



October 5, 2023

Ms. Holly Porter
Associate Chief Counsel, Office of Chief Counsel
Passthroughs and Special Industries
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Guidance on Employee Retention Credit as it Relates to S Corporations

Dear Ms. Porter:

The AICPA appreciates the efforts by Treasury and the IRS to clarify the application of the employee retention credit (ERC) for eligible employers through the ERC Guidance and is pleased to submit comments regarding the tax treatment of the ERC. However, guidance is still needed to clarify the interaction of the wage deduction disallowance on the federal income tax return, in the amount of the ERC, and an S corporation's accumulated adjustment account (AAA).

Overview

Section 2301 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act),¹ created the ERC. The ERC was subsequently amended by the Consolidated Appropriations Act, 2021, the American Rescue Plan Act of 2021, and the Infrastructure Investment and Jobs Act.² The ERC was codified (section 3134)³ for the period beginning July 1, 2021, and ending September 30, 2021. This legislation, which we collectively refer to as the "ERC Statutes," provides for an ERC to eligible employers that paid qualified wages to some or all employees after March 12, 2020, and before October 1, 2021 (or January 1, 2022, for qualified wages paid by a recovery startup business).

To aid in the implementation of the ERC, the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) issued Notices 2021-20, 2021-23, 2021-49, 2021-65, and Rev. Proc. 2021-33 (collectively, the "ERC Guidance"),⁴ and published regulations under section 3134.⁵

¹ P.L. 116-136.

² P.L. 116-160; P.L. 117-2; and P.L. 117-58.

³ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, or to the Treasury Regulations promulgated thereunder.

⁴ 2021-11 IRB 922; 2021-16 IRB 1113; 2021-34 IRB 316; 2021-51 IRB 880; and 2021-34 IRB 327.

⁵ T.D. 9978.

Wage Deduction Disallowance Equal to Employee Retention Credit

Section 2301(e) of the CARES Act and section 3134(e) provide that rules similar to the rules of section 280C(a) apply for purposes of the ERC. Section 280C(a) generally disallows a deduction for the portion of wages or salaries paid or incurred equal to the sum of certain tax credits.

Notice 2021-20 clarifies that an employer's deduction of qualified wages, including qualified health plan expenses, is reduced by the amount of ERC received by the employer. In addition, the notice states that an employer receiving an ERC is not required to include any portion of the credit in its gross income for federal income tax purposes.

Notice 2021-49 further clarifies that the reduction in the amount of the deduction allowed for qualified wages, including qualified health plan expenses, equal to the ERC, must occur in the taxable year in which the qualified wages were paid or incurred.

S Corporation's Accumulated Adjustment Account

An S corporation's AAA is relevant in determining the tax characterization of distributions from an S corporation with accumulated earnings and profits (AE&P). Distributions from an S corporation with AE&P are not made from its AE&P (taxable as a dividend to the shareholders) to the extent of the AAA.⁶ The AAA is adjusted "in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax" ⁷ The AAA is decreased, but not below zero, by the amount of distributions.⁸

Distributions made from the AAA are tax-free to a shareholder to the extent of the shareholder's stock basis.⁹ Expenses properly chargeable to a capital account do not reduce the AAA.¹⁰ In addition, nondeductible expenses related to tax-exempt income do not reduce the AAA.¹¹ Instead, those nondeductible expenses reduce the other adjustments account (OAA).¹² The IRC contains no reference to the OAA as it is a "holding pen" for items that increase basis in stock for the shareholders, but are not available for distribution until the S corporation has fully distributed its AE&P.¹³

While the ERC Statutes disallow a deduction for the portion of qualified wages paid or incurred equal to the ERC claimed by an eligible employer it is currently unclear if the wage deduction disallowance impacts an S corporation's AAA or OAA.

⁶ Section 1368(c)(1).

⁷ Section 1368(e)(1)(A).

⁸ Treas. Reg. § 1.1368-2(a)(3)(iii).

⁹ Section 1368(b)(1).

