Current Federal Tax Developments

Week of November 23, 2020

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF NOVEMBER 23, 2020

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Published in 2020 by Kaplan Financial Education.

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Current Federal Tax Developments

Kaplan Financial Education

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IRS RULES TAXPAYERS MAY NOT DEDUCT EXPENSES THAT LEAD TO PPP FORGIVENESS IF TAXPAYER REASONABLY BELIEVED FORGIVENESS WOULD BE GRANTED AT YEAR END

Citation: Revenue Ruling 2020-27, Revenue Procedure 2020-51, 11/18/20

In an earlier article we had discussed reports that the IRS was planning to issue guidance to block borrowers from claiming a deduction for expenses they expected to use for Paycheck Protection Program (PPP) loan forgiveness even if they had not yet applied for or received forgiveness.[1] Now that shoe has dropped with the issuance of Revenue Ruling 2020-27.[2]

IRS Original Primary Theory – It's a Deduction Related to Tax Exempt Income

The IRS issued Notice 2020-32 in April that took the position that expenses that led to the obligation to repay a PPP loan being forgiven could not be deducted. In the ruling, the IRS spends virtually the entire notice outlining a justification for denial of the deduction that relies on treating the forgiveness income as tax exempt income once CARES Act §1106(i) is considered (which provides the forgiveness will not be taxable to the borrower), triggering IRC §265(a)(1) which bars a deduction for expenses related to tax exempt income.

However, in the very last paragraph before the contact information, the IRS poses an alternative theory for why the expenses cannot be deducted:

> The deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement. See, e.g., *Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966); *Wolfers v. Commissioner*, 69 T.C. 975 (1978); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80- 348, 1980-2 C.B. 31; Rev. Rul. 80-173, 1980-2 C.B. 60.[3]

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[1] Ed Zollars, "Guidance Denying Deduction for PPP Forgivable Expenses Even if Forgiveness Not Granted by Year End Reported to Be on the Way from Treasury," *Current Federal Tax Developments* website, November 14, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/11/14/guidance-denying-deduction-for-ppp-forgivable-expenses-even-if-forgiveness-not-granted-by-year-end-reported-to-be-on-the-way-from-treasury (retrieved November 19, 2020)

[2] Revenue Ruling 2020-27, November 18, 2020, https://www.irs.gov/pub/irs-drop/rr-20-27.pdf (retrieved November 19, 2020)

[3] Notice 2020-32, https://www.irs.gov/pub/irs-drop/n-20-32.pdf (retrieved November 19, 2020)

As Nathan Smith of CBIZ Inc. remarked in an article published in *Tax Notes Today Federal* on November 11[4] discussing speculation that the IRS would issue a ruling dealing with the status of payments made when, at year end, no forgiveness had been obtained, the two theories advanced by Treasury appear to lead to different results prior to forgiveness being obtained.

> Because the government offered two different positions for nondeductible treatment, the ancillary question about timing must be addressed discretely under each of those positions, Smith said. And as it turns out, the answer to the timing question appears to be different depending on which of the two positions from Notice 2020-32 a taxpayer chooses to follow, he added.
>
> The primary and the alternative positions in Notice 2020-32 are distinct because receiving tax-exempt income isn't the same as receiving an expense reimbursement, Smith said. He pointed to a few court decisions that held that expense reimbursements aren't tantamount to gross income, and other cases showing instead that the reimbursement reduces the amount of the deduction. The rationale for that conclusion is that the taxpayer hasn't made an expenditure or cost outlay, Smith said.
>
> "On the other hand, the primary position that relies on section 265 relies on the existence of tax-exempt income — in this case loan forgiveness income," Smith said. "So pick your poison — either tax-exempt income (income exists) or expense reimbursement (no income exists). Two different timing answers, depending on which one you pick."[5]

As was noted in our article, the Supreme Court's ruling in *Bliss Dairy* would seem to require use of the tax benefit rule, giving a deduction in the current year and then picking up income in the following year if the "tax exempt income" view is correct. But if this is an expected reimbursement, then a taxpayer would not be allowed a deduction even if the reimbursement had not yet been received.[6]

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[4] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, 2020 TNTF 218-1, November 11, 2020 , https://www.taxnotes.com/tax-notes-today-federal/partnerships/ppp-borrowers-brace-potentially-problematic-irs-guidance/2020/11/11/2d5zd (retrieved November 19, 2020)

[5] Eric Yauch, "PPP Borrowers Brace for Potentially Problematic IRS Guidance," *Tax Notes Today Federal*, 2020 TNTF 218-1, November 11, 2020

[6] Ed Zollars, "Guidance Denying Deduction for PPP Forgivable Expenses Even if Forgiveness Not Granted by Year End Reported to Be on the Way from Treasury," *Current Federal Tax Developments* website, November 14, 2020

So Let's Go With Reimbursement as Our Primary Theory…

Revenue Ruling 2020-27 bars a deduction for expenses paid prior to receiving PPP loan forgiveness if a taxpayer has a reasonable expectation of receiving forgiveness based on those expenses. The holding provides:

> A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period, even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year.[7]

While the IRS in the analysis does note that the original ruling discussed the "tax exempt income" with a deduction denial under §265(a)(1) theory, this time only a single paragraph is devoted to that justification.[8]

The bulk of the analysis of the law this time turns to the reimbursement theory to disallow the deduction.

> Notice 2020-32 also relied on authorities holding that deductions for otherwise deductible expenses are disallowed if the taxpayer receives reimbursement for such expenses. Authorities addressing reimbursement further hold that an otherwise allowable deduction is disallowed if there is a reasonable expectation of reimbursement. See *Burnett v. Commissioner*, 356 F. 2d 755 (5th Cir. 1966) *cert. denied* 385 U.S. 832 (1966); *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), *aff'd* 447 F.2d 484 (9th Cir.1971); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 60; Rev. Rul. 79-263, 1979-2 C.B. 82.
>
> In *Burnett*, a lawyer advanced expenses to clients that the clients were obligated to repay only to the extent the lawyer was successful in obtaining recovery on the client's claim. The taxpayer argued that the advances were deductible trade or business expenses under section 162 of the Code because there was no unconditional obligation on the part of the clients to repay the advances. The court noted that the taxpayer provided assistance only to clients with claims that were likely to be successful and that the advances were "made to clients with the expectation, substantially realized, that they would be recovered." 356 F.2d at 758. On that basis, the court affirmed the Tax Court's holding that the advances were not deductible. Similarly, in *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), *aff'd* 447 F.2d 484 (9th Cir.1971), a personal injury law firm advanced litigation costs on behalf of its clients, and the clients had no obligation to repay the

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[7] Revenue Ruling 2020-27, p. 8

[8] Revenue Ruling 2020-27, pp. 3-4

costs unless their case was successful. The law firm deducted the litigation costs in the year paid and included the reimbursed costs in income in the year of reimbursement. The law firm screened clients to reduce the risk that the advanced costs would not be repaid and took cases when there was a "good hope" of recovery. The court determined that the law firm's advances operated as loans to its clients for which the law firm had an expectation of reimbursement. Therefore, deductions for the advances under section 162 were not allowed. See also *Herrick v. Commissioner*, 63 T.C. 562 (1975) (similar effect); *Silverton v. Commissioner*, T.C. Memo. 1977-198 (1977) (similar effect).[9]

Examples

The ruling provides us with two examples of applying this holding.

