Current Federal Tax Developments

Week of June 8, 2020

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ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JUNE 8, 2020
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Kaplan Financial Education

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SECTION: PPP LOAN
PAYROLL PROTECTION PROGRAM FLEXIBILITY ACT OF 2020 ENACTED INTO LAW

Citation: Paycheck Protection Program Flexibility Act of 2020, 6/4/20

Congress has now passed the Paycheck Protection Program Flexibility Act of 2020 (PPPFA),[1] with the Act passing the Senate by unanimous consent in the early evening hours of June 3, 2020. The Act changes a number of provisions in the original PPP loan program enacted as part of the CARES Act. The President signed the bill into law on June 5, 2020 (the date of enactment).

Change in Loan Maturity

The SBA had previously provided that PPP loans would have a 2-year maturity, even though the law provided for a maximum maturity of up to 10 years. Congress has now modified the law to provide that PPP loans will have a minimum maturity of 5 years.[2]

The Act provides the following effective date for this provision:

> The amendment made by this section shall take effect on the date of the enactment[3] of this Act and shall apply to any loan made pursuant to section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)) on or after such date. Nothing in this Act, the CARES Act (Public Law 116–136), or the Paycheck Protection Program and Health Care Enhancement Act (Public Law 116–139) shall be construed to prohibit lenders and borrowers from mutually agreeing to modify the maturity terms of a covered loan described in subparagraph (K) of such section to conform with requirements of this section.[4]

Thus, while lenders and borrowers are not required to modify loans to provide for a longer payment period, the law will allow such a modification to be made.

Covered Period Extension for a PPP Loan

The Act has modified the *covered period* in the PPP loan program definition found at Small Business Act §7(a)(36)(A)(iii) to change the ending date from June 30, 2020 to

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[1] HR 7010, "Paycheck Protection Program Flexibility Act of 2020," Passed United States Senate June 3, 2020, https://www.congress.gov/bill/116th-congress/house-bill/7010/text (retrieved June 3, 2020)

[2] HR 7010, Act Section 2(a)

[3] June 5, 2020

[4] HR 7010, Act Section 2(b)

December 31, 2020.[5] The covered period in this section now runs from February 15, 2020 to December 31, 2020. A *covered loan* is a loan made under this program during the covered period, and this covered period is referenced in other portions of the PPP loan provisions found in the CARES Act Section 1102.

Forgiveness Changes

The separate CARES Act Section 1106 *covered period* is also modified by the PPPFA. Under the CARES Act this covered period was the 8-week period beginning with the date of origination of the PPP loan. The date of origination was later defined by the SBA as the date that funds were received by the borrower from the loan. This *covered period* is the period that a borrower had to spend the funds for appropriate uses to obtain forgiveness.

Under the revised rule, that period is now tripled for most loans. The new provision reads:

> (3) the term 'covered period' means, subject to subsection (l), the period beginning on the date of the origination of a covered loan and ending the earlier of—
>
> (A) the date that is 24 weeks after such date of origination; or
>
> (B) December 31, 2020[6]

However, as noted above, "subsection (l)" modifies this period to allow those who had the PPP loans before this revision was passed to retain the 8-week covered period. That provision provides:

> An eligible recipient that received a covered loan before the date of enactment[7] of this subsection may elect for the covered period applicable to such covered loan to end on the date that is 8 weeks after the date of the origination of such covered loan. [8]

Why would a borrower want an 8-week period rather than a 24-week period? A key reason is that the FTE reduction rule measures average FTEs during the covered period. So while 24 weeks gives borrowers a longer period during which they can spend the money and qualify for forgiveness, it also increases the period over which the employer

- Must maintain the FTE level under CARES Act Section 1106(d)(2) and
- Must avoid a reduction of salary and wages under CARES Act Section 1106(d)(3)

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[5] HR 7010, Act Section 3(a)

[6] HR 7010, Section 3(b)(1)

[7] June 5, 2020

[8] HR 7010, Section 3(b)(3)

if the employer cannot meet the restoration of FTEs and salary/wages under CARES Act Section 1106(d)(5). The restoration deadline under that section is moved by the PPPFA from June 30, 2020 to December 31, 2020.[9]

Added Exemption Based on Employee Availability

The PPPFA adds a new relief provision that will prevent a reduction in forgiveness in additional circumstances.

The new provision, found at revised CARES Act Section 1106(d)(7), provides:

> (7) EXEMPTION BASED ON EMPLOYEE AVAILABILITY.—During the period beginning on February 15, 2020, and ending on December 31, 2020, the amount of loan forgiveness under this section shall be determined without regard to a proportional reduction in the number of full-time equivalent employees if an eligible recipient, in good faith—
>
> > (A) is able to document—
> >
> > > (i) an inability to rehire individuals who were employees of the eligible recipient on February 15, 2020; and
> > >
> > > (ii) an inability to hire similarly qualified employees for unfilled positions on or before December 31, 2020; or
> >
> > (B) is able to document an inability to return to the same level of business activity as such business was operating at before February 15, 2020, due to compliance with requirements established or guidance issued by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration during the period beginning on March 1, 2020, and ending December 31, 2020, related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID–19.[10]

This change may serve to grant relief if the employer is unable to rehire employees or has to reduce staff to comply with requirements imposed on a business to control COVID-19, such as reducing the number of customers served to enable social distancing.

