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Tax Implications of Paycheck Protection Program and Related Expenses: Deductibility, PPP Loan Forgiveness and Exclusion from Taxable Income, Notice 2020-32, and Benefit to Taxpayers

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Tax Implications of Paycheck Protection Program and Related Expenses: Deductibility, PPP Loan Forgiveness and Exclusion from Taxable Income, Notice 2020-32, and Benefit to Taxpayers

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August 13, 2020

Paycheck Protection Program ("PPP")

- On March 27, 2020 PPP enacted as part of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act").
  - CARES Act authorizes the Small Business Administration (SBA) to temporarily guarantee $349 billion in loans under the PPP which are eligible for loan forgiveness. The PPP is a temporary SBA 7(a) small business loan program.
  - Loans up to $10 million to Eligible Recipients.
  - Lending period ends June 30, 2020.
- SBA and the IRS continue to issue new guidance up to the present.
- On April 24, 2020 Congress passes the Paycheck Protection Program Health Care Enhancement Act ("Enhancement Act").
  - Appropriates an additional $310 billion to the PPP.
- On June 5, 2020 Congress passes the Paycheck Protection Flexibility Act ("Flexibility Act"), which modifies the covered period, allocation requirements, in addition to other aspects of the PPP.
- On August 8, 2020 the PPP application period closed. The SBA is longer accepting PPP applications, subject to new legislative action.

PPP Statistics as of July 31, 2020

- 5,083,585 loans issued
  - Texas: 406,255 loans issued (8%)
- $521.4 billion
  - Texas: $41 billion (7.9%)
- 5,459 lenders
- Overall average loan size is $103K
  - 80% under $2 million
  - 20% over $2 million
- Remaining Funding: $128.2 billion

Eligibility for a PPP Loan

- A small business applicant is eligible for a PPP loan if it can substantiate that it:
  - Has 500 or fewer employees whose principal place of residence is in the U.S., or is a business that operates in a certain industry and meets the applicable SBA employee-based size standards for that industry.
    - SBA's Alternative Size Standard
      - If a business has a sufficiently low net worth and low income, it may qualify without taking into consideration the number of employees it has.
      - Requirements:
        - » Maximum tangible net worth is not more than $15 million; and
        - » The average net income after Federal income taxes (excluding any carry-over losses) of the business for the two full fiscal years before the date of application is $5 million or less.
  - Is a small business concern, IRC 501(c)(3) non-profit organization, IRC 501(c)(9) veterans organization, Tribal business concern, or any other business; and
  - Was in operation on February 15, 2020 and either had employees for whom it paid salaries and payroll taxes or paid independent contractors, as reported on a Form 1099-MISC.
- Individuals
  - Sole proprietorships and independent contractors in operation on February 15, 2020 are also eligible recipients.

Disqualifying Factors for a PPP Loan

- You are ineligible for a PPP loan if:
  - You are engaged in any activity that is illegal under Federal, state, or local law;
  - You are a household employer (individuals who employ household employees such as nannies or housekeepers);
  - An owner of 20% or more of the equity of the applicant is incarcerated, on probation, on parole; presently subject to an indictment, criminal information, arraignment, or other means by which formal criminal charges are brought in any jurisdiction; or has been convicted of a felony within the last 5 years; or
  - You, or any business owned or controlled by you or any of your owners, has ever obtained a direct or guaranteed loan from the SBA or any other Federal agency that is currently delinquent or has defaulted within the last 7 years and caused a loss to the government.
- Unpaid or delinquent state/federal taxes is not a disqualifying factor. Individuals and businesses with unpaid or delinquent state/federal taxes can qualify as eligible recipients if they otherwise satisfy the requirements.

Applying for PPP Loan

- PPP still has $128.2 billion in available funds.
- Prospective applicants had until August 8, 2020 to apply.
- Applicants must certify in good faith that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient.
  - Considerations
    - Current business activity (at the time of application); and
    - Access to other sources of liquidity sufficient to support ongoing operations in a manner that is not significantly detrimental to the business.

