Current Federal Tax Developments

Week of August 9, 2021

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ACCOUNTING
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CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF AUGUST 9, 2021
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SECTION: ERC
IRS RELEASES ADDITIONAL GUIDANCE ON THE ERC , AND IT'S NOT GOOD NEWS FOR MAJORITY SHAREHOLDERS

Citation: Notice 2021-49, 8/4/21

The IRS has published 34 pages of additional guidance[1] on the Employee Retention Credit (ERC), including the first guidance on the changes made for the 3rd and 4th quarter credits and the official IRS word on the related party issues raised by the references to IRC §§51(i)(1) and 267(c) we wrote about in April of 2021.[2]

In the case of the issues for §§51(i)(1) and 267(c), the IRS arrived at an identical conclusion to that expressed in our April article—wages paid to those with a controlling interest in the employer will not be eligible for the credit unless the controlling interest holder has no living relatives (or just very remote ones).

There are two major sections to the Notice, the first providing guidance on the changes made to the ERC for the 3rd and 4th quarter of 2021 and the second providing guidance on additional issues applicable to all versions of the ERC.

Guidance Applicable to Both the 2020 and 2021 Versions of the ERC

The Notice contains guidance related to various issues that had not been addressed in the previous Notices. This guidance generally applies to all versions of the ERC.

Related Individuals

The most controversial portion of the Notice is likely to be the IRS analysis of the impact of the related party rules found in all versions of the ERC. The answer is not totally surprising—as discussed earlier, we had previously come to the same conclusion the IRS arrived at that the text referenced was unambiguous and would most often render the wages paid to a majority owner ineligible for the ERC. But the result is one that will greatly surprise many business owners and more than a few tax professionals.

The IRS decided to address two issues that had become the subject of discussion among tax professionals regarding the ERC:

- Are wages paid to a more than 50% owner of the value of a corporation eligible to be treated as qualified wages? (The answer will be no in the overwhelming majority of cases.)

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[1] Notice 2021-49, August 4, 2021, https://www.irs.gov/pub/irs-drop/n-21-49.pdf (retrieved August 4, 2021)

[2] Edward K. Zollars, CPA, "Tax Advisers' Area 51 - Employee Retention Credit and Majority Shareholders," *Current Federal Tax Developments* website, April 3, 2021,

- Are wages paid to the spouse of that same more than 50% owner eligible to be treated as qualified wages? (While it's easier for a spouse's wages to qualify for the ERC, it's still highly unlikely to work in the vast majority of real-world situations.)

The IRS began by analyzing the impact of the "rules similar to" IRC §51(i)(1) language in the various versions of the ERC:

> Section 2301(e) of the CARES Act and section 3134(e) of the Code provide, in relevant part, that rules similar to the rules of section 51(i)(1) of the Code apply. Section 51(i)(1) generally provides that wages paid to certain related individuals are not taken into account for purposes of the work opportunity credit. Specifically, section 51(i)(1) and Treas. Reg. § 1.51-1(e)(1) provide that wages are not taken into account with respect to an individual who bears any of the relationships described in section 152(d)(2)(A)-(H) of the Code to the following:
>
> > (i) the taxpayer, or
> >
> > (ii) if the taxpayer is a corporation, to an individual who owns, directly or indirectly more than 50 percent in value of the outstanding stock of the corporation (majority owner of a corporation), or
> >
> > (iii) if the taxpayer is an entity other than a corporation, to any individual who owns, directly or indirectly, more than 50 percent of the capital and profits interests in the entity (majority owner of a noncorporate entity).[3]

The relationships that are in the group whose wages are not eligible for the credit are listed in the Notice:

> Initially, simply applying the rules of section 152(d)(2)(A)-(H) of the Code for purposes of the employee retention credit, before taking into consideration the attribution rules of section 267(c), the wages paid to employees with the following relationships to a majority owner of a corporation or of a partnership or other entity are not qualified wages:
>
> > (A) A child or a descendant of a child.
> >
> > (B) A brother, sister, stepbrother, or stepsister.
> >
> > (C) The father or mother, or an ancestor of either.
> >
> > (D) A stepfather or stepmother.
> >
> > (E) A niece or nephew.

[3] Notice 2021-49, Section IV.D

> > (F) An aunt or uncle.
> >
> > (G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
> >
> > (H) An individual (other than a spouse, determined without regard to section 7703, of the taxpayer) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. [4]

NOTE

The inclusion of the member of the household in the above list in the Notice appears to be a drafting error. IRC §51(1)(i) only refers to "subparagraphs (A) through (G) of section 152(d)(2)" for the list of individuals whose wages cannot be used to claim a credit.

Since the Internal Revenue Code controls when it is at odds with IRS guidance, a credit would be allowed for wages paid to a person who was a member of the household of any direct or indirect majority interest holder unless that member of the household also has one of the relationships listed in (A) – (G) above.

But there is a complication—the reference to IRC §267(c) that was referred to:

> Section 51(i)(1)(A) includes a parenthetical at the end of the subparagraph stating that an individual's ownership is determined with the application of section 267(c) of the Code. The Treasury Department and the IRS have concluded that the section 267(c) ownership attribution rules apply for purposes of determining both an individual's ownership of stock of a corporation and an individual's capital and profits interests in a partnership or other entity, consistent with the language in Treas. Reg. § 1.51-1(e)(1)(iii) and section 51(i)(1)(A). [5]

As we are directed to determine ownership using the rules of IRC §267(c), the Notice describes those rules:

> Section 267(c) of the Code provides rules regarding the constructive ownership of stock for purposes of determining whether an individual is considered a majority owner of a corporation. 9 Section 267(c) sets forth the following rules to determine whether an individual has constructive ownership of stock of a corporation:
>
> > (1) stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

[4] Notice 2021-49, Section IV.D

[5] Notice 2021-49, Section IV.D

> (2) an individual is considered to own the stock owned, directly or indirectly, by or for the individual's family;
>
> (3) an individual owning (otherwise than by the application of (2)) any stock in a corporation is considered to own the stock owned, directly or indirectly, by or for his partner;
>
> (4) the family of an individual includes only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants; and
>
> (5) stock constructively owned by a person by reason of the application of (1) will be treated, for the purpose of applying (1), (2), or (3), as actually owned by that person. Stock constructively owned by an individual by reason of the application of (2) or (3) will not be treated as owned by the individual to again apply either rule to reattribute and make another individual the constructive owner of the stock.[6]

The list of family members found at (4) will prove particularly vexing in this context, as the Notice will make clear. The relatives will end up being attributed ownership from the qualifying owner, and then the actual owner will end up in that family member's list of barred relationships:

> Applying the rules of sections 152(d)(2)(A)-(H) and 267(c) of the Code, a majority owner of a corporation is a related individual for purposes of the employee retention credit, whose wages are not qualified wages, if the majority owner has a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant.[7]

Specifically, the problem is detailed as follows:

> That is, applying the constructive ownership rules of section 267(c), the direct majority owner's ownership of the corporation is attributed to each of the owner's family members with a relationship described in section 267(c)(4); further, because each of those family members is considered to own more than 50 percent of the stock of the corporation after applying section 267(c), the direct majority owner of the corporation would have a relationship as defined in section 152(d)(2)(A)-(H) to the family member who is a constructive majority owner. Therefore, the direct majority owner is a related individual for purposes of the employee retention credit.[8]

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[6] Notice 2021-49, Section IV.D

[7] Notice 2021-49, Section IV.D

[8] Notice 2021-49, Section IV.D

In a footnote the IRS warns us that minority shareholders are not necessarily safe in this situation either, especially when the other shareholders are members of the same family:

> Depending on the facts, the application of the rules of sections 152(d)(2)(A)-(H) and 267(c) may also result in a minority owner of a corporation being a related individual for purposes of the employee retention credit. See, example 4.[9]

While a person's spouse is not listed as a barred relative under IRC §152(d)(2)(A)-(H), the in-law relative rules or those for a descendant will often trap the majority owner's spouse:

> The spouse of a majority owner is a related individual for purposes of the employee retention credit, whose wages are not qualified wages, if the majority owner has a family member who is a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant (and thus is deemed to own the majority owner's shares under section 267(c) of the Code) and the spouse bears a relationship described in section 152(d)(2)(A)-(H) of the Code to the family member. For example, a direct majority owner's brother would be a constructive majority owner under section 267(c)(2) and (4) and the spouse of the direct majority owner would be considered a related individual to the constructive majority owner by virtue of the in-law relationship described in section 152(d)(2)(G).[10]

The IRS notes there is a (relatively rare) situation where the majority owner and/or spouse will not have an issue—if there are no living relatives on the list found in IRC §267(c)(4):

> In the event that the majority owner of a corporation has no brother or sister (whether by whole or half-blood), ancestor, or lineal descendant as defined in section 267(c)(4) of the Code, then neither the majority owner nor the spouse is a related individual within the meaning of section 51(i)(1) of the Code and the wages paid to the majority owner and/or the spouse are qualified wages for purposes of the employee retention credit, assuming the other requirements for qualified wages are satisfied. [11]

This section concludes with a series of four examples illustrating the application of these rules.

EXAMPLE 1, NOTICE 2021-49, SECTION IV.D

Parent and Child Shareholders

Corporation A is owned 80 percent by Individual E and 20 percent by Individual F. Individual F is the child of Individual E. Corporation A is an eligible employer with respect to the first

[9] Notice 2021-49, Section IV.D, Footnote 10

[10] Notice 2021-49, Section IV.D

[11] Notice 2021-49, Section IV.D

calendar quarter of 2021. Both Individual E and Individual F are employees of Corporation A. Pursuant to the attribution rules of section 267(c) of the Code, both Individual E and Individual F are treated as 100 percent owners of Corporation A. Individual E has the relationship to Individual F described in section 152(d)(2)(C) of the Code, and Individual F has the relationship to Individual E described in section 152(d)(2)(A). Accordingly, Corporation A may not treat as qualified wages any wages paid to either Individual E or Individual F because both Individual E and Individual F are each related individuals for purposes of the employee retention credit.

EXAMPLE 2, NOTICE 2021-49, SECTION IV.D

Child of Shareholder Not An Employee of the Business

Corporation B is owned 100 percent by Individual G. Individual H is the child of Individual G. Corporation B is an eligible employer with respect to the first calendar quarter of 2021. Individual G is an employee of Corporation B, but Individual H is not. Pursuant to the attribution rules of section 267(c) of the Code, Individual H is attributed 100 percent ownership of Corporation B, and both Individual G and Individual H are treated as 100 percent owners. Individual G has the relationship to Individual H described in section 152(d)(2)(C) of the Code. Accordingly, Corporation B may not treat as qualified wages any wages paid to Individual G because Individual G is a related individual for purposes of the employee retention credit.

EXAMPLE 3, NOTICE 2021-49, SECTION IV.D

No Living Relatives Exception

Corporation C is owned 100 percent by Individual J. Corporation C is an eligible employer with respect to the first calendar quarter of 2021. Individual J is married to Individual K, and they have no other family members as defined in section 267(c)(4) of the Code. Individual J and Individual K are both employees of Corporation C. Pursuant to the attribution rules of section 267(c), Individual K is attributed 100 percent ownership of Corporation A, and both Individual J and Individual K are treated as 100 percent owners. However, Individuals J and K do not have any of the relationships to each other described in section 152(d)(2)(A)-(H) of the Code. Accordingly, wages paid by Corporation C to Individual J and Individual K in the first calendar quarter of 2021 may be treated as qualified wages if the amounts satisfy the other requirements to be treated as qualified wages.

EXAMPLE 4, NOTICE 2021-49, SECTION IV.D

Minority Shareholders, All Related

Corporation D is owned 34 percent by Individual L, 33 percent by Individual M, and 33 percent by Individual N. Individual L, Individual M, and Individual N are siblings. Corporation D is an eligible employer with respect to the first calendar quarter of 2021. Individual L, Individual M, and Individual N are employees of Corporation D. Pursuant to the attribution rules of section 267(c) of the Code, Individual L, Individual M, and Individual N are treated as 100 percent owners. Individual L, Individual M, and Individual N have the relationship to each

other described in section 152(d)(2)(B) of the Code. Accordingly, Corporation D may not treat as qualified wages any wages paid to Individual L, Individual M, or Individual N.

Timing of the Qualified Wages Deduction Disallowance

One real practical problem that many tax advisers ran into was determining when the reduction of deductible wages had to be taken into account for income tax purposes. Due to the major changes made to the ERC in December 2020, many employers are filing for refunds in 2021 for wages paid in 2020 and most are finding that the funds take substantial time to be received.

While many advisers may have been hoping the IRS would allow reducing the wage deduction in the year the refund is finally received, the IRS did not take that route in the Notice:

> Under section III.L. of Notice 2021-20, a reduction in the amount of the deduction allowed for qualified wages, including qualified health plan expenses, caused by receipt of the employee retention credit occurs for the tax year in which the qualified wages were paid or incurred. When a taxpayer claims the employee retention credit because of the retroactive amendment of section 2301 of the CARES Act by section 206(c) of the Relief Act (relating to eligibility of PPP borrowers to claim the employee retention credit) or otherwise files an adjusted employment tax return to claim the employee retention credit, the taxpayer should file an amended federal income tax return or administrative adjustment request (AAR), if applicable, for the taxable year in which the qualified wages were paid or incurred to correct any overstated deduction taken with respect to those same wages on the original federal tax return. Section 2301(e) generally provides, in relevant part, that rules similar to the rules of section 280C(a) of the Code shall apply. Section 280C(a) requires tracing to the specific wages generating the applicable credit. See, generally, Treas. Reg. § 1.280C-1. To satisfy this tracing requirement, the taxpayer must file an amended return or AAR, as applicable.[12]

Alternative Quarter Election for Calendar Year 2021 ERC Versions

Under both 2021 versions of the ERC, employers have a choice of testing either the current quarter or the immediately prior quarter for a 20% revenue reduction compared to the same quarter in 2019. If either of the testing quarters has the requisite reduction in revenue, then the employer can claim the ERC for the payroll quarter.

But if an employer used Quarter 1 of 2021's reduction in revenue to qualify for the ERC for the first quarter of 2021, is the employer barred from using that same first quarter decrease to qualify for the ERC in the second quarter? The IRS holds in the

[12] Notice 2021-49, Section IV.C

Notice that the taxpayer can still choose to look to either the prior or current quarter, regardless of what choice was made on the prior Form 941.

> As noted in section III.C. of Notice 2021-23, the determination of whether an employer is an eligible employer based on a decline in gross receipts is made separately for each calendar quarter. Thus, employers are not required to use the alternative quarter election consistently. For example, an employer may be an eligible employer due to a decline in gross receipts for the second quarter of 2021 if its gross receipts for the second quarter are equal to 75 percent of its gross receipts in the second quarter of 2019 (i.e., the employer does not rely on the alternative quarter election for the second quarter); the employer could then use the alternative quarter election to be an eligible employer for the third quarter of 2021.[13]

The practical effect of this means that if a taxpayer has a 20% drop in one quarter, the employer will automatically qualify for the ERC not just for the quarter with the drop in revenue, but also for the following quarter so long as the ERC has not expired prior to that following quarter.