SITUATION 1, REVENUE RULING 2020-27

During the period beginning on February 15, 2020, and ending on December 31, 2020 (covered period), Taxpayer A (A) paid expenses that are described in section 161 of the Internal Revenue Code (Code) and section 1106(a) of the CARES Act (eligible expenses). These expenses include payroll costs that qualify under section 1106(a)(8) of the CARES Act, interest on a mortgage that qualifies as interest on a covered mortgage obligation under section 1106(a)(2) of the CARES Act, utility payments that qualify as covered utility payments under section 1106(a)(5) of the CARES Act, and rent that qualifies as payment on a covered rent obligation under section 1106(a)(4) of the CARES Act. In November 2020, pursuant to the terms of section 1106 of the CARES Act, A applied to the lender for forgiveness of the covered loan on the basis of the eligible expenses it paid during the covered period. At that time, and based on A's payment of the eligible expenses, A satisfied all requirements under section 1106 of the CARES Act for forgiveness of the covered loan. The lender does not inform A whether the loan will be forgiven before the end of 2020.

Based on the foregoing, when A completed its application for covered loan forgiveness, A knew the amount of its eligible expenses that qualified for reimbursement, in the form of covered loan forgiveness, and had a reasonable expectation of reimbursement. The reimbursement, in the form of covered loan forgiveness, was foreseeable. Therefore, pursuant to the foregoing authorities, A may not deduct A's eligible expenses.

In the alternative, section 265(a)(1) disallows a deduction of A's otherwise deductible eligible expenses because the expenses are allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness.[10]

SITUATION 2, REVENUE PROCEDURE 2020-27

During the covered period, Taxpayer B (B) paid the same types of eligible expenses that A paid in Situation 1. B, unlike A, did not apply for forgiveness of the covered loan before the end of 2020, although, taking into account B's payment of the eligible expenses during the covered period, B satisfied all other requirements under section 1106 of the CARES Act for

[9] Revenue Ruling 2020-27, pp. 4-5

[10] Revenue Ruling 2020-27

forgiveness of the covered loan. B expects to apply to the lender for forgiveness of the covered loan in 2021.

Although B did not complete an application for covered loan forgiveness in 2020, at the end of 2020, B satisfied all other requirements under section 1106 of the CARES Act for forgiveness of the covered loan and at the end of 2020 expected to apply to the lender for covered loan forgiveness of the covered loan in 2021. Thus, at the end of 2020 B both knew the amount of its eligible expenses that qualified for reimbursement, in the form of covered loan forgiveness, and had a reasonable expectation of reimbursement. The reimbursement in the form of covered loan forgiveness was foreseeable. Therefore, pursuant to the foregoing authorities, B may not deduct B's eligible expenses.

In the alternative, section 265(a)(1) disallows a deduction of B's otherwise deductible eligible expenses because the expenses are allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness.

Note that in both cases the bulk of the reasoning supporting the answer relies on the reimbursement theory. In each case, a short sentence is added to the end to mention a §265(a)(1) tax exempt income theory.

Is It a Reimbursement?

It's not clear to this author that the reimbursement theory is necessarily the proper way to view this program, since it's pretty clear that Congress consistently referred to it as a *loan* program in the CARES Act. As well, the inclusion of §1106(i)'s rules on not picking up the forgiveness as taxable income also seems to argue in favor of the view that Congress was enacting a loan program—reimbursements would not have been income to the taxpayer. Thus, §1106(i) becomes a provision that does nothing under the law.

It is reasonable to suspect that the reason the IRS led with the tax exempt income theory in Notice 2020-32 and devoted most of the analysis to that view is because while you might argue this has the same effect as viewing the transaction in the form of a reimbursement, it's pretty clear that Congress had chosen the form of a loan for the structure rather than making the amounts into a advance reimbursement that would need to be returned if not used for appropriate purposes.

But when the Paycheck Protection Program Flexibility Act (PPPFA) greatly lengthened the time period for spending the funds and applying for forgiveness without having to make payments on the loans, the IRS now faced the situation where many (and perhaps most) borrowers with calendar year ends would not have received a forgiveness decision by December 31. So now the question of whether the expense could be disallowed based on being paid from tax exempt income before any such tax exempt income was generated became a real problem for the agency.

What the IRS appears to be doing now is trying to argue substance over form in this case. And, clearly, the IRS has won numerous cases against taxpayers by taking that position to treat a transaction differently from its formal structure. But note that the primary justification for allowing such a restructuring is that the *taxpayer was in charge of establishing the form of the transaction*. In this case, the borrower had no choice about the structure of this program—it was a loan.

At the time Notice 2020-32 was released, the PPP loan program was structured to make it likely most borrowers would apply for forgiveness well before their year end unless that fiscal year end was in the summer. The issue of timing was not going to arise in that context, as the borrower would have received forgiveness by the end of the calendar year, by far the most popular fiscal year end.

And even if reimbursement would be allowed as a possible route to non-deductibility, the IRS conceded in Notice 2020-32 and even in this ruling that it is possible to view it as a loan that is forgiven.

The switch in emphasis from "tax exempt income-no deduction under IRC §265(a)(1)" to "no deduction due to expected reimbursement" presumably has taken place because the IRS recognizes the relative weakness of their position on timing in the loan scenario if forgiveness has not yet taken place.

IRS Addressing the Tax Benefit Rule

If we accept that these expenses will be eventually non-deductible if forgiveness is obtained, the primary argument for allowing a deduction initially if no forgiveness is obtained by the year end is that the tax benefit rule will serve to pick up the income in a later year.

The IRS does address the issue in their ruling, arguing the following:

> Under the related "tax benefit rule," if a taxpayer takes a proper deduction and, in a later tax year, an event occurs that is fundamentally inconsistent with the premise on which the previous deduction was based (for example, an unforeseen refund of deducted expenses), the taxpayer must take the deducted amount into income. See section 111 of the Code (providing that gross income does not include income attributable to the recovery during a taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by chapter 1 of the Code). The Supreme Court applied the tax benefit rule in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983). In that case, the Court observed that "[t]he basic purpose of the tax benefit rule is to achieve rough transactional parity in tax . . . and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule." *Id.* at 383.[11]

Those who have read articles arguing for a deduction of such expense and later inclusion of income under the tax benefit rule may note those articles refer to *Bliss Dairy* for their support. What is of interest is that the Supreme Court decided *Hillsboro* and *Bliss Dairy* at the same time in the same opinion. So is the opinion internally inconsistent?

