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IRS Issues Proposed Reliance Regulations on Carried Interests

The IRS issued proposed reliance regulations (https://www.irs.gov/pub/irs-drop/reg-107213-18.pdf) on the rules in Section 1061, often referred to as the carried interest rules. (Section references are to the Internal Revenue Code of 1986, as amended (the Code).) Effective for tax years beginning after Dec. 31, 2017, Section 1061(a) recharacterizes as short-term capital gain the difference between a taxpayer's net long-term capital gain with respect to one or more applicable partnership interests (APIs) and the taxpayer's net long-term capital gain with respect to these APIs if paragraphs (3) and (4) of Section 1222, which define the terms long-term capital gain and long-term capital loss, respectively, are applied using a three-year holding period instead of a one-year holding period. The carried interest rules thereby extend the period for long-term capital gain treatment from one to three years. The proposed carried interest rules generally determine the three-year holding period by reference to the owner of the asset sold. The asset, in this case, might be the carried interest or an asset held by the partnership that issued the carried interest. Under the proposed rules, gain from the sale of an asset that a partnership has held for three years or less generally is recharacterized as short-term capital gain to the extent that the gain is allocated to a fund manager related to its carried interest even if the fund manager has held the carried interest for more than three years. If, however, the fund manager sells the carried interest to an unrelated third party after holding it for more than three years, then, subject to the application of special look-through rules, the proposed rules do not recharacterize the gain on the sale.

- *What is a carried interest?* A carried interest generally is a form of compensation often received by fund managers of alternative investment vehicles (e.g., private equity or hedge funds). Fund managers, or general partners, typically receive two types of compensation for managing a fund. In a common compensation agreement, general partners receive a management fee equal to 2-percent of the invested assets plus a 20-percent share in profits as carried interest. The compensation structure is referred to colloquially as "2 and 20." The management fee paid by a fund generally is fixed as a percentage of assets, the carried interest is variable because it is generally a share of fund profits once specified investment returns have been met (i.e., subject to a hurdle rate).

- *What is an API?* Section 1061(c)(1) generally defines the term API as meaning any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business (ATB).

  Section 1061(d) provides a rule for transfers of APIs to certain related persons and Section 1061(d)(2) provides a definition of a related person that applies solely to transfers subject to Section 1061(d). The proposed regulations refer to that person as a Section 1061(d) Related Person (which is determined by reference to Section 707(b) or Section 267(b)). (See Proposed Regulations Section 1.1061-1(a).) The proposed regulations note that Section 1061 does not include a definition of a related person for the remainder of Section 1061.

  Section 1061 does not contain a provision that would cause interest to cease to be an API unless and until one of the exceptions to the definition of API applies. (See

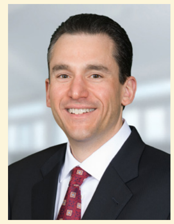
Proposed Regulations Section 1.1061-2(a)(1)(i).) Therefore, the proposed regulations clarify that once a partnership interest becomes an API, the partnership interest remains an API unless and until an exception applies, regardless of whether the taxpayer or a Related Person continues to provide services in an ATB. Therefore, even after a partner retires and provides no further services if the retired partner continues to hold the partnership interest, it remains an API. Similarly, if the partner provides services, but the partnership ceases to engage in ATBs in a later year, the partnership interest will continue to be an API. Further, an API remains an API if it is contributed to another Passthrough Entity or trust or is held by an estate.

Section 1061(c)(1) provides that an interest in a partnership is an API only if the interest is transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer, or by a related person, in an ATB. If a taxpayer provides any services in an ATB and an allocation of a partnership's profits is transferred to or held by the taxpayer in connection with those services, the proposed regulations presume that those services are substantial for purposes of Section 1061. (See Proposed Regulations Section 1.1061-2(a)(1)(iv).)

- *Are S corporations exempt from Section 1061?* Section 1061(c)(4) contains exceptions to the application of Section 1061(a). One of those exceptions, Section 1061(c)(4)(A), provides that API does not include any interest in a partnership directly or indirectly held by a corporation. Consistent with the IRS's position in Notice 2018-18, 2018-12 IRB (see our prior coverage https://www.stradley.com/insights/publications/2018/03/tax-insights-march-7-2018), an S corporation is not treated as a corporation for purposes of the exception in Section 1061(c)(4)(A). (See Proposed Regulations Section 1.1061-3(b)(2)(i).) The Proposed Regulations, therefore, clarify that partnership interests held by S corporations are treated as APIs if the interest otherwise meets the API definition. This rule is proposed to apply to tax years beginning after Dec. 31, 2017. (See Proposed Regulations Section 1.1061-3(f)(2).)

