Congress Should Revisit CARES Act Tax Provisions

By **Joseph Mandarino**

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With the signature of the president on March 27, the Coronavirus Aid, Relief and Economic Security, or CARES, Act became law. Recently, Congress has proposed a number of follow-up approaches to buttress the CARES Act and to provide additional relief and stimulus.

In a March Law360 guest article, I described some aspects of the proposed changes for net operating loss, or NOL, rules in the U.S. Senate version of the Cares Act.[1]

In this article I assess important Internal Revenue Service guidance that undermines the CARES Act and describe how the U.S. Department of the Treasury may be able to supercharge these new tax rules to provide more stimulus relief.

While both of these issues could be addressed administratively, it may take Congress to rein in the IRS and redirect it to help the CARES Act and its successor acts to provide needed stimulus to the U.S. economy.

Supercharging NOL Relief in the CARES Act

When deductions and losses exceed income and gains, a taxpayer has a net operating loss.[2] Under the law in effect immediately prior to the CARES Act, an NOL could be carried forward and used to offset income and gains in future years.[3] Generally, an NOL could not be carried back, only forward.[4]

Section 2203 of the CARES Act amended those rules so that NOLs that arise in 2018, 2019 and 2020 can be carried back five years. In this regard, the CARES Act follows economic relief legislation passed in the wake of the 9/11 terrorist attacks and the 2007 mortgage crisis by liberalizing the NOL carryback rules.

However, while many businesses are expected to sustain losses in 2020 as result of the Coronavirus crisis, many of these same businesses were profitable in 2018 and 2019. For these companies the rule change will primarily have an effect only on 2020 tax losses. While this is still an important stimulus, there are obstacles to its speedy use by taxpayers.

Note that under the administrative procedures applicable to years in which carrybacks were permitted, a tax loss in a given year could not be carried back until the end of the year in which the tax loss arises.

For example, the instructions to IRS Form 1139, the corporation application for tentative refund, which was used by corporate taxpayers to apply for a tentative refund for an NOL carryback, stated:

> Generally, the corporation must file Form 1139 within 12 months of the end of the tax year in which an NOL, net capital loss, unused credit, or claim of right adjustment arose.[5]

This is because the amount of the carryback cannot be determined until the end of the year.

Accordingly, for many taxpayers the NOL tax relief in the CARES Act will not generate a tangible benefit until early 2021. It would be possible to eliminate this timing issue if the Treasury Department were to adopt a quarterly refund procedure.[6]

Under the procedures prior to the repeal of the NOL carryback rules, taxpayers filed a special form shortly after the end of the tax year in which the NOL arose. Given that the NOL carryover forms will need to be revised to take into account the new carryback rules, the Treasury Department should consider permitting taxpayers to carryback an NOL each quarter, starting with the quarter ending on March 31.

Under this approach, a taxpayer would make an estimate of its NOL, if any, as of the end of each quarter. The taxpayer would then file a quarterly IRS Form 1045, the application for tentative refund, or Form 1139 to permit a fast carryback of that amount. The operation of this approach is examined in the following paragraphs.

Assume Bizco is a calendar year corporate taxpayer formed in 2018. Bizco had substantial profits in 2018 and 2019. In 2020, the company begins sustaining losses as a result of the coronavirus outbreak. As of the end of the first quarter of 2020, Bizco has a $500 loss.

Under an accelerated refund regime, Bizco would be permitted to file an IRS Form 1139 with respect to its first quarter as early as April 1. Bizco would carryback the loss to 2018 and 2019, as necessary. Assuming that Bizco had profits of at least $500 in 2018 and 2019, and based on current federal tax rates, Bizco would receive a $105 refund (i.e., $500 x 21% = $105).

Now assume that as of the end of Bizco's second quarter its cumulative loss for 2020 is estimated to be $750. Given that Bizco's first quarter loss was $500, by implication Bizco's stand-alone second quarter loss is $250. Again, under this accelerated refund regime, Bizco would be permitted to file an IRS Form 1139 with respect to its second quarter results as early as July 1. Because Bizco has already carried back $500, its second quarter carryback would be for $250. Assuming that Bizco had profits of at least $750 in 2018 and 2019, and based on current federal tax rates, Bizco would receive a $52.50 refund (i.e., $250 x 21% = $52.50).

