXAMPLE 3, LOAN FORGIVENESS REDUCTION FAQS, Q4

An employee earned a wage of $20 per hour between January 1, 2020 and March 31, 2020 and worked 40 hours per week. During the Covered Period, the employee's wage was not changed, but his or her hours were reduced to 25 hours per week. In this case, the salary/hourly wage reduction for that employee is zero, because the hourly wage was unchanged. As a result, the borrower would enter $0 in the Salary/Hourly Wage Reduction

column for that employee on the PPP Schedule A Worksheet, Table 1. The employee's reduction in hours would be taken into account in the borrower's calculation of its FTE during the Covered Period, which is calculated separately and may result in a reduction of the borrower's loan forgiveness amount.

The final question clarifies that only salaries and wages are considered for the reduction in salary/wages, with other compensation not included in the calculation:

> **5. Question: For purposes of calculating the loan forgiveness reduction required for salary/hourly wage reductions in excess of 25% for certain employees, are all forms of compensation included or only salaries and wages?**
>
> Answer: For purposes of calculating reductions in the loan forgiveness amount, the borrower should only take into account decreases in salaries or wages.

SECTION: 61
EMPLOYERS MAY ESTABLISH LEAVE SHARING PLANS TO WHICH EMPLOYEES MAY DONATE FOR COVID-19 RELATED LEAVE

Citation: "Leave Sharing Plans Frequently Asked Questions," IRS website, 8/4/20

The IRS has published an FAQ that provides an employer may set up a leave sharing plan related to the COVID-19 national emergency that will be treated as meeting the requirements of Notice 2006-59.[3]

The FAQ starts out by answering the following question:

> **Q1. May employers set up a leave-sharing plan under IRS Notice 2006-59 (PDF) that permits employees to deposit leave in an employer-sponsored leave bank for use by other employees who have been adversely affected by the COVID-19 pandemic?**
>
> A1. Yes. Notice 2006-59 provides guidance on the federal tax consequences of certain leave-sharing plans that permit employees to deposit leave in an employer-sponsored leave bank for use by other employees who have been adversely affected by a major disaster such

[3] "Leave Sharing Plans Frequently Asked Questions," IRS website, https://www.irs.gov/newsroom/leave-sharing-plans-frequently-asked-questions, August 3, 2020

> as the COVID-19 pandemic. See Notice 2006-59 for the requirements of a qualifying leave-sharing plan.[4]

Notice 2006-59 provides that a qualified leave sharing plan related to a disaster must be a written plan that meets the following requirements:

> 1. The plan allows a leave donor to deposit accrued leave in an employer-sponsored leave bank for use by other employees who have been adversely affected by a major disaster. For purposes of the plan, an employee is considered to be adversely affected by a major disaster if the disaster has caused severe hardship to the employee or a family member of the employee that requires the employee to be absent from work.
>
> 2. The plan does not allow a leave donor to deposit leave for transfer to a specific leave recipient.
>
> 3. The amount of leave that may be donated by a leave donor in any year generally does not exceed the maximum amount of leave that an employee normally accrues during the year.
>
> 4. A leave recipient may receive paid leave (at his or her normal rate of compensation) from leave deposited in the leave bank. Each leave recipient must use this leave for purposes related to the major disaster.
>
> 5. The plan adopts a reasonable limit, based on the severity of the disaster, on the period of time after the major disaster occurs during which a leave donor may deposit the leave in the leave bank, and a leave recipient must use the leave received from the leave bank.
>
> 6. A leave recipient may not convert leave received under the plan into cash in lieu of using the leave. However, a leave recipient may use leave received under the plan to eliminate a negative leave balance that arose from leave that was advanced to the leave recipient because of the effects of the major disaster. A leave recipient also may substitute leave received under the plan for leave without pay used because of the major disaster.
>
> 7. The employer must make a reasonable determination, based on need, as to how much leave each approved leave recipient may receive under the leave-sharing plan.
>
> 8. Leave deposited on account of one major disaster may be used only for employees affected by that major disaster. Except for an amount so small as to make accounting for it unreasonable or administratively impracticable, any leave deposited under a major disaster leave-sharing plan that is not used by leave recipients by the end of the period

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[4] "Leave Sharing Plans Frequently Asked Questions," IRS website, https://www.irs.gov/newsroom/leave-sharing-plans-frequently-asked-questions, August 3, 2020

> specified in paragraph 5, above, must be returned within a reasonable period of time to the leave donors (or, at the employer's option, to those leave donors who are still employed by the employer) so that the donor will be able to use the leave. The amount of leave returned to each leave donor must be in the same proportion as the amount of leave donated by the leave donor bears to the total amount of leave donated on account of that major disaster. [5]

