<u>NON-DEDUCTIBILITY OF EXPENSES PAID WITH PPP LOAN PROCEEDS & OTHER COD ISSUES</u>

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I. <u>NON-DEDUCTIBILITY OF EXPENSES PAID WITH PPP LOAN PROCEEDS</u>.

A. Under Section 1106 of the CARES Act, Borrowers of a Payroll Protection Program ("PPP") Loan are eligible for <u>forgiveness</u> of up to 100% for the costs incurred and payments made during the Covered Period (the period beginning on the date that the borrower received the PPP loan proceeds and ending on the date that is 24 weeks later or December 31, 2020, if earlier. This 24-week period is referred to as the "Covered Period." Borrowers who obtained loans prior to June 5, 2020, may elect an 8-week period beginning on the Funding Date as their Covered Period)

B. Expenses eligible for Forgiveness are Payroll Costs (not in excess of $100,000 per annum salary, pro-rated), mortgage interest, rents and utilities, but no more than 40% can be attributable to non-payroll costs. Amounts forgiven are excluded from a borrower's gross income. Amounts not forgiven must be repaid with 1% Interest by the two year (or 5 year) maturity date. Loans issued prior to June 5, 2020 have a maturity of 2 years. Loans issued after June 5, 2020 have a maturity of 5 years as set forth in Section 1102 of the Cares Act. Loan payments may be deferred for six months.

C. The amount of the forgiveness may be reduced if, during the covered period, there are reductions in the number of full-time employees and the wages and salaries of certain employees. There are various FTE Reduction Exemptions set forth in the materials published by the SBA.

D. While forgiven indebtedness in normally included in a solvent taxpayer's income, the CARES Act specifically provided that amounts of PPP loan which are forgiven are excluded from gross income.

E. IRS Notice 2020-32

(i) After the enactment of the CARES Act, the IRS issued Notice 2020-32, stating that no deduction is allowed under the Code for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a covered loan pursuant to section 1106(b) of CARES Act and the income associated with the forgiveness is excluded from gross income for purposes of the Code pursuant to section 1106(i) of the CARES Act.

(ii) The Service relied on IRC Sec. 265(a)(1) and the accompanying treasury regulations, which disallow a deduction for an amount otherwise allowable as a deduction to the extent it is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from federal income tax.

(iii) Put simply, the IRS maintains that no deduction is allowed for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a PPP loan. It explains that, to prevent a double tax benefit, IRC Sec. 265 disallows a deduction for any amount otherwise allowable as a deduction that is allocable to tax-exempt income (other than interest). The IRS asserts that forgiven PPP funds constitute such tax-exempt income.

(iv) The combined effect of section 1106(i) of the CARES Act and the Notice is similar; that is, there is an exclusion from gross income and an associated denial of deductions. Arguably, this was the opposite of the intention of the drafters of the CARES Act.

(a) The Joint Committee on Taxation said in a July 27th letter that S. 3612, the Small Business Expense Protection Act of 2020, which would allow Paycheck Protection Program loan recipients to claim deductions for ordinary business expenses paid with loan proceeds, is "consistent with the original Congressional intent of the CARES Act." The letter stated that in their calculations of the effect of the PPP Loan program on the economy, the Joint Committee staff understood the intent of the legislation was not to deny deductions for qualifying expenses.

(b) The proposed Small Business Expense Protection Act of 2020 S.3612 - 116th Congress (2019-2020) would *reverse* the IRS and make the expenses deductible after all. Some observers thought this bill would sail through, but there has been surprising push-back, and, as of October 6, 2020, it has not passed. Next, the Amendment to the Hero's Act, first passed by the House of Representatives as part of the new proposed $2.3 trillion Stimulus Bill, contains Section 301 entitled "Tax Provisions" but these related to better coordination of PPP and the Employee Retention Tax Credit and did not address the deductibility issue. A second version of the Hero's Act passed by the House on October 6, 2020 deleted the coordination provision from Section 301 and instead dealt with denial of net operating losses-but did not address the non-deductibility issue. Then, on October 7, the President suggested that further negotiations to a new Stimulus Act should be delayed until after the November election.

(c) The American Institute of CPAs in early August, 2020, joined with more than 170 business and trade organizations in asking congressional leaders to allow businesses to write off expenses BE paid for with Paycheck Protection Program loans that have been forgiven.

(d) However, with the recent release of much-anticipated guidance, the IRS has confirmed their position that business expenses paid with PPP funds that are forgiven <u>cannot be deducted</u> for federal tax purposes. This guidance now places the responsibility on Congress to take legislative action if their intention was to ensure deductibility of business expenses that are funded with a forgiven PPP loan.