- *Are PFICs exempt from Section 1061?* Additionally, the proposed regulations provide that the term corporation does not include a PFIC with respect to which the shareholder has a quailed electing fund election (QEF) under Section 1295 in effect. Therefore, a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect will be treated as an API if the interest otherwise meets the API definition. The rule is proposed to apply for tax years beginning after the date the proposed regulations are published in the Federal Register. (See Proposed Regulations Section 1.1061-3(f)(3).)

- *What is an interest in a partnership for purposes of the proposed rules?* Proposed Regulation Section 1.1061-1(a) provides that, for purposes of Section 1061, an interest in a partnership includes any financial instrument or contract, the value of which is determined, in whole or in part, by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations).



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- *What is the significance of an "Owner Taxpayer" and "Passthrough Taxpayer" under the proposed rules?* The proposed regulations provide for two definitions of a taxpayer – an Owner Taxpayer and a Passthrough Taxpayer for purposes of Section 1061. These definitions are provided to define the scope of the term "taxpayer" for purposes of computing the Recharacterization Amount and for purposes of determining whether a partnership interest is an API. An Owner Taxpayer, under the proposed regulations, is defined as the person subject to tax on the net gain with respect to the API. (See Proposed Regulation Section 1.1061-4(a)(1).) The Recharacterization Amount is determined by the Owner Taxpayer. For this purpose, the term Owner Taxpayer includes individuals, simple and complex trusts, and estates. If an Owner Taxpayer holds one or more APIs indirectly (through one or more Passthrough Entities), amounts subject to Section 1061 flow through those entities and are netted at the Owner Taxpayer level to determine the Recharacterization Amount.

The proposed regulations define the term Passthrough Taxpayer as an entity that generally does not pay tax itself, and that is treated as a taxpayer for the purpose of determining the existence of an API. (See Proposed Regulation Section 1.1061-4(a)(1).)

An Owner Taxpayer and a Passthrough Taxpayer each are treated as a taxpayer for the purpose of determining whether an API exists. In determining whether the elements of an API are present, a Passthrough Taxpayer can be (1) the service provider, (2) a person related to the service provider, (3) engaged in an ATB, or (4) the recipient of an interest in connection with the performance of substantial services in an ATB. If a Passthrough Taxpayer is treated as the recipient (or holder) of a partnership interest, directly or indirectly, for purposes of determining the existence of an API, the ultimate owners of the Passthrough Taxpayer are treated as Owner Taxpayers for the purpose of determining the Recharacterization Amount. Owner Taxpayers do not include owners of a Passthrough Taxpayer who are excepted from the application of Section 1061 under Proposed Regulation Section 1.1061-3. Additionally, Owner Taxpayers to whom a partnership interest is directly or indirectly transferred in connection with the Owner Taxpayer's or a related party's performance of substantial services in an ATB are also treated as taxpayers for purposes of determining the existence of an API.

- *What is an API Holder?* An API Holder under the proposed regulations refers to any person who holds an interest in a particular API. (See Proposed Regulation Section 1.1061-1(a).) An API Holder can include either or both a Passthrough Taxpayer and an Owner Taxpayer.

- *What is an Indirect API?* The proposed regulations define an Indirect API as an API that is held through one or more Passthrough Entities. (See Proposed Regulation Section 1.1061-1(a).)

- *What is Passthrough Interest?* The proposed regulations define Passthrough Interest as an interest in a Passthrough Entity that represents, in whole or in part, an API. (See Proposed Regulation Section 1.1061-1(a).)