Under the Notice, the following tax consequences will arise from such a plan:

> The IRS will not assert that a leave donor who deposits leave in an employer-sponsored leave bank under a major disaster leave-sharing plan realizes income or has wages, compensation, or rail wages with respect to the deposited leave, provided that the plan treats payments made by the employer to the leave recipient as "wages" for purposes of FICA, FUTA, and income tax withholding, and as "compensation" for purposes of RRTA and "rail wages" for purposes of RURT, unless excluded therefrom under a specific provision of the Code. A leave donor may not claim an expense, charitable contribution, or loss deduction on account of the deposit of the leave or its use by a leave recipient.[6]

The IRS FAQ on COVID-19 related plans confirms the lack of negative tax consequences to the employee:

> **Q2. Does an employee who deposits leave have any income tax consequences?**
>
> A2. No. The employee who deposits leave need not include the deposited leave in income or wages.[7]

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[5] Notice 2006-59

[6] Notice 2006-59

[7] "Leave Sharing Plans Frequently Asked Questions," IRS website, https://www.irs.gov/newsroom/leave-sharing-plans-frequently-asked-questions, August 3, 2020

Similarly, the employee is not going to be allowed to claim any sort of deduction related to this donation of leave:

> **Q3. May an employee who deposits leave claim an expense, charitable contribution, or loss deduction in the amount of the deposited leave?**
>
> A3. No. An employee who deposits leave may not claim an expense, charitable contribution, or loss deduction with respect to the deposited leave.[8]

SECTION: 163
PROPOSED REVENUE PROCEDURE ISSUED TO ALLOW QUALIFIED RESIDENTIAL LIVING FACILITIES TO BE §163(J) ELECTING REAL PROPERTY TRADE OR BUSINESS

Citation: Notice 2020-59, 7/28/20

At the same time the IRS issued final regulations on the business interest deduction limitations under IRC §163(j), the agency issued a proposed Revenue Procedure in Notice 2020-59 to provide a safe harbor for a trade or business that manages or operates a qualified residential living facility to be treated as a real property trade or business solely for the purposes of qualifying as an electing real property trade or business under IRC §163(j)(7)(B).[9]

An electing real property or business is exempted from the business interest limitations under IRC §163(j) but is required to use the alternative depreciation system (ADS) methods to depreciate any real property.

The IRS explains the reason why they are proposing this safe harbor in Notice 2020-59:

> The Treasury Department and the IRS are aware that taxpayers have uncertainty about whether residential living facilities that include the provision of supplemental assistive, nursing, or routine medical services qualify as electing real property trades or businesses under section 163(j)(7)(B).
>
> To mitigate this uncertainty, the proposed revenue procedure in section 6 of this notice provides a safe harbor under which a qualified residential living facility, as defined in section 3.01 of the proposed

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[8] "Leave Sharing Plans Frequently Asked Questions," IRS website, https://www.irs.gov/newsroom/leave-sharing-plans-frequently-asked-questions, August 3, 2020

[9] Notice 2020-59, July 28, 2020 https://www.irs.gov/pub/irs-drop/n-20-59.pdf (retrieved August 6, 2020)

> revenue procedure, is treated as eligible to be an electing real property trade or business under section 163(j)(7)(B).[10]

Although the procedure is issued as a draft, the IRS provides that taxpayers may rely on the procedure until the date a final revenue procedure is published:

> Until the date on which the proposed revenue procedure is published as a revenue procedure in the Internal Revenue Bulletin, taxpayers may rely on the safe harbor described in the proposed revenue procedure for purposes of determining whether a qualified residential living facility, as defined in section 3.01 of the proposed revenue procedure, is eligible to be an electing real property trade or business solely for purposes of section 163(j).[11]

The proposed Revenue Procedure defines a *qualified residential living facility* as a facility that:

- Consists of multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences on a permanent or semi-permanent basis to individual customers or patients;
- Includes the provision of supplemental assistive, nursing, or other routine medical services; and
- Has an average period of customer or patient use of the individual rental dwelling units that is 90 days or more.[12]

The proposed revenue procedure provides the following guidance on determining the average period of customer use:

> The average period of customer or patient use is determined by dividing (i) the sum of the total number of days in the taxable year that each customer or patient resides in a rental dwelling unit of the residential living facility (which may be determined by reference to a rental contract or other formal written lease agreement); by (ii) the total number of individual residential customers or patients that reside in all of the rental dwelling units of the facility for the taxable year. For this purpose, a married couple residing in a single rental dwelling unit of the residential living facility will be counted as one individual customer or patient, unless each spouse is separately properly treated as an individual customer or patient of the residential living facility that