(v) The stakes clearly matter to businesses who have scooped up Paycheck Protection Program loans of up to $10M to keep their employees on the payroll during the shutdown. For most businesses, the key feature of the loan is that it can be forgiven without any income tax consequences. That makes the "loan" really more of a government grant. Usually, a cancellation of debt triggers income tax as cancellation of debt income. Denying expense deductions in Notice 2020-32, the IRS says "this treatment prevents a double tax benefit." One can argue however that the PPP loans are *supposed* to be used for exactly that purpose.

(vi) Comparison Example:

XYZ is a S Corporation of which A is the sole shareholder. XYZ receives a $100,000 PPP loan, spends it all on defined payroll, and the lender forgives the $100,000.

On its 2020 tax return, XYZ reports no PPP income, but it may not deduct $100,000 of payroll expenses. The non-deduction creates $100,000 of net taxable income that XYZ, the S corporation, passes on to its sole shareholder, A.

Assume A is in the 45% tax bracket when you consider both his federal and state income taxes. A pays taxes of $45,000 on this income. And let's say that XYZ passes to A the $100,000 of tax-exempt income. This puts A ahead by $55,000 ($100,000 - $45,000).

However, if the payroll were deductible, XYZ would be ahead by both the $100,000 and the tax benefit of the payroll being deductible—giving the company a better chance of continuing to pay its employees after the PPP loan and its forgiveness.

But for this position of the IRD, since the S corporation doesn't pay income taxes, A would have the $100,000 plus the tax benefit of the payroll deduction ($45,000).

Here is the comparison:

- $145,000 if the PPP is as "we thought it was" before the IRS Notice
- $55,000 as the IRS has it now

(vii) Anomaly for the Schedule C Taxpayer

(a) The self-employed taxpayer with no employees has his or her loan forgiven based on his or her 2019 net income. Generally, the PPP loan amount that businesses qualify for is based on their average payroll expenses. However, since sole props and independent contractors usually do not have payroll, their loan is based on 2019 net profit divided by 12, to get a monthly "average" net profit. This number times 2.5 equals their PPP loan amount. Which means this PPP loan is roughly 10.8 weeks' worth of net profit. There's no spend on payroll.

(b) Further, the self-employed person does not have to spend any PPP monies on interest, rent, or utilities. He or she can achieve full forgiveness in 10.8 weeks based solely on the 2019 tax return.

(c) In Notice 2020-32, the IRS invokes IRC Section 265, but Section 265 does not consider how the PPP treats forgiveness for the self-employed. It applies to expenses incurred for the purpose of earning or otherwise producing tax-exempt income. Thus, for the Schedule C taxpayer, no such expenses to produce tax-exempt income need to be paid to achieve 100 percent forgiveness.

F. Potential Challenge to Notice 2020-32?

(i) Some observers have pointed out that the IRS may be incorrect in its position, based on the following:

(a) No court has ever ruled that cancellation of debt that is claimed to be non-taxable pursuant to existing exclusions, whether that be due to insolvency or bankruptcy under Section 108, somehow requires a taxpayer to amend prior-year returns to remove deductions attributable to the non-taxable cancellation of debt.

(b) No court has ever ruled that a future contingent event that may or may not occur (*i.e.*, loan forgiveness) in a future tax year can somehow retroactively treat expenses that were deductible at the time they were incurred as though they are now nondeductible expenses.

(c) At the time the PPP loan proceeds are acquired, they are not considered "wholly exempt income." In fact, because the loan proceeds may be only partially forgiven, it would logically be classified as “partially exempt”. So the Argument is that because the Notice ways “wholly exempt” it is wrong.

(d) If the IRS intends to require taxpayers to amend their 2020 U.S. federal income tax returns if and when the PPP loan proceeds are cancelled in future years, to be consistent, it is arguable that they must do the same companies that have debt discharged pursuant to Section 108 in bankruptcy court.

(e) Most notably, President Trump’s companies that have, in the past, had debt discharged without having to amend prior-year returns to remove deductions attributable to the discharged debt would be very unhappy with this result!

(ii) And so the Argument is that because the IRS’s interpretation of Section 265 could result in a requirement that debt discharged in bankruptcy or claimed as non-taxable by reason of insolvency pursuant to Section 108 give rise to an affirmative requirement to amend prior-year returns, which is beyond unreasonable, IRS Notice 2020-32 is invalid as a matter of law. Well, good luck with that.

II. <u>OTHER COD INCOME ISSUES</u>

A. Section 108- List of Exemptions

Bankruptcy/ insolvency (for corporations or individuals)

QPRI (for residences only)

Qualified Farm Indebtedness

QRBPI (Qualified Real Property Business Indebtedness)

Cancellation of a Debt That Would Be Deductible If Paid

Purchase Money Debt Reduction (seller-financing)

B. Mortgage Foreclosures or Modifications

(i) For Residential Mortgages:

(a) Home loans are generally Recourse Debts.