Tips and the §45B Credit

The issue of how an employer is to treat tips for purposes of the ERC has been raised with the IRS, and the Notice seeks to clarify this issue:

> Section 3121(a)(12) of the Code excludes from the definition of "wages" tips paid in any medium other than cash and cash tips received by an employee in any calendar month in the course of employment by an employer unless the amount of the cash tips is $20 or more. Accordingly, if cash tips received by an employee in a calendar month amount to $20 or more, all of the cash tips received by the employee in that calendar month are included in wages. Similarly, section 3231(e)(3) of the Code provides that the term "compensation" includes cash tips received by an employee in any calendar month in the course of employment by an employer unless the amount of such cash tips is less than $20. Under section 3121(q), tips received by an employee in the course of the employee's employment are considered remuneration for that employment (i.e., wages) and are deemed to have been paid by the employer for purposes of the taxes imposed by section 3111(a) and (b) of the Code. Thus, for purposes of chapters 21 and 22 of the Code, cash tips of $20 or more in a month are treated as wages paid by the employer.[14]

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[13] Notice 2021-49, Section IV.E

[14] Notice 2021-49, Section IV.B

So long as the tips are treated as wages (that is, they are in cash and more than $20 in a calendar month), they will be qualified wages for the ERC so long as they otherwise qualify:

> Therefore, any cash tips treated as wages within the definition of section 3121(a) of the Code or compensation within the definition of section 3231(e)(3) of the Code are treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.[15]

The IRS Notice also provides that claiming the credit for certain tips under IRC §45B and the ERC on the same amounts is allowed:

> Section 2301 of the CARES Act and section 3134 of the Code cross-reference specific provisions in the Code, the CARES Act, the FFCRA, the Consolidated Appropriations Act, 2021, and the ARP that prevent the receipt of a double benefit with respect to wages for which the employee retention credit is claimed. Neither section 2301 nor section 3134 cross-references section 45B of the Code. Section 45B(c) denies a deduction under chapter 1 of the Code for any amount taken into account in determining the credit under section 45B; however, this provision does not prevent the receipt of both the employee retention credit and the section 45B credit for the same wages. Therefore, eligible employers are not prevented from receiving both the employee retention credit and the section 45B credit for the same wages.[16]

Full Time Employees and Full-Time Equivalents

The Notice clarifies the importance of full-time employees (as opposed to full-time equivalents) in applying the ERC rules:

> The Treasury Department and the IRS have been asked about the definition of "full-time employee" for the purpose of the employee retention credit, including (i) whether "full-time equivalents" (within the meaning of section 4980H(c)(2)(E) of the Code) are required to be included in the determination of whether an eligible employer is a large eligible employer or small eligible employer and (ii) whether wages paid to employees who are not full-time employees may be treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.[17]

The Notice reminds readers of the definition of a full-time employee for these purposes in a footnote:

> The term "full-time employee" means an employee who, with respect to any calendar month in 2019, had an average of at least 30 hours of service per week or 130 hours of service in the month (130 hours of

[15] Notice 2021-49, Section IV.B

[16] Notice 2021-49, Section IV.B

[17] Notice 2021-49, Section IV.A.

> service in a month is treated as the monthly equivalent of at least 30 hours of service per week), as determined in accordance with section 4980H of the Code. See Q/A-31 of Notice 2021-20 and section III.E. of Notice 2021-23.[18]

The Notice holds that for purposes of determining if an employer is a large or small employer, only full-time employees are considered:

> For purposes of determining whether an eligible employer is a large eligible employer or a small eligible employer, eligible employers are not required to include full-time equivalents when determining the average number of full-time employees.[19]

However, qualified wages are not limited to those paid to individuals who are full-time employees:

> However, for purposes of identifying qualified wages, an employee's status as a full-time employee is irrelevant and wages paid to an employee who is not full-time may be treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.[20]

Continued Application of the Gross Receipts Safe Harbor in Notice 2021-20 Into 2021

A safe harbor the IRS introduced for employers that acquired another business in 2020 will also apply to employers who acquire a business in 2021:

> Section III.E. of Notice 2021-20 permits an employer that acquires a business in 2020 to include the gross receipts of the acquired business in its gross receipts for 2019 to determine whether the employer experienced a significant decline in gross receipts. The safe harbor allows the employer to include the gross receipts of the acquired business regardless of the fact that the employer did not own the acquired business during a calendar quarter in 2019. The Treasury Department and the IRS have been asked whether this rule continues to apply to employers that acquire businesses in 2021. This rule continues to apply to employers that acquire businesses in 2021 for purposes of measuring whether a decline in gross receipts occurred.[21]

Similarly, the rule dealing with businesses that came into existence during the middle of a calendar quarter in 2019 found in Notice 2021-20 will apply to businesses that came into existence in 2020:

> The Treasury Department and the IRS have also been asked how to calculate gross receipts of employers that came into existence in the

[18] Notice 2021-49, Section IV.A.

[19] Notice 2021-49, Section IV.A.

[20] Notice 2021-49, Section IV.A.

[21] Notice 2021-49, Section IV.F

> middle of a calendar quarter in 2020. Section III.E. of Notice 2021-20 provides rules for determining gross receipts for an employer that came into existence in 2019. The same rule set forth in section III.E. of Notice 2021-20 continues to apply for 2021. For example, an employer that came into existence in the third quarter of 2020 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for the first three quarters in 2021 and should use the fourth quarter of 2020 for comparison to the fourth quarter of 2021 to determine whether it experienced a significant decline in gross receipts.[22]

Changes Made Related to the Credit for the Last Six Months of 2021 (IRC §3134)

The first section of the guidance discusses the changes in the ERC that apply for the last six months of 2021.[23]

Change in Applicable Employment Taxes Offset First by Credit

For reasons having to do with the trust fund tax penalties and other accounting issues, the ERC has always been used in the following order:

- First, to reduce the employer's share of certain payroll taxes imposed on the employer (but not those withheld from the employee) and then
- Second, any remaining balance is treated as refunded to the taxpayer, though the IRS has very reasonably allowed this refund to first be offset against the payroll tax deposits remaining due when the credit is claimed.[24]

For purposes of the credit from its inception in March 2020 through June 30, 2021, the credit was first used to offset the following employer payroll taxes:

> For purposes of the employee retention credit under the CARES Act, section 2301(c)(1) defines "applicable employment taxes" to mean the taxes imposed on employers by section 3111(a) of the Code (employer's share of the Old Age, Survivors, and Disability Insurance (social security tax)), or so much of the taxes imposed on employers by section 3221(a) of the Code (Tier 1 tax under the Railroad Retirement Tax Act (RRTA)) that are attributable to the rate in effect under section 3111(a). Section II.A. of Notice 2021-20 provides that, under section 2301, eligible employers are entitled to claim the employee retention credit against the employer's share of social security tax after these taxes are reduced by any credits claimed under sections 3111(e) and (f), sections 7001 and 7003 of the Families First Coronavirus

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[22] Notice 2021-49, Section IV.F

[23] At the time this written, Congress was considering bipartisan infrastructure legislation that would get a portion of the funds to pay for the additional spending by repealing this credit for the 4th quarter of 2021 except for recovery startup businesses.