[10] Notice 2020-59, Section 2

[11] Notice 2020-59, Section 4

[12] Notice 2020-59, Proposed Revenue Procedure Section 3.01

> receives supplemental assistive, nursing, or other routine medical services from or on behalf of the residential living facility.[13]

The proposed procedure provides the following example:

EXAMPLE, PROPOSED REVENUE PROCEDURE, NOTICE 2020-59

Facility has 100 rental dwelling units. Of the 100 units, 60 units are occupied by the same customer or patient for the entire year, 25 units are occupied by each customer or patient for three months (90 days) of the year, and 15 units are occupied for only 10 months (300 days) of the year (for a total of 100 customers for the year). Of the 15 units occupied for only 10 months of the year, 10 units are occupied by customers or patients for 5 months (150 days) each (for a total of 20 customers for the 10-month period). For the remaining 5 of 15 units that are occupied for only 10 months of the year, 5 customers or patients occupy the units for 8 months (240 days) of the year, and 5 other customers or patients occupy the units for 2 months (60 days) of the year. The average period of customer or patient use is determined by dividing the sum of the total number of days in the taxable year that each customer resides in a rental dwelling unit, by the total number of individual residential customers or patients that reside in all of the rental dwelling units for the taxable year. The total number of days in the taxable year that the customers or patients reside in the rental dwelling unit is 35,400 days [21,900 days (60 units that are occupied for the entire year x 365 days per year) + 9,000 days (25 units that are occupied for 90 days each x 90 days x 4 90-day periods in a year) + 4,500 days (15 units that are occupied for only 10 months x 300 days)]. The total number of individual residential customers or patients is 190 [60 customers or patients occupying a unit for the entire year + 100 (25 customers or patients occupying units for 90 days each x 4 90-day periods in a year) + 20 customers or patients that occupy a unit for a 5-month period + 5 customers or patients that occupy a unit for a 8-month period + 5 customers or patients that occupy a unit for a 2-month period]. Accordingly, the average period of customer or patient use is approximately 186 days (35,400/190).

The proposed revenue procedure defines *supplemental assistive, nursing or other routine medical services* as:

> Supplemental assistive, nursing, or other routine medical services are personal and professional services that are customarily and routinely provided to individual residential customers or patients of nursing homes, assisted living facilities, memory care residences, continuing care retirement communities, skilled nursing facilities, or similar facilities, as needed, on a day-to-day basis. Such services generally do not include surgical, radiological, or other intensive or specialized medical services that are usually only provided in emergency or short-term in-patient or out-patient hospital or surgical settings.[14]

The proposed revenue procedure defines *permanent or semi-permanent basis* as:

> The rental dwelling units of a residential living facility serve as primary residences on a permanent or semi-permanent basis to customers or

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[13] Notice 2020-59, Proposed Revenue Procedure Section 3.02(1)

[14] Notice 2020-59, Proposed Revenue Procedure Section 3.03

> patients whose use of the units is generally long-term (more than 90 days) in nature, even though some customers or patients may arrive at the residential living facility with significantly shortened life expectancies due to advanced age or terminal medical conditions, and some customers or patients otherwise may be expected to periodically reside away from the residential living facility (such as at the primary residence of a spouse or other relative) for short periods or durations of time.[15]

Under the proposed revenue procedure, a taxpayer that manages or operates a qualified residential living facility may, solely for the purpose of the election to be treated as an electing real property business under IRC §163(j), treat the operation as a real property trade or business. Meeting the tests to qualify under the safe harbor does not establish that the business is engaged in a real property trade or business for the passive activity rules found at IRC §469.[16]

The proposed revenue procedure provides the following information on the effect of the election and how it should be made:

> If a taxpayer makes the election pursuant to this safe harbor, the provisions in § 1.163(j)-9 of the regulations apply, and the taxpayer must use the alternative depreciation system of section 168(g) of the Code to depreciate the property described in section 168(g)(8). The taxpayer makes the election at the time, and in the manner prescribed by § 1.163(j)-9(d). See also Rev. Proc. 2020-22.[17]

The proposed revenue procedure imposes the following requirements for keeping books and records:

> A trade or business that manages or operates a residential living facility to which this revenue procedure applies must retain books and records to substantiate that all the requirements of this section 4 have been met in accordance with section 6001 of the Code.[18]

The proposed revenue procedure also contains the following broad anti-abuse rule applicable to this procedure:

> Arrangements entered into with a principal purpose of avoiding the rules of section 163(j) of the Code or the regulations under section 163(j) may be disregarded or recharacterized by the Commissioner of

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[15] Notice 2020-59, Proposed Revenue Procedure Section 3.04

[16] Notice 2020-59, Proposed Revenue Procedure Section 4.01

[17] Notice 2020-59, Proposed Revenue Procedure Section 4.02

[18] Notice 2020-59, Proposed Revenue Procedure Section 4.03

> Internal Revenue to the extent necessary to carry out the purposes of section 163(j). See § 1.163(j)-2(j).[19]