Eligible Expenses: Payroll Costs

- Employees' principal place of residence must be in the U.S.
- Cash Compensation
  - Cannot exceed $100K annualized over covered period for each employee
  - Salary, wages, commissions, or similar compensation;
    - Cash tips or equivalent (based on employer records of past tips, or if no records, a reasonable, good-faith employer estimate of such tips);
    - Payment for vacation, parental, family, medical, or sick leave;
    - Allowances for separation or dismissal;
    - Hazard pay and Bonuses
- Non-Cash Compensation
  - No limit
  - Employer contributions for employee health insurance, including insurance premiums;
  - Employer contributions to employee retirement plans;
  - Payment of state and local taxes assessed on compensation of employees (e.g. state unemployment insurance tax)

Eligible Expenses: Non-Payroll Costs

- Interest on Mortgage
  - Business mortgage interest payments during covered period for any business mortgage obligation or personal property entered into before February 15, 2020
- Rent or Lease
  - Business rent or lease payments for real or personal property during covered period pursuant to lease agreements in force before February 15, 2020
- Utility Payments
  - Business utility payments during covered period, including electricity, gas, water, transportation, telephone, and internet for which service began before February 15, 2020

When Eligible Expenses can be Made

- Payroll Costs
  - Eligible for loan forgiveness if:
    - **Paid** during the covered period; or
      - Payroll costs are paid when paychecks are distributed or the borrower originates an ACH credit transaction.
    - **Incurred** during the covered period and paid on or before the next regular payroll date, even if the payroll date is after the covered period.
      - Payroll costs are incurred on the day the employee's pay is earned (i.e. the day the employee worked).
      - For employees who are not performing work but are still on the payroll, payroll costs are incurred based on the schedule established by the borrower (typically, each day that the employee would have performed work).
  - Can be no less than 60% of the total amount forgiven
    - Previously, the SBA issued an Interim Final Rule requiring at least 75% of forgivable expenses to be for payroll costs. This appeared to conflict with the broad language in the CARES Act and ultimately led to Congress passing the Flexibility Act which reduced the amount that needed to be allocated to payroll costs to 60%.
- Non-Payroll Costs
  - Eligible for loan forgiveness if:
    - **Paid** during the covered period; or
    - **Incurred** during the covered period and paid on or before the next regular billing date, even if the billing date is after the covered period.
  - Can be up to 40% of the total amount forgiven

Eligible Payroll Cost Example

- Borrower's covered period begins June 1 and ends July 26.
- Borrower pays its employees twice during the covered period for work performed exclusively in May and then exclusively in June.
- Borrower also pays its employees on the next regular payroll date after the covered period for work performed in July.
- Because May and June payroll costs were paid during covered period, they are eligible for loan forgiveness.
  - May payroll cost does not need to also be incurred during the covered period to be eligible.
  - June payroll cost is counted once even though it was both paid and incurred during the covered period.
- July payroll cost is eligible for loan forgiveness because it was incurred during the covered period and paid on or before the next regular payroll date.
  - But note that only the portion that was incurred during the covered period is eligible, which would be work performed from July 1 to July 26.

Eligible Non-Payroll Cost Example

- Borrower's covered period begins June 1 and ends July 26.
- Borrower pays its May and June electricity bill during the covered period.
- Borrower pays its July electricity bill on August 10, which is the next regular billing date.
- Borrower may seek loan forgiveness for its May and June electricity bills, because they were paid during the covered period.
- Borrower may seek loan forgiveness for the portion of its July electricity bill through July 26, because it was incurred during the covered period and paid on the next regular billing date.

Covered Period

- Covered Period:
  - Period during which eligible expenses must be paid or incurred to qualify for loan forgiveness.
  - Begins on the first day the PPP loan is disbursed, even if the full amount is issued over multiple disbursements.
- Borrowers with a PPP loan before June 5, 2020 have the option between:
  - 24-week covered period (default); or
  - 8-week covered period (can elect).
- Borrowers with a PPP loan starting on June 5, 2020 will have a 24-week covered period.

Alternative Payroll Covered Period

- Borrowers with a biweekly (or more frequent) payroll schedule may elect to calculate eligible payroll costs using the 8-week (56-day) period that begins on the first day after the loan is disbursed.
- Note that this alternative period only applies for payroll costs.
  - Non-payroll expenses continue to use the normal 8-week covered period.
- Unclear whether borrowers with a 24-week covered period are eligible for the Alternative Payroll Covered Period.

Applying for Loan Forgiveness

- Borrower may apply for loan forgiveness before the covered period ends if PPP loan funds are exhausted and all required documentation has been gathered.
- Lender must provide complete payment deferment relief (including principal, interest, and fees) until the date on which the amount of loan forgiveness is determined and remitted to the lender.
- Borrower should submit its loan forgiveness application to the lender servicing its PPP loan within 10-months after the last day of its covered period, otherwise repayment may begin.
- Lender has 60 days after it receives a loan forgiveness application to issue a decision to the SBA.
- SBA will, subject to its review of the loan or loan application, remit the appropriate forgiveness amount to the lender, plus interest accrued through date of payment, within 90 days after the lender issues its decision.