¹⁰ Treas. Reg. § 1.1368-2(a)(3)(i)(C) ("The AAA is decreased for the taxable year of the corporation by the sum of the following items with respect to the corporation for the taxable year— . . . (C) Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to a capital account . . .").

¹¹ Treas. Reg. § 1.1368-2(a)(3)(i)(A), (B).

¹² Treas. Reg. § 1.1368-2(a)(3)(i)(C).

¹³ Section 1368(c)(1).

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance clarifying that an S Corporation's AAA is not reduced by the wage deduction disallowance equal to the amount of ERC claimed. Specifically, the AICPA recommends issuing guidance which applies one of the following two options to the receipt of the ERC and corresponding wage deduction disallowance:

Option 1

An ERC benefit received by an S corporation would be treated as the S corporation's tax-exempt income, increasing the S corporation's OAA in the year of the receipt of the ERC benefit. The corresponding wage deduction disallowance with respect to the ERC would be treated as a nondeductible expense related to the S corporation's tax-exempt income, decreasing the S corporation's OAA in the year the wage is paid or incurred.

Option 2

The S corporation would treat the wage deduction disallowance with respect to the ERC as an expense, chargeable to the capital account as a receivable, which would not affect the S corporation's AAA or OAA. The S corporation's later receipt of the ERC benefit would be treated as in satisfaction of that receivable. As the amount of the ERC benefit is equal to the amount of the receivable, the S corporation's receipt of the ERC would not result in gain or loss and would not affect the S corporation's AAA or OAA.

We recognize that the proposed treatment of the wage expenses as a capital expenditure under this Option 2 may be viewed as contrary to the provisions of section 3134(e) and Notice 2021-20, Q&A-60, both of which simply disallow a deduction for these wages. To the extent that Treasury and the IRS agree with this view, the approach in Option 1 may be the preferred alternative.

Analysis

Option 1 and Option 2 provide the appropriate tax treatment with respect to an S corporation's receipt of ERC and the corresponding wage deduction disallowance. Both options increase the S corporation's taxable income by the amount of ERC claimed, consistent with the application of section 280C(a) as referenced by the ERC Statute. As the S corporation's taxable income is increased by the amount of ERC claimed, the S corporation's overall AAA should be increased by the same amount, as illustrated in the following example.

Example

T is an S corporation with a calendar taxable year. For taxable year 2021, T claimed \$50,000 of ERC. For taxable year 2021, T's taxable income would have been \$30,000 if the qualified wage deduction was not disallowed under the ERC Statute.

Results under Option 1 and Option 2:

- T's wage expense of \$50,000, equal to the ERC, is not deductible for federal income tax purposes since it is either a nondeductible expense (Option 1) or chargeable to the capital account of a receivable for the ERC (Option 2).
- The \$50,000 ERC claimed by T is not taxable income, because it is tax-exempt income (Option 1) or because it satisfies the receivable for the ERC with the same tax basis (Option 2).
- T's taxable income for taxable year 2021 was \$80,000 (\$30,000 taxable income plus \$50,000 wage deduction disallowance).

As discussed below, neither Option 1 nor Option 2 reduces an S corporation's AAA by the amount of the wage deduction disallowance.

Option 1 Results

T's AAA would be increased by \$80,000 of taxable income for taxable year 2021. The wage deduction disallowance of \$50,000 would be treated as a nondeductible expense. However, since the receipt of ERC in the amount of \$50,000 would be treated as tax-exempt income, the wage deduction disallowance should be an expense related to tax-exempt income, which would not adjust T's AAA.¹⁴ Accordingly, both the wage deduction disallowance and the receipt of ERC should adjust T's OAA, not AAA. In addition, the wage deduction disallowance and the receipt of ERC collectively result in a net effect of zero on T's OAA and the shareholders' tax bases in T's stock.