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[9] HR 7010, Section 3(b)(2)

[10] HR 7010, Section 3(b)(2)(B)

Requirement to Spend 60% of Loan Proceeds on Payroll Costs

In what could be either good news or bad news for a borrower, the PPPFA added a minimum payroll cost requirement for use of the funds in order to obtain forgiveness. Under the rules established by the SBA for the original PPP loan program, a minimum of 75% of the amount forgiven for a PPP loan had to be paid for payroll costs.

EXAMPLE OF ORIGINAL FORGIVENESS 75% TEST

Arrow, Inc. obtained a PPP loan of $100,000. During the covered period, Arrow Inc. spends $60,000 on payroll costs and $40,000 on other allowable costs. Under the original rules for forgiveness for the PPP program, Arrow, Inc. is eligible for forgiveness of $80,000 ($60,000 is 75% of $80,000) and would need to repay the $20,000 additional portion of the loan under the repayment terms.

Under the PPPFA, the law now provides, in revised CARES Act Section 1106(d)(8):

> (8) LIMITATION ON FORGIVENESS.—To receive loan forgiveness under this section, an eligible recipient shall use at least 60 percent of the covered loan amount for payroll costs, and may use up to 40 percent of such amount for any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation), any payment on any covered rent obligation, or any covered utility payment.[11]

While the percentage is reduced to 60%, the test is no longer simply on the amount forgiven. Rather, now a borrower who fails to spend 60% of the *amount borrowed* on payroll costs will not receive any forgiveness.

EXAMPLE UNDER NEW PROVISION

In the earlier example, Arrow, Inc. would now qualify for full forgiveness of the loan, as they spent 60% of the borrowed funds on payroll costs and used the remaining funds for other covered costs.

Note that since the requirement is that a minimum be spent on payroll costs, Arrow could have spend $75,000 or even the entire $100,000 on payroll costs and still receive full forgiveness.

However, if Arrow, Inc. only spends $59,999 on payroll costs and $40,001 on other allowable costs, Arrow would be required to repay the entire loan under the revised provision added by the PPPFA.

Extension of Deferral Period

The PPPFA also expands the deferral period found in Section 7(a)(36)(M) of the Small Business Act, now providing that the SBA will require lenders under this program to "provide complete payment deferral relief for impacted borrowers with covered loans, including payment of principal, interest, and fees, until the date on which the amount of

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[11] HR 7010, Section 3(b)(2)(B)

forgiveness determined under section 1106 of the CARES Act is remitted to the lender."[12]

A similar deferral rule applies to loans sold on the secondary market.[13]

However, if a borrower waits too long to apply for forgiveness, the law will require payments to begin. The PPPFA adds Section 7(a)(36)(M)(iv) of the Small Business Act which reads:

> (v) RULE OF CONSTRUCTION.—If an eligible recipient fails to apply for forgiveness of a covered loan within 10 months after the last day of the covered period defined in section 1106(a) of the CARES Act, such eligible recipient shall make payments of principal, interest, and fees on such covered loan beginning on the day that is not earlier than the date that is 10 months after the last day of such covered period.

Payroll Tax Deferral Available Through End of the Year for Borrowers With Forgiven PPP Debt

The PPPFA removed the provision found at CARES Act Section 2302(a)(3)[14] that required borrowers who received forgiveness of debt to cease the deferral of payment of employer old age, survivors and disability insurance (OASDI).

Now all employers may defer the payment of such taxes for wages paid after March 27, 2020 and before January 1, 2021, paying half of the deferred balance on December 31, 2021 and the other half on December 31, 2022.

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[12] HR 7010, Act Section 3(c)(1)

[13] HR 7010, Act Section 3(c)(2)

[14] HR 7010, Act Section 4(a)

SECTION: 401
RELIEF PROVIDED FROM THE PHYSICAL PRESENCE OF A NOTARY OR PLAN REPRESENTATIVE FOR 2020 FOR CERTAIN PLAN ELECTIONS

Citation: Notice 2020-42, 6/4/20

In Notice 2020-42[15] the IRS has provided relief from a physical presence requirement for spousal and other qualified retirement plan related consents in recognition of the COVID-19 emergency. The purpose of the notice is described as follows:

> In response to the unprecedented public health emergency caused by the Coronavirus Disease 2019 (COVID-19) pandemic, and the related social distancing that has been implemented, this notice provides temporary relief from the physical presence requirement in Treasury Regulations § 1.401(a)-21(d)(6) for participant elections required to be witnessed by a plan representative or a notary public, including a spousal consent required under § 417 of the Internal Revenue Code (Code). While this temporary relief, which covers the period from January 1, 2020, through December 31, 2020, is intended to facilitate the payment of coronavirus-related distributions and plan loans to qualified individuals, as permitted by section 2202 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136, 134 Stat. 281 (2020) (CARES Act), the temporary relief applies to any participant election that requires the signature of an individual to be witnessed in the physical presence of a plan representative or notary.[16]