Loan Forgiveness Application

- SBA Form 3508 or 3508EZ;
- PPP Schedule A;
- PPP Schedule A Worksheet; and
- Optional PPP Borrower Demographic Information Form.

SBA Form 3508EZ

- Does not include adjustments for Full-Time Equivalency (FTE) and Salary/Hourly Wage Reductions
- Can use SBA Form 3508EZ if:
  - Did not reduce annual salary or hourly wages of any employee by more than 25 percent during the Covered Period or the Alternative Payroll Covered Period (as defined below) compared to the period between January 1, 2020 and March 31, 2020, and either:
    - did not reduce the number of employees or the average paid hours of employees between January 1, 2020 and the end of the Covered Period; or
    - unable to operate during the Covered Period at the same level of business activity as before February 15, 2020, due to compliance with requirements established or guidance issued between March 1, 2020 and December 31, 2020 by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration, related to the maintenance of standards of sanitation, social distancing, or any other work or customer safety requirement related to COVID-19.

Full-Time Equivalency (FTE) and Salary/Hourly Wage Reductions

- FTE Test:
  - Forgiveness is reduced proportionally to the extent that the average monthly FTEs during the covered period is less than the average monthly FTEs during either:
    - the period from February 15, 2019 to June 30, 2019 or
    - the period from January 1, 2020 to February 29, 2020, at the borrower's election.
  - 1 FTE = 40 hours or more on average each week
  - Can elect to count each part-time employee (39 hours or less on average each week) as either:
    - 0.5 FTE; or
    - The actual percentage out of 40 hours worked (rounded to tenths)

Full-Time Equivalency (FTE) and Salary/Hourly Wage Reductions

- Wage Reduction Test:
  - Total salary and wages paid during the Covered Period to each employee who, during 2019, did not receive wages and salary at an annual rate more than $100,000 per year, cannot be reduced during the Covered Period by more than 25% of the total salary and wages paid to each of those employees during the most recent full quarter before the Covered Period began. The test applies on an individual employee basis, which requires examination of the wages and salary of each employee. In the case of borrowers who employ tipped employees, additional wages paid to those employees are eligible for forgiveness. To the extent borrowers fail this test, the amount of loan forgiveness is reduced.

Safe Harbors

- FTE and Wage Reduction tests don't apply if by December 31, 2020, its FTE count and employees' wages are brought back to February 15, 2020 numbers.
- During the period February 15, 2020 through December 31, 2020, loan forgiveness is not reduced related to a proportional reduction in FTEs for the following:
  - An inability to rehire individuals who were employees of the Borrower on February 15, 2020; and an inability to hire similarly qualified employees for unfilled positions on or before December 31, 2020; or
  - An inability to return to the same level of business activity as the Borrower was operating at before February 15, 2020 due to compliance regulations and requirements related to standards for sanitization, worker safety, or social distancing.

Documenting Eligible Payroll Expenses

- Bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees;
- Tax forms (or equivalent third-party payroll service provider reports) for the periods that overlap with the covered period:
  - Payroll tax filings reported, or that will be reported, to the IRS, and
  - State quarterly business and individual employee wage reporting and unemployment insurance tax filings reported, or that will be reported.
- Payment receipts, cancelled checks, or account statements documenting the amount of any employer contributions to employee health insurance and retirement plans that borrowers include in the forgiveness amount.

Documenting Eligible Non-Payroll Expenses

- Interest on Mortgage:
  - Copy of lender amortization schedule and receipts or cancelled checks verifying payments from the covered period; or
  - Lender account statements from February 2020 and the months of the covered period through one month after the covered period verifying interest amounts and eligible payments.

Documenting Eligible Non-Payroll Expenses

- Rent or Lease:
  - Copy of current lease agreement and receipts or cancelled checks verifying eligible payments from the covered period; or
  - Lessor account statements from February 2020 and from the covered period through one month after the end of the covered period verifying eligible payments.

Documenting Eligible Non-Payroll Expenses

- Utility Payments:
  - Copy of invoices from February 2020 and those paid during the covered period; and
  - Receipts, cancelled checks, or account statements verifying eligible payments.