Continuing with our example, assume that as of the end of Bizco's third quarter its cumulative loss for 2020 is estimated to be $750. Given that Bizco's first quarter loss was $500, and its second quarter loss was $250, the stand-alone loss for the third quarter is zero. Thus, Bizco would not be entitled to file a quarterly carryback for any amount — in effect it has already recovered the entire $750 loss via its first and second quarter refunds.

Finally, assume that as of the end of Bizco's fourth quarter, its cumulative loss for 2020 is estimated to be $500. In effect, Bizco has turned the corner and was profitable in its fourth quarter — i.e., Bizco lost $500 in the first quarter, $250 in the second quarter, broke even in the third quarter and had a profit of $250 in quarter four.

Because Bizco has already carried back losses of $750, this procedure would require Bizco to recapture some of the tax refunds already received. This is accomplished by requiring Bizco to pay estimated tax of $52.50 on the $250 of profits earned in the fourth quarter.

There are at least two criticisms of this system: first, it deviates from the use of the annual accounting period, and second, it would necessarily rely on estimates.

However, in this regard it very closely follows the current rules for the estimated tax payment system, which also deviates from the annual accounting period and relies on estimates.

Note also that the main effect of this system is to accelerate Bizco's tax refunds of its losses in 2020 without requiring it to wait until sometime in 2021. In total, Bizco received net refunds of $105, which aligns exactly to its total 2020 losses of $500. By providing these funds to struggling businesses sooner, it is more likely that they will survive and, ultimately, flourish.

Note that the Treasury Department has significant administrative powers under Internal Revenue Code Section 7801. The establishment of an accelerated refund system during the coronavirus outbreak could be viewed as a reasonable administrative reaction to the economic relief that pervades the CARES Act. Under this view, the Treasury Department could institute such procedures even in the absence of specific statutory authorization.

It is worth noting that a taxpayer could engineer the same results by merging with another entity that has a helpful year end. For example, if Bizco merged with a corporation with a Sept. 30 year end, then the surviving corporation could apply for a refund starting Oct. 1.

Finally, there is a fall back even if it were determined that the Treasury Department does not have sufficient administrative power. Specifically, the Treasury Department could provide refund anticipation loans to taxpayers along the same lines discussed above.

While banks generally do not make refund anticipation loans, and some states have enacted regulatory hurdles that discourage nonbank financial institutions from making them, the Treasury Department would not face the same burdens. Indeed, given the explicit lending authority granted to the Treasury Department under the CARES Act, the making of short-term refund anticipation loans to distressed businesses would be a useful tool to carry out the goals of this law.

Reversing IRS Guidance on PPP Loan Forgiveness

While the foregoing paragraphs address a missed opportunity for the IRS to push out congressional-mandated stimulus relief faster, the following paragraphs address recent IRS guidance that has been viewed by some as undermining a major feature of the CARES Act — the Paycheck Protection Program.

As the IRS has explained, the PPP was established by Section 1102 of the CARES Act.[7] Under the program, the recipient of a PPP loan can use the proceeds to pay (1) payroll and certain benefit costs, (2) interest on mortgage obligations, (3) rent, (4) utilities, and (5) interest on any other existing debt obligations.[8]

Under Section 1106(b) of the CARES Act, a recipient of a PPP loan can receive forgiveness of the loan in an amount equal to the sum of payments made for certain listed expenses during the eight-week period beginning on the loan's origination date. The expenses, generally, are: (1) payroll costs, (2) mortgage interest, (3) rent payments, and (4) utility payments.

However, Section 1106(d) of the CARES Act provides that the amount of loan forgiveness is reduced if, during that eight-week period, (1) the average number of full-time equivalent employees of the recipient is reduced as compared to the number of full-time employees in a specified base period, or (2) the salary or wages of certain employees is reduced by more than 25% as compared to the last full quarter before the covered period.

Section 1106(i) of the CARES Act addresses certain income tax consequences resulting from loan forgiveness. Specifically, that subsection states:

> For purposes of the Internal Revenue Code of 1986, any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in subsection (b) shall be excluded from gross income.

IRS Notice 2020-32 provides guidance in connection with PPP loans that are cancelled in whole or part. Specifically, the IRS takes the position that no tax deductions are permitted to the extent of covered expenses.

This position significantly undercuts the benefit of a PPP loan by eliminating the tax value associated with the deduction of covered expenses. For corporate taxpayers, this could represent a quarter of the value of the program or more, depending on the applicable tax burden, and for pass-through businesses this could represent a third or more of the value.