Physical Presence Rule

The physical presence issue arises under the rules found at Reg. §1.401(a)-21(d)(6). That regulation contains the following physical presence standards that may present issues during the COVID-19 emergency:

> Section 1.401(a)-21(d)(6)(i) provides that, in the case of a participant election that is required to be witnessed by a plan representative or a notary public (such as a spousal consent to a waiver of a QJSA under § 417), the signature of the individual making the participant election must be witnessed in the physical presence of a plan representative or a notary public. Section 1.401(a)-21(d)(6)(ii) provides that, if the signature is witnessed in the physical presence of a notary public, an electronic signature acknowledging the signature (in accordance with section 101(g) of the Electronic Signatures in Global and National Commerce Act, Pub. L. 106-229, 114 Stat. 464 (2000) (E-SIGN), and

[15] Notice 2020-43, June 4, 2020, https://www.irs.gov/pub/irs-drop/n-20-42.pdf (retrieved June 5, 2020)

[16] Notice 2020-43, June 4, 2020, Section I

> applicable state law for notaries public) will not be denied legal effect.[17]

A footnote reference provides the following information on E-SIGN:

> Section 101(g) of E-SIGN provides that "[i]f a statute, regulation, or other rule of law requires a signature or record relating to a transaction in or affecting interstate or foreign commerce to be notarized, acknowledged, verified, or made under oath, that requirement is satisfied if the electronic signature of the person authorized to perform those acts, together with all other information required to be included by other applicable statute, regulation, or rule of law, is attached to or logically associated with the signature or record."[18]

Relief Granted

The Notice grants temporary relief during 2020 from the physical presence requirement of Reg. §1.401(a)-21(d)(6) described in the prior section:

- Temporary relief from the physical presence requirement for any participant election witnessed by a notary public of a state that permits remote electronic notarization, and

- Temporary relief from the physical presence requirement for any participant election witnessed by a plan representative.[19]

Notary Public Physical Presence Relief

The temporary relief provided from the physical presence requirement for a notary public is:

> In the case of a participant election witnessed by a notary public, for the period from January 1, 2020, through December 31, 2020, the physical presence requirement in § 1.401(a)-21(d)(6) is deemed satisfied for an electronic system that uses remote notarization if executed via live audio-video technology that otherwise satisfies the requirements of participant elections under § 1.401(a)-21(d)(6) and is consistent with state law requirements that apply to the notary public.[20]

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[17] Notice 2020-43, June 4, 2020, Section II

[18] Notice 2020-43, June 4, 2020, Section II

[19] Notice 2020-42, June 4, 2020, Section III

[20] Notice 2020-42, June 4, 2020, Section III.A.

In this case the IRS is leaning heavily on provisions found in state law, so the relief is only possible if the state law will allow the notary public to execute a remote notarization.

Plan Representative Physical Presence Relief

More detailed rules are provided by the IRS in the case of gaining an exception from the physical presence rule for a plan representative, since there is no underlying state law for the IRS to rely upon. For 2020, the physical presence requirement of Reg. §1.401(a)-21(d)(6) will be deemed satisfied for an electronic system if the electronic system using audio-video technology satisfies the following requirements:

- The individual signing the participant election must present a valid photo ID to the plan representative during the live audio-video conference, and may not merely transmit a copy of the photo ID prior to or after the witnessing;
- The live audio-video conference must allow for direct interaction between the individual and the plan representative (for example, a pre-recorded video of the person signing is not sufficient);
- The individual must transmit by fax or electronic means a legible copy of the signed document directly to the plan representative on the same date it was signed; and
- After receiving the signed document, the plan representative must acknowledge that the signature has been witnessed by the plan representative in accordance with the requirements of this notice and transmit the signed document, including the acknowledgement, back to the individual under a system that satisfies the applicable notice requirements under § 1.401(a)-21(c).[21]

Online meeting systems such as Zoom, Google Meet, Microsoft Teams, and Apple Facetime should be sufficient to allow the signing to meet the first two requirements. The individual could then transmit their signed form to the plan representative using a scanner or even a picture of the signed form.

The representative's retransmission system must meet the requirements of Reg. §1.401(a)-21(c). The two key requirements are:

- The electronic medium used to provide an applicable notice must be a medium that the recipient has the effective ability to access and
- At the time the applicable notice is provided, the recipient must be advised that he or she may request and receive the applicable notice in writing on paper at no charge, and, upon request, that applicable notice must be provided to the recipient at no charge.[22]

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[21] Notice 2020-42, June 4, 2020, Section III.B.