SBA Review

- Loans under $2 million are deemed to satisfy the good faith certification requirement, but still may be subject to SBA review.
- Loans above $2 million are subject to SBA review. It is unknown at this time what this review will look like.
- If SBA determines a borrower was ineligible for PPP loan at the time of application, the loan is not eligible for forgiveness.
  - Lender must notify borrower within 5 business days.
  - Borrower may provide additional information to the lender and SBA contesting the determination.
  - Borrower may appeal the determination. It is unknown at this time what the appeal process will look like.

Consequences of Loan Forgiveness

- Treatment of Loan Forgiveness
  - The lender may issue a Form 1099-C, *Cancellation of Debt*, reflecting the amount of loan forgiveness.
  - The entire amount of PPP loan forgiveness is **excluded** from gross income.

Consequences of Loan Forgiveness

- Deductibility of Forgiven Expenses
  - The IRS has taken the position in Notice 2020-32 that ordinary business expenses that are forgiven as part of a PPP loan are not deductible.
  - Contrary to Congressional intent and could be subject to court challenges in light of lack of notice-and-comment period.
  - Senator John Cornyn (Rep. Tex.) introduced the Small Business Expense Protection Act of 2020, which if passed would amend the CARES Act to clarify that business expenses forgiven as part of a PPP loan are also deductible as ordinary business expenses.

Consequences of Loan Forgiveness

- Payroll Tax Deferral Eligibility
  - Under the CARES Act, businesses that received loan forgiveness would be prohibited from deferring their payroll taxes.
  - The Flexibility Act eliminated this exclusion so that all businesses, including those receiving loan forgiveness, are able to defer the deposit and payment of the employer's share of Social Security tax and certain railroad retirement taxes that would normally be deposited between March 27, 2020 and Dec. 31, 2020.

Employee Retention Credit

- Employee Retention Tax Credit - equal to 50% of up to $10,000 in qualified wages paid to an employee by an eligible employer that expedited economic hardship due to COVID-19.
  - Maximum credit is $5,000 per employee
- For wages paid from 3/13/2020 through 12/31/2020, including health plan expenses
- Designed to encourage employees on their payroll
- Is no cap on the size of the employer
- If under 100 employees, credit is based on qualified wages paid to the employee, whether they worked or not; if over 100, only for qualified wages paid that are not providing services.
- Eligibility: Business fully or partially suspended by Government order due to COVID-19 OR Employer has a significant decline in Gross receipts (below 50% of same quarter in 2019)
- Refundable tax credit that is first used to offset the employer portion of Social Security Taxes; reaming credit can be used to offset remaining payroll taxes (both employer and employee portion)

*Business that receive PPP Loan are not eligible

*Cannot use same wages for the Employee Retention Credit and the credits for paid sick and family leave, but is not affected by an employer's deferral of payroll taxes under CARES Act

Other Tax Deferrals & Tax Credits

- **Payroll Tax Deferral** – employers can defer the 6.2% FICA (SS) tax on employers portion of payroll tax for any payroll period from 3/27/2020 through 12/31/2020. Permits payment of 50% on 12/31/2021 and the other 50% on 12/31/2022.

- **Credit for Paid Sick Leave and Family Leave –** refundable tax credit similar to the employee retention credit totaling 100% of qualified sick leave wages and health care expenses required in 2020 plus payroll tax exemption.
  - Maximum credit $2,000 (or $5,111 where applicable).

- **Payroll Tax Credit for Required Paid Family Leave** – similar to sick leave credit, totaling 100% of required wages and healthcare for employees who need to care for a child due to due to school closures because of COVID-19.

Disaster Relief Payments

- IRC §139(a) provides for "qualifying disaster relief payments" from an employer to an employee
- Payments on a account of the disaster are excluded from gross income
- must be "reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster" that are not reimbursed by insurance or otherwise, such as governmental assistance, nor can it reimburse for lost wages or replace lost business income.
- Examples possibly include:
  - Out of pocket medical expenses like co-pays or products including face masks, sanitizing and cleaning products, hand sanitizer.
  - Childcare costs incurred as a result of the disaster and tutoring expenses
  - Technology costs to facilitate working remote or online education
  - Increased costs due to working from home, such as utility, supplies, enhanced cellular bill and Wifi.