[24] CARES Act Section 2301 and IRC §3134

> Response Act (FFCRA), Pub. L. No. 116-127, 134 Stat. 178 (2020), and section 303(d) of the Relief Act. Section II.A. of Notice 2021-20 further provides that, under section 2301, eligible employers subject to the RRTA are entitled to claim the employee retention credit against the portion of Tier 1 tax under the RRTA that is equivalent to the employer's share of social security tax after these taxes are reduced by any credits allowed under sections 7001 and 7003 of the FFCRA and section 303(d) of the Relief Act.[25]

The Notice points out that, beginning with the wages paid in June 2021, the taxes to be offset switch from the employer share of FICA (and the equivalent RRTA tax) to the Medicare taxes imposed on the employer:

> For purposes of the employee retention credit under section 3134 of the Code, section 3134(c)(1) defines "applicable employment taxes" to mean the taxes imposed under section 3111(b) of the Code (employer's share of Hospital Insurance (Medicare) tax), or so much of the portion of Tier 1 tax under the RRTA that is equivalent to the employer's share of Medicare tax. Section 3134(b)(2) provides that the credit allowed under section 3134(a) with respect to a calendar quarter will not exceed the applicable employment taxes, reduced by any credits allowed under sections 3131 and 3132 of the Code (tax credits under the ARP for qualified sick leave wages and qualified family leave wages, respectively, paid with respect to leave taken by employees beginning on April 1, 2021, through September 30, 2021), on the wages paid with respect to the employment of all the employees of the eligible employer for such calendar quarter. Section 3134(b)(3) provides that if any amount of the credit under section 3134(a) exceeds the limitation under section 3134(b)(2) for any calendar quarter, such excess will be treated as an overpayment that will be refunded under sections 6402(a) and 6413(b) of the Code.
>
> Accordingly, for the third and fourth quarters of 2021, eligible employers are entitled to claim the employee retention credit against the employer's share of Medicare tax, or the portion of Tier 1 tax under the RRTA that is equivalent to the employer's share of Medicare tax, after these taxes are reduced by any credits allowed under sections 3131 and 3132 of the Code, with the excess refunded under section 6402 or 6413 of the Code.[26]

For employers this will result in a change in the mechanics of reporting the credit on the Form 941 (the nonrefundable portion will offset employer Medicare, rather than social security, taxes), but not the ultimate result of effectively applying the credit against total payroll taxes withheld and imposed on the employer for the quarter.

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[25] Notice 2021-49, Section III.B.

[26] Notice 2021-49, Section III.B.

Limits on the Amount of the Credit

The Notice notes that while the maximum credit rules remain the same as for the ERC credit for first two quarters of 2021 (70% of qualified wages and health plan expenses with a limit of total costs counted of $10,000 per employee per quarter) for most employers, there is a new limit for recovery start-up businesses, discussed next.[27]

Recovery Startup Businesses

The Notice discusses the new category of "recovery startup businesses" eligible for the ERC in the third and fourth quarters of 2021.

The Notice begins with a broad discussion of the definition of a *recovery startup business* along with a summary of the special rules that apply to such businesses:

> Section 3134(c)(5) of the Code defines a "recovery startup business" as an employer (i) that began carrying on any trade or business after February 15, 2020, (ii) for which the average annual gross receipts of the employer (as determined under rules similar to the rules under section 448(c)(3) of the Code) for the 3-taxable-year period ending with the taxable year that precedes the calendar quarter for which the credit is determined does not exceed $1,000,000, and (iii) that is not otherwise an eligible employer due to a full or partial suspension of operations or a decline in gross receipts. Section 3134(b)(1)(B) provides that in the case of an eligible employer that is a recovery startup business, the amount of the credit allowed under subsection 3134(a) (after application of the limit under subsection 3134(b)(1)(A)) for each of the third and fourth calendar quarters of 2021 cannot exceed $50,000.[28]

The Notice moves on to the issue of how to determine the date when a taxpayer begins carrying on a trade or business:

> Section III.A. of Notice 2021-20 provides that for purposes of the employee retention credit, "trade or business" has the same meaning as when used in section 162 of the Code other than the trade or business of performing services as an employee. Section 3134(c)(5)(A) of the Code provides that a recovery startup business is an employer that began carrying on a trade or business after February 15, 2020. Therefore, the determination of when an employer "began carrying on a trade or business" is made in the same manner as for purposes of section 162. In general, for purposes of section 162, a taxpayer has not begun carrying on a trade or business "until such time as the business has begun to function as a going concern and performed those activities for which it was organized." *Richmond Television Corp. v. U.S.*, 345 F.2d 901, 907 (4th Cir. 1965), *vacated and remanded on other grounds per curiam*, 382 U.S. 68 (1965), *on remand*, 354 F.2d 410 (4th Cir. 1965),

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[27] Notice 2021-49, Section III.C

[28] Notice 2021-49, Section III.D.

> *overruled on other grounds*; *NCNB Corporation v. United States*, 684 F.2d 285 (4th Cir. 1982); see also Rev. Rul. 81-150, 1981-1 C.B. 119.[29]

The Notice points out the revenue limits that apply to such businesses and the time period in question:

> Section 3134(c)(5) of the Code indicates that the average annual gross receipts of an employer is determined by applying rules similar to the rules in section 448(c)(3) of the Code and that the 3-taxable-year period ends with the taxable year preceding the calendar quarter for which the employer is claiming the employee retention credit.[30]

The Notice continues on to provide guidance on applying the recovery startup business rules to an exempt organization under IRC §501(c).

> Section III.A. of Notice 2021-20 states that, for purposes of the employee retention credit, a tax-exempt organization described in section 501(c) of the Code that is exempt from tax under section 501(a) is deemed to be engaged in a "trade or business" with respect to all operations of the organization, as provided in section 2301(c)(2)(C) of the CARES Act. Similar to the rule in section 2301(c)(2)(C), section 3134(c)(2)(C)(i) provides that, in the case of an organization described in section 501(c) and exempt from tax under section 501(a), the requirement in section 3134(c)(2)(A)(i) of carrying on a trade or business to be an eligible employer and the requirement in section 3134(c)(2)(A)(ii)(I) that a trade or business has been fully or partially suspended due to an appropriate governmental order to be an eligible employer apply to all operations of the organization. Section 3134(c)(2)(C)(ii) further provides that, in the case of a tax-exempt organization, any reference to gross receipts will be treated as a reference to gross receipts within the meaning of section 6033 of the Code. While section 3134(c)(2)(C)(i) does not specifically reference the trade or business requirement in the definition of a recovery startup business in section 3134(c)(5)(A), because of the broad language in section 3134(c)(2)(C)(ii) for measuring gross receipts and the other language in section 3134(c)(2)(C)(i) indicating an intent by Congress to fully include tax-exempt organizations within the three categories of an eligible employer, the Treasury Department and the IRS have determined that it is appropriate for an organization described in section 501(c) and exempt from tax under section 501(a) to be able to be treated as an eligible employer due to being a recovery startup business based on all of its operations and average annual gross receipts determined under section 6033 as defined in section III.E. of Notice 2021-20.[31]

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[29] Notice 2021-49, Section III.D.

[30] Notice 2021-49, Section III.D.

[31] Notice 2021-49, Section III.D.