[11] Revenue Ruling 2020-27

Not really. While the quote noted by the IRS is in the opinion, when the Court looked at a case with the following facts *in the very same opinion*, the Court found the tax benefit rule applied and did not suggest the original deduction should have been disallowed as the reversal was clearly foreseeable at the end of the tax year:

- A cash basis taxpayer (Bliss Dairy) claimed a deduction for feed purchased just before the end of the taxpayer's fiscal year ended June 30, 1973. The vast majority of the feed was not used by June 30, 1973.

- The taxpayer liquidated the corporation on July 2, 1973 (two days later) and distributed the feed to the shareholders. Under the then existing version of IRC §336 the corporation did not recognize any gain when this feed was transferred out to the shareholders in liquidation.

- Under the then in force "one-month liquidation rule" of §333 the shareholders were also able to limit the amount of gain they recognized on disposing of their stock. Under those rules, they were able to allocate a portion of the basis in their stock to the feed.

- Finally, they continued to operate the dairy as an unincorporated entity, claiming a deduction again for the grain that was used.[12]

While the decision found that Bliss was required to reverse the deduction for the portion of the feed on hand at the date of the liquidation under the tax benefit rule, it is important to note that it was clearly foreseen that Bliss would be liquidating immediately after that year end—in fact, that was the key to their tax planning strategy to effectively get a double deduction.

The Court did not use the IRS approach proposed in Revenue Ruling 2020-27 to find the tax benefit rule inapplicable, as no deduction should have been allowed for the year ended June 30, 1973. Rather, the Supreme Court agreed with the IRS position at that time that the deduction was allowed, but once the event occurred inconsistent with the deduction (in this case, the one-month liquidation) the tax benefit rule forced a reversal of the deduction related to the feed that would be distributed to the shareholders.

Again, a skeptic might assume that the IRS intentionally ignored the Bliss facts in this ruling but cited a sentence in the decision to give the appearance they were dealing with the well-known criticism of denying the deduction in this case (see, your case supports our position!), but without having to deal with those pesky facts that were the basis of the position for those citing *Bliss*.

So What Does a Taxpayer Do?

This is where things get complicated. It certainly appears there is still a reasonable basis to argue that if the expenses aren't deductible eventually, it's via the §265(a)(1) nontaxable income standard the IRS emphasized in Notice 2020-32. And, if that is the case, the event inconsistent with a deduction had not occurred by year end if there was not forgiveness granted—no tax-exempt income yet existed to which the deduction

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[12] *Hillsboro National Bank v. Commissioner*, 460 US 370 (consolidated with *United States v. Bliss Dairy Inc.,* 81-930)

could relate. And you can argue this view is consistent with the treatment of the program as a loan with a later forgiveness of indebtedness, which is the only view Congress expressed in the CARES Act. The "reimbursement" construct is one that was created by the IRS.

So it is possible to claim the deduction on the return and simply disclose the position on a Form 8275. That would serve to limit the taxpayer's exposure to penalties.

But a taxpayer that takes this position needs to be aware of some key facts:

- The IRS is not likely to concede this issue if the return is pulled for examination, nor is it likely that an appellate conferee will go against this ruling of the National Office unless the IRS has already been defeated on the issue in court.
- Taking this issue to Court entails a very significant amount of expense that the taxpayer will need to pay up front, and they aren't likely to win an award of these expenses by the court even if the taxpayer prevails.
- Even if the taxpayer decides not to take the matter to court, there will still be the costs of representation and dealing with the examination, which could include a period of dealing with proposed penalties and the mere fact the IRS may raise other issues as long as they are looking at the return.

So the client needs to understand the uncertainty that exists here, as well as the fact that it may simply not prove to be cost-effective to take the more aggressive position to claim the deduction if the IRS challenges that position—and that might be the case even if the taxpayer ultimately prevails.

There is still a possibility that Congress will address the deductibility of these expenses in legislation in the next few months. One option that should be given to taxpayers is to extend the return to see if Congress does act to allow the deduction.

What if My Reasonable Expectation of Forgiveness Turns Out to Be Mistaken?

Assuming a taxpayer follows the IRS ruling and does not deduct the expenses on their 2020 return, what happens if the taxpayer later finds that some or all of the loan is not going to be forgiven? Does the taxpayer now have to go back and amend the 2020 return?

The situation does create a quirky problem. Generally, the Supreme Court has ruled that we have an annual tax system and the results have to be based on applying facts there were at least *knowable* at year end to the law ultimately in effect at that time. When the forgiveness applicable is fully or partially denied by the lender in 2021, that is a fact that was not knowable at the end of 2020. But it's also clear the expense was actually paid in 2020 and was only not deducted because we believed the amount would be reimbursed—a belief that proved, ultimately, to be in error.

To deal with this conundrum the IRS has released Revenue Procedure 2020-51[13] to provide a safe harbor to deal with some of these issues.

A taxpayer who meets the following tests is eligible to use the safe harbor:

- The taxpayer paid or incurred eligible expenses in the 2020 taxable year for which no deduction is permitted because at the end of the 2020 taxable year the taxpayer reasonably expects to receive forgiveness of the covered loan based on those eligible expenses (non-deducted eligible expenses);
- The taxpayer submitted before the end of the 2020 taxable year, or as of the end of the 2020 taxable year intends to submit in a subsequent taxable year, an application for covered loan forgiveness to the lender; and
- In a subsequent taxable year, the lender notifies the taxpayer that forgiveness of all or part of the covered loan is denied.[14]

As well, a taxpayer may use this safe harbor by meeting the following requirements:

- The taxpayer meets the first two requirements cited under the immediately preceding test; and
- In a subsequent taxable year, the taxpayer irrevocably decides not to seek forgiveness for some or all of the covered loan. For example, a taxpayer that determines that it will not qualify for covered loan forgiveness and withdraws the application submitted to the lender would be such a taxpayer.[15]

Taxpayers meeting one of those two sets of conditions can make use of one of two options to deal with deducting these expenses for which no forgiveness will be granted.