[22] Reg. §1.401(a)-21(c)

SECTION: 1400Z-2
IRS EXPANDS PRIOR GRANT OF COVID-19 QOF RELIEF AND ADDS MORE OPPORTUNITY ZONE RELIEF

Citation: Notice 2020-39, 6/4/20

The IRS has provided additional relief to certain taxpayers looking to reinvest proceeds in Qualified Opportunity Funds in Notice 2020-39.[23] As well, the Notice provides additional relief related to Opportunity Zones.

180-Day Reinvestment Period for QOF Investors

Generally, investors who wish to defer gains using the qualified opportunity fund provisions of IRC §1400Z-2 have 180 days to reinvest those gains. The IRS had previously granted an extension of time to make certain reinvestments in Notice 2020-23. This original relief is summarized in the new notice as follows:

> One of the time-sensitive acts postponed by Notice 2020-23 was the making of "an investment at the election of a taxpayer due to be made during the 180-day period described in section 1400Z-2(a)(1)(A) of the Code" (180-day investment period). See Notice 2020-23, Part III.A and C. Specifically, Notice 2020-23 postponed to July 15, 2020, any deadline for the 180-day investment requirement that otherwise would have occurred on or after April 1, 2020 and before July 15, 2020. See id., Part III.C. [24]

Notice 2020-39 extends this relief through December 31, 2020, providing:

> If the last day of the 180-day investment period within which a taxpayer must make an investment in a QOF in order to satisfy the 180-day investment requirement falls on or after April 1, 2020, and before December 31, 2020, the last day of that 180-day investment period is postponed to December 31, 2020. [25]

The IRS provides the following guidance in the Notice for taxpayers taking advantage of this relief:

> This relief is automatic; taxpayers do not have to call the IRS or send letters or other documents to the IRS to receive this relief. However, a taxpayer will still need to make a valid deferral election in accordance with the instructions to Form 8949, complete Form 8997, and file the completed Form 8949 and Form 8997 with a timely filed Federal

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[23] Notice 2020-39, June 4, 2020, https://www.irs.gov/pub/irs-drop/n-20-39.pdf (retrieved June 5, 2020)

[24] Notice 2020-39, Section II.B

[25] Notice 2020-39, Section III.A

> income tax return (including extensions) or amended Federal income tax return for the taxable year in which the gain would be recognized if section 1400Z-2(a)(1) did not apply to defer recognition of the gain. For additional information, see https://www.irs.gov/form8949 and https://www.irs.gov/form8997. [26]

90-Percent Investment Standard for QOFs

The law provides a requirement that a minimum percentage of a fund's property must consist of qualified opportunity zone property. The Notice describes this requirement as follows:

> Section 1400Z-2(d)(1) defines a QOF as any investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another QOF). This definition also requires a QOF to hold at least 90 percent of its assets in qualified opportunity zone property, determined by the average of the percentage of qualified opportunity zone property held by that QOF as measured (i) on the last day of the first 6-month period of the taxable year of the QOF, and (ii) on the last day of the taxable year of the QOF. See section 1400Z-2(d)(1). The requirement that the average percentages of the QOF's qualified opportunity zone property on these two dates (semi-annual testing dates) must equal at least 90 percent of the QOF's assets is referred to as the 90-percent investment standard. See section 1400Z-2(f). Section 1.1400Z2(d)-1 provides definitions and rules to implement the 90-percent investment standard.
>
> If the average of the percentages of the qualified opportunity zone property held by a QOF on these semi-annual testing dates fails to meet the 90-percent investment standard, section 1400Z-2(f)(1) provides a general rule that the QOF must pay a penalty for each month that the QOF fails to meet that standard. However, section 1400Z-2(f)(3) provides that no such penalty is imposed "with respect to any failure if it is shown that such failure is due to reasonable cause."[27]

Due to the economic disruption brought about by COVID-19, Notice 2020-39 provides the following blanket relief for certain violations of this provision:

> In the case of a QOF whose (i) last day of the first 6-month period of the taxable year or (ii) last day of the taxable year falls within the period beginning on April 1, 2020, and ending on December 31, 2020,

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[26] Notice 2020-39, Section III.A

[27] Notice 2020-39, June 4, 2020, Section II.C

> any failure by that QOF to satisfy the 90-percent investment standard for that taxable year of the QOF is —
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> (1) due to reasonable cause under section 1400Z-2(f)(3); and
>
> (2) disregarded for purposes of determining whether the QOF or any otherwise qualifying investments in that QOF satisfy the requirements of section 1400Z-2 and the section 1400Z-2 regulations for any taxable year of the QOF.[28]

The steps to be undertaken by a QOF covered by this relief are outlined by the IRS in the Notice:

> This relief is automatic; QOFs do not have to call the IRS or send letters or other documents to the IRS to receive this relief. However, a QOF must accurately complete all lines on Form 8996 filed with respect to each affected taxable year EXCEPT that the QOF should place a "0" in Part IV, Line 8 (Penalty). The accurately completed Form 8996 must be filed with the QOF's timely filed Federal income tax return (including extensions) for the affected taxable year(s). For additional information, see https://www.irs.gov/form8996.[29]