The Notice also indicates that, despite Congress failing to update the definition of *qualified wages* to include wages paid by a recovery startup business, the IRS will treat such wages as qualified wages:

> The Treasury Department and the IRS have also determined that it is appropriate for the term "qualified wages" to include wages paid by a recovery startup business. The definition of "qualified wages" in section 3134(c)(3)(A) of the Code is identical to the definition in section 2301(c)(3)(A) of the CARES Act. Section 3134(c)(3)(A)(i), the large eligible employer rule, defines qualified wages as wages paid with respect to which an employee is not providing services due to circumstances described in section 3134(c)(2)(A)(ii)(I) (relating to a full or partial suspension) or section 3134(c)(2)(A)(ii)(II) (relating to a decline in gross receipts). Section 3134(c)(3)(A)(ii), the small eligible employer rule, defines qualified wages as wages paid during any period described in section 3134(c)(2)(A)(ii)(I) (relating to a full or partial suspension) or paid with respect to any employee during a quarter described in section 3134(c)(2)(A)(ii)(II) (relating to a decline in gross receipts). Neither the large eligible employer rule in section 3134(c)(3)(A)(i) nor the small eligible employer rule in section 3134(c)(3)(A)(ii) was updated to include section 3134(c)(2)(A)(ii)(III) (relating to a recovery startup business). Thus, the language of the statute does not include a definition of qualified wages applicable to a recovery startup business. However, the inclusion of recovery startup businesses as a new category of eligible employer and the provision of a specific limitation on the amount of the employee retention credit to which recovery startup businesses are entitled indicates that Congress intended that this new category of eligible employer be able to claim the employee retention credit. In order to carry out this intent, the Treasury Department and the IRS have concluded that it is appropriate to read the small eligible employer rule in section 3134(c)(3)(A)(ii)(II) as if section 3134(c)(2)(A)(ii)(III) were included after the reference to section 3134(c)(2)(A)(ii)(II). Accordingly, in the third and fourth calendar quarters of 2021, a recovery startup business that is a small eligible employer within the meaning of section 3134(c)(3)(A)(ii) may treat all wages paid with respect to an employee during the quarter as qualified wages.[32]

An employer tests whether it is a recovery startup business on a quarter-by-quarter basis per the Notice:

> The determination of whether an employer is a recovery startup business is made separately for each calendar quarter. For example, if an eligible employer is a recovery startup business in the third quarter of 2021 but is not a recovery startup business in the fourth quarter of 2021 because it is an eligible employer due to a full or partial suspension or a decline in gross receipts during the fourth quarter of

[32] Notice 2021-49, Section III.D.

> 2021, the $50,000 limitation applies to the third quarter of 2021 but does not apply to the fourth quarter of 2021.[33]

The Notice also provides that the aggregation rules discussed in Notice 2021-20 will apply for determining if a business is a recovery startup business:

> The aggregation rules described in section III.B. of Notice 2021-20 apply when determining whether an employer's trade or business is fully or partially suspended or the employer experiences a decline in gross receipts. Similarly, the aggregation rules described in section III.B. of Notice 2021-20 apply when determining if an employer is a recovery startup business. The aggregation rules also apply with respect to the $50,000 limitation on the credit.[34]

Qualified Wages

The Notice goes on to discuss the changes to qualified wages that apply for the 3rd and 4th quarter ERC. While these changes won't affect most employers, they will allow some employers to claim the credit or qualify for an increased credit as compared to the prior qualified wage rules.

The Notice first discusses the special rules added for employers not in existence during 2019:

> Section 3134(c)(3)(A) of the Code defines the term "qualified wages" and provides the distinction in treatment between large eligible employers and small eligible employers. Section 3134(c)(3)(B) provides that in the case of any employer that was not in existence in 2019, section 3134(c)(3)(A) is applied by substituting "2020" for "2019" each place it appears and requires eligible employers not in existence in 2019 to determine the average number of full-time employees in 2020 instead of 2019. Section III.G. of Notice 2021-20 provides rules for determining the average number of full-time employees, including for employers that came into existence in 2020. Accordingly, the rules set forth in section III.G. of Notice 2021-20 for determining the average number of full-time employees continue to apply in the third and fourth calendar quarters of 2021.[35]

The Notice also discusses the new category of *severely financially distressed employers* which enables certain employers that would normally be limited to claiming the credit only for employees that were not performing services to claim the credit regardless of whether the employee performed services:

> Section 3134(c)(3)(C) of the Code provides a different rule for qualified wages paid by "severely financially distressed employers."

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[33] Notice 2021-49, Section III.D.

[34] Notice 2021-49, Section III.D.

[35] Notice 2021-49, Section III.E.

> Section 3134(c)(3)(C)(ii) defines a "severely financially distressed employer" as an employer that is an eligible employer based on a decline in gross receipts, but the gross receipts for the eligible employer for the calendar quarter are less than 10 percent of the gross receipts as compared to the same calendar quarter in calendar year 2019, instead of less than 80 percent.
>
> Accordingly, for purposes of the employee retention credit for the third and fourth calendar quarters of 2021, an eligible employer with gross receipts that are less than 10 percent of the gross receipts for the same calendar quarter in calendar year 2019 (or 2020, if the employer was not in existence in 2019) is a severely financially distressed employer.[36]

The Notice goes on to outline how an employer determines if it has a qualifying decline in gross receipts for purposes of qualifying as a *severely financially distressed employer*:

> The rules for how an employer determines whether it has experienced a decline in gross receipts for purposes of the employee retention credit are set forth in section III.C. of Notice 2021-23. Whether an employer has met the decline in gross receipts test generally is determined by comparing the quarter in 2020 or 2021 to the same quarter in 2019. Notice 2021-23 also provides rules that address the circumstance in which the employer was not in existence as of the beginning of a calendar quarter in 2019 and rules for how an employer may elect to use an alternative quarter to determine whether it has experienced a decline in gross receipts. These rules that apply for purposes of determining whether an employer is an eligible employer based on a decline in gross receipts also apply, in the third and fourth calendar quarters of 2021, for purposes of determining whether an eligible employer is a severely financially distressed employer based on the 10 percent threshold. For example, an eligible employer that has gross receipts of 5 percent in the second quarter of 2021 compared to gross receipts in the second quarter of 2019 is a severely financially distressed employer for the third quarter of 2021 based on the alternative quarter election.[37]

In a footnote, the IRS also addresses an ambiguity in the law regarding *when* the qualifying wages need to be paid for a severely financially distressed employer:

> The language of section 3134(c)(3)(C)(i) of the Code is ambiguous as to the calendar quarter in which wages paid by a severely financially distressed employer may be treated as qualified wages. Due to the reference to section 3134(c)(3)(A)(i) of the Code, however, the Treasury Department and the IRS have determined that Congress intended section 3134(c)(3)(C)(i) to extend the small eligible employer

[36] Notice 2021-49, Section III.E.

[37] Notice 2021-49, Section III.E.

> rule to a severely financially distressed employer that is also a large eligible employer, and not to change the timing of when qualified wages are paid for purposes of claiming the employee retention credit. Therefore, a severely financially distressed employer may claim the employee retention credit only with respect to qualified wages the employer paid in the same calendar quarter in which it is claiming the credit.[38]

The Notice provides the following example of the financially distressed employer rules in action:

EXAMPLE, NOTICE 2021-49, SECTION III.D.

Employer A is a large eligible employer with gross receipts in the third quarter of 2021 equal to 15 percent of its gross receipts in the third quarter of 2019. Employer A is not a severely financially distressed employer for the third quarter of 2021 based on the third quarter's gross receipts. However, Employer A's gross receipts in the second quarter of 2021 are less than 10 percent of its gross receipts in the second quarter of 2019; therefore, Employer A may elect to use the alternative election rule to meet the definition of a severely financially distressed employer under section 3134(c)(3)(C)(ii) of the Code in the third quarter of 2021.

In the third quarter of 2021, Employer A pays Employee B $10,000 in wages for services Employee B provided during the third quarter. Employer A may claim the employee retention credit in the third quarter of 2021 (the quarter in which Employer A is determined to be severely financially distressed under the alternative election rule) and may treat all of the wages paid to Employee B during the third quarter of 2021 as qualified wages.

