November PPP Round-Up

By William E. Sigler

Apparently to show that there is still someone working in Washington, the IRS on November 18, 2020, issued Revenue Ruling 2020-27, which addresses the issue of borrowers who pay expenses in 2020 but whose Paycheck Protection Program (PPP) loan is not forgiven until 2021, and Revenue Procedure 2020-51, which provides a safe harbor for PPP borrowers who have their loan forgiveness denied or who choose not to request loan forgiveness.

The IRS has also issued guidance in the form of FAQs on the rules that apply for purposes of determining whether an employer that acquires the stock or assets of an entity in a transaction that results in the target becoming a member of an aggregated group with the acquiring employer, who is treated as a single employer under the aggregation rules, is eligible for the employee retention credit after the closing.

Refresher: Nondeducibility of PPP Loan Funded Expenses.

Section 1102 and 1106 of the CARES Act established the PPP as a new loan program administered by the SBA as part of its section 7(a) Loan Program. It was designed to help small businesses adversely impacted by the COVID–19 pandemic to pay payroll costs and other covered expenses. An individual or entity eligible to receive a PPP loan can have the loan forgiven to the extent the proceeds are used for the following kinds of expenses paid or incurred during the covered period: (i) payroll costs, (ii) interest on a covered mortgage obligation, (iii) any covered rent obligation payment, and (iv) any covered utility payment.

Section 1106(i) of the CARES Act excludes the forgiven amounts from gross income regardless of whether the income would be (i) income from the discharge of indebtedness under section 61(a)(11) of the Code, or (ii) otherwise includible in gross income under section 61 of the Code. On May 2, 2020, the IRS released Notice 2020-32 stating that no deduction is allowed for an eligible expense that is otherwise deductible if the payment of the eligible expense results in forgiveness of a covered loan.

Notice 2020-32 relied on section 265(a)(1) of the Code and §1.265-1 of the Regulations which provide that no deduction is allowed for any amount otherwise allowable as a deduction to the extent the amount is allocable to one or more classes of income, other than interest, wholly exempt from the taxes imposed by subtitle A of the Code. The Notice cites further authorities holding that an otherwise allowable deduction is disallowed if there is a reasonable expectation of reimbursement. See Burnett v. Commissioner, 356 F. 2d 755 (5th Cir. 1966) cert. denied 385 U.S. 832 (1966); Canelo v. Commissioner, 53 TC 217, 225-226 (1969), aff'd 447 F.2d 484 (9th Cir.1971); Charles Baloian Co. v. Commissioner, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 60; Rev. Rul. 79-263, 1979-2 C.B. 82. Lastly, the Notice makes reference to the "tax benefit rule" which provides that if a taxpayer takes a proper deduction and, in a later tax year, an event occurs that is fundamentally inconsistent with the premise on which the previous deduction was based (for example, an unforeseen refund of deducted expenses), the taxpayer must take the deducted amount into income.

Expenses Paid in the Year Preceding Loan Forgiveness.

Revenue Ruling 2020-27 provides guidance on whether a PPP borrower that paid or incurred certain otherwise deductible expenses can deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan. The revenue ruling also provides guidance if, as of the end of the 2020 taxable year, the PPP loan participant has not applied for forgiveness, but intends to apply in the next taxable year.

The revenue ruling is framed around two situations in which a taxpayer receives a PPP loan in 2020 and pays expenses, including payroll, mortgage interest, and rent, that are eligible expenses under Section 1106(a) of the CARES Act. In the first situation, the taxpayer paid expenses during the covered period beginning on February 15, 2020, and ending on December 31, 2020 which consisted of payroll costs that qualified under section 1106(a)(8) of the CARES Act, interest on a mortgage that qualified as interest on a covered mortgage obligation under section 1106(a)(2) of the CARES Act, utility payments that qualified as covered utility payments under section 1106(a)(5) of the CARES Act, and rent that qualified as payment on a covered rent obligation under section 1106(a)(4) of the CARES Act. In November 2020, pursuant to the terms of section 1106 of the CARES Act, the taxpayer applied to the lender for forgiveness of the loan on the basis of the eligible expenses it paid during the covered period. At that time, and based on the taxpayer’s payment of the eligible expenses, the taxpayer satisfied all requirements under section 1106 of the CARES Act for forgiveness of the covered loan. However, the lender did not inform the taxpayer whether the loan would be forgiven before the end of 2020.