Working Capital Safe Harbor for Qualified Opportunity Zone Businesses

Rules also apply to qualified opportunity zone businesses restricting the amount of holdings of "nonqualified financial property" by the business. However, a reasonable amount of working capital is allowed to be excluded from that category of asset. The regulations under IRC §1400Z-2 provide for a safe harbor calculation of such reasonable amounts of working capital. These rules are described in Notice 2020-23 as follows:

> An entity must meet certain requirements to be a qualified opportunity zone business, including the requirement of section 1397C(b)(8) that less than 5 percent of the average of the aggregate unadjusted bases of the entity's property be attributable to nonqualified financial property, as defined in section 1397C(e). Section 1397C(e) excludes from nonqualified financial property reasonable amounts of working capital that are held in cash, cash equivalents, or debt instruments with a term of 18 months or less. See § 1.1400Z2(d)-1(d)(3)(iv).
>
> The section 1400Z-2 regulations provide qualified opportunity zone businesses with a safe harbor for treating an amount of working capital as reasonable for purposes of section 1397C(e) if certain requirements are satisfied (working capital safe harbor). See § 1.1400Z2(d)-1(d)(3)(v) (providing the scope of the working capital safe harbor and conditions

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[28] Notice 2020-39, June 4, 2020, Section III.B

[29] Notice 2020-39, June 4, 2020, Section III.B

> for eligibility). One of those requirements is that there is a written schedule consistent with the ordinary start-up of a trade or business for the expenditure of the working capital assets within 31 months of the receipt by the business of the assets. See § 1.1400Z2(d)-1(d)(3)(v)(B). A qualified opportunity zone business may extend the working capital safe harbor period to a maximum 62-month period under § 1.1400Z2(d)-1(d)(3)(vi) if certain additional requirements are met.
>
> If such qualified opportunity zone business is located in a qualified opportunity zone within a Federally declared disaster (as defined in section 165(i)(5)(A)), the qualified opportunity zone business may receive not more than an additional 24 months to expend its working capital assets, as long as the qualified opportunity zone business otherwise meets the requirements of the working capital safe harbor. See § 1.1400Z2(d)-1(d)(3)(v)(D). Therefore, a qualified opportunity zone business may, if each applicable requirement of § 1.1400Z2(d)-1(d)(3)(v) and (vi) is satisfied, have up to a maximum 86-months to expend working capital assets if the qualified opportunity zone business is located in a qualified opportunity zone within a Federally declared disaster.[30]

The Notice clarifies that the COVID-19 emergency will enable a qualified opportunity zone business to use the additional 24-month period:

> As a result of the Emergency Declaration (that is, the declaration of a Federally declared disaster for purposes of section 165(i)(5)(A)), all qualified opportunity zone businesses holding working capital assets intended to be covered by the working capital safe harbor before December 31, 2020, receive not more than an additional 24 months to expend the working capital assets of the qualified opportunity zone business, as long as the qualified opportunity zone business otherwise meets the requirements of § 1.1400Z2(d)-1(d)(3)(v) (that is, the requirements to qualify for the working capital safe harbor). See § 1.1400Z2(d)-1(d)(3)(v)(D) (providing such 24-month extension due to a Federally declared disaster).[31]

30-Month Substantial Improvement Period for QOFs

Another requirement imposed on QOFs is a 30-month limit on the time to substantially improve property that is not "original use investment" for the property to be considered qualified opportunity zone business property. Notice 2020-39 summarizes this rule as follows:

> Section 1400Z-2(d)(2)(D)(i) provides that tangible property is treated as qualified opportunity zone business property if the tangible property is used in a trade or business of the QOF and satisfies three

[30] Notice 2020-39, June 4, 2020, Section II.D

[31] Notice 2020-39, June 4, 2020, Section IV.A

> general requirements. One of these requirements is that the original use of post-2017 acquired tangible property in the qualified opportunity zone must begin with the QOF (referred to as the "original use requirement"), or the QOF must substantially improve that property (substantial improvement requirement). See section 1400Z-2(d)(2)(D)(i)(II). The substantial improvement requirement is met only if, during any 30-month period beginning after the date of acquisition of the post-2017 acquired tangible property, there are "additions to basis with respect to such property" held by the QOF that, in the aggregate, exceed the QOF's adjusted basis of that property as of the beginning of that 30-month period (30-month substantial improvement period). See section 1400Z-2(d)(2)(D)(ii). Section 1.1400Z2(d)-2(b)(4) provides rules to implement the substantial improvement requirement.[32]

Notice 2020-39 gives relief by providing that the period from April 1, 2020 to December 31, 2020 will be disregarded for these purposes:

> For purposes of the substantial improvement requirement with respect to property held by a QOF or qualified opportunity zone business, the period beginning on April 1, 2020, and ending on December 31, 2020, is disregarded in determining any 30-month substantial improvement period (that is, the 30-month substantial improvement period is tolled during the period beginning on April 1, 2020, and ending on December 31, 2020).[33]

12-Month Reinvestment Period for QOFs

The regulations under IRC §1400Z-2 provided a special rule that allowed a QOF that sells or disposes of some or all of its qualified opportunity zone property or that receives a distribution that is treated as a return of capital from qualified opportunity zone stock can continue to count those proceeds as qualified opportunity zone property if the amounts are properly reinvested within 12 months.