- *What is the significance of API Gains and Losses and Unrealized API Gains and Losses?* API Gains and Losses are long-term capital gains and losses recognized with respect to an API. The proposed regulations provide that API Gains and Losses include long-term capital gain or loss from a deemed or actual disposition of the API and the holder's distributive share of the net long-term capital gain or loss from the partnership under Sections 702 and 704 with respect to the API. The proposed regulations also treat long-term capital gain or loss on the disposition of a capital asset distributed from a partnership with respect to an API (Distributed API Property) as API Gain or Loss if the asset is held for more than one year, but not more than three years at the time the distributee-partner disposes of the property. The holding period of the asset in the partner's hands includes the partnership's holding period with respect to the asset. (See Proposed Regulation Sections 1.1061-1(a) and 1.1061-4(a).) The proposed regulations state that API Gains and Losses <u>do not</u> include long-term capital gain determined under Sections 1231 and 1256, qualified dividends (which are taxed as long-term capital gains pursuant to Section 1(h)(11)(B)), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in Section 1222.

- *Do the proposed regulations provide guidance on carried interest waivers?* According to the preamble to the proposed regulations, the IRS is aware that taxpayers may seek to circumvent Section 1061(a) by waiving their rights to gains generated from the disposition of a partnership's capital assets held for three years or less and substituting for these amounts gains generated from capital assets held for more than three years. Alternatively, taxpayers may waive their rights to API Gains and substitute gains that are not taken into account for purposes of determining the Recharacterization Amount. Some arrangements also may include the ability for an API Holder to periodically waive its right to an allocation of capital gains from all assets in favor of allocation of capital gains from assets held for more than three years and/or a priority fill up allocation designed to replicate the economics of an arrangement in which the API Holder shares in all realized gains over the life of the fund. These arrangements are often referred to as carry waivers or carried interest waivers. The preamble to the proposed regulations states that taxpayers should be aware that these and similar arrangements may not be respected and maybe challenged under Section 707(a)(2)(A) (regarding the treatment of payments to partners for property or services), Treasury Regulation Sections 1.701-2 and 1.704-1(b)(2)(iii), and/or the substance over form or economic substance doctrines. (Note that possible planning opportunities might include using a tax-deferred distribution of property with respect to an API, considering whether the sale of assets or property creates a more favorable result or considering whether a properly structured carry waiver will be respected (as the preamble to the proposed regulations focuses on the deferral of carried interest allocations – however, deferrals of carried interest distributions might be done for business reasons unrelated to tax).

- *What are the applicability dates of the proposed regulations?* The proposed regulations generally provide that the final regulations apply to tax years of Owner Taxpayers and Passthrough Entities beginning on or after the date final regulations are published in the Federal Register.

- *Can a taxpayer rely on the proposed regulations?* Except for the rules in the proposed regulations regarding Partnership Transition Amounts and API Holder Transition Amounts, Owner Taxpayers and Passthrough Entities may rely on the proposed regulations for tax years beginning before the date final regulations are published in the Federal Register provided they follow the proposed regulations in their entirety and in a consistent manner.

  Taxpayers may rely on the rules in the proposed regulations regarding Partnership Transition Amounts and API Holder Transition Amounts for tax years beginning in 2020, and subsequent tax years beginning before the date final regulations are published in the Federal Register and may do so without consistently following all of the rules provided in Proposed Regulations Sections 1.1061-1 through -6 if the partnership treats capital gains and losses from the identified assets as "Partnership Transition Amounts" and "API Holder Transition Amounts" for the year in which the election is made, and all subsequent tax years beginning before the date final regulations are published in the Federal Register.

With respect to an API in a partnership with a fiscal year ending after Dec. 31, 2017, Section 706 determines the capital gains and losses the Owner Taxpayer includes in income with respect to an API after Dec. 31, 2017. Section 706 provides that the taxable income of a partner for a tax year includes amounts required by Sections 702 (regarding income and credits of a partner) and 707(c) (guaranteed payments) with respect to a partnership based on the income, gain, loss, deduction, or credit of a partnership for any tax year ending within or with the tax year of the partner. Accordingly, if a calendar year Owner Taxpayer has an API in a fiscal year partnership that has a year-end after Dec. 31, 2017, Section 1061 applies to the Owner Taxpayer's distributive share of the long-term capital gain or loss with respect to the API in the calendar year 2018 regardless of whether the partnership disposed of the property giving rise to the gains and losses in the period prior to Jan. 1, 2018.