In the second situation, the taxpayer paid the same types of eligible expenses, but did not apply for forgiveness before the end of 2020, even though the taxpayer satisfied all of the requirements under section 1106 of the CARES Act for forgiveness of the loan. The taxpayer expects to apply to the lender for forgiveness in 2021.

In both situations, the ruling concludes that the taxpayer has a reasonable expectation of reimbursement. At the end of 2020, the reimbursement of each taxpayer’s eligible expenses, in the form of loan forgiveness, is reasonably expected to occur — rather than being unforeseeable — such that a deduction is inappropriate. Citing section 265(a)(1) of the Code and §1.265-1 of the Regulations, the ruling provides that the fact the tax-exempt income may not have been accrued or received by the end of the taxable year does not change this result because the disallowance applies whether or not any amount of tax-exempt income in the form of loan forgiveness and to which the eligible expenses are allocable is received or accrued.

Safe Harbor for Expenses Paid with PPP Loan Proceeds not Reasonably Expected to be Forgiven.

Revenue Procedure 2020-51 provides a safe harbor for certain PPP borrowers, whose loan forgiveness has been partially or fully denied or who decide to forego requesting loan forgiveness, to claim a deduction for otherwise deductible payments on (i) the taxpayer’s timely filed, including extensions, original income tax return or information return for the 2020 taxable year, or (ii) an amended return or an administrative adjustment request (AAR) under section 6227 of the Code for the 2020 taxable year. The safe harbor also allows taxpayers who decide to forego requesting loan forgiveness to claim a deduction for the otherwise deductible payments on an original income tax return or information return for the taxable year in which the taxpayer decides to forego requesting forgiveness.

To qualify for the safe harbor, taxpayers must attach a statement to their return titled “Revenue Procedure 2020-51 Statement” that contains:

1. The taxpayer's name, address, and social security number or employer identification number;
2. A statement specifying whether the taxpayer is eligible for the safe harbor under either section 3.01 of the revenue procedure (for a taxpayer who applied for loan forgiveness in 2020 or who as of the end of the 2020 tax year intended to apply for loan forgiveness in a subsequent tax year and the application was denied in whole or part), or under section 3.02 (for a taxpayer who applied for loan forgiveness in 2020 or who as of the end of the 2020 tax year intended to apply for loan forgiveness in a subsequent tax year but in a later tax year decides to irrevocably withdraw its request for forgiveness);
3. A statement that the taxpayer is applying the safe harbor in section 4.01 of the revenue procedure (for expenses claimed in 2020) or Section 4.02 (for expenses claimed in a later year);
4. The amount and date of disbursement of the taxpayer's covered loan;
5. The total amount of covered loan forgiveness that the taxpayer was denied or decided to no longer seek;
6. The date the taxpayer was denied or decided to no longer seek covered loan forgiveness; and
7. The total amount of eligible expenses and non-deducted eligible expenses that are reported on the return.

Lastly, the revenue procedure provides that nothing precludes the IRS from examining other issues relating to the claimed deductions for non-deducted eligible expenses, including the amount of the deduction and whether the taxpayer has substantiated the deduction claimed. It also does not preclude the IRS from requesting additional information or documentation verifying any amounts described in the "Revenue Procedure 2020-51 Statement."

Partnership Problems.

Revenue Ruling 2020-27 may create problems for some partnerships that took PPP loans. A partner's distributive share of partnership income and loss will typically vary year to year as partners transfer their partnership interests to third parties and new partners are admitted to the partnership.

Since the expenses funded with a PPP loan would not be deductible in 2020 if the loan is expected to be forgiven in 2021, these expenses would reduce book income in 2020. As a result, the economic cost of those expenses would be borne by the 2020 partners, based upon their respective 2020 distributive shares of partnership income and loss.