- **Deduct the expenses on the 2020 tax return**. A qualified taxpayer may deduct non-deducted eligible expenses on the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the 2020 taxable year, or amended return or AAR under section 6227 of the Code for the 2020 taxable year, as applicable;[16] *or*
- **Deduct the expenses on the 2021 tax return.** A qualified taxpayer may deduct non-deducted eligible expenses on the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the subsequent taxable year (normally a 2021 taxable year).[17]

The ruling clarifies that if a taxpayer applies for forgiveness and has amounts formally denied (the taxpayer meets the first set of conditions to use the safe harbor), the taxpayer may use the second safe harbor but is not required to formally elect to use the

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[13] Revenue Procedure 2020-51, November 18, 2020, https://www.irs.gov/pub/irs-drop/rp-20-51.pdf (retrieved November 19, 2020)

[14] Revenue Procedure 2020-51, Section 3.01

[15] Revenue Procedure 2020-51, Section 3.02

[16] Revenue Procedure 2020-51, Section 4.01

[17] Revenue Procedure 2020-51, Section 4.02

safe harbor to deduct the expenses in the subsequent tax year. Such a taxpayer would only need to use the safe harbor to claim the deduction for the 2020 tax year.

The procedure provides the deduction is limited as noted:

> A taxpayer applying …[one of the safe harbors] may not deduct an amount of non-deducted eligible expenses in excess of the principal amount of the taxpayer's covered loan for which forgiveness was denied or will no longer be sought.[18]

A taxpayer making use of this safe harbor must attach a statement to the tax return containing the following information:

- The taxpayer's name, address, and social security number or employer identification number;
- A statement specifying whether the taxpayer is an eligible taxpayer under either section 3.01 or section 3.02 of Revenue Procedure 2020-51;
- A statement that the taxpayer is applying section 4.01 or section 4.02 of Revenue Procedure 2020-51;
- The amount and date of disbursement of the taxpayer's covered loan;
- The total amount of covered loan forgiveness that the taxpayer was denied or decided to no longer seek;
- The date the taxpayer was denied or decided to no longer seek covered loan forgiveness; and
- The total amount of eligible expenses and non-deducted eligible expenses that are reported on the return.[19]

The IRS concludes by noting that merely because this procedure is used for a particular expense, the IRS can still look at the underlying details of an expense and challenge it for other reasons:

> Nothing in this revenue procedure precludes the IRS from examining other issues relating to the claimed deductions for non-deducted eligible expenses, including the amount of the deduction and whether the taxpayer has substantiated the deduction claim. It also does not preclude the IRS from requesting additional information or documentation verifying any amounts described in the statement described in section 4.04 of this revenue procedure.[20]

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[18] Revenue Procedure 2020-51, Section 4.03

[19] Revenue Procedure 2020-51, Section 4.04

[20] Revenue Procedure 2020-51, Section 4.05

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

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

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

The PPP loan program, established by the CARES Act signed into law in March of 2020[21], provided loans to eligible small businesses. If the borrower used the loan proceeds to pay certain eligible expenses, an amount of the loan up to such eligible expenses would be forgiven under the law[22] and such forgiveness would not be treated as taxable income to the borrower.[23]

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

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

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

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[21] CARES Act Section 1102

[22] CARES Act Section 1106

[23] CARES Act Section 1106(i)

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

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

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

Year End Passes Without Forgiveness – Is the Expense Deductible?

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

The AICPA has inquired about this issue with the United States Treasury, per an article published in *Tax Notes Today Federal* on November 11, 2020.[24] The article noted:

> Edward S. Karl of the American Institute of CPAs said Treasury officials told him they anticipated issuing more guidance before the end of the year, and possibly by the end of November, generally stating that if a borrower has a reasonable expectation of loan forgiveness, the expenses can't be deducted to the extent they're paid for with the loan. That's true regardless of when the loan is forgiven, Karl added.[25]

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

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

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

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

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

Mr. Karl in his presentation to the conference noted that many advisers do not agree with this view, and that many cite the Supreme Court's holding in *Bliss Dairy* to justify a current deduction followed by recovery under the tax benefit rule in the subsequent year.[26]

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

> As a cash basis taxpayer, in the taxable year ending June 30, 1973, it deducted upon purchase the full cost of the cattle feed purchased for use in its operations, as permitted by Section 162 of the Internal Revenue Code, 26 U.S.C. Section 162. A substantial portion of the feed was still on hand at the end of the taxable year. On July 2, 1973, two days into the next taxable year, Bliss adopted a plan of liquidation, and, during the month of July, it distributed its assets, including the remaining cattle feed, to the shareholders. Relying on Section 336, which shields the corporation from the recognition of gain on the distribution of property to its shareholders on liquidation, Bliss reported no income on the transaction.[27]

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

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

While not directly addressed by the Court, those seeing *Bliss Dairy* as applicable here note that even though Bliss Dairy almost certainly was aware that a liquidation would occur two days into the following year and had occurred by the time the prior year tax return was prepared, the Court did not find that a denial of the deduction in the prior year would have been the proper treatment. Rather, Bliss Dairy was to pick up the income in the subsequent year, as that was the year when the event occurred that was inconsistent with the original deduction.[28]

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

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

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

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

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

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

The Other IRS Argument for Denying a Deduction

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

The IRS provides the following description of this rationale:

> The deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement. See, e.g., *Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966); *Wolfers v. Commissioner*, 69 T.C. 975 (1978); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 31; Rev. Rul. 80-173, 1980-2 C.B. 60.[29]

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

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

[29] Notice 2020-32

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

"On the other hand, the primary position that relies on section 265 relies on the existence of tax-exempt income — in this case loan forgiveness income," Smith said. "So pick your poison — either tax-exempt income (income exists) or expense reimbursement (no income exists). Two different timing answers, depending on which one you pick."[30]

What is An Adviser to Do?

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

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

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

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

SECTION: 469
RESTAURANTS FOUND TO MEET SIGNIFICANT PARTICIPATION ACTIVITY TEST, TAXPAYER MATERIALLY PARTICIPATED AND COULD DEDUCT LOSSES

Citation: Padda v. Commissioner, TC Memo 2020-154, 11/16/20

The taxpayer in the case of *Padda v. Commissioner*, TC Memo 2020-154,[31] was able to show material participation in various restaurants by use of the significant participation activity test found in Reg. §1.469-5T(a)(4).

We did cover this case in another article for the separate issue of the taxpayer's unsuccessful attempt to avoid a late filing penalty for the year under exam. But the taxpayer's arguments for claiming material participation in the restaurant activities were found far more persuasive by the court, with the taxpayer prevailing on the issue.

At first glance some of the facts of this case make it look a lot like many of the cases that have proven to be easy victories for the IRS in the Tax Court. Both spouses were physicians in Missouri. Dr. Padda, the key spouse in this case, had a number of other businesses he owned in addition to his medical practice. He worked the largest chunk of his hours in his medical practice, but also spent between 210 and 220 hours each year working in a medical billing service he also ran.