The proposed revenue procedure applies to tax years beginning after December 31, 2017.[20]

SECTION: 402
SAFE HARBOR PLAN DISTRIBUTION NOTICES UPDATED BY IRS TO REFLECT SECURE AND CARES ACT CHANGES

Citation: Notice 2020-62, 8/6/20

The IRS has issued two new safe harbor explanations to be given to participants receiving a distribution by qualified plans to satisfy the requirements of IRC §402(f). The new documents have been updated to take into account changes to the law made by the SECURE Act and the CARES Act related to qualified retirement plans in Notice 2020-40.[21] The new documents update the notices found in Notice 2018-74.

IRC §402(f) imposes the following requirements on qualified retirement plans:

> (f) Written explanation to recipients of distributions eligible for rollover treatment
>
> (1)In general
>
> The plan administrator of any plan shall, within a reasonable period of time before making an eligible rollover distribution, provide a written explanation to the recipient—
>
> > (A) of the provisions under which the recipient may have the distribution directly transferred to an eligible retirement plan and that the automatic distribution by direct transfer applies to certain distributions in accordance with section 401(a)(31)(B),
> >
> > (B) of the provision which requires the withholding of tax on the distribution if it is not directly transferred to an eligible retirement plan,
> >
> > (C) of the provisions under which the distribution will not be subject to tax if transferred to an eligible retirement plan

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[19] Notice 2020-59, Proposed Revenue Procedure Section 4.04

[20] Notice 2020-59, Proposed Revenue Procedure Section 5

[21] Notice 2020-62, August 6, 2020, https://www.irs.gov/pub/irs-drop/n-20-62.pdf (retrieved August 6, 2020)

> within 60 days after the date on which the recipient received the distribution,
>
> (D) if applicable, of the provisions of subsections (d) and (e) of this section, and
>
> (E) of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to distributions from the plan making such distribution.
>
> (2)Definitions
>
> For purposes of this subsection—
>
> (A)Eligible rollover distribution
>
> The term "eligible rollover distribution" has the same meaning as when used in subsection (c) of this section, paragraph (4) of section 403(a), subparagraph (A) of section 403(b)(8), or subparagraph (A) of section 457(e)(16). Such term shall include any distribution to a designated beneficiary which would be treated as an eligible rollover distribution by reason of subsection (c)(11), or section 403(a)(4)(B), 403(b)(8)(B), or 457(e)(16)(B), if the requirements of subsection (c)(11) were satisfied.
>
> (B)Eligible retirement plan
>
> The term "eligible retirement plan" has the meaning given such term by subsection (c)(8)(B).

The IRS provides safe harbor notices that plans may use to fulfill the requirements, updating the notices from time to time to take into account law changes. The IRS last provided such updated notices in Notice 2018-74.

In this Notice the IRS provides a pair of notices:

- One for distributions that are not from a designated Roth account, and
- The other for distributions from a designated Roth account.[22]

The Notice describes three recent law changes taken into account in the revised notices.

[22] Notice 2020-62, Section I

Qualified Birth or Adoption Distributions

The SECURE Act created a new category of distributions from a plan, the *qualified birth or adoption distribution.* The Notice describes this new distribution as follows:

> Section 72(t)(1) generally provides for a 10% additional tax on a distribution from a qualified retirement plan, unless the distribution qualifies for one of the exceptions in § 72(t)(2). Section 113 of the SECURE Act amended § 72(t)(2) of the Code to add § 72(t)(2)(H), which permits an individual to receive up to $5,000 for a qualified birth or adoption distribution from an applicable eligible retirement plan (defined in § 72(t)(2)(H)(vi)(I) as an eligible retirement plan as defined in § 402(c)(8)(B) other than a defined benefit plan). The distribution is not subject to the 10% additional tax under § 72(t)(1) to the extent it meets the requirements of a qualified birth or adoption distribution. A qualified birth or adoption distribution is defined in § 72(t)(2)(H)(iii)(I) as any distribution from an applicable eligible retirement plan to an individual if made during the 1- year period beginning on the date on which the child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized.
>
> Section 72(t)(2)(H)(v)(I) provides that the individual may recontribute a qualified birth or adoption distribution (not to exceed the amount of the distribution) to an applicable eligible retirement plan in which the taxpayer is a beneficiary and to which a rollover can be made. However, § 72(t)(2)(H)(vi)(II) provides that a qualified birth or adoption distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules of § 401(a)(31), the notice requirement under § 402(f), or the mandatory withholding rules under § 3405. Thus, although a qualified birth or adoption distribution generally may be recontributed to an applicable eligible retirement plan, a plan administrator is not required to provide a § 402(f) notice to a recipient of a qualified birth or adoption distribution.[23]