Notice 2020-39 outlines this rule from the regulations:

> The section 1400Z-2 regulations provide generally that, if (i) a QOF sells or disposes of some or all of its qualified opportunity zone property or if a distribution with respect to the QOF's qualified opportunity zone stock is treated as a return of capital in the QOF's hands, and if (ii) the QOF reinvests some or all of the proceeds in qualified opportunity zone property by the last day of the 12-month period beginning on the date of the distribution, sale, or disposition, then the proceeds, to the extent that they are so reinvested, are treated as qualified opportunity zone property for purposes of the 90-percent investment standard. See § 1.1400Z2(f)-1(b)(1). This treatment is available to a QOF only to the extent that, prior to the reinvestment in

[32] Notice 2020-39, June 4, 2020, Section II.E

[33] Notice 2020-39, June 4, 2020, Section III.C

> qualified opportunity zone property, the reinvested proceeds are continuously held in cash, cash equivalents, or debt instruments with a term of 18 months or less. See *id.*
>
> If the QOF's plan to reinvest some or all of the above-described proceeds in qualified opportunity zone property is delayed due to a Federally declared disaster (as defined in section 165(i)(5)(A)), the QOF may receive not more than an additional 12 months to reinvest the proceeds, provided that the QOF invests the proceeds in the manner originally intended before the disaster. See § 1.1400Z2(f)-1(b)(2).[34]

The Notice grants relief if the 12-month reinvestment period includes January 20, 2020, giving the QOF an additional 12 months to reinvest:

> If any QOF's 12-month reinvestment period includes January 20, 2020 (that is, the date of the disaster identified in the Major Disaster Declarations), that QOF receives up to an additional 12 months to reinvest in qualified opportunity zone property some or all of the proceeds received by the QOF from the return of capital or the sale or disposition of some or all of the QOF's qualified opportunity zone property, provided that the QOF satisfies the requirements of § 1.1400Z2(f)-1(b)(1) and invests the proceeds in the manner originally intended before January 20, 2020. See § 1.1400Z2(f)-1(b)(2) (providing such 12-month extension due to a Federally declared disaster).[35]

SECTION: 6031
IRS PROPOSES METHODS TO BE USED TO COMPUTE TAX BASIS CAPITAL TO BE REPORTED ON PARTNERSHIP INCOME TAX RETURNS

Citation: Notice 2020-43, 6/5/20

The IRS, in releasing the drafts for the 2019 Form 1065 and related instructions, indicated that all partnerships would have to provide information on tax basis capital accounts on Schedules K-1 prepared for 2019 and later years. The IRS in the end decided to remove the requirement from the 2019 Form 1065 Schedule K-1s after receiving a number of comments indicating that providing that information would be very difficult or impossible for many partnerships. The agency indicated that it would be providing additional information on the calculation of partner tax capital.

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[34] Notice 2020-39, June 4, 2020, Section II.F

[35] Notice 2020-39, June 4, 2020, Section IV.B

In Notice 2020-43[36] the IRS indicated the agency had decided that, in lieu of providing that information the agency would propose to offer two proposed methods for partnerships to comply with the tax capital reporting requirement. The agency is using the notice to request comments on these proposed methods.

The two methods the IRS proposes in this Notice are:

- The partner's basis in its partnership interest, reduced by the partner's allocable share of partnership liabilities, as determined under § 752 of the Code (*Modified Outside Basis Method*) or

- The partner's share of previously taxed capital, as calculated under a modified version of § 1.743-1(d) of the Income Tax Regulations (*Modified Previously Taxed Capital Method*).[37]

Issues Faced in Computing Partner Tax Capital

While the IRS may have initially believed providing partners' capital on a tax basis would not create issues for partnerships, the agency found that many commenters did not agree. As the Notice indicates:

> Commenters have indicated that many partnerships that currently possess partner tax capital information generally develop and maintain partner tax capital by applying the provisions and principles of subchapter K of chapter 1 of the Code (subchapter K), including those contained in §§ 705, 722, 733, and 742 of the Code, to relevant partnership and partner events. In such a situation, commenters have indicated that partnerships maintaining tax capital (i) increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and (ii) decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner (Transactional Approach).
>
> The Treasury Department and the IRS understand that many partnerships and other persons have maintained partner tax capital accounts according to the Transactional Approach, but due to the array of transactions that might affect partner tax capital, it is possible that partnerships and other persons that have been using the Transactional Approach may not have been adjusting partner tax

[36] Notice 2020-43, June 5, 2020, https://www.irs.gov/pub/irs-drop/n-20-43.pdf (retrieved June 5, 2020)