In addition, Dr. Padda operated five restaurants and a brewery, the activities at question here. The taxpayers had regularly failed to file their tax returns on time in recent years, a fact discussed in our earlier article on this case regarding the late filing penalties.[32]

Based on those facts, and being aware of prior cases, you might assume that:

- The taxpayer's evidence to show participation would be poor—after all, quite often taxpayers who annually get information together late in the process are some of the least organized taxpayers advisers see and

- Given the time Dr. Padda would be expected to spent in a medical practice and running the billing company, it seems unlikely he'd be able to find time to qualify to materially participate in the restaurants and brewery.

But in this case, those assumptions would not hold true. And it was via using the significant participation activity test, along with what turned out to better corroborated evidence than we tend to see in these passive activity cases to bolster Dr. Padda's level

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[31] *Padda v. Commissioner*, TC Memo 2020-154, November 16, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12359 (retrieved November 18, 2020)

[32] Ed Zollars, CPA, "Taxpayer Hit With Late Filing Penalty When Accounting Firm Submits Return Seconds After the Filing Deadline," *Current Federal Tax Developments* website, November 17, 2020, https://www.currentfederaltaxdevelopments.com/blog/2020/11/17/taxpayer-hit-with-late-filing-penalty-when-accounting-firm-submits-return-seconds-after-the-filing-deadline (retrieved November 18, 2020)

of activity in these undertakings, that the Court found he did materially participate in each of the activities.

As the Tax Court notes, one of the ways a taxpayer can show he/she materially participated in an activity is via the *significant participation activity* test:

> A taxpayer can establish material participation in an activity by satisfying any one of seven tests set forth in section 1.469-5T(a), Temporary Income Tax Regs., 53 Fed. Reg. 5725-5726 (Feb. 25, 1988). Paragraph (a)(4) provides that the fourth test is met if the "activity is a significant participation activity * * * for the taxable year, and the individual's aggregate participation in all significant participation activities during such year exceeds 500 hours". A significant participation activity is a trade or business activity in which the individual participates for more than 100 hours during the year. Id. para. (c), 53 Fed. Reg. 5726.[33]

Although not mentioned by the Court, since the IRS was not disputing this point, another requirement is that none of the activities can be ones that the taxpayer would otherwise be found to be materially participating in under any other test.[34]

The Tax Court assumed that each of the five restaurants and the brewery were separate activities.[35]

To establish the hours Dr. Padda worked in these activities, first Dr. Padda testified about his work:

> Padda presented testimony to establish his hours spent on the restaurant and the brewery activities. He personally testified for an entire day of trial, explaining in detail his nontravel involvement in each restaurant and the brewery. Padda stated the nontravel hours he spent working on the restaurants and the brewery each year.
>
> …
>
> Padda's testimony was also directed to how many hours he spent on each activity for each year. For example, Padda testified that he spent 400 hours in 2011 on Cafe Ventana, of which 200 hours were spent on renovations.[36]

If that had been the only evidence offered, though, we'd expect the Tax Court to make its standard statement that the Court is not required to accept a taxpayer's self-serving

[33] *Padda v. Commissioner*, TC Memo 2020-154, p. 11

[34] Reg. §1.469-5T(c)(1)(ii)

[35] *Padda v. Commissioner*, TC Memo 2020-154, p. 11

[36] *Padda v. Commissioner*, TC Memo 2020-154, pp. 12-13

and uncorroborated testimony. But Dr. Padda had a number of individuals that separately could testify about Dr. Padda's involvement with the activities:

> Following Padda's testimony, 12 individuals testified regarding Padda's nontravel involvement in the restaurants and the brewery. They explained how Padda was involved in every aspect of the restaurants and the brewery. This included hands-on work and onsite instruction.[37]

The Court found the combination of Dr. Padda's testimony and those of the other witnesses to be persuasive:

> On the basis of the testimony we described from Padda and the corroborating witnesses, we find that the nontravel time Padda spent on each activity exceeded 100 hours for each year at issue.
>
> Because there are six activities involved in this calculation, our finding means that Padda annually devoted more than 600 hours (i.e., 6 × 100 = 600) of nontravel time to the five restaurants and the brewery. This conclusion is valid despite the IRS's skepticism that Padda could have spent significant time on the restaurants and the brewery given the demands of his work at his medical practice (which was highly successful) and the lack of documentary evidence of his personal involvement in the restaurants and the brewery. These reasons for skepticism might be well placed in another case. But the record in this case is consistent with our conclusions about Padda's hours. Padda did not use correspondence or emails with respect to the restaurants and the brewery. Instead he used the telephone and face-to-face meetings. Using these means of communications, Padda exercised tight control of many aspects of the restaurants and the brewery. In particular, he paid close attention to the quality and ingredients of the food and beverages. He also rigorously controlled the decor and appearance of the establishments. His employees confirmed his heavy involvement. They complained in their testimony about his micromanagement. Perhaps as a result of Padda's efforts, the restaurants and the brewery were lavishly appointed. The food and beverages were of the highest quality. The restaurants and the brewery were also costly to operate. Year after year, they produced massive financial losses that largely wiped out Padda's profits from his medical practice. Thus it was that Padda was a successful doctor and at the same time spent significant time on the restaurants and the brewery.[38]

The Court also considered records of time Dr. Padda spent traveling between these locations, finding he had spent an additional 25 hours of travel time for each restaurant each year in addition to the more than 100 hours the Court had previously given him credit for in each activity.

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[37] *Padda v. Commissioner*, TC Memo 2020-154, p. 13

[38] *Padda v. Commissioner*, TC Memo 2020-154, pp. 13-14

The Court concluded:

> For each activity for each year (i.e., for each of the restaurants and the brewery), Padda's hours exceeded the 100-hour threshold required for an activity to be a significant participation activity. This is because for each activity and for each year his nontravel hours exceeded 100 hours and his travel hours exceeded 25 hours. Each activity was therefore a significant participation activity for year Padda had at least these six significant participation activities, his aggregate participation in all significant participation activities during the year exceeded the 500-hour threshold of section 1.469-5T(a)(4), Temporary Income Tax Regs., supra. The five restaurants and the brewery were not passive activities.[39]

The evidence Dr. Padda presented should be taken with an understanding that the Court clearly found Dr. Padda to be believable—he was a good witness, and knew many details of the activities that lent credence to the belief he was deeply involved in each. Similarly, the supporting witnesses also were believed by the Court and did not seem to have a reason to stretch the truth on Dr. Padda's behalf.

It would likely have been better had Dr. Padda had detailed time records to back up his assertion regarding his involvement—the existence of such records might have allowed the case to be resolved at the exam level, saving the taxpayer a lot of time and expense. Nevertheless, this case does demonstrate the types of information that can be used to back up a claim of material participation.