For example, assume that in 2020 a partnership is owned equally by four partners, and that one of them sells his or her partnership interest to a third party, effective as of January 1, 2021. Assume further that in 2020, the partnership incurred expenses funded with a PPP loan, which is expected to be forgiven in 2021. The departing partner will bear the economic cost for his or her distributive share of those expenses, because the expenses would reduce book income. He or she would also realize phantom income in 2020 as a result of the nondeducibility of the expenses, and won't derive any economic benefit as a result of the forgiveness of the loan in 2021.

Similar problems may arise not only if new partners are admitted or partnership interests are transferred, but also if partners' interests in the partnership vary in 2020 and 2021 without any change in the partners.

Section 199A.

Section 199A, which was added to the Code by the Tax Cuts and Jobs Act, allows taxpayers other than corporations a deduction of 20% of qualified business income (QBI) earned in a qualified trade or business, subject to certain limitations. The deduction is limited to the greater of (i) 50% of the W-2 wages with respect to the trade or business, or (ii) the sum of 25% of the W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property (generally, tangible property subject to depreciation under section 167).

Some practitioners worry because the IRS has said that the PPP loan proceeds used for payroll costs, such as wages, are not deductible, there is an argument that they would not count toward the section 199A wage limitation. Treasury is aware of the issue, but it's not clear if and when it will be addressed.

But there could be good news in any event. If deductions funded with PPP loans are denied, then it would actually increase QBI for purposes of the section 199A deduction. The taxpayers' income would go up by the amount of the deductions that are denied, but if the income qualifies for the section 199A deduction as QBI, and the taxpayer is otherwise not phased out, then the taxpayer may only have to pick up 80% because the section 199A deduction would protect the rest.

In Other News . . .

On November 16, 2020, the IRS provided long-awaited guidance clarifying businesses' eligibility for the employee retention tax credit (ERTC) when they acquire target entities that have received a PPP loan. Without this guidance, many private equity firms and corporate strategic buyers were reluctant to acquire a target company that had received a PPP loan because of the potential disqualification for significant ERTCs by the acquiring group.

The problem arises because the benefits of PPP loan forgiveness and ERTCs are mutually exclusive. An employer with a PPP loan may not claim the ERTCs. And, if multiple entities are treated as a single employer under the aggregation rules and one entity obtains a PPP loan, then all of the entities in the group are precluded from claiming the ERTCs.

In FAQ No. 81a, the IRS said that for stock or equity acquisitions of a target employer with a PPP loan which has been fully satisfied, or where the borrower has submitted a forgiveness application and established an escrow account satisfying the requirements in the notice issued by the SBA on October 2, 2020, the post-transaction "aggregated employer group" will not be treated as having received a PPP loan if certain conditions are met. In order to be eligible for the ERTCs, the acquiring group must not have received a PPP loan before the transaction closed, and no member of the group may receive a PPP loan on or after the closing date.

This means any employer which is a member of the aggregated employer group post-transaction, including the target employer, may claim the ERTCs for qualified wages paid on and after the closing date if the group meets the requirements for claiming the ERTCs. The guidance also states that the pre-transaction aggregated employer group's ERTCs for wages paid before the closing date will not be subject to recapture under the CARES Act.

If the target entity's PPP loan is not fully satisfied and no escrow account has been established before the transaction closes, then the same restrictions on PPP loans for the aggregated employer group and its members apply for them to be eligible for ERTCs post-transaction, except those rules do not apply to the target entity. Because the target entity received a PPP loan before the transaction and would continue to be obligated for the loan afterward, it cannot claim ERTCs for any wages paid to its employees before or after the closing date.

Under FAQ 81b, businesses that acquire a target entity's assets without assuming the PPP loan obligations will not be treated as having received the loan, and therefore will be eligible for ERTCs after the transaction closes, and prior credits claimed will not be subject to recapture. If the acquiring company assumes the target's PPP loan obligations in the transaction, it generally will not be treated as having received a PPP loan if it did not receive a PPP loan before, on, or after the closing date. However, the wages paid by the acquiring company after the closing to any individual who was employed by the target entity on the closing date will not be treated as qualified wages.

Parting Words.

If you have a hankering to discuss PPP loans, and nobody else will talk to you, call us!