Option 2 Results

T's AAA would be increased by \$80,000 of taxable income for taxable year 2021. The wage deduction disallowance of \$50,000 would be treated as chargeable to a capital account of the ERC receivable for the same amount, which would not reduce T's AAA.¹⁵ When T receives the ERC benefit of \$50,000, T's ERC receivable of \$50,000 will be satisfied, resulting in no additional taxable income or loss to T. In addition, the wage deduction disallowance and the receipt of ERC collectively result in zero net effect on shareholders' tax bases in T's stock.

The primary policy goal of subchapter S is to treat an S corporation as a passthrough entity and ensure a single level of tax for S corporation shareholders. To the extent the S corporation's taxable income is increased by the wage deduction disallowance with respect to the ERC claimed, the S corporation shareholders will have borne the single level of tax for their shares of the S corporation's taxable income, as reflected in the AAA increase. Reducing the S corporation's AAA

¹⁴ Treas. Reg. § 1.1368-2(a)(3)(i)(A), (B).

¹⁵ Treas. Reg. § 1.1368-2(a)(3)(i)(C).

by the amount of the wage deduction disallowance nullifies the AAA increase with respect to the additional income recognized by the S corporation and creates a potential second level of tax when an S corporation with AE&P distributes the ERC benefit to the shareholders.

In addition, due to the different tax treatments with respect to the ERC and tax credits listed in section 280C (e.g., work opportunity tax credits described in section 51(a)), the ERC Statutes' reference to section 280C should not result in a reduction of an S corporation's AAA by the amount of wage deduction disallowance with respect to the ERC. An S corporation claiming section 280C credits passes them through to its shareholders.¹⁶ The wage deduction disallowance for those credits also increases the S corporation's taxable income and AAA. Without regard to the reduction to the AAA by the wage deduction disallowance, the S corporation shareholders would benefit from both the credits passed from the S corporation and the increased AAA due to the wage deduction disallowance.

Unlike the tax credits referenced in section 280C, an ERC is not passed from an S corporation to its shareholders. Instead, the S corporation reduces its payroll taxes through the receipt of ERC, which increases the federal taxable income allocated to shareholders. As shareholders of an S corporation receiving an ERC do not benefit directly from the ERC, reducing the AAA by the related wage deduction disallowance negates the sole benefit shareholders have for recognizing additional taxable income, rather than one of the two benefits in the case of credits listed in section 280C. Therefore, the ERC Statutes' reference to section 280C should not dictate a reduction in an S corporation's AAA by the amount of disallowed wage deduction with respect to an ERC.

Since the primary policy goal of section 1368 is to permit shareholders to receive distributions tax free to the extent of previously undistributed taxable income, the AICPA recommends that Treasury and the IRS clarify that an S corporation eligible employer's AAA is not reduced by the wage deduction disallowance corresponding to the ERC claimed. If Treasury and the IRS conclude that Option 1 is the appropriate tax treatment with respect to the ERC and the corresponding wage deduction disallowance, we recommend clarifying that the S corporation's wage deduction disallowance and receipt of the ERC benefit should both adjust the S corporation's OAA. If Treasury and the IRS conclude that Option 2 is the appropriate tax treatment with respect to the ERC and the corresponding wage deduction disallowance, we recommend clarifying that the S corporation's wage deduction disallowance and receipt of the ERC benefit does not adjust the S corporation's AAA or OAA.

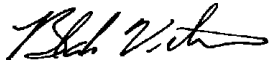
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¹⁶ Section 1366(a)(1)(A).

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Kristin Hill, Chair, AICPA S Corporation Taxation Technical Resource Panel, at (510) 525-4797, or krishill@krishillcpa.com; Kristin Esposito, AICPA Director – Tax Policy & Advocacy, at (202) 434-9241, or kristin.esposito@aicpa-cima.com; or me, at (830) 372-9692, or bvickers@alamo-group.com.

Sincerely,



Blake Vickers, CPA
Chair, AICPA Tax Executive Committee

cc: Ms. Carol Weiser, Benefits Tax Counsel, Department of the Treasury
Ms. Rachel Leiser Levy, Associate Chief Counsel, Internal Revenue Service