SECTION: 6037
IRS TO REQUEST DISCLOSURE OF SHARES HELD AND LOANS TO SHAREHOLDER ON FORM 1120-S K-1S FOR 2020

Citation: 2020 Instructions for Form 1120-S (Draft), 11/17/20

The IRS has issued draft instructions[40] to go with the Draft Schedule K-1[41] issued in July and Draft Form 1120-S[42] issued in August. The draft instructions contain information on the new items G (related to stock ownership) and H (related to loans from shareholders) added to this year's K-1, as well as a discussion of expenses paid with forgiven Paycheck Protection Program (PPP) loan proceeds.

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[39] *Padda v. Commissioner*, TC Memo 2020-154, pp. 16-17

[40] 2020 Instructions for Form 1120-S (Draft), November 17, 2020, https://www.irs.gov/pub/irs-dft/i1120s--dft.pdf (retrieved November 18, 2020)

[41] Schedule K-1 (Form 1120-S) (Draft), July 2, 2020, https://www.irs.gov/pub/irs-dft/f1120ssk--dft.pdf (retrieved November 18, 2020)

[42] Form 1120-S (Draft), August 31, 2020, https://www.irs.gov/pub/irs-dft/f1120s--dft.pdf (retrieved November 18, 2020)

Schedule K-1, Item G, Number of Shares

G	Shareholder's number of shares	
	Beginning of tax year	______
	End of tax year	______

In 2020 the shareholder's K-1 will report the number of shares held by the shareholder at the beginning and the end of the year. The instructions provide the following information about reporting for this item on each shareholder's K-1:

> Report the number of shares for purposes of allocating items of income, loss, or deduction at the beginning and end of the S corporation's tax year. An entity without stock, such as an LLC, should enter the number of units or other equivalent to S corporation stock (including ownership percentages).[43]

In this case, the IRS provides an example of reporting these amounts:

> **Example**. If shareholders X and Y each owned 50 shares for the entire tax year, enter 50 in item G for both the beginning and ending amounts for each shareholder. However, if A and B each owned 50 shares of stock for the first half the tax year and C purchased 10 shares of A's and B's stock during the year, A's and B's beginning of tax year number of shares is 50, while C's is 0, and the end of tax year number of shares for A and B is 40, while C's is 20.[44]

Presumably the IRS will use this information to help identify situations where it appears that allocations have not been properly made on a per-share basis to the K-1s, as well as cases where there may have been a disposition of shares that the shareholder should have reported as a sale or exchange on their individual return.

Schedule K-1, Item H, Debt Owed to Shareholders

H	Loans from shareholder	
	Beginning of tax year	$ ______
	End of tax year	$ ______

The Schedule K-1 will now ask for the balances for debts owed to the shareholder at both the beginning and end of the tax year. The instructions provide:

> Report the amount of debt owed by the S corporation directly to the shareholder as of the beginning and end of the S corporation's tax

[43] 2020 Instructions for Form 1120-S (Draft), November 17, 2020, p. 23

[44] 2020 Instructions for Form 1120-S (Draft), November 17, 2020, p. 23

> year. Generally, the amount reported on Schedule L, line 19, Loans from shareholder, should reconcile to the sum of all amounts reported on Schedules K-1. Do not include amounts for which the shareholder is a co-borrower or guarantor of corporate level debt. Also do not include any intercompany debt.[45]

This information will likely be used by the IRS to identify issues related to shareholder loans and basis in the S context. It also now explicitly tells those preparing the K-1 that the amounts on the individual K-1s should reconcile to the total shareholder loans reported on Schedule L, as well as reminding those preparing the K-1 that the loans do not include loans from a third party that the shareholder has guaranteed or is listed as a co-borrower on.

Expenses Related to PPP Loans

The instructions for preparing the Form 1120-S also bring up the IRS's position, found in Notice 2020-32, that a taxpayer is not allowed to deduct expenses paid with proceeds from a forgiven PPP loan.

> **Expenses related to a forgiven Paycheck Protection Program (PPP) loan**. If the corporation received a PPP loan under section 7(a)(36) of the Small Business Act, no deduction is allowed for an expense if the payment of the expense results in forgiveness of all or part of the loan and the income associated with the forgiveness is excluded from gross income. Reduce any deductions reported on Form 1120-S, including deductions being passed through to shareholders using Schedule K, by the amounts that can't be deducted as a result of a forgiven PPP loan. For more information, see Notice 2020-32, 2020-21 I.R.B. 837, available at IRS.gov/irb/ 2020-21_IRB#NOT-2020-32.

The IRS does not explicitly address the situation when a return is being prepared and no PPP forgiveness final decision had been obtained from the Small Business Administration prior to the end of the tax year of the corporation. However, the wording is not inconsistent with the position it is reported that the IRS plans to take regarding such payments—that they are not to be deducted if the taxpayer expects such a payment to result in forgiveness of a portion of the PPP loan, regardless of whether such forgiveness has been requested or received by the end of the tax year.

[45] 2020 Instructions for Form 1120-S (Draft), November 17, 2020, p. 23

SECTION: 6651
IRS COMMISSIONER REJECTS AICPA CALL FOR COVID-19 RELIEF ON LATE-PAYMENT AND LATE-FILING PENALTIES

Citation: William Hoffman, "Rettig to Tax Pros: Blanket Penalty Relief 'Not Going to Happen'", Tax Notes Today,

2020 TNTF 223-1, 11/18/20

IRS Commissioner Charles Rettig told an AICPA online conference on November 17 that blanket penalty relief from late-filing and late payment penalties is "not going to happen" per a report of the session published in *Tax Notes Today Federal.*[46]

The AICPA had sent letters to the agency during 2020 asking for relief, the most recent being issued on November 5.[47] In the letter, the AICPA outlined the situation the organization felt called for relief:

> Throughout the summer, the AICPA heard from practitioners expressing concerns about being able to complete returns by the September 15 and October 15 extended due dates because of the significant impact the Coronavirus has had on their clients and on their practices. Practitioners, and clients, are still managing remote work environments, often have had difficulty communicating with the IRS, and many are caring for sick family members or are sick themselves. Practitioners are helping small businesses with the Paycheck Protection Program applications and forgiveness, and otherwise advising small businesses on the brink of closure. Despite making every good faith effort to comply, these practitioners and taxpayers were fearful of missing the due dates. These concerns were relayed to the IRS.
>
> Starting approximately a month after the September 15, 2020 filing deadline, many taxpayers that missed the filing and payment deadline, due to the Coronavirus, started to receive notices for failure to file penalties. We are fearful that a second wave of notices for failure to file and late payment penalties will soon be sent to taxpayers for returns that were due October 15 but were filed late as a result of the impact of the Coronavirus.[48]