Proposed Legislation: RESTAURANTS Act

- Establishes a $120 billion Restaurant Revitalization Fund for restaurants, bars, or similar places that own or operate 20 or fewer locations.
- No more than one $10 million grant to each eligible entity (and any affiliated businesses) through December 31, 2020.
  - Initial 14-day period in which grants would only be awarded to eligible entities with annual revenues of less than $1.5 million.
- Grants are determined by the, "difference in revenues or estimated revenues during a calendar quarter in 2020 selected by the eligible entity as compared to 95% of the revenues of the eligible entity in the same calendar quarter in 2019.
- Grants are expressly excluded from gross income and, if applicable, expenses made with the grants are expressly deductible.
- Under certain circumstances the grants may be converted into loans subject to repayment. Any grant amounts unused after December 31, 2020 or amounts that exceed the estimated revenues in a calendar quarter would be converted to a loan with a 1% interest rate and a 10-year maturity date beginning on January 1, 2021.

Proposed Legislation: RESTAURANTS Act

- Covered period for each grant, regardless of when it is disbursed, is Feb 15, 2020 to Dec 31, 2020.
- Grant funds may be used more broadly than under the Paycheck Protection Program, including (expenses not expressly included in the Paycheck Protection Program are **bolded**) the following:
  - Payroll costs (same definition as in the Paycheck Protection Program).
  - Payments of **principal** or interest on any mortgage obligation.
  - Rent payments, including rent under a lease agreement.
  - Utilities.
  - **Maintenance expenses**, including:
    - Construction to accommodate outdoor seating; and
    - Walls, floors, deck surfaces, furniture, fixtures, and equipment.
  - **Supplies**, including protective equipment and cleaning materials, as required by applicable public health departments.
  - **Food and beverage expenses** that are within the scope of the normal business practice of the eligible entity before the covered period.
  - **Debt obligations** to suppliers that were incurred before the covered period.
  - Any other expenses that the Secretary determines to be essential to maintaining the eligible entity

Proposed Legislation: RESTART Act

- Establishes the Restart Loan Program for recipients that are eligible to receive a PPP loan or have 5,000 or fewer full-time employees.
- Restart loans can be up to but the lesser of:
  - $12 million or
  - 45% of 2019 gross receipts.
  - But is reduced by existing PPP loan
- Eligible for up to 2 Restart loans which in aggregate cannot exceed the maximum amount allowed.
- The loans themselves have a duration of up to 7 years, an initial interest rate of between 2% and 4%, and are potentially forgivable.
- Covered period for is either 6 months or 12 months, with options for when such a period begins:
  - when loan is originated (disbursed), the first day of the next scheduled pay period, or the first day of the next full month).
- No payroll allocation rule (such as the 60/40 rule).

Proposed Legislation: RESTART Act

- Eligible expenses include
  - payroll costs (same definition as in the Paycheck Protection Program),
  - rent,
  - utilities,
  - mortgage interest payments
  - scheduled interest payments on other scheduled debt,
  - costs related to personal protective equipment,
  - **payments of principal on outstanding loans,**
  - **payments to independent contractors, and**
  - **other ordinary and necessary business expenses (debts to vendors, inventory, maintenance, administrative costs, taxes, leases)**.
- Loan forgiveness is based on the following formula:
  - (% decline in revenues x .90) x sum of eligible expenses paid during covered period (excluding the **bolded** above).

Proposed Legislation: HEALS Act

- Modifies the existing Paycheck Protection Program.
- Simplified Application Process:
  - For PPP loans between $150,000 and $2 million, borrowers are not required to submit supporting documentation to the lender (payroll tax filings and substantiation of eligible expenses), but must make the required certifications and retain relevant records for 3 years.
- Existing PPP Loan Borrowers are Eligible for One (1) Additional PPP Loan (referred to as a "Second Draw Loan") if:
  - Meet the SBA's relevant size standard (if applicable);
  - Employ 300 or fewer employees; and
  - Demonstrate at least a 50% reduction in gross receipts in the first quarter or second quarter of 2020 relative to the same quarter in 2019.
  - However, businesses with an NAICS Code 72 (such as restaurants) are considered eligible even if no single location employs more than 300 employees.
- The maximum loan amount is the lesser of:
  - 2.5x the average total monthly payroll costs during 1-year period before the loan is made; or
  - $2 million.
- Borrowers can Select Covered Period End Date up to December 31, 2020.