In the fourth quarter of 2021, Employer A's gross receipts equal 20 percent of its gross receipts in the fourth quarter of 2019. Employer A is not a severely financially distressed employer for the fourth quarter of 2021 based on the fourth quarter's gross receipts. In addition, Employer A cannot use the alternative election rule in the fourth quarter of 2021 to qualify as a severely distressed employer because Employer A's gross receipts in the third quarter of 2021 are not less than 10 percent of its gross receipts in 2019; therefore, Employer A is not a severely financially distressed employer (though it is still an eligible employer) in the fourth quarter of 2021.

Employer A pays Employee B $10,000 in wages in the fourth quarter of 2021 for services Employee B provided during the fourth quarter of 2021. Employer A may not treat any of the wages paid to Employee B for services provided during the fourth quarter as qualified wages because Employer A is a large eligible employer and does not meet the definition of a severely financially distressed employer for the fourth quarter of 2021.

Coordination with Certain Tax Credits and Programs

The 3rd and 4th quarter ERC has somewhat modified rules for coordination with certain tax credits and other federal programs.

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[38] Notice 2021-49, Section III.E., Footnote 4

The Notice explains the rule that applies with regard to wages taken into consideration for certain tax credits:

> Section 3134(c)(3)(D) of the Code provides that for the third and fourth calendar quarters of 2021, the term "qualified wages" does not include any wages taken into account under sections 41, 45A, 45P, 45S, 51, 1396, 3131, and 3132 of the Code. That is, if wages are taken into account for purposes of those sections, those wages cannot be taken into account for purposes of the employee retention credit.[39]

A footnote explains how this differs from the prior versions of the ERC:

> These Code sections, with the exception of sections 3131 and 3132, were included in the denial of double benefit provisions for the first and second calendar quarters of 2021 and applied in the inverse order, meaning that any wages taken into account as qualified wages for the employee retention credit could not be taken into account for those sections. See section III.E. of Notice 2021-23.[40]

Wages taken into account under various federal relief programs are also removed from qualified wages for purposes of the 3rd and 4th quarter ERC. The Notice begins by holding that the same rules provided in Notice 2021-20 will continue to apply for wages used to apply for forgiveness for Paycheck Protection Program loans.

> Section III.I. of Notice 2021-20 provides rules related to the interaction between PPP loans and the employee retention credit; under those rules, the employee retention credit does not apply to the qualified wages for which an election or deemed election to not take the wages into account for purposes of the credit is made. These rules are derived from section 2301(g)(1) and (g)(2) of the CARES Act, as amended by the Relief Act. Section 3134(g) of the Code retains the same language as section 2301(g)(1) of the CARES Act and section 3134(h)(1) and (h)(2) is similar in operation to section 2301(g)(1) and (g)(2); accordingly, the rules related to the interaction between PPP loans and the employee retention credit under section III.I. of Notice 2021-20 continue to apply in the third and fourth calendar quarters of 2021. Thus, the determination of whether section 3134 applies to amounts of qualified wages taken into account as payroll costs for PPP loans for purposes of section 3134(h)(1)(A) and (h)(2) are made in the same manner and under the same principles as prescribed in section III.I. of Notice 2021-20.[41]

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[39] Notice 2021-49, Section III.E (It appears that this discussion should have been in the next section, but in the original published Notice this discussion comes immediately after the discussion of the severely financially distressed employer rules.)

[40] Notice 2021-49, Section III.E., Footnote 6

[41] Notice 2021-49, Section III.F.

The Notice outlines the similar rules that apply to employers who obtained a restaurant revitalization grant or a shuttered venue operators grant.

> The shuttered venue operators grant was established by section 324 of the Economic Aid to Hard-Hit Small Businesses, Non-Profits, and Venues Act and amended by the ARP. The restaurant revitalization grant was established by the ARP. Coordination between the employee retention credit and these grants is not required under section 2301 of the CARES Act, which governs the employee retention credit for 2020 and the first two quarters of 2021. However, pursuant to section 3134(h)(1)(B) and (C) of the Code, an eligible employer receiving a shuttered venue operators grant or restaurant revitalization grant may not treat any amounts reported to the Small Business Administration (SBA) or otherwise taken into account as payroll costs in connection with either program as qualified wages for purposes of the employee retention credit in the third and fourth quarters of 2021. An eligible employer receiving a shuttered venue operators grant or restaurant revitalization grant must retain in its records support for the employee retention credit claimed, which includes any documentation supporting that the eligible employer did not claim the employee retention credit on amounts taken into account as payroll costs paid in the third and fourth quarters of 2021 in connection with the shuttered venue operators grant or restaurant revitalization grant programs.[42]

Extended Statute of Limitations on 3rd and 4th Quarter ERC

The Notice points out that there is an extended five-year statute of limitations on the IRS assessing an amount attributable to a 3rd or 4th quarter ERC that does not apply to the earlier versions of the credit:

> Section 3134(l) of the Code extends the limitation on assessment. Section 3134(l) provides that, notwithstanding section 6501 of the Code, the limitation on the time period for the assessment of any amount attributable to a credit claimed under section 3134 will not expire before the date that is 5 years after the later of (i) the date on which the original return that includes the calendar quarter with respect to which the credit is determined is filed, or (ii) the date on which the return is treated as filed under section 6501(b)(2). The extension of limitation on assessment applies to the employee retention credit claimed for the third and fourth calendar quarters of 2021 under section 3134 but does not apply to the employee retention credit under section 2301 of the CARES Act.[43]

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[42] Notice 2021-49, Section III.F.

[43] Notice 2021-49, Section III.G.

SECTION: 170
IRS MEMORANDUM INDICATES LIMITS ON THE TERMS OF CONSERVATION EASEMENTS

Citation: CCA 202130014, 7/30/21

In CCA 202130014[44] the IRS Chief Counsel's office discussed the issues related to conservation easement extinguishment, stating that the requirements prevent an easement with an extinguishment clause that removes post-donation increases in property values due to post-donation improvements from the calculation of the charity's share of such proceeds from qualifying for a charitable deduction under IRC §170(h).

The CCA states the issue to be addressed as follows:

> Does a conservation easement fail to satisfy the requirements of section 170(h) of the Code if the deed contains language subtracting from the donee's extinguishment proceeds the value of post-donation improvements or the post-donation increase in value of the property attributable to improvements?[45]

The memorandum describes the requirements under the IRC for a qualified conservation easement eligible for a charitable deduction as follows:

> Section 170(h)(1) defines the term "qualified conservation contribution" as a contribution (A) of a qualified real property interest, (B) to a qualified organization, (C) exclusively for conservation purposes. Section 170(h)(2) defines the term "qualified real property interest" as any of the following interests in real property: (A) the entire interest of the donor other than a qualified mineral interest, (B) a remainder interest, and (C) a restriction (granted in perpetuity) on the use which may be made of the real property. Section 170(h)(4) defines the term "conservation purpose." Section 170(h)(5)(A) provides that a contribution shall not be treated as exclusively for conservation purposes unless the conservation purpose is protected in perpetuity. A conservation easement must meet both of these perpetuity requirements, meaning the property interest must be granted in perpetuity under section 170(h)(2)(C) and enforceable in perpetuity under section 170(h)(5)(A).[46]

In the real world, situations may arise (say due to a government acquiring the land under eminent domain) where, regardless of the easement, the property may no longer

[44] CCA 202130014, July 30, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/irs-explains-easement-extinguishment-requirements/76ygb (retrieved July 30, 2021)

[45] CCA 202130014, July 30, 2021

[46] CCA 202130014, July 30, 2021

be possible or practical to hold for easement purposes. Reg. §1.170A-14(g)(6) deals with these cases. The memorandum describes the general requirements as follows:

> Treasury Regulation § 1.170A-14(g)(6)(i) provides that if conditions surrounding the property unexpectedly change, and if those changes make continued use of the property for conservation purposes impossible or impractical, then the conservation purpose can nonetheless be treated as protected in perpetuity if the easement is extinguished by judicial proceeding and the donee organization uses all of its proceeds from the sale or exchange of the property in a manner that is consistent with the original contribution's conservation purposes.[47]

The memorandum continues describing how this is to be accomplished:

> Treasury Regulation § 1.170A-14(g)(6)(ii) sets forth requirements for the distribution of proceeds in the event the easement is extinguished. It provides that, for a deduction to be allowed, at the time of the gift, the donor must agree that the donation of the perpetual conservation restriction gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction at the time of the gift bears to the value of the property as a whole at that time. That proportionate value of the donee's property rights must remain constant. As such, if the easement is extinguished, the donee organization must be entitled to a portion of the proceeds at least equal to the proportionate value of the perpetual conservation restriction, unless state law provides that the donor is entitled to the full proceeds from the conversion without regard to the terms of the prior perpetual conservation restriction. The regulation states that the donor must agree to these requirements at the time of the donation for the donor to be eligible to claim a charitable contribution deduction.[48]

The memorandum indicates that the Tax Court has held that attempting to reduce the proceeds to the charity for improvements violates these rules:

> The Tax Court has held that the requirements of Treas. Reg. § 1.170A-14(g)(6)(i) and (ii) are strictly construed; if a grantee is not absolutely entitled to a proportionate share of extinguishment proceeds, then the conservation purpose of the contribution is not protected in perpetuity. *Carroll v. Commissioner*, 146 T.C. 196, 212 (2016). Reducing the portion of the grantee's proceeds by the value of any post-donation improvements or any post-donation increase in value of the property attributable to improvements reduces the grantee's proportionate share of proceeds and violates Treas. Reg. § 1.170A-14(g)(6)(ii) unless state law provides that the donor is entitled to the full proceeds from the extinguishment. See *PBBM-Rose Hill, Ltd. v.*

[47] CCA 202130014, July 30, 2021

[48] CCA 202130014, July 30, 2021

> *Commissioner*, 900 F.3d 193, 208 (5th Cir. 2018); *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126, 144 (2019).[49]

The CCA holds that, therefore, such a clause will be fatal to the claim of a charitable deduction for the donation of such an easement:

> Decreasing the portion of the proceeds that is required to be allocated to the donee upon extinguishment under Treas. Reg. § 1.170A-14(g)(6)(ii) causes the easement to fail to satisfy the requirements of section 170(h) unless, as provided in Treas. Reg. § 1.170A-14(g)(6)(ii), state law provides that the donor is entitled to the full proceeds from the conversion.[50]

The CCA does offer suggested language that would not cause this issue:

> Language in a conservation easement deed that closely adheres to the language of Treas. Reg. § 1.170A-14(g)(6)(ii) generally will not cause a deed to violate the enforceability in perpetuity requirements. For an example, see the following sample conservation easement deed language:
>
>> Donor agrees that the donation of the perpetual conservation restriction described in this deed gives rise to a property right, immediately vested in the donee organization, with a fair market value that is at least equal to the proportionate value that the perpetual conservation restriction, at the time of the gift, bears to the fair market value of the property as a whole at that time. For purposes of this paragraph, the proportionate value of the donee organization's property rights shall remain constant.
>>
>> On a subsequent sale, exchange, or involuntary conversion of the subject property, the donee organization will be entitled to a portion of the proceeds at least equal to that proportionate value of the perpetual conservation restriction.
>>
>> All of the donee organization's proceeds from a subsequent sale or exchange of the property must be used by the donee organization in a manner consistent with the conservation purposes of the original contribution.[51]

[49] CCA 202130014, July 30, 2021

[50] CCA 202130014, July 30, 2021

[51] CCA 202130014, July 30, 2021

SECTION: 1402
ELEVENTH CIRCUIT AFFIRMS TAX COURT RULING THAT AUTHOR HAD TO TREAT ALL OF HER PUBLISHING CONTRACT INCOME AS SELF-EMPLOYMENT INCOME

Citation: Slaughter v. Commissioner, No. 20-10786, CA 11, 8/3/21

The Eleventh Circuit Court of Appeals upheld the Tax Court's decision regarding self-employment income in the case of *Slaughter v. Commissioner*.[52] In this case, an author argued that most of the income she received from her publishing contract was for activities other than the time she spent writing books. She argued that payments for anything other than time spent writing a book was not income from a trade or business for self-employment tax purposes.

The case involves bestselling crime fiction author Karin Slaughter. The opinion describes her income received from her publishing contracts as follows:

> During the years relevant to this appeal, Slaughter received income for her books through contracts with publishers. Her contractual obligations varied with the publisher. For English-language publishers, Slaughter was required to write an original manuscript for a book. If the manuscript was delivered to and accepted by the publisher, she received a fixed advance payment in installments specified in her contract. Slaughter also received royalties or subsidiary rights income from those sales if they exceeded her advance. For foreign-language publishers, Slaughter also received similar advances in exchange for the right to print, publish, and sell a foreign-language translation of one of her existing books.
>
> Since signing her first publishing contract in 1999, Slaughter has retained the same literary agent to help promote her work with publishers, booksellers, and book reviewers. Slaughter and her agent promote her brand in several ways: maintaining contact with her readership through her website, newsletter, and social media presence; giving interviews; attending promotional and publicity events; giving gifts to business associates and inviting publishers to stay with her in her home; renting an apartment in New York City to attend trade shows and meet publishers there; and paying for a promotional bus poster. Significantly, Slaughter claimed business-expense deductions for all of those activities on her income tax returns for 2010 and 2011.[53]

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[52] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/eleventh-circuit-affirms-author-is-liable-for-self-employment-taxes/76zkq (retrieved August 3, 2021)

[53] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

For the two years involved in the case, Ms. Slaughter received income of over $5.4 million and $3.6 million from her publishing work. On her return, this income was divided between business and non-business income using the following method:

> In allocating Slaughter's publishing income for both returns, her accountants began with the fact that she took 12 to 15 weeks to write a book and wrote approximately one book per year. For her 2010 return, they assumed that Slaughter worked five days a week for 12 weeks, meaning that she worked 60 days that year. And because 60 days is about 16.43% of a 365-day year, they reported that percentage of Slaughter's publishing income as her gross business income. For her 2011 return, they used the same method but calculated a higher percentage of publishing income to report as her gross business income because Slaughter had spent more time writing that year.[54]

The IRS objected to this division of income, finding that all of the income she received was derived from her trade or business of writing books. The United States Tax Court agreed with the IRS, treating all income received by Ms. Slaughter on these contracts as self-employment income. Ms. Slaughter appealed the decision to the Eleventh Circuit Court of Appeals.

Ms. Slaughter argued that her promotional activities should not be treated as part of her trade or business.