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[46] William Hoffman, "Rettig to Tax Pros: Blanket Penalty Relief 'Not Going to Happen'", *Tax Notes Today*, 2020 TNTF 223-1, November 18, 2020, https://www.taxnotes.com/tax-notes-today-federal/penalties/rettig-tax-pros-blanket-penalty-relief-not-going-happen/2020/11/18/2d6y2 (retrieved November 18, 2020, subscription required)

[47] AICPA Letter, "Penalty Relief for 2019 Tax Year Filing Season," November 5, 2020, https://www.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/aicpa-penalty-relief-letter-final.pdf (retrieved November 18, 2020)

[48] AICPA Letter, "Penalty Relief for 2019 Tax Year Filing Season," November 5, 2020

The letter went on to recommend the IRS provide for the following relief:

> For taxpayers that have received failure to file or late payment penalty notices, due to the monumental difficulties of the Coronavirus, the AICPA recommends the IRS create an expedited and streamlined reasonable cause penalty abatement process that eliminates the need for written requests. The IRS should offer a penalty waiver, similar to the procedures of first time abate (FTA) administrative waiver, based on the Coronavirus impacts on both the taxpayer or the practitioner. As the Coronavirus is an extraordinary event, unlike anything faced in recent history, penalty relief based on a Coronavirus impacts should not be considered first time abate. A taxpayer's eligibility for first time abate should not be impacted in future tax years even if the taxpayer was granted penalty relief due to Coronavirus impacts.
>
> This expedited and streamlined relief should also be available through oral requests and by the practitioner, rather than requiring the request in writing.
>
> Furthermore, it is critical that immediate guidance, such as Interim Guidance, with specific Coronavirus examples that qualify for reasonable cause is developed and provided to all telephone assistors. The examples should illustrate situations where reasonable cause relief should be granted as a result of the effects of the Coronavirus on either the taxpayer or the practitioner.
>
> Finally, a dedicated telephone number, or a dedicated prompt within the already existing taxpayer call lines and the Practitioner Priority Service line, should be established to call and request Coronavirus-related penalty relief. To ensure that assistors are familiar with the Interim Guidance and have authority to abate or waive penalties, training should be provided to the telephone assistors.[49]

However, the Commissioner indicated that existing, case-by-case appeals, are what professionals and taxpayers will need to make use of, stating "[w]e provided as much [penalty] relief as we could."[50]

The AICPA's chief tax officer, Edward Karl, was quoted in the article as stating "I'm not understanding this." The article continued outlining Mr. Karl's reaction:

> "This is not a typical year," Karl said. "Frankly, this is not the year where I would be concerned about being a little too generous to the many taxpayers who are suffering the effects of COVID-19 . . . and the tax practitioners . . . who are trying to make everything work."[51]

[49] AICPA Letter, "Penalty Relief for 2019 Tax Year Filing Season," November 5, 2020

[50] William Hoffman, "Rettig to Tax Pros: Blanket Penalty Relief 'Not Going to Happen'", *Tax Notes Today*, 2020 TNTF 223-1, November 18, 2020

[51] William Hoffman, "Rettig to Tax Pros: Blanket Penalty Relief 'Not Going to Happen'", *Tax Notes Today*, 2020 TNTF 223-1, November 18, 2020

But the article concluded with the Commissioner standing by his position:

> Rettig seemed determined to stick to his position. "We're not willing to provide blanket relief that might assist people who might not have tried to pay attention to their responsibilities, as a practitioner or a taxpayer," he told the AICPA conference. "If you were sitting in my chair . . . you would be able to look at it as we do."[52]

SECTION: 6651
TAXPAYER HIT WITH LATE FILING PENALTY WHEN ACCOUNTING FIRM SUBMITS RETURN SECONDS AFTER THE FILING DEADLINE

Citation: Padda v. Commissioner, TC Memo 2020-154, 11/16/20

The Tax Court found that a taxpayer did not reasonably rely on a CPA retained to timely file his tax return in the case of *Padda v. Commissioner*, TC Memo 2020-154.[53] This was true even though the CPA submitted the return seconds after the clock ticked past midnight on October 15, 2013.

The Court described the events leading to the late filing of the taxpayers' return as follows:

> Padda and Kane's 2012 federal individual income tax return was due October 15, 2013. On October 15, 2013, Padda and Kane signed IRS Form 8879, "IRS e-file Signature Authorization" to authorize Ehrenreich's accounting firm to electronically file their 2012 Form 1040, "U.S. Individual Income Tax Return". On October 15, 2013, Ehrenreich's accounting firm was electronically filing several tax returns just before midnight. Ehrenreich's accounting firm created an electronic version of Padda and Kane's return on October 15, 2013, at 11:59 p.m. It transmitted the electronic version to the IRS on October 16, 2013, at 12 a.m. On October 16, 2013, the IRS rejected the return as a duplicate submission. Ehrenreich's accounting firm electronically resent the return on October 25, 2013, and it was received and accepted by the IRS the same day.[54]

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[52] William Hoffman, "Rettig to Tax Pros: Blanket Penalty Relief 'Not Going to Happen'", *Tax Notes Today*, 2020 TNTF 223-1, November 18, 2020

[53] *Padda v. Commissioner*, TC Memo 2020-154, November 16, 2020, https://www.ustaxcourt.gov/UstcInOp2/OpinionViewer.aspx?ID=12359, (retrieved November 17, 2020)

[54] *Padda v. Commissioner*, TC Memo 2020-154, pp.8-9

At trial, the taxpayer and the IRS stipulated that the return was filed on October 25, 2013. The taxpayers claimed that they shouldn't be held responsible for the late filing because the CPA firm was responsible for the late submission.[55]

We've before discussed the general rule that a taxpayer cannot rely upon the actions of a third party for timely filing,[56] but rather must demonstrate that the taxpayer exercised reasonable care and prudence but was unable to timely file.[57]

The taxpayers described their actions as follows:

> Padda and Kane argue that the reason that their 2012 return was filed late was that (1) Ehrenreich's accounting firm pressed a button only a few seconds late, (2) they relied on Ehrenreich's accounting firm to timely file the return, and (3) they themselves could not have pressed the button to timely file the return.[58]

The Tax Court rejected their defense, both because ultimately they were attempting to delegate timely filing to a third party, but also because even if that was allowed it would have been unreasonable to have relied on the firm to file timely in this case based on their previous experience with this accounting firm:

> Even if sometimes it might be reasonable for a taxpayer to rely on his or her accountant to timely file his or her returns (contrary to the caselaw), it was not reasonable in this particular case for Padda and Kane to rely on Ehrenreich's firm to timely file their return. Padda and Kane have relied on Ehrenreich's firm to file their returns every year since at least 2006. And every year since then, except for 2011, their return was filed late. Yet they have continued to use Ehrenreich's firm to file their return year after year. Padda and Kane's failure to ensure that Ehrenreich's firm timely filed their 2012 return demonstrates a lack of ordinary business care, particularly in the light of the firm's history of delinquent filings.[59]