Required Minimum Distribution Required Beginning Date Revision in the SECURE Act

The SECURE Act revised the required beginning date rules related to requirement minimum distributions from retirement plans. The Notice describes this change as follows:

> Section 114 of the SECURE Act amended § 401(a)(9) of the Code to change the required beginning date applicable to § 401(a) plans and other eligible retirement plans described in § 402(c)(8), including a § 401(a) qualified plan, a § 403(a) annuity plan, a § 403(b) annuity contract, a § 457(b) plan maintained by a governmental employer, and an individual retirement account or annuity (IRA) described in § 408(a)

[23] Notice 2020-62, Section II.B.1

> or (b). The new required beginning date for an employee or an IRA owner is April 1 of the calendar year following the calendar year in which the individual attains age 72, rather than April 1 of the calendar year following the calendar year in which the individual attains age 70½. This amendment to § 401(a)(9) is effective for distributions required to be made after December 31, 2019, with respect to individuals who will attain age 70½ after that date. As a result of this change, employees and IRA owners who will attain age 70½ in 2020 will not have a required beginning date of April 1, 2021.[24]

CARES Act Coronavirus-Related Distributions

The CARES Act temporarily adds a new distribution category for retirement plans, the *coronavirus-related distribution*. The Notice describes this type of distribution as follows:

> Section 2202(a) of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136, 134 Stat. 281 (2020) (CARES Act) permits an individual to receive a coronavirus-related distribution from an eligible retirement plan (as defined in § 402(c)(8)(B)). Section 2202(a)(4)(A) of the CARES Act defines a coronavirus-related distribution as any distribution from an eligible retirement plan made on or after January 1, 2020, and before December 31, 2020, to a qualified individual. Section 2202(a)(2) of the CARES Act limits the amount of the aggregate distributions from all eligible retirement plans that can be treated as coronavirus-related distributions to no more than $100,000. A coronavirusrelated distribution under section 2202(a) of the CARES Act is not subject to the 10% additional tax under § 72(t)(1). In addition, the coronavirus-related distribution may be included in gross income ratably over the 3-year period beginning with the taxable year of the distribution.
>
> Section 2202(a)(3) of the CARES Act provides that a qualified individual may recontribute a coronavirus-related distribution (not to exceed the amount of the distribution) to an applicable eligible retirement plan in which the taxpayer is a beneficiary and to which a rollover can be made. However, a coronavirus-related distribution is not an eligible rollover distribution for purposes of the direct rollover rules of § 401(a)(31), the notice requirement under § 402(f), or the mandatory withholding rules under § 3405. Thus, although a coronavirus-related distribution generally may be recontributed to an applicable eligible retirement plan, a plan administrator is not required to provide a § 402(f) notice to a recipient of a coronavirus-related distribution. For more information relating to section 2202 of the CARES Act, see Notice 2020-50, 2020-28 I.R.B. 35.[25]

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[24] Notice 2020-62, Section II.B.2

[25] Notice 2020-62, Section II.B.3

Revised Notices

The Notice describes the individual revised notices as follows:

> The first safe harbor explanation reflects the rules relating to distributions not from a designated Roth account. Thus, the first safe harbor explanation should be used only for a distribution that is not from a designated Roth account. The second safe harbor explanation reflects the rules relating to distributions from a designated Roth account. Thus, the second safe harbor explanation should be used only for a distribution from a designated Roth account. Both explanations should be provided to a participant if the participant is eligible to receive eligible rollover distributions from both a designated Roth account and an account other than a designated Roth account.
>
> The safe harbor explanation in this notice for distributions not from a designated Roth account meets the requirements of § 402(f) for an eligible rollover distribution that is not from a designated Roth account if provided to the recipient of the eligible rollover distribution within a reasonable period of time before the distribution is made. Similarly, the safe harbor explanation in this notice for distributions from a designated Roth account meets the requirements of § 402(f) for an eligible rollover distribution from a designated Roth account if provided to the recipient of the eligible rollover distribution within a reasonable period of time before the distribution is made.
>
> Section 1.402(f)-1, Q&A-2, provides, in general, that a reasonable period of time for providing an explanation is no less than 30 days (subject to waiver) and no more than 90 days before the date on which the distribution is made. However, proposed § 1.402(f)-1, Q&A-2(a), pursuant to section 1102(a)(1)(B) of the Pension Protection Act of 2006, Pub. L. 109-280, 120 Stat. 780 (2006), provides that a notice required to be provided under § 402(f) may be provided to a participant as much as 180 days before the date on which the distribution is made (or the annuity starting date). These proposed regulations further provide that, with respect to the extended period for notices, plans may rely on the proposed regulations for notices provided during the period beginning on the first day of the first plan year beginning on or after January 1, 2007, and ending on the effective date of final regulations. Thus, the § 402(f) notice may be provided as many as 180 days before the date on which the distribution is made (or the annuity starting date).[26]