Proposed Legislation: HEALS Act

- In addition to payroll costs, mortgage interest, rent, and utility payments, the following expenses are eligible for loan forgiveness:
  - Operations expenditures – Payment for any software, cloud computing, and other human resources and accounting needs.
  - Property damage costs – Costs related to property damage due to public disturbances that occurred during 2020 that are not covered by insurance.
  - Supplier costs – Expenditures to a supplier pursuant to a contract for goods in effect before February 15, 2020 that are essential to current operations.
  - Worker protection expenditures – personal protective equipment and adaptive investments to help comply with federal health and safety guidelines related to COVID-19 between March 1, 2020 and December 31, 2020.
- 60/40 allocation rule still applies.
- Does not address the deductibility of business expenses made with forgiven funds

Recent Publications

Tax Issues Associated with Paycheck Protection Program Loan Forgiveness Process, BLOOMBERG TAX (May 21, 2020)

Bloomberg Tax
bloombergindustry.com

INSIGHT: Tax Issues Associated With Paycheck Protection Program Loan Forgiveness Process

BY JUAN F. VASQUEZ, JR., JAIME VASQUEZ, AND VICTOR J. VISER

For the well deserving small businesses receiving Paycheck Protection Program (PPP) loans from the SBA that agonized through the myriad of rule changes and conflicting information, the most important issues first and foremost were to provide necessary jobs and serve as lifelines to their employees and the greater community so that they could weather the Covid-19 pandemic and see a better tomorrow. After making it through those initial challenges, small businesses need to consider the tax issues that come with the loan forgiveness process.

The recently released PPP loan forgiveness application provides much needed flexibility for small businesses hoping to take advantage of excludable loan forgiveness available for certain eligible expenses (defined with respect to each applicable PPP loan amount as applying at least 75% towards payroll costs and up to 25% towards rent, mortgage interest, and utilities that were in existence as of February 15, 2020) made during their eight-week covered period.

Significantly, the application provides an optional Alternative Payroll Covered Period for small businesses with a biweekly (every other week) or more frequent payroll schedule. If elected, the small business's eight-week covered period, for purposes of calculating eligible payroll costs, begins on the first day of their first pay period after the loan was disbursed. On the other hand, if no election is made, the small business will continue to use the normal covered period which starts on the first day the loan was disbursed. Small businesses using the Alternative Payroll Covered Period should keep in mind that, in general, this alternative period only applies for payroll costs, and other non-payroll expenses continue to use the normal eight-week covered period.

Regarding eligible payroll and non-payroll expenses, the application broadly interprets the CARES Act to allow loan forgiveness for both (i) expenses paid, but not incurred, during the covered period and (ii) expenses incurred, but not paid, during the covered period. In particular, payroll costs that were incurred before the covered period are eligible for loan forgiveness if they are paid during the eight-week covered period. Payroll costs that are incurred during the last pay period of the covered period are eligible for loan forgiveness if they are paid on or before the next regular payroll date following the end of the covered period.

Finally, the application provides a potentially more generous full-time equivalent (FTE) calculation than what many small businesses have been using. Before the application was released, many small businesses have been conservatively using the FTE calculation found under the Affordable Care Act, which considers an employee working an average of 30 or more hours per week to be 1 FTE. The application increases the threshold to be considered 1 FTE to employees working an average of 40 or more hours per week, which should result in fewer FTEs overall. In addition, the application allows less sophisticated small businesses to use a simpler FTE calculation where employees working 40 hours or more per week on average count as 1 FTE and employees working less than 40 hours per week on average count as 0.5 FTE.

A borrower may apply for loan forgiveness only after the eight-week covered period expires and the borrower gathers the required loan documentation. Comprehensive documentation is required to substantiate all eligible expenses. With regard to payroll expenses, the borrower must provide:

Recent Publications

Congress Adds 'Flexibility' to Loan Forgiveness and Corresponding Tax Consequences, BLOOMBERG TAX (June 5, 2020)

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INSIGHT: Congress Adds 'Flexibility' to Loan Forgiveness and Corresponding Tax Consequences



BY JUAN F. VASQUEZ, JR., JAIME VASQUEZ, AND VICTOR J. VISER

The House and Senate recently passed the Paycheck Protection Program Flexibility Act (Flexibility Act) which, if signed into law by the President, would address many of the complaints small businesses have with their Paycheck Protection Program loans (PPP loans), particularly the lack of autonomy over how and when expenses can be made and still qualify for loan forgiveness. The most pressing complaints for many small businesses have been the requirement that at least 75% of eligible expenses be for payroll costs and the relatively short eight-week covered period during which expenses must be paid or incurred to be eligible for loan forgiveness.

Further complicating the original covered period's brevity was confusion over whether, during such period, expenses had to be both paid and incurred to be considered eligible expenses. This confusion was later dispelled after the Small Business Administration (SBA) released an Interim Final Rule confirming a broader reading of the CARES Act's language on May 22, eight weeks after the CARES Act was enacted and well into many businesses' covered periods.