IRS Issues Final and Proposed Regulations on Business Interest Expense Deduction Limitation

The IRS issued final (https://www.irs.gov/pub/irs-drop/td_9905_reg_106089_18.pdf) and proposed regulations (https://www.irs.gov/pub/irs-drop/nprm_reg_107911_18.pdf) that provide guidance on the business interest expense deduction limitation after changes made to Section 163(j) by the 2017 Tax Cuts and Jobs Act (TCJA), and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). (The IRS originally released proposed regulations under Section 163(j) in 2018 – see our coverage of the 2018 Section 163(j) proposed regulations https://www.stradley.com/insights/publications/2018/12/tax-insights-december-5-2018.)

Section 163(j) generally limits the amount of business interest allowed as a deduction to 30% of adjusted taxable income. The final regulations provide guidance on how to calculate the business interest expense deduction limitation, what constitutes interest for purposes of the limitation, which taxpayers and trades or businesses are subject to the limitation, and how the limitation applies in consolidated group, partnership, international and other contexts. Concurrently with the publication of the final regulations, the IRS published additional proposed regulations under Section 163(j). The proposed regulations include proposed rules relating to changes made to Section 163(j) under the CARES Act (see our coverage https://www.stradley.com/insights/publications/2020/03/tax-insights-march-31-2020). The CARES Act temporarily and retroactively increases the limitation on the deductibility of interest expense under Section 163(j)(1) from 30% to 50% for tax years beginning in 2019 and 2020. Under a special rule for partnerships, the increase in the limitation will not apply to partners in partnerships for 2019 (it applies only in 2020).

Relating to the investment management industry, at least two items are of note:

- *Rules relating to regulated investment companies (RICs):* The proposed regulations provide rules under which certain dividends paid by regulated investment companies (RICs) may be treated by shareholders as interest income for purposes of Section 163(j).

  Commenters on the 2018 proposed regulations recommended that dividend income from a RIC be treated as interest income for a shareholder in a RIC, to the extent that the income earned by the RIC is interest income. Because a RIC is a subchapter C corporation, Section 163(j) applies at the RIC level, and any business interest expense (BIE) that is disallowed at the RIC level is carried forward to subsequent years at the RIC level. Additionally, because a RIC is a subchapter C corporation, a shareholder in a RIC generally does not take into account a share of the RIC's items of income, deduction, gain, or loss. Therefore, if a RIC's business interest income (BII) exceeds its BIE in a taxable year, the RIC may not directly allocate the excess amount to its shareholders (unlike a partnership, which may allocate excess BII to its partners).

  Under certain provisions of the Code, a RIC that has certain items of income or gain may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying items of income or gain if the shareholder realized the items directly (e.g., interest-related dividends, capital gain dividends, exempt-interest dividends, short-term capital gain dividends, dividends eligible for the dividends received deduction and qualified dividend income).

  The proposed regulations provide rules under which a RIC that earns BII may pay Section 163(j) interest dividends. A shareholder that receives a Section 163(j) interest dividend may treat the dividend as interest income for purposes of Section 163(j), subject to holding period requirements and other limitations. A Section 163(j) interest dividend that meets these requirements is treated as BII if it is properly allocable to a non-excepted trade or business of the shareholder. A Section 163(j) interest dividend is treated as interest income solely for purposes of Section 163(j).

  The rules under which a RIC may report Section 163(j) interest dividends are based on the rules for reporting exempt-interest dividends in Section 852(b)(5) and interest-related dividends in Section 871(k)(1). The total amount of a RIC's Section 163(j) interest dividends for a taxable year is limited to the excess of the RIC's BII for the taxable year over the sum of the RIC's

BIE for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's BII. For some types of income and gain to which conduit treatment applies, the gross amount of the RIC's income or gain of that type serves as the limit on the RIC's corresponding dividends. According to the preamble to the proposed regulations, It would be inconsistent with the purposes of Section 163(j) to permit a RIC to pay Section 163(j) interest dividends in an amount based on the RIC's gross BII, unreduced by the RIC's BIE. The preamble to the proposed regulations further states that reducing the limit on a RIC's Section 163(j) interest dividends by the amount of the RIC's other deductions that are properly allocable to the RIC's BII is consistent with the provisions of the Code that provide conduit treatment for types of interest earned by a RIC. The preamble cites that, as an example, the limit on interest-related dividends in Section 871(k)(1)(D) is reduced by the deductions properly allocable to the RIC's qualified interest income. Similarly, the limit on exempt-interest dividends in Section 852(b)(5)(A)(iv)(V) is reduced by the amounts disallowed as deductions under Sections 265 and 171(a)(2). According to the preamble, taking into account the appropriate share of deductions also reduces the likelihood that the sum of a RIC's items that are eligible for conduit treatment and that are relevant to a particular shareholder will exceed the amount of the dividend distribution paid to the particular shareholder.