The Notice reminds plan administrators that the documents do not have to be used verbatim—they may be appropriately modified:

> A plan administrator or payor may customize a safe harbor explanation by omitting any information that does not apply to the

[26] Notice 2020-62, Section III

> plan. For example, if the plan does not hold after-tax employee contributions, it would be appropriate to eliminate the section "If your payment includes after-tax contributions" in the explanation for payments not from a designated Roth account. Similarly, if the plan does not provide for distributions of employer stock or other employer securities, it would be appropriate to eliminate the section "If your payment includes employer stock that you do not roll over." Other information that may not be relevant to a particular plan includes, for example, the sections "If your payment is from a governmental section 457(b) plan" and "If you are an eligible retired public safety officer and your payment is used to pay for health coverage or qualified long-term care insurance." In addition, the plan administrator or payor may provide additional information with a safe harbor explanation if the information is not inconsistent with § 402(f).[27]

As these are merely safe harbor notices, a plan administrator could decide to write a different notice not using the safe harbor notice as a starting point. The IRS warns that if the administrator does this, the notice must be easily understood:

> Alternatively, a plan administrator or payor may satisfy § 402(f) by providing an explanation that is different from a safe harbor explanation. Any explanation must include the information required by § 402(f) and must be written in a manner designed to be easily understood.[28]

Administrators are also reminded that if Congress changes the underlying law (something Congress does from time to time), these notices will lose their safe harbor status if not corrected by the administrator to reflect any change in the law made after August 6, 2020:

> The updated safe harbor explanations provided in this notice may be used by plan administrators and payors to satisfy § 402(f). However, the updated safe harbor explanations will not satisfy § 402(f) to the extent the explanations are no longer accurate because of a change in the relevant law occurring after August 6, 2020.[29]

The revised participant notices are found in the appendix found at the end of Notice 2020-62.[30]

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[27] Notice 2020-62, Section III

[28] Notice 2020-62, Section III

[29] Notice 2020-62, Section III

[30] Notice 2020-62, Appendix

SECTION: 1041
PAYMENTS TO FORMER SPOUSE FOR INTEREST IN DENTAL PRACTICE AS PART OF A DIVORCE DID NOT ADD TO BASIS OF INTEREST

Citation: Matzkin and Schroeder v. Commissioner, TC Memo 2020-117, 8/6/20

In the case of *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117,[31] the Tax Court ruled that a taxpayer could not increase his basis in an LLC (Dental Care Alliance, LLC, or DCA) interest by the amounts he had paid his former spouse Georgeann as part of the divorce to obtain full ownership. The Tax Court found that this was part of the property settlement for federal tax purposes and such payments do not add to the basis of the asset in question.

Eventually Stephen's 70% interest in the dental practice LLC was transferred by Steven into an S corporation of which he was the only shareholder, SRM Consulting, LLC (SRM).

In Steven Matzkin's divorce his interest in the LLC, which contained his dental practice, was assumed to be $21 million. The interest was ruled to be a marital asset under Florida law, and it was proposed to divide such assets 50/50 between the two soon to be former spouses.

But, as the opinion notes, the interest in the LLC was not an asset that Georgeann wanted, nor one she could realistically be given, noting in a footnote:

> Georgeann had no professional experience in dentistry, and the DCA partnership agreement required consent from a majority of its managers to admit a new partner. Steven controlled DCA and did not want to be in business with his ex-wife.[32]

Thus, the opinion noted:

> The letter accordingly anticipated that Steven would pay Georgeann her $10.5 million share by making upfront cash payments, by executing a promissory note, and by paying Georgeann's share of the couple's liabilities.[33]

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[31] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, August 5, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12303 (retrieved August 6, 2020)

[32] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, p. 3

[33] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, pp. 3-4

The final agreement followed this outline, described as follows by the Tax Court:

> A document executed four days later, captioned "Partial terms of the Matzkin agreement related to Equitable Distributions and Spousal Support," reflected similar terms regarding Steven's indirect interest in DCA. It provided that Steven would make a lump-sum payment to Georgeann and execute a note secured by his interest in the partnership. Interest only would be due on the note, with the principal payable in October 2014 or when DCA was sold (if earlier). The document stated that, if DCA were sold within 18 months for a price exceeding $30 million, then Georgeann would receive half of Steven's pro rata share of any proceeds above $30 million. It specified that Georgeann would receive no alimony apart from Steven's payments on the promissory note, which would "be deemed non-modifiable and non-taxable alimony."
>
> On December 16, 2008, Georgeann and Steven signed a marital settlement agreement (agreement) formalizing the terms of their divorce and the division of their assets. While specifying somewhat different cashflows from the earlier drafts, the agreement followed those drafts by recognizing Georgeann's right to property representing half the value of Steven's indirect interest in DCA. The agreement called for a cash downpayment and monthly payments on a $5.4 million promissory note. Like the previous drafts it provided that, if DCA were sold within 18 months and Steven's share of the proceeds exceeded $21 million (approximately), Georgeann would receive 50% of any excess. If DCA were sold the promissory note would be accelerated, becoming payable in full 30 days after Steven received proceeds.
>
> The agreement referred to the payments described above as "non-modifiable alimony for * * * [Georgeann's] support and maintenance." However, it provided that Steven's payment obligations were not terminable on either party's death or on Georgeann's remarriage. It explicitly stated that Steven's payments were not intended to be taxable to Georgeann or deductible by him for income tax purposes. The agreement recited that it recorded the parties' "final, complete, and exclusive understanding regarding * * * [their] marital separation, dissolution, and property settlement and supersede[d] any prior or contemporaneous agreement, understanding, or representation, oral or written."[34]

In 2012 the dental practice was sold:

> On May 24, 2012, SRM sold its interest in DCA for $93,770,600. Gains from that sale passed through to Steven as SRM's sole

[34] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, pp. 4-5

> shareholder. In June 2012, as required by the agreement, Steven satisfied the $5,462,312 remaining balance of the promissory note.[35]

On the 2012 income tax return Steven reported a gain on the sale of the interest and, in computing the gain, increased his basis in the LLC by amounts paid to his former spouse. The IRS selected the return for examination and argued that the basis had been overstated, as such amounts did not increase the basis of Steven's interest in the LLC.[36]

The IRS's initial argument to reduce the basis was not accepted by the Tax Court. The IRS noted that the payments were characterized in the agreement as alimony[37] for her support and maintenance and thus could not generate additional basis in the interest.[38] But the Tax Court notes that Florida law refers to three types of alimony, one of which is lump sum alimony which is treated as a form of property settlement, and the Court ruled:

> The agreement described Steven's payments as being made for Georgeann's "support and maintenance." See *Pipitone v. Pipitone*, 23 So. 3d 131, 136 (Fla. Dist. Ct. App. 2009) ("Ordinarily, the trial court specifies whether lump sum alimony is for support or for equitable distribution."). But the agreement also provided (with seeming inconsistency) that the payments would survive Georgeann's death or remarriage. (Neither party contends that Steven's payments should be considered "alimony" for Federal income tax purposes. See secs. 71, 215.) We find that the agreement is ambiguous and conclude that the parties' negotiating history is relevant in dispelling the ambiguity.
>
> The negotiating history makes absolutely clear that the parties desired to effect an equitable distribution of marital assets, including real estate, cash and securities, life insurance, personal property, and Steven's indirect interest in DCA. The payments specified in the agreement are consistent with the parties' understanding, as shown in the negotiating history, that $10.5 million of value would be placed on Georgeann's side of the ledger on account of Steven's indirect interest in DCA. Because it was impractical for Georgeann to receive a $10.5 million partnership interest in DCA, the parties agreed that she would be paid that value in the form of cash, a promissory note, and Steven's discharge of her share of certain liabilities.

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[35] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, p. 6

[36] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, pp. 6-7

[37] Note that the IRS was not arguing this was deductible alimony for federal tax purposes, as it both would payable to Georgeann's estate if she died before full payment was made and the agreement specifically provided it was not taxable to Georgeann. Either provision in the agreement is sufficient, for pre-2018 divorce document, to render a payment not alimony (see prior IRC §72(b)(1)(B) and (D)).

[38] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, p. 11

> Although Steven's payments were made over time, they may be considered components of lump-sum alimony payable in installments. See *Rood*, 103 T.C.M. (CCH) at 1670; *Donoff v. Donoff*, 691 So. 2d 1091, 1092 (Fla. Dist. Ct. App. 1997); *Paetzold v. Paetzold*, 673 So. 2d 888, 889 (Fla. Dist. Ct. App. 1996); *Turner v. Turner*, 529 So. 2d 1138, 1143 (Fla. Dist. Ct. App. 1988). Considering the text of the agreement and its negotiating history, we conclude that the alimony it specified is "[l]ump-sum alimony * * * in the nature of a final property settlement * * * [that] creates a vested right which survives death and is not terminable on the recipient party's remarriage." *Rood*, 103 T.C.M. (CCH) at 1670 (quoting *Filipov*, 717 So. 2d at 1084).[39]

But even though the Court rejected the view, the Court found that a proper analysis of the matter would lead to the same result as the IRS was arguing for.

