NON-DEDUCTIBILITY OF EXPENSES PAID WITH PPP LOAN PROCEEDS & OTHER COD ISSUES

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- Non-Deductibility of Expenses Paid With PPP Loan Proceeds-IRS NOTICE 2020-32
- Other COD Issues – Section 108 Exemptions
- Mortgage Foreclosures of Modifications
- Qualified Real Property Business Indebtedness Exemption (QRPBI)

Non-Deductibility of Expenses Paid with PPP Loan Proceeds

- Cares Act Section 1106

  PPP borrowers eligible for loan forgiveness

  - Covered period - 8 weeks or 24 weeks

  Payroll costs (No>100,000), mortgage interest, rents & utilities

  Possible reduction of forgiveness

  Specific exclusion of proceeds from gross income-no COD income

IRS Notice 2020-32

- 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.

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- 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.
- 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 20, 2020, it has not passed.
- A proposed Amendment to the Hero's Act which would add New $2.3 Trillion Stimulus prepared by the Democrats on 9/29/2020 and passed by the House has "Tax Provisions" unrelated to the deductibility issue. A revised version passed by the House on 10/6/2020 likewise did not address the issue.

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- 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.
- 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.

IRS Notice 2020-32 Cont'd

- **Comparison Example**:

XYZ, S Corp. of which A is the sole shareholder, 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 does not report $100,000 COD income but does not deduct $100,000 payroll expense, creating $100,000 taxable income which S Corp, passes on to its sole shareholder, A.

If A is in the 45% tax bracket (federal and state) A pays taxes of $45,000 on this income. This puts A ahead by $55,000 ($100,000 - $45,000).

However, if the payroll were deductible, benefit would be:

$145,000 if the PPP is as we originally thought it was

$55,000 as the IRS has it now

Anomaly for the Schedule C Taxpayer

- Consider this: the self-employed taxpayer with no employees has his or her loan forgiven based on his or her 2019 net income.
- Sole props and independent contractors 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 is no spend on payroll. 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.
- Thus, for the Schedule C taxpayer, no such expenses to produce tax-exempt income need to be paid to achieve 100 percent forgiveness.

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 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) 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.

Potential Challenge to Notice 2020-32?

(d) **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) 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.

Timing Issues

- PPP funds were used to pay expenses in 2020
- Loan forgiven in 2021
- If you deduct the expenses in 2020, what happens when the loan is forgiven? No Guidance has been made available.
- Best to delay filing of 2020 return until forgiveness approved
- Nondeductibility expense allocation- interest

II OTHER COD INCOME ISSUES

Section 108 - List of Exemptions

- Bankruptcy/ insolvency (for corporations or individuals)
- QPRI (for residences only)
- Qualified Farm Indebtedness
- QRPBI (Qualified Real Property Business Indebtedness)
- Cancellation of a Debt That Would Be Deductible If Paid
- Purchase Money Debt Reduction (seller-financing)

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Mortgage Foreclosures or Modifications

1. **For Residential Mortgages**:

   Home loans are generally Recourse Debts

   Foreclosure treated as "sale" for Fair Market Value

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

   COD =debt in excess of "sale amount" if Lender waives deficiency

   Two Exceptions to Taxable COD income may apply: QPRI or Insolvency

      QPRI (qualified personal residence indebtedness)-which is exempt from tax under Sec. 108(h).

      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. Acquisition Debt may include second mortgage for Improvements

      Note that while originally set to expire at the end of 2012, it was extended by the Further Consolidated Appropriations Act of 2020.

Mortgage Foreclosures or Modifications Cont'd

A. Commercial Mortgages

1. 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 but QRBPI may apply

Mortgage Foreclosures or Modifications

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2. **Non-recourse Loans**

Foreclosure = 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

Qualified Real Property Business Indebtedness Exemption (QRPBI)

- **QRPBI requirements:**
  - Trade or Business Property
  - File election to invoke (Sec. 108(c))
  - 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
  - Can only reduce debt to FMV of secured property

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

QRPBI

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- Generally must continue to own property on the following January 1 to be worthwhile
- Basis reduction amortized by reducing future depreciation
- Unamortized basis reduction generally recaptured as ordinary income upon sale (unless hold property until end of depreciation period)

QRPBI

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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. Again, any unamortized basis reduction recaptured on sale.

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

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.