[37] Notice 2020-43, June 5, 2020, Section III

> capital accounts in the same way under similar fact patterns. Several commenters explained that providing detailed guidance that would make the Transactional Approach consistent in all potential transactions would be a major project that would consume significant IRS resources.[38]

The IRS, taking these comments into account, still believes it's important to move forward with the Tax Capital Reporting Requirement, as it will "aid the IRS in administering the tax law, and consistency will ultimately reduce complexity of the preparation of partnership returns."[39]

The IRS notes that the agency intends to require partnerships to use one of the two methods described in this notice, and that "[c]apital account amounts based on the Transactional Approach will not satisfy the Tax Capital Reporting Requirement."[40] Rather, the Notice provides:

> It is intended that a partnership must use one of these two methods for purposes of satisfying the Tax Capital Reporting Requirement and the method selected must be used with respect to all of the partnership's partners.[41]

The partnership will not be required to use the same method each year, so the selection for 2020 would not bind the partnership into the future. But the IRS would demand certain disclosures if a change takes place:

> For taxable years after 2020, a partnership may change its Tax Capital Reporting Requirement method from the Modified Outside Basis Method to the Modified Previously Taxed Capital Method, or vice versa, by attaching a disclosure to each Schedule K-1 describing the change, if any, to the amount attributable to each partner's beginning and end of year balances, and the reason for the change.[42]

Proposed Modified Outside Basis Method

The first method looks to use the partners' outside basis (that is, the partner's basis in his interest in the partnership) after adjustment for debt allocated to the partner to determine the partner's tax basis capital.

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[38] Notice 2020-43, June 5, 2020, Section III

[39] Notice 2020-43, June 5, 2020, Section III

[40] Notice 2020-43, June 5, 2020, Section III

[41] Notice 2020-43, June 5, 2020, Section III

[42] Notice 2020-43, June 5, 2020, Section III

Per the Notice, under the modified outside basis method the partnership can determine each partners' tax basis capital in the following manner:

> A partnership may satisfy the Tax Capital Reporting Requirement by determining, or being provided by its partners, the partner's adjusted basis in its partnership interest, determined under the principles and provisions of subchapter K (including those contained in §§ 705, 722, 733, and 742), and subtracting from that basis the partner's share of partnership liabilities under § 752.[43]

If a partnership uses this method, notification requirements are imposed on the partner regarding basis adjustments that the partnership would not generally be aware of from its books:

> If the partnership is satisfying the Tax Capital Reporting Requirement by using the Modified Outside Basis Method, a partner must notify its partnership, in writing, of any changes to the partner's basis in its partnership interest during each partnership taxable year other than changes attributable to contributions to and distributions from the partnership and the partner's share of income, gain, loss, or deduction that are otherwise reflected on the partnership's schedule K-1. The partner must provide such written notification of such changes to the partner's basis within thirty days or by the taxable year-end of the partnership, whichever is later.[44]

The notice uses the following example of such a notification event:

EXAMPLE (BASED ON NOTICE 2020-43, SECTION III(1))

If a person purchases an interest in a partnership that has chosen to use the Modified Outside Basis Method, the purchasing partner must notify the partnership of its basis in the acquired partnership interest, regardless of whether the partnership has an election under § 754 of the Code in effect or has a substantial built-in loss, as defined in § 743(d) of the Code, at the time of such interest purchase.

Partnerships using this method will generally be able to rely on information given to the partnership by a partner:

> For purposes of the Modified Outside Basis Method, a partnership is entitled to rely on the partner basis information that the partnership is provided by its partners unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous.[45]

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[43] Notice 2020-43, June 5, 2020, Section III(1)

[44] Notice 2020-43, June 5, 2020, Section III(1)

[45] Notice 2020-43, June 5, 2020, Section III(1)

Proposed Modified Previously Taxed Capital Method

The second method borrows from the regulations found at Reg. §1.743-1(d)(1). As the Notice provides:

> Section 1.743-1(d)(1) generally provides that a partnership interest transferee's (transferee's) share of the adjusted basis of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. [46]

Previously taxed capital is defined as an amount equal to:

- (i) The amount of cash that the partner would receive on a liquidation of the partnership following a hypothetical transaction; increased by
- (ii) The amount of tax loss (including any remedial allocations under § 1.704-3(d) of the Income Tax Regulations) that would be allocated to the partner from the hypothetical transaction; and decreased by
- (iii) The amount of tax gain (including any remedial allocations under § 1.704-3(d)) that would be allocated to the partner from the hypothetical transaction.[47]

The notice indicates that "[t]he hypothetical transaction is a disposition by the partnership of all of its assets in a fully taxable transaction for cash equal to the fair market value of the assets."[48]

Of course, partnerships will not generally be able to quickly discover the amount to be received from that hypothetical sale:

> Part (i) of the above calculation is intended to quantify, for each partner, the partner's economic right to a share of the distributable proceeds of the partnership immediately after the hypothetical transaction and the payment by the partnership of all of its liabilities (partnership net liquidity value). The Treasury Department and the IRS understand that although some partnerships may be able to determine the fair market value of their assets for each taxable period, such information will not be readily available for all partnerships.[49]