Currently, to receive the full amount of loan forgiveness available at least 75% of eligible expenses have to be for payroll costs and conversely, no more than 25% of eligible expenses can be for non-payroll costs. Under the Flexibility Act, businesses need only allocate 60% of their eligible expenses for payroll costs and could spend up to 40% on mortgage interest and certain rent and utility payments. This business friendly change is very much welcomed as it gives businesses more discretion over how they allocate their PPP loan.

The Flexibility Act addresses the covered period issue by replacing the original eight-week covered period with a period of either 24 weeks or lasting until Dec. 31, 2020, whichever comes first. Given that PPP loans may only be made through June 30, it is safe to say that most, if not all, borrowers would fall under the 24-week covered period absent additional legislative action or SBA guidance extending the June 30 deadline. Businesses that already have a PPP loan as of the date the Flexibility Act becomes law may elect to use the original eight-week covered period instead. However, this choice will impact the loan forgiveness application process as there are multiple tax-related consequences to consider when deciding between keeping the new 24-week covered period or electing to return to the original eight-week covered period.

First, a longer covered period requires businesses to wait longer to apply for loan forgiveness. The amount of loan forgiveness is reduced according to the difference in the number of full-time equivalent employees and the reduction in wages for certain employees. These tests can only be calculated after the covered period ends and therefore a 24-week covered period delays when an application for loan forgiveness can be made. Note that the Flexibility Act gives businesses 10 months after the last day of the covered period to apply for loan forgiveness.

Second, a longer covered period increases the burden to provide the necessary documentation for loan forgiveness. To substantiate eligible expenses, businesses must provide tax forms for the periods that overlap the covered period such as Forms 941, *Employer's Quarterly Federal Tax Return*, and any state quarterly business and individual employee wage reporting and unemployment insurance tax filings, whether or not al-

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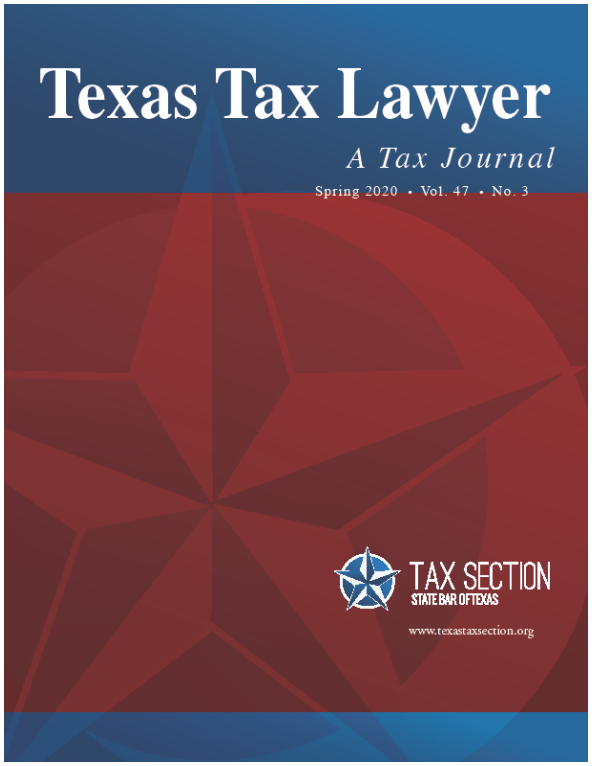

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ACCOUNTING & AUDITING

PREPARING FOR A POTENTIAL AUDIT OF YOUR CLIENT'S PAYCHECK PROTECTION PROGRAM LOAN

By Juan F. Vasquez, Jr., Jaime Vasquez and Victor J. Viser

Businesses with Paycheck Protection Program loans have used PPP loan funds despite the lack of clear guidance on several aspects of the program. This article discusses three areas of potential review or audit by lenders, the SBA and/or the IRS.

First, applicants were required to make a good-faith certification concerning need for a PPP loan. This good-faith certification may be subject to review by the SBA, especially for borrowers with loans in excess of $2 million. Second, when borrowers submit their application for loan forgiveness, they must provide documentation substantiating eligible expenses. Third, when the business completes its federal income tax return, it may decide to deduct under 162 of the Code business expenses that were forgiven as part of its PPP loan. If the business takes this deduction, it may be subject to audit by the IRS. These review/audit risks can be prepared for and are considered in turn.