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[55] *Padda v. Commissioner*, TC Memo 2020-154, p. 22

[56] *United States v. Boyle*, 469 US 241 (1985)

[57] Reg. §301.6651-1

[58] *Padda v. Commissioner*, TC Memo 2020-154, pp. 22-23

[59] *Padda v. Commissioner*, TC Memo 2020-154, p. 23

SECTION: ERC
UPDATED IRS FAQ OUTLINES HOW ACQUISTIONS IMPACT CLAIMING EMPLOYEE RETENTION CREDIT

Citation: COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, 11/16/20

The IRS has updated their FAQ on the Employee Retention Credit (ERC) added by the CARES Act in March to give guidance when an employer acquires stock or assets of another employer that received a Paycheck Protection Program (PPP) loan.[60]

Under the ERC, no credit may be claimed by an employer who received a PPP program loan, regardless of whether or not the employer sought forgiveness of some or all of the loan. This raises a question about what happens if an employer who did not obtain a PPP loan later acquires an employer who did obtain such a loan. Does that employer and related entities now lose access to the ERC due to having acquired a "tainted" entity?

The new FAQ questions sought to give some guidance on these issues to help clarify matters.

Acquisition of the Equity of an Employer Who Took Out a PPP Loan

The first new question looks at the situation when an entity acquires the stock or equity interests of another entity that had taken out a PPP loan and where the target employer becomes a member of an aggregated group with the acquiring employer under the PPP rules.[61]

The IRS outlines two structures under which the employer is eligible for the ERC on and after the transaction date. The first deals with the case when the acquired employer's loan is fully satisfied or an escrow was established prior to the transaction:

> **PPP loan is fully satisfied or escrow established pre-transaction**
>
> If the Target Employer had received a PPP loan, but prior to the transaction closing date, the Target Employer fully satisfied the PPP loan in accordance with paragraph 1 of the Small Business Administration Notice effective October 2, 2020 (the SBA October 2 Notice), or submitted a forgiveness application to the PPP lender and established an interest-bearing escrow account in accordance with paragraph 2.a of the SBA October 2 Notice, then, after the closing

[60] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-interaction-with-other-credit-and-relief-provisions-faqs (retrieved November 18, 2020)

[61] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81a

> date, the Aggregated Employer Group will not be treated as having received a PPP loan, provided that the Acquiring Employer (including any member of the Acquiring Employer's pre-transaction Aggregated Employer Group) had not received a PPP loan before the closing date and no member of the Aggregated Employer Group receives a PPP loan on or after the closing date. In this case, any employer that is a member of the Aggregated Employer Group, including the Target Employer, may claim the Employee Retention Credit for qualified wages paid on and after the closing date, provided that the Aggregated Employer Group otherwise meets the requirements to claim the Employee Retention Credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer's pre-transaction Aggregated Employer Group for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act.[62]

If the above conditions are not met, the IRS outlines the following method by which the employer continues to be able to claim the credit—but not for amounts paid to the target employer's employees:

> **PPP loan is not fully satisfied and no escrow established pre-transaction**
>
> If the Target Employer had received a PPP loan, but prior to the transaction closing date, the PPP Loan is not fully satisfied and no escrow account was established in accordance with paragraphs 1 or 2.a of the SBA October 2 Notice, then, after the closing date, the Aggregated Employer Group (other than the Target Employer) will not be treated as having received a PPP loan, provided that the Acquiring Employer (including any member of the Acquiring Employer's pre-transaction Aggregated Employer Group) had not received a PPP loan before the closing date and no member of the Aggregated Employer Group receives a PPP loan on or after the closing date. Any employer (other than the Target Employer) that is a member of the Aggregated Employer Group may claim the Employee Retention Credit for qualified wages paid on and after the closing date, provided that the Aggregated Employer Group otherwise meets the requirements to claim the Employee Retention Credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer's pre-transaction Aggregated Employer Group for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act. *However, the Target Employer that received the PPP loan prior to the transaction closing date and that continues to be obligated on the PPP loan after the closing date is ineligible for the Employee Retention*

[62] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81a

> *Credit for any wages paid to any employee of the Target Employer before or after the closing date.*[63]

Note that the key difference is that, if the loan was not paid off and no escrow had been established, the acquired entity's payroll would not qualify for the ERC. But the other members of the group could continue to qualify for the ERC credit.

Acquisition of the Assets of an Employer Who Took Out a PPP Loan

If the acquiring employer acquires the assets, rather than the equity interests, of a target employer, the rules are somewhat different depending on whether the acquiring employer does or does not assume the PPP loan obligations of the target employer.

If the acquiring employer *does not* assume the PPP loan obligations of the target employer, the following rules apply:

> **No assumption of PPP loan obligations**
>
> An Acquiring Employer that acquires the assets of a Target Employer that had received a PPP loan will not be treated as having received a PPP loan by virtue of the asset acquisition, provided that the Acquiring Employer does not assume the Target Employer's obligations under the PPP loan. In this case, the Acquiring Employer will be eligible for the Employee Retention Credit after the transaction closing date if the employer otherwise meets the requirements to claim the credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act.[64]

However, the results are not quite as good for the combined organization if the entity *does* assume the PPP loan obligations:

> **Assumption of PPP loan obligations**
>
> If, as part of the acquisition of the Target Employer's assets and liabilities, the Acquiring Employer assumes the Target Employer's obligations under the PPP loan, then after the transaction closing date, the Acquiring Employer generally will not be treated as having received a PPP loan, provided that the Acquiring Employer had not received a PPP loan before or on or after the closing date; however, the wages that may be treated as qualified wages after the closing date will be limited. *Specifically, the wages paid by the Acquiring Employer after the closing date to any individual who was employed by the Target Employer on the closing date shall not be treated as qualified wages.* Subject to this limitation, the Acquiring Employer may claim the Employee Retention Credit for

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[63] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81a

[64] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81b

> qualified wages paid on and after the closing date, provided that the employer otherwise meets the requirements to claim the Employee Retention Credit. In addition, any Employee Retention Credit claimed by the Acquiring Employer for qualified wages paid before the closing date will not be subject to recapture under section 2301(l)(3) of the CARES Act.[65]

If the PPP obligation is assumed by the buyer, the employees of the target will not be allowed to be treated as employees on which the ERC can be claimed.

[65] COVID-19-Related Employee Retention Credits: Interaction with Other Credit and Relief Provisions FAQs, IRS Website, November 16, 2020, Question 81b