The IRS notes that in many cases the exact amount of the sale proceeds won't change the ultimate calculation, since the second and third steps remove the gains and losses inherent in the deemed sale, leaving in place what is essentially the partner's share of the

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[46] Notice 2020-43, June 5, 2020, Section III(2)

[47] Notice 2020-43, June 5, 2020, Section III(2)

[48] Notice 2020-43, June 5, 2020, Section IV(2)

[49] Notice 2020-43, June 5, 2020, Section IV(2)

basis in each asset. So for purposes of the Modified Previously Taxed Capital Method, the traditional §1.743-1(d)(2) calculation is modified as follows:

- The cash a partner would receive on a partnership liquidation and calculations of gain and loss in the hypothetical transaction would be based on the assets' fair market value, if readily available. Otherwise, a partnership may determine its partnership net liquidity value and gain or loss by using such assets' bases as determined under § 704(b), GAAP, or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management; and

- All liabilities are treated as nonrecourse for purposes of parts (ii) and (iii) of the calculation referring to gain or loss, respectively. This is to avoid the burden of having to characterize the underlying debt and to simplify the computation.[50]

The Notice provides the following example of applying this method:

EXAMPLE (FROM NOTICE 2020-23, SECTION III(2))

Facts. A and B are equal partners in AB LLC, a calendar-year partnership. On December 31, 2020, AB LLC's balance sheet reflects the following assets and liabilities:

- $500 of cash;
- Inventory with a tax and book basis of $1,000;
- Equipment with a tax and book basis of $500;
- Land with a tax and book basis of $1,000; and
- A long-term loan of $5,000.

AB LLC chooses to comply with the Tax Capital Reporting Requirement by using the Previously Taxed Capital Method and calculating liquidation values, gains, and losses, based on the book basis of the assets. Each of A and B's Previously Taxed Capital under that method would be $(1,000), an amount equal to (i) the cash each would receive after the hypothetical liquidation (zero, because the debt of $5,000 exceeds the $3,000 book basis of the assets), less (ii) gain that would be allocated to each partner on the hypothetical liquidation and sale ($1,000, each partner's 50% share of the excess of the $5,000 amount realized on a sale of the property for the debt over the tax basis of $3,000), plus (iii) loss that would be allocated to each partner (zero).

The IRS plans to require the following disclosures to be made when a partnership uses the Modified Previously Taxed Capital Method:

> A partnership that adopts the Modified Previously Taxed Capital Method would be required, for each taxable year in which the method is used, to attach a statement indicating that the Modified Previously Taxed Capital Method is used and the method it used to determine its

[50] Notice 2020-43, June 5, 2020, Section IV(2)

partnership net liquidity value (for example, fair market value, §704(b) book basis, etc.).[51]

Request for Comments

For the moment this is only proposed guidance. The IRS is looking for comments on the following topics related to this Notice:

- Whether the methods used to satisfy the Tax Capital Reporting Requirement described in section III of this notice should be modified or adopted;

- Whether an ordering rule should apply to the basis used in determining the partnership's net liquidity value; for example, use of fair market value is required, but if not readily available, §704(b) book basis is required, and, if the partnership does not maintain § 704(b) capital, GAAP is required, etc.;

- How, if at all, the Tax Capital Reporting Requirement should be modified to apply to partnerships that are treated as publicly traded partnerships under § 7704 of the Code;

- Whether the Transactional Approach, or similar method, should be permitted for purposes of meeting the Tax Capital Reporting Requirement and, if recommended, what additional guidance would be necessary; and

- Whether and in what circumstances limitations should be imposed on partnerships to change from one method to another (for example, whether there should be a limit on how many times the method can be changed over a period of years), including compliance with such rules in the case of the merger of partnerships using different methods.[52]

Comments are due by August 4, 2020 and should contain a reference to Notice 2020-43. The IRS is encouraging commenters to use the electronic submission option rather than sending comments by mail, as the IRS notes that access to mail may be limited.[53]

Electronic comments are to be submitted "via the Federal eRulemaking Portal at www.regulations.gov (type IRS Notice 2020-43 in the search field on the regulations.gov homepage to find the docket for this notice and submit comments)."[54]

Those who insist on sending comments by mail can do so, though the IRS is likely correct to caution that doing so is not the best course. There is more than an outside possibility that these comments may not be available to those making the final decisions on this guidance at the time those decisions are made. Mailed comments are sent "to

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[51] Notice 2020-43, June 5, 2020, Section III(2)

[52] Notice 2020-43, June 5, 2020, Section IV

[53] Notice 2020-43, June 5, 2020, Section IV

[54] Notice 2020-43, June 5, 2020, Section IV

Internal Revenue Service, CC:PA: LPD (Notice 2020- 43), Room 5207, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044."[55]

Comments received are going to be subject to public inspection and copying.[56]

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[55] Notice 2020-43, June 5, 2020, Section IV

[56] Notice 2020-43, June 5, 2020, Section IV