Defending the Good-Faith Certification

Businesses must be ready to defend the good-faith certification made when they applied for their PPP loans and potentially when they signed their promissory notes. The certification states, "that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient." To make the certification in good faith, businesses must take into account two factors:

- Their business activity at the time the certification was made: and
- Whether they had access to other sources of liquidity, the use of which would not be significantly detrimental to their business.

Business Activity

Importantly, for purposes of the good-faith certification, business activity is determined as of the date of the application. A business, therefore, will want to support the narrative by showing that its business activity was negatively affected by COVID-19 at the time of its application. Part of this can be the number of jobs potentially impacted. This should be done through a combination of financial records and analysis and secondary sources. With regard to financial records, year-over-year comparisons of revenue, sales or other industry-specific metrics can be used to show the decline relative to the prior year, as well as highlighting the days leading up to the application date to further emphasize the declines in business activity.

With regard to secondary sources, consider referencing ordinances that prohibited business activity and/or specifically targeted the business. Note that multiple ordinances were likely in effect before the application date. Industry-wide or regional

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President Donald Trump has signed into law a temporary extension of a subsidy program for small businesses battered by the coronavirus.

Texas businesses seeking financial assistance amid the coronavirus pandemic received positive news July 4 when President Donald Trump signed a new law extending the deadline for applying for a Paycheck Protection Program loan from June 30 to Aug. 8.

The law also gave business owners more flexibility with how they can spend the funds, said Juan Vasquez, a Houston-based attorney who concentrates his practice on federal, state and local tax matters. Previously, 75% had to be spent on wages, with the remaining 25% left over for other covered areas; now the ratio is 60% for wages and 40% for other expenses. Another

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IRS Undermines Congressional Intent for Paycheck Protection Program Loans, BLOOMBERG TAX (July 23, 2020)

Bloomberg Tax
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INSIGHT: IRS Undermines Congressional Intent for Payroll Protection Program Loans



BY JUAN VASQUEZ JR., JAIME VASQUEZ, AND VICTOR VISER

The Paycheck Protection Program (PPP), created as part of the Coronavirus, Aid, Relief, and Economic Security Act (CARES Act), has provided over 4.8 million loans to businesses impacted by the Covid-19 pandemic. If businesses use their PPP loans for business expenses such as rent, utilities, certain payroll costs, and mortgage interest then those expenses may be forgiven, subject to wage and full-time equivalent tests. This forgiveness is a critical feature of the program, incentivizing businesses to allocate funds toward supporting their employees and by extension their communities.

In fact, it is so important that Congress expressly excludes this forgiveness from gross income under Section 1106(i) of the CARES Act. Forgiven disbursements are considered, "canceled indebtedness" and Section 1106(i) of the CARES Act excludes this canceled indebtedness from gross income, providing, "any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in [1106(b)] shall be excluded from gross income."

While the CARES Act allows businesses to exclude from gross income expenses that are forgiven as part of their PPP loan, the IRS, in Notice 2020-32, signaled its intention to deny corresponding deductions for such expenses. In general, businesses are able to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Rent, utility payments, and payroll costs comprise typical trade or business expenses for which a deduction under tax code Section 162 generally is generally appropriate. Mortgage interest payments are similarly deductible under Section 163. If these costs were also excluded from gross income because they were eligible expenses as part of a PPP loan, then businesses may receive a potential double tax benefit, by both excluding the forgiven disbursement from income while also deducting the same expense. The double tax benefit provided for in the PPP is not a problem, but rather is the mechanism by which businesses are incentivized to allocate funds towards favored uses.

Notice 2020-32 clarifies the IRS position that the double tax benefit will not be permitted, providing, "no deduction is allowed under the Internal Revenue 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 the. . .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." The notice cites tax code Section 265(a)(1), which provides that no deduction is allowed for any amount otherwise allowable as a deduction [that 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 the taxes imposed by subtitle A of the tax code.

Under the IRS position, businesses would be able to exclude forgiven disbursements from gross income, but would not be allowed to deduct such expenses, offsetting the double tax benefit. As described below, there may be a supportable position to deduct business expenses that were forgiven as part of a PPP loan, especially when considering (1) the plain and unambiguous

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1. *Tax Issues Associated with Paycheck Protection Program Loan Forgiveness Process*, Bloomberg Tax (May 21, 2020) https://news.bloombergtax.com/daily-tax-report/insight-tax-issues-associated-with-paycheck-protection-program-loan-forgiveness-process

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Thank You

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