In the notice, the IRS advances two theories for this position:

- The application of IRC Section 265(a)(1); and
- The application of the reimbursed expense rule.

Both of these theories are considered below.

Section 265 Analysis

First, the IRS argues that IRC Section 265(a)(1) provides that no deduction is allowed to a taxpayer for any amount otherwise allowable as a deduction to the extent it is allocable to one or more classes of income wholly exempt from the taxes imposed by Subtitle A of the code.

The IRS reasons that to the extent that Section 1106(i) of the CARES Act operates to exclude from gross income the amount of a PPP loan forgiven under the CARES Act, then the application of Section 1106(i) results in a so-called class of exempt income.

Accordingly, so goes the IRS' reasoning, IRC Section 265(a)(1) disallows any otherwise allowable deduction for the amount of any payment of an eligible Section 1106 expense to the extent of the resulting loan forgiveness because such payment is allocable to tax-exempt income. The notice states that this disallowance is necessary to prevent a double tax benefit.

There are several problems with this analysis. First, while the notice states that the purpose of IRC Section 265(a)(1) is to prevent a double tax benefit, in fact its purpose is to prevent an unintended tax benefit.

Loan forgiveness that is excluded under the PPP creates only a single tax benefit, not a double tax benefit. That is, the portion of the transaction, if any, that would be taxable cancellation-of-debt income is excluded.

The deduction of covered expenses does not create a tax benefit — generally there is no issue with the deduction of expenses that are actually paid. Presumably the IRS would not have any issue with the deduction side if the cancellation-of-debt event were includible in income. Thus, the complaint is really that there is a single tax benefit, not a double tax benefit.

As others have noted and as the notice concedes, Congress was clear that any income from the forgiveness of a PPP loan should be excluded from income and there is no suggestion in the statute or the legislative history that IRC Section 265 was meant to apply to PPP loan covered expenses.

In fact, in statements by the Treasury secretary touting the PPP loan provisions, he routinely listed the value of the program by reference to the gross amount of loans that would be funded under the program.[9] If it was intended that participants would lose tax benefits for covered expenses he would have listed the value of the program on a tax-effective basis, i.e., at a quarter or a third less than the gross value.

Because of the rush to pass the CARES Act, no budget scoring analysis was prepared. Such an analysis can sometimes be used to discern legislative intent.

Here, in the absence of a formal budget scoring analysis we have only statements from the participants that uniformly refer to the cost of the program by reference to the gross amount of loans to be funded. The natural inference from this is that the parties did not intend for the value of the PPP loan program to be degraded by application of IRC Section 265.

To put it differently, the parties understood that a tax benefit would be obtained by many loan recipients in the form of an exclusion of cancellation-of-debt income, but there is no suggestion that any of the participants meant to offset this benefit by denying otherwise proper tax deductions.[10]

Thus, it seems clear from the face of the statute and what little can be inferred from the participants that a tax benefit was intended, and that the application of IRC Section 265 in this context would completely undermine that tax benefit.

Even if this is disregarded, there is another problem. IRC Section 265(a)(1) applies only to income that is "wholly exempt from the taxes imposed by this subtitle." The applicable regulations echo the use of the term "wholly exempt."[11] However, Section 1106(i) of the CARES Act states:

> For purposes of the Internal Revenue Code of 1986, any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in subsection (b) shall be excluded from gross income.

In fact, in many cases PPP loan recipients will be able to defer income under IRC Section 108 — income from discharge of indebtedness — so the provisions of IRC Section 1106(i) would not apply. Because of this, it does not appear that PPP loan forgiveness is wholly exempt from tax. Accordingly, under this interpretation, IRC Section 265(a)(1) cannot apply to PPP loans.

Even if PPP loan forgiveness is treated as wholly-exempt income, it is not clear that IRC Section 265(a)(1) would apply to covered expenses. The IRS in Notice 2020-32 argues that:

> the direct link between (1) the amount of tax exempt covered loan forgiveness that a recipient receives pursuant to section 1106 of the CARES Act, and (2) an equivalent

> amount of the otherwise deductible payments made by a recipient for eligible section 1106 expenses, constitutes a sufficient connection for section 265(a) to apply to disallow deductions for such payments.

However, this attempt to link covered expenses and loan forgiveness misses the point.