The Court notes that the issue is determining the basis in the partnership interest in question, so the opinion looks at the relevant provisions and determines no provision allows Steven to treat the payments to Georgeann as an increase in his basis in the interest:

> A partner's basis in a partnership is generally determined under section 705, captioned "Determination of Basis of Partner's Interest." Upon formation on January 1, 2008, SRM's basis in DCA presumably equaled Steven's basis in DCA. See sec. 705(a) (cross-referencing sections 722 and 742). Section 705(a)(1) provides that a partner's initial basis is increased by the sum of the partner's distributive share of "(A) taxable income of the partnership as determined under section 703(a), (B) income of the partnership exempt from tax under this title, and (C) the excess of the deductions for depletion over the basis of the property subject to depletion." Steven's payments to Georgeann and his divorce lawyer did not affect SRM's distributive share of DCA's income or deductions. Accordingly, these payments did not increase or otherwise affect SRM's basis under section 705(a)(1).
>
> The basis of a partner's interest is also increased by any subsequent "contribution of property, including money, to the partnership," and by a partner's assumption of partnership liabilities. See secs. 722, 752(a). But Steven's payments to Georgeann and his divorce lawyer did not result in DCA's receipt of any money or other property. Nor did SRM (or Steven) assume any of DCA's liabilities.
>
> Petitioners characterize Steven's payments as "acquisition costs" and contend that they generate basis under section 742, which provides that "[t]he basis of an interest in a partnership acquired other than by contribution" shall be determined under the Code's general basis rules. See sec. 742 (cross-referencing sections 1011-1022). But SRM owned 70% of DCA both before and after the divorce. Neither Steven nor

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[39] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, pp. 10-11

> SRM "acquired" any interest in DCA (from Georgeann or anyone else) in consequence of these payments.[40]

Although the taxpayer was correct that the payments were property settlement, the Court points out the simple fact that payments of property settlement do not create basis.

> …[W]hile we agree with petitioners that Steven's payments to Georgeann were part of a property settlement, it does not follow that his payments generated additional basis in DCA. The conclusion would be the same (if perhaps more obvious) if the key marital asset consisted of publicly traded stock rather than a partnership interest. For example, assume that Steven owned $21 million of IBM stock, which the parties regarded as a marital asset whose value was to be split 50%-50% between them. If Georgeann received $10.5 million of IBM stock in the property settlement, Steven could not plausibly contend that his basis in his retained IBM shares should be increased by $10.5 million. And the result would be no different if Steven retained all the IBM shares and paid Georgeann the value of her 50% interest in cash.
>
> As it was, the key marital asset was a 70% interest in a partnership that supplied technical support services to dentists. In theory, the property settlement could have awarded Georgeann a 35% interest in the partnership, but that was impractical for numerous reasons: Georgeann had no expertise in that business, admission of a new partner would require consent of a majority of its managers, and Steven did not want to be in partnership with his ex-wife. So the spouses sensibly agreed to have Georgeann receive the value of her $10.5 million share in cash rather than in kind. Steven's payments in fulfillment of that obligation did not generate additional basis in DCA, just as they would not have generated additional basis if the asset in question had been publicly traded stock.[41]

And, in a footnote, the Court gives another example that I suspect CPAs run into far more often and also cites IRC §1041(b) which provides the general carryover basis rules for all property settlement items:

> Alternatively, assume a divorcing couple that has marital assets consisting of a house worth $1 million and $1 million of cash. If the husband received the house and the wife received the cash, the husband's basis in the house would be unchanged; he could not increase his basis by the $1 million received by the wife. See sec. 1041(b) (providing a transferred basis rule). The result would be the same if the husband received the house, the couple split the cash, and the husband gave the wife a $500,000 promissory note for her share of the house. It is immaterial whether the $1 million received by the wife

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[40] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, pp. 12-13

[41] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, pp. 13-15

> consists of cash or cash plus a promissory note; in neither event can the husband claim additional basis in the house.[42]

Taxpayers quite often have a hard time understanding the results described in this case—after all, the taxpayer just paid his/her former spouse cash to get ownership of what would have been that spouse's interest had the property remained jointly held. And, quite often, they weren't exactly happy about making those payments to a former spouse, so getting no basis for the payments seems doubly unfair.

But this is the trade-off for not having any gain recognition on these transactions for the spouse receiving the cash—IRC §1041 allows spouses to divide property without a tax consequence, and that includes both favorable and unfavorable consequences to a specific spouse.

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[42] *Matzkin and Schroeder v. Commissioner*, TC Memo 2020-117, p. 14