The proposed regulations contain an additional limit to prevent inconsistent treatment of RIC dividends by RIC shareholders. Revenue Ruling 2005-31, 2005-1 C.B. 1084, allows a RIC to report the maximum amount of capital gain dividends, exempt-interest dividends, interest-related dividends, short-term capital gain dividends, dividends eligible for the dividends received deduction, and qualified dividend income for a taxable year, even if the sum of the reported amounts exceeds the amount of the RIC's dividends for the taxable year. The ruling allows different categories of shareholders (United States persons and nonresident aliens) to report the dividends they receive by giving effect to the conduit treatment of the items relevant to them. A single shareholder, however, generally does not benefit from the conduit treatment of amounts in excess of the dividend paid to that shareholder, because to do so would require the shareholder to include in its taxable income amounts exceeding the dividend is received. Conduit treatment of BII, however, differs from the conduit treatment of other items, because a Section 163(j) interest dividend is treated as interest income only for purposes of Section 163(j). Thus, absent a limit, a RIC shareholder could obtain an inappropriate benefit by treating a portion of a RIC dividend as interest income for purposes of Section 163(j) while treating the same portion of the dividend as another non-interest type of income, such as a dividend eligible for the dividends received deduction under Sections 243 and 854(b). Therefore, the proposed regulations limit the amount of Section 163(j) interest dividend that a shareholder may treat as interest income for purposes of Section 163(j) to the excess of the amount of the RIC dividend that includes the Section 163(j) interest dividend over the sum of the portions of that dividend affected by conduit treatment in the hands of that shareholder, other than interest-related dividends under Section 871(k)(1)(C) and Section 163(j) interest dividends.

Under the proposed regulations, a shareholder generally may not treat a Section 163(j) interest dividend as interest income unless it meets the certain holding period and similar requirements. The holding period requirements do not apply to (i) dividends paid by a RIC regulated as a money market fund under 17 CFR 270.2a-7 or (ii) certain regular dividends paid by a RIC that declares Section 163(j) interest dividends on a daily basis and distributes such dividends on a monthly or more frequent basis.

The Treasury Department and the IRS have requested comments on whether there are other categories of Section 163(j) interest dividends for which the holding period requirements should not apply or should be modified. The Treasury Department and the IRS also request comments on whether any payments that are substitutes for Section 163(j) interest dividends (for example, in a securities lending or sale-repurchase transaction with respect to RIC shares) should be treated for purposes of section 163(j) as interest expense of taxpayers making the payments or interest income to taxpayers receiving the payments.

The Proposed Regulations, to the extent they concern the payment of Section 163(j) interest dividends by a RIC and the treatment of such dividends as interest by a RIC shareholder, are proposed to apply to taxable years beginning on or after the date that is 60 days after the date the Treasury decision adopting these regulations as final regulations is published in the Federal Register. Solely in the case of Section 163(j) interest dividends that would be exempt from the holding period rules under these Proposed Regulations, the RIC paying such dividends and the shareholders receiving such dividends may rely on the provisions of these Proposed Regulations pertaining to Section 163(j) interest dividends for taxable years ending on or after the date that the proposed regulations are published in the federal register, and beginning before the date that is 60 days after the date the Treasury decision adopting these regulations as final regulations are published in the Federal Register.

- *Application of Limitation to Trading Partnerships:* The preamble to the 2018 proposed Section 163(j) regulations stated that the BIE of passthrough entities allocable to a trade or business activities that are per se passive under Section 469 or to activities with respect to which the taxpayer does not materially participate are subject to Section 163(j) at the partnership level, even where the interest expense is also subject to the investment interest limitation under Section

163(d) at the partner level. Because of this, the interest expense of a partnership engaged in a trade or business potentially could have been subject to two Section 163 limitations – one at the partnership level under Section 163(j), and a second at the partner level under Section 163(d).