> Here, Slaughter argues that her trade or business does not include promotional activities because they were only sporadic and occasional rather than continuous and regular. And she further argues that when the tax court found otherwise, it failed to provide specific details about the time, duration, and frequency of her promotional activities or explain why those activities were continuous and regular in 2010 and 2011.[55]

As the opinion notes, Ms. Slaughter is correct that an activity that is sporadic will not rise to the level of a trade or business:

> Section 1402(c) defines "[t]he term 'trade or business,' when used with reference to self-employment income or net earnings from self-employment" to "have the same meaning as when used in section 162" of the Tax Code, with limited exceptions that are not applicable to this appeal. 26 U.S.C. § 1402(c). The Supreme Court has held that to be engaged in a trade or business under Section 162, "the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit." *Comm'r v. Groetzinger,* 480 U.S. 23, 35 (1987). "A sporadic activity, a hobby, or an amusement diversion does not qualify." *Id.*[56]

[54] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

[55] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

[56] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

However, the panel did not agree with her view that this applied to her promotional activities:

> First, determining whether an activity is sufficiently continuous and regular to constitute a trade or business "requires an examination of the facts in each case." Id. at 36 (quoting *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941)). Consequently, we review the tax court's findings on that issue for clear error. "A factual finding is clearly erroneous when a review of the entire record leaves us with the definite and firm conviction that a mistake has been committed." *Berenguela-Alvarado v. Castanos*, 950 F.3d 1352, 1357 (11th Cir. 2020) (internal quotation marks omitted). Yet whatever doubts might exist about the tax court's findings here, they rise nowhere near the level of certainty required for clear error.

One key problem the panel pointed out was the fact that Ms. Slaughter claimed deductions related to expenses incurred for her promotional activities—deductions that could only have been allowed as trade or business expenses under IRC §162(a):

> For example, Slaughter's prior business-expense deductions amply support the tax court's finding. As the IRS noted throughout the proceedings below, those deductions were for (1) the rent for Slaughter's New York apartment that she used when going to trade shows and meeting with publishers, (2) payments for a car — which was the same model used by her main character Sara Linton — that she drove to interviews and promotional and networking events, (3) catering expenses and gifts for business associates, and (4) expenses for advertising, her website, and "promotions." Slaughter could not have claimed deductions for those expenses unless they were paid or incurred "in carrying on any trade or business." 26 U.S.C. § 162(a). That Slaughter deducted these expenses illustrates that the promotion of her written work was part of her writing business. Indeed, the promotion and sale of books is a key factor distinguishing a writing business, which one engages in for income and profit, from a writing hobby.[57]

The Court also found that Ms. Slaughter had conceded that writing was conducted frequently enough to rise to a trade or business even though she spent relatively small amounts of time writing each year, less than she spent on the promotional activities she argued were sporadic:

> Second, Slaughter's insistence that her promotional activities were interrupted and not full time — and therefore too sporadic and occasional to be a part of her trade or business — is inconsistent with her own position. Although Slaughter maintains that her trade or business is limited to the physical labor of writing — the act of putting pen to paper or finger to key — she spent only approximately 16 and 25 percent of 2010 and 2011, respectively, engaged in that labor. By Slaughter's own definition, her writing — an indisputably core part of

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[57] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

> her trade or business — would qualify only as "sporadic and occasional." Both common sense and Slaughter's own position therefore require that her promotional activities be considered part of her trade or business. *Helvering v. Horst*, 311 U.S. 112, 118 (1940) ("Common understanding and experience are the touchstones for the interpretation of the revenue laws.").[58]

Ms. Slaughter also argued that even if promotion was part of her trade or business, the IRS failed to show the entire amount of her publishing income was sufficiently connected with the trade or business to be self-employment income:

> Slaughter also argues that the tax court erred in finding that all of her publishing income in 2010 and 2011 was derived from her trade or business. This argument differs from her first argument: the fact that Slaughter's promotional activities were a part of her trade or business does not automatically mean that all of her publishing income was derived from her trade or business.[59]

The opinion goes on to explain what would be necessary to show that income is related to a trade or business:

> We have held that for self-employment income to be derived from a trade or business, "there must be a nexus between the income received and a trade or business that is, or was, actually carried on." *Peterson*, 827 F.3d at 986 (cleaned up). Additionally, "the income must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer before such income becomes subject to self-employment taxes." *Id.* (cleaned up). Nonetheless, "[t]he self-employment tax provisions are broadly construed to favor treatment of income as earnings from self-employment." *Id.* (quoting *Bot v. Comm'r*, 353 F.3d 595, 599 (8th Cir. 2003)).[60]

Ms. Slaughter argues that income from her intangible assets is not self-employment income, lacking sufficient nexus to the writing business:

> Here, Slaughter argues that income from her intangible assets — specifically the rights to her name and likeness, access to her readership, the right to use characters from her previous books, and noncompetition agreements — is not subject to self-employment tax because there is no nexus between that income and her trade or business. In support of this argument, she cites a Ninth Circuit decision stating that the nexus test is satisfied only if the "earnings [are] tied to the quantity or quality of the taxpayer's prior labor, rather than the mere fact that the taxpayer worked or works for the payor." *Milligan v. Comm'r*, 38 F.3d 1094, 1098 (9th Cir. 1994).[61]

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[58] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

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The panel first points out that the Eleventh Circuit only has applied *Milligan* in the specific type of situation that existed in that case—which was not that of being author:

> We have declined to apply the Ninth Circuit's quantity-or-quality test beyond the context of post-termination payments to insurance agents. See *Peterson*, 827 F.3d at 992–93 (describing *Milligan* as "nonbinding," "distinguish[ing] [that] insurance case[ ] on at least four bases," and concluding that "the after-termination payments of insurance salesmen" in that case were not "comparable" outside its facts).[62]

As well, the opinion goes on to hold that even if the Ninth Circuit's test was to be applied in this situation, Ms. Slaughter would still not prevail:

> And even if the Ninth Circuit's test did apply here, we think that all of Slaughter's publishing income — including the portions from her intangible assets — readily satisfies it. If Slaughter ceased to write or promote her books, then her brand and success as an author would be affected. If she were not writing books, publishers would pay less — or even nothing — for her name and likeness, access to her readership, the right to use her characters, and her agreements not to compete.[63]

The panel found that the licensing of her likeness and name was tied directly to her writing of books:

> Regarding her name and likeness, she avers that their licensing "can[not] be reasonably described as used predominantly for profit rather than as a personal right." She then concludes that income from that licensing cannot be derived from her trade or business because trade or business activity must have the primary purpose of profit. Although she is correct that trade or business activity must be primarily profit-motivated, there is no reason to believe that Slaughter — a longtime bestselling author who has earned millions of dollars from her books — licensed her name and likeness for use on books and related materials for any purpose other than increasing her profit.[64]

Similarly, the panel did not find that she could carve out a portion of her contracts related to a non-competition clause from self-employment income given the nature of such clauses in her contracts:

> As for her noncompetition agreements, Slaughter avers that income from an agreement not to compete does not derive from a trade or business. But the supporting caselaw that Slaughter cites in fact undermines her assertion. As she correctly notes, the tax court has previously addressed "whether noncompetition under a covenant not to compete constitutes a trade or business[.]" *Ohio Farm Fed'n, Inc. v.*

[62] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

[63] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

[64] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021

> *Comm'r*, 106 T.C. 222, 234 (1996). But contrary to her suggestion, the tax court did not categorically exclude such noncompetition from being a trade or business. Instead, it held that the standard continuity-and-regularity test applied and concluded that in the case before it, "a one-time agreement not to engage in certain activities" did not constitute "the kind of continuous and regular activity characteristic of a trade or business." *Id.* But Slaughter's noncompetition agreements were not one-time events — noncompetition clauses appeared in every American contract that she signed. Moreover, the clauses for the most part did not prevent Slaughter from writing for other publishers — they merely required her to complete the contracted books first. Consequently, we cannot say that the tax court erred in determining that Slaughter's income from her noncompetition agreements was derived from her trade or business.[65]

Thus, the panel sustained the Tax Court's finding that all her publishing income was self-employment income.

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[65] *Slaughter v. Commissioner*, No. 20-10786, CA 11, August 3, 2021