The vast majority of businesses paid covered expenses in order to survive and eventually flourish and grow. While the terms of the CARES Act provide that the Treasury Department will not grant forgiveness unless certain expenditures are made, it is not clear that businesses only made the payments because of the loans.

To put it differently, almost all PPP loan recipients should be able to demonstrate that they paid covered expenses to produce business profits and/or mitigate business losses. Thus, such a taxpayer would argue that the expenses were allocable to taxable income, not exempt income.

In contrast, the IRS would need to prove that a business paid covered expenses solely to obtain a PPP loan and not in order to advance the business. Absent such a link, it would be difficult for the IRS to prove that such expenses are allocable to exempt income rather than to taxable income.

A useful analogy can be made to research and development credits under IRC Section 41 — credit for increasing research activities. While a portion of the research expenditures giving rise to the credit are statutorily disallowed under IRC Section 280C(c), the balance are permitted.

The approach taken in Notice 2020-32, however, would by its terms apply to research expenditures on the grounds that (1) IRC Section 41 effectively exempts income, and (2) research expenditures are allocable to that exempt income because the credit would not arise but for the expenditures.

It seems quite clear, however, that Congress did not intend for IRC Section 265 to apply to research expenditures that give rise to IRC Section 41 credits. As with covered expenses under the PPP, it is more accurate to say that research expenditures are made to further a taxpayer's business activities and ultimately to produce taxable income. Accordingly, such outlays are allocable to taxable income, not exempt income.

Reimbursed Expense Rule

The IRS argues in Notice 2020-32, in the alternative, that the deductibility of covered expenses "is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement." As authority for this proposition, the notice cites Burnett v. Commissioner, Wolfers v. Commissioner, Charles Baloian Co. v. Commissioner, Revenue Ruling 80-348 and Revenue Ruling 80-173.[12]

While it would seem logical that if a taxpayer is reimbursed for an expense then it cannot deduct that expense, and the cited authorities provide some support for that position, that is not the fact pattern here. While the Treasury Department measures loan forgiveness by the amount of covered expenses paid by the borrower, it does not formally reimburse the borrower.

Indeed the form of the program — which was designed by the Treasury Department — is almost completely flexible in how a business uses the loan proceeds. Moreover, because the program uses the device of cancelling a loan, there is no physical reimbursement of any funds to the borrower which would bring the fact pattern closer to the cited authorities.

However, even if the cancellation feature were viewed as a deemed repayment of the loan and then transfer by the government of the same amount back to the business, it is not clear that these authorities would apply.

For example, Burnett is really a loan advance case — an attorney deducted advances to plaintiffs when made, then included the repayments in income when they were recovered.[13] The court determined that these were advances — loans — rather than expenses and thus did not give rise to deductions.[14]

Here there is no expense versus loan issue as to the nature of the covered expenses.

Baloian and Wolfers involve fact patterns in which a business was required to move and another party agreed to reimburse the relevant moving expenses.

In Baloian, the U.S. Tax Court ruled that an accrual basis taxpayer's right to reimbursement arose at the same time as the moving expenses, so that the deduction could not be taken in a different year than the reimbursement.[15]

Baloian was a timing case and the Tax Court effectively required that the deduction and the income element offset each other in the same year. In the context of PPP loans, the income element is not relevant so the applicability of this case seems uncertain. To put it differently, this case would provide guidance on the timing of a deduction, not for the disallowance of a deduction.

Wolfers involved similar facts and the Tax Court applied its rationale from Baloian to the same effect.[16]

Revenue Ruling 80- 348 involved the tax treatment of the travel expenses of elected representatives of union locals from their international union, for expenses of traveling away from home to attend the union's annual convention. While two issues are addressed, the relevant issue is the tax treatment where the expenses were incurred in one year and reimbursed in the following year.

Presumably, taxpayers were attempting to deduct the expense in the first year and then include the reimbursement in income the following year when received. Under the accrual method the two amounts would offset in the year the expenditures occurred and no guidance would be necessary, but it is likely that most of these taxpayers were on the cash method.

The ruling holds that:

> travel expenditures incurred at the close of one taxable period, even though they would otherwise be allowable under section 162(a)(2) of the Code, may not be deducted because of the expectation of reimbursement. Also, the reimbursement that is received in the following taxable period would not be includible in income.

Again, this is a timing case that is not relevant given the issues and facts of the PPP loan program.

