Paycheck Protection Program Update: Tax Implications of the CARES Act and Loan Forgiveness Under the PPP

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The Small Business Administration (SBA), under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, was granted authority to issue over $300 Billion in forgivable loans in response to the economic fallout of the Covid-19 pandemic in the US. The interest rate for these loans is only 1% and is subject to forgiveness if businesses used the loans for eligible expenses such as payroll, interest payments on mortgages, rent payments, and/or utility payments.

Generally, loan forgiveness would trigger waves of tax implications and reporting requirements as cancelation of indebtedness income (COD). However, forgiven Paycheck Protection Program (PPP) loans are specifically excluded from gross income. Recently, the Internal Revenue Service (IRS) issued Announcement 2020-12 which stated that the loaning entity or individual is not required and **should not** issue a Form 1099-C or provide a 6050P statement once the loan recipient has satisfied the loan forgiveness requirements of the PPP loans. Filing a Form 1099-C in error will trigger underreporting notices to be issued by the IRS.

Additionally, while the PPP loans were designed to pay payroll and rents, which are normally deductible as business expenses, the IRS has stated its opposition to this view in this case. While the CARES Act §1106 does not specifically address business deductions, IRS Notice 2020-32 states that normal deductible expenses, such as rent payments, utility, and payroll expenses, will not be deductible if the expenses were paid or reimbursed with funds received from the PPP program.

The IRS relies on Code §265 and corresponding regulation 1.265-1, which states an expense is not deductible if paid with funds from a tax-exempt source. In theory, this is an anti-abuse, anti-double dipping provision. This is consistent with prior precedent from the IRS in private letter rulings and Tax Court opinions.

In response, the American Institute of Certified Public Accountants (AICPA) believes the IRS position contravenes the Congressional intent of PPP to provide relief for struggling businesses without further tax complications. Additionally, there is hope Congress will address this issue in potential future bills to help small businesses.

As an alternative to the PPP loan, the CARES Act created a temporary refundable tax credit for certain employers who retained their employees even while their business suffered due to the pandemic. The Employee Retention Credit (ERC) is a fully refundable tax credit for business and tax-exempt entities to offset the employer's portion of social security taxes. To be an Eligible Employer, the Employer's business had to be "fully or partially suspended… due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings" or "the employer suffer[ed] a significant decline in its gross receipts."

The IRS defines a "significant decline in gross receipts" as a decrease in 50% of gross receipts as compared to **the same quarter** of 2019, (e.g., where 2019 Q2 gross receipts were $100,000 but 2020 Q2 gross receipts were only$50,000). This credit ends when the business' gross receipts are greater than 80% of gross receipts for the corresponding quarter of 2019.

For example, if a business had gross receipts of $100,000 for each quarter (Q1-Q4) in 2019, but in 2020 the business had gross receipts of $95,000 in Q1, $50,000 in Q2, $75,000 in Q3, and $85,000 in Q4, then this business would be eligible for the credit in Q2 and Q3 but not Q1 or Q4. The business would not be eligible in Q1 because the credit is only available starting March 13, 2020. The business would not be eligible in Q4 because the business' gross receipts of $85,000 in Q4 2020 were greater than 80% of the gross receipts the business generated in Q4 2019.

The credit is for 50% of qualified wages up to $10,000, therefore the maximum credit amount is $5,000. There are additional limitations based on the number of employees the business had in 2019. Most importantly, this credit cannot be used in conjunction with receiving a PPP loan.

The CARES Act also creates temporary changes to the Tax Cuts and Jobs Act, which placed limitations on the carryback and carryforward of net operating losses (NOL). Under the CARES Act, companies can carry back unused NOLs generated in 2018 thru 2020 for five years. This means a company that generated a NOL in 2018 can carry it back to 2014 by modifying their tax return.

The CARES Act also removes the 80% cap on NOLs for the current year. Therefore, entities could use all of the NOLs for 2020 instead of having to carry it forward into 2021. The 80% cap will once again apply for 2021.

We expect a large number of IRS audits stemming from the CARES Act and PPP loans as well as erroneously issued notices of deficiency. If you have any concerns regarding your PPP loan application or IRS audit notice, or would like more information regarding other CARES Act tax planning opportunities, please contact Bailey Glasser as our attorneys stand ready to assist during this unprecedented time.

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Practice Areas

Tax