The Treasury Department and the IRS received multiple comments questioning this interpretation of Section 163(j)(5) and its interaction with Section 163(d)(5)(A)(ii). Specifically, commenters stated that the interpretation improperly results in the application of Section 163(j) to partnerships engaged in a trade or business activity of trading personal property (including marketable securities) for the account of owners of interests in the activity, as described in Temporary Regulations Section 1.469-1T(e)(6) (trading partnerships). At issue is the extent to which BIE of trading partnerships should be subject to limitation under Section 163(j). This issue involves the definition of BIE under Section 163(j)(5) and, more specifically, the second sentence of Section 163(j)(5), which generally provides that BIE shall not include investment interest within the meaning of Section 163(d).

The proposed Section 163(j) regulations would interpret Section 163(j)(5) as requiring a trading partnership to bifurcate its interest expense from a trading activity between partners that materially participate in the trading activity and partners that are passive investors, and as subjecting only the portion of the interest expense that is allocable to the materially participating partners to limitation under Section 163(j) at the partnership level. The portion of interest expense from a trading activity allocable to passive investors will be subject to limitation under Section 163(d) at the partner level, as provided in Section 163(d)(5)(A)(ii).

Additionally, the proposed regulations require that a trading partnership bifurcate all of its other items of income, gain, loss and deduction from its trading activity between partners that materially participate in the partnership's trading activity and partners that are passive investors. The portion of the partnership's other items of income, gain, loss or deduction from its trading activity properly allocable to the passive investors in the partnership will not be taken into account at the partnership level as items from a trade or business for purposes of applying section 163(j) at the partnership level. Instead, all such partnership items properly allocable to passive investors will be treated as items from an investment activity of the partnership, for purposes of Sections 163(j) and 163(d).

The approach of the proposed regulations adopts the presumption that a trading partnership generally will possess knowledge regarding whether its individual partners are material participants in its trading activity. No rules currently exist requiring a partner to inform the partnership whether the partner has grouped activities of the partnership with other activities of the partner outside of the partnership. Therefore, the partnership might possess little or no knowledge regarding whether an individual partner has made such a grouping. Without this information, a trading partnership may presume that an individual partner is a passive investor in the partnership's trading activity based solely on the partnership's understanding as to the lack of work performed by the partner in that activity, whereas the partner may, in fact, be treated as a material participant in the partnership's trading activity by grouping that activity with one or more activities of the partner in which the partner materially participates. In order to avoid this result and the potential for abuse, a new rule is proposed for the Section 469 activity grouping rules to provide that any activity described in Section 163(d)(5)(A)(ii) may not be grouped with any other activity of the taxpayer, including any other activity described in Section 163(d)(5)(A)(ii). The Treasury Department and the IRS invite comments regarding whether other approaches may be feasible and preferable to a special rule that prohibits the grouping of trading activities with other activities of a partner, such as the adoption of a rule or reporting regime requiring all partners in the partnership to annually certify or report to the partnership whether they are material participants in a grouped activity that includes the partnership's trading activity.

IRS Issues FAQs on Taxation of Payments and Loans From Coronavirus Relief Fund

The IRS issued two FAQs (https://www.irs.gov/newsroom/cares-act-coronavirus-relief-fund-frequently-asked-questions) regarding the taxation of payments and loans from the Coronavirus Relief Fund (the Fund) that was established by the CARES Act. $150 billion was appropriated to the Fund. The Fund is used to make payments for specified uses to States and certain local governments; the District of Columbia and U.S. Territories (consisting of the Commonwealth of Puerto Rico, the United States Virgin Islands, Guam, American Samoa, and the Commonwealth of the Northern Mariana Islands); and Tribal governments.

One FAQ states that if governments use Fund payments as described in guidance relating to the Fund to establish a grant program to support businesses, the receipt of a government grant by a business generally is not excluded from the business's gross income under the Code and, therefore, is taxable. The other FAQ provides that if governments use Fund payments as described in the guidance relating to the Fund to establish a loan program to support business, generally, the receipt of loan proceeds is not included in gross income. However, if the government forgives all or a portion of the loan, the amount of the loan that is forgiven is generally included in the gross income of the business and is taxable unless an exclusion in Section 108 or other Federal law applies. If an exclusion applies, an equivalent amount of any deductions, basis, losses or other tax attributes may have to be reduced in accordance with the Code or other Federal law.