(b) Foreclosure treated as “sale” for Fair Market Value,

(c) Gain or Loss= deemed value less cost basis. Gain generally excluded under Sec. 121 ($250,000 for single, $500,000 joint with spouse).

(d) COD =debt in excess of “sale amount” if Lender waives deficiency

(e) Two Exceptions to Taxable COD income may apply: <u>QPRI or Insolvency</u>

QPRI (qualified personal residence indebtedness)-which is exempt from tax under Sec. 108(h). The QPRI exclusion allows a taxpayer to exclude up to $2 million of the forgiven Acquisition Debt related to a decline in the value of the residence or to the financial condition of the taxpayer. Note that while originally set to expire at the end of 2012, it was extended by the Further Consolidated Appropriations Act of 2020.

(ii) Commercial Mortgages.

(a) Recourse Loans.

A foreclosure is treated as a sale for the “fair market value” (FMV)

Difference between FMV & basis is gain or loss

COD income to extent loan exceeds FMV unless deficiency lawsuit

Example:

Property with Recourse Debt of 2,000,000, FMV of 1,000,000 and

Adjusted Basis of 750,000 transferred in satisfaction of Debt.
Gain =1,000,000-750,000
COD = 1,000,000

(b) Non-recourse Loans

Foreclosure treated as sale for amount of debt.

Section 7701(g); Deemed Value = Mortgage Amount. The fair market value of the property is irrelevant so that there is no COD income. Tufts v. Commissioner, 461 U.S. 300 (1983)

Thus, the foreclosure on a mortgage that secures a non-recourse liability will result in the recognition of gain or loss but not COD income.

Tax Treatment Equivalent to a Deed in Lieu of Foreclosure

(c) Qualified Real Property Business Indebtedness Exemption (QPRBI)

1. QRPBI requirements:

1.1 Trade or business property;

1.2 File election to invoke (Sec. 108(c));

1.3 Must be “acquisition debt” (The indebtedness was incurred or assumed to acquire, construct, reconstruct or substantially improve the real property. for purchase or improvements) or replacement of such debt;

1.4 Can only reduce debt to FMV of secured property;

1.5 For partnerships, elections made at partner level (partnership must consent), like reverse 754 election.

1.6 Generally must continue to own property on the following Jan. 1 to be worthwhile.

1.7 Basis reduction amortized by reducing future depreciation. The basis of the partners interest in their partnership interests is reduced by the amount of COD income excluded to the extent the partnership interest is treated as a depreciable asset for purposes of Section 108(c)(1) and under Section 1017(b)(3)(C) and a corresponding reduction in bases by the partnership in its assets. Basis is first reduced in the depreciable real property secured by the debt. Thereafter, can reduce basis in other depreciable real property (including real property owned by partnerships, with the consent of the partnerships).

1.8 Unamortized basis reduction generally recaptured as ordinary income upon sale (unless hold property until end of depreciation period).

2. QRPBI Example

TP has $3 million non-rec. debt on office bldg. Basis is $2 million. Lender agrees to settle for $1.6 million cash.

TP has never refinanced the property and taken money out. Thus, acquisition debt requirement satisfied.

Building is rental – trade / business requirement met.

FMV of property – presumed to be $1.6 million? (Exclusion limited to amount by which the Qualified Real Property Indebtedness exceeds FMV of Property).

TP reduces depreciable basis by $1.4 million; no currently taxable COD

3. Qualified Farm Indebtedness

Similar to QRPB Debt but if taxpayer is engaged in Farming, the Qualified Farm Indebtedness exception applies.

50% or > of Taxpayers Gross Receipts must be from farming in the 3 years prior to the year in which the debt is cancelled;

Debt must be owed to a “Qualified Person” who is unrelated to TP and is either (i) actively engaged in the lending industry; (ii) a vendor of the property to the taxpayer or (iii) a person who earns a fee with respect to TP’s investment in the Property

Amount Excluded cannot exceed (i) TP’s adjusted tax attributes, plus (ii) TP’s aggregate adjusted basis in property used in the active trade or business in the year following the year of exclusion

4. Purchase Price Adjustment

Section 108(e)(5) provides an exception to COD income if debt issued by a purchaser of property to the seller is reduced.

The debt reduction will be treated as a purchase price adjustment if 2 requirements are met.

1. The first requirement is that the purchaser is not in a title 11 bankruptcy case or is insolvent.
2. The second requirement is that the reduction would result in COD income but for Section 108(e)(5) treatment.