Revenue Ruling 80-173 involves reimbursement of training expenses that would otherwise be deductible. The issue was complicated by the fact that the reimbursements occurred under a veterans benefit plan which specifically stated that the reimbursements were excluded from income. The ruling holds that the reimbursed expenses cannot be deducted:

> If an expense has been (or will be) reimbursed in whole or in part, any deduction otherwise allowable with respect to the expense is disallowed to the extent of the reimbursement. In such a case, the taxpayer suffers no economic detriment and incurs no expense in making the expenditure to the extent of the reimbursement.

This language comes from some of the timing concept authorities covered above. While the ruling adopts this timing rule to come to the nondeductibility result, there is no timing issue in the fact pattern addressed in the ruling.

In effect, this ruling is a disguised IRC Section 265 ruling and its holding can only be reconciled with other IRS authorities as such. Thus, it does not provide any support for the reimbursed-expenses-cannot-be-deducted theory advanced by the IRS.

The inapplicability of these authorities and the reimbursed expense rule to the facts of the PPP program further weakens the IRS' basis for disallowance of taxpayer expenses.

Indeed, the entire exercise represented by Notice 2020-32 is astonishing. On one hand the U.S. Treasury secretary expended enormous effort to shepherd a $350 billion relief and stimulus package through Congress and then to administer it.

At the same time, even though the IRS has a backlog of unfinished regulatory projects,[17] another division of the Treasury Department found time to produce guidance that would reduce the value of this program by perhaps $100 billion.

The notion that the Washington D.C. bureaucracy constitutes a countervailing force arrayed against the current president's agenda is a highly politicized notion.[18] However, it is difficult to understand why one division of the Treasury Department would undertake this action, especially when, as shown, there is tenuous support for its position.

Conclusion

With new efforts to bolster the relief and stimulus measures pending in Congress, it may make sense to also consider legislation that would bolster the provisions of the CARES Act, which passed with significant bipartisan support.

For example, specific legislation could be drafted to permit the IRS to provide accelerated tax refunds and to legislatively undo IRS Notice 2020-32. Alternatively, the Treasury department could determine that it has authority to administer real-time refunds, and thereby accelerate the relief and stimulus aspects of the NOL rule changes in the CARES Act.

As for Notice 2020-32, it is clear that the Treasury Department has the authority to issue new guidance stating that neither of the theories advanced therein will be used to disallow deductions for covered expenses.

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[1] New Loss Carryback Rules Fortify Coronavirus Relief Package, https://www.law360.com/tax-authority/articles/1256431.

[2] IRC Section 172.

[3] IRC Section 172(a), before enactment by Section 2203 of the CARES Act.

[4] Id.

[5] Instructions to IRS Form 1139, page 1 (https://www.irs.gov/pub/irs-pdf/i1139.pdf).

[6] While this article contemplates an accelerated refund regime that pivots on calendar quarters, it should also be possible to establish a monthly refund procedure.

[7] This description is largely drawn from IRS Notice 2020-32.

[8] Section 7(a)(36)(F) of the Small Business Act.

[9] See, e.g., https://home.treasury.gov/news/press-releases/sm961.

[10] Indeed, some of the legislators involved in the CARES Act have expressed disagreement with the positions in Notice 2020-32 https://www.wsj.com/articles/tax-deductions-tied-to-forgiven-small-business-loans-draw-support-11588718734?mod=hp_major_pos2#cxrecs_s.

[11] See, e.g., Treas. Reg. §1.265-1(b)(1).

[12] Burnett v. Commissioner, 356 at 759-60; Wolfers v. Commissioner, 69 T.C. 975 (1978); Charles Baloian Co. v. Commissioner, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 31; and Rev. Rul. 80-173, 1980-2 C.B. 60.

[13] Burnett v. Commissioner, 356 F.2d 755 (5th Cir. 1966), 17 AFTR 2d 358 at 360.

[14] Id. at 362.

[15] Charles Baloian Co. v. Commissioner, 68 T.C. at 626.

[16] Wolfers v. Commissioner, 69 T.C. at 984 ("Our decision in Charles Baloian Co.is controlling in this case . . . .").

[17] See, e.g., https://www.irs.gov/pub/irs-utl/2019-2020_pgp_initial.pdf.

[18] https://www.heritage.org/political-process/event/drain-the-swamp-how-washington-corruption-worse-you-think.