IRS Releases Additional Guidance Regarding Exempt Organization NOLs and UBTI

The IRS issued Legal Advice Issued by Associate Chief Counsel 2020-008 (https://www.irs.gov/pub/lanoa/am-2020-008.pdf), which expands upon what it said in frequently asked questions (https://www.irs.gov/newsroom/faqs-carryback-of-nols-by-certain-exempt-organizations) that were posted to its website in June (see our coverage https://www.stradley.com/insights/publications/2020/06/tax-insights-june-24-2020), about the effect of net operating losses (NOL) on the calculation of a tax-exempt organization's unrelated business taxable income. The guidance issued by the IRS relates to the CARES Act amendment to Section 172, which provides that any NOL arising in a tax year beginning after Dec. 31, 2017, and before Jan. 1, 2021 may be carried back to the five tax years preceding the tax year of such loss. As a result of this rule, carrybacks may be made to tax years prior to the date of enactment of Section 512(a)(6), which was added to the Code by the TCJA, and changed the calculation of UBTI for exempt organizations with more than one unrelated trade or business by requiring such an exempt organization to calculate UBTI separately, including for purposes of calculating any NOL deduction, with respect to each unrelated trade or business in tax years beginning after Dec. 31, 2017.

IRS Provides Relief From Certain Rehabilitation Tax Credit Deadlines

The IRS issued Notice 2020-58 (https://www.irs.gov/pub/irs-drop/n_20_58.pdf) in which it grants relief for meeting certain Section 47 rehabilitation credit deadlines due to COVID-19. Generally, the Notice broadens relief for rehabilitation credit deadlines recently afforded to those affected by the COVID-19 pandemic, where taxpayers that have measuring period under substantial rehabilitation test ending on or after Apr. 1 and before March 31, 2021, or those qualifying under TCJA transition rules, will now have until March 31, 2021, to satisfy the test. An IRS news release (https://content.govdelivery.com/accounts/USIRS/bulletins/2980786) accompanied the release of the Notice.

PA Commonwealth Court Upholds Benefits-Received Method of Determining Pennsylvania Sales Factor

The Pennsylvania Commonwealth Court, in *Synthes USA HQ, Inc. v. Commonwealth of Pennsylvania* (http://www.pacourts.us/assets/opinions/Commonwealth/out/108FR16_7-24-20.pdf?cb=1), held that the taxpayer was entitled to a tax refund of its 2011 taxes. The taxpayer, a Pennsylvania corporation, provided research, development, and management services to affiliates located outside Pennsylvania. The issue in the case was how to apportion sales of services by the taxpayer to businesses outside of Pennsylvania. The taxpayer originally used the costs-of-performance method for determining its sales factor in the apportionment formula. The taxpayer subsequently sought a tax refund on the basis that the Pennsylvania Department of Revenue (DOR) had consistently applied the benefits-received method in calculating the sales factor, which would have resulted in a lower tax. The DOR denied the refund, as did the Tax Review Board. On appeal, the court rejected an argument by the Commonwealth that the refund should be denied because the DOR's interpretation was in error. The Commonwealth Court noted that the DOR has consistently applied the benefits-received method for many years and that the state legislature acquiesced in that interpretation. Therefore, the Commonwealth Court upheld the use of the benefits-received method of calculating the sales factor and reversed the Tax Review Board's decision.

Pennsylvania DOR States COVID-19 Hazard Pay is Taxable

The Pennsylvania Department of Revenue issued a release (https://www.revenue.pa.gov/Pages/COVID19.aspx#HazardPay) announcing that additional hazard pay to employees is taxable as compensation for personal income tax. Governor Wolf announced the availability of $50 million in grant funding to help employers provide hazard pay to employees in life-sustaining occupations during the COVID-19 pandemic. Hazard pay is intended to keep front-line employees working in vital industry sectors across Pennsylvania. Further, for personal income tax purposes, the grant funding is not income to the employer (sole proprietor or pass-through entity). However, even though the grant funding is not taxable income, the employer may still take a business expense deduction for grant funding used to pay its employees hazard pay.