

# The possible tax consequences of PPP loans

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If your business was fortunate enough to get a Paycheck Protection Program ("PPP") loan in connection with the COVID-19 crisis, you should be aware of the potential tax implications.

## PPP basics

The Coronavirus Aid, Relief and Economic Security ("CARES") Act, which was enacted on March 27, 2020, is designed to provide financial assistance to Americans suffering during the COVID-19 pandemic. The CARES Act authorized up to \$349 billion in forgivable loans to small businesses for job retention and certain other expenses through the PPP. In April, Congress authorized additional PPP funding and it's possible more relief could be part of another stimulus law.

The PPP allows qualifying small businesses and other organizations to receive loans with an interest rate of 1%. PPP loan proceeds must be used by the business on certain eligible expenses. The PPP allows the interest and principal on the PPP loan to be entirely forgiven if the business spends the loan proceeds on these expense items within a designated period of time and uses a certain percentage of the PPP loan proceeds on payroll expenses.

An eligible recipient may have a PPP loan forgiven in an amount equal to the sum of the following costs incurred and payments made during the covered period:

1. Payroll costs;
2. Interest (not principal) payments on covered mortgage obligations (for mortgages in place before February 15, 2020);
3. Payments for covered rent obligations (for leases that began before February 15, 2020); and
4. Certain utility payments.

An eligible recipient seeking forgiveness of indebtedness on a covered loan must verify that the amount for which forgiveness is requested was used to retain employees, make interest payments on a covered mortgage, make payments on a covered lease or make eligible utility payments.

## Cancellation of debt income

In general, the reduction or cancellation of non-PPP indebtedness results in cancellation of debt ("COD") income to the debtor, which may affect a debtor's tax bill. However, the forgiveness of PPP debt is excluded from gross income. Your tax attributes (net operating losses, credits, capital and passive activity loss carryovers, and basis) wouldn't generally be reduced on account of this exclusion.

## **Expenses paid with loan proceeds**

The IRS has stated that expenses paid with proceeds of PPP loans can't be deducted, because the loans are forgiven without you having taxable COD income. Accordingly, the proceeds are, in effect, tax-exempt income. Expenses allocable to tax-exempt income are nondeductible, because deducting the expenses would result in a double tax benefit.

However, the IRS's position on this issue has been criticized and some members of Congress have argued that the denial of the deduction for these expenses is inconsistent with legislative intent. Congress may pass new legislation directing IRS to allow deductions for expenses paid with PPP loan proceeds.

## **PPP Audits**

Be aware that leaders at the U.S. Treasury and the Small Business Administration recently announced that recipients of PPP loans of \$2 million or more should expect an audit if they apply for loan forgiveness. This safe harbor will protect smaller borrowers from PPP audits based on good faith certifications. However, government leaders have stated that there may be audits of smaller PPP loans if they see possible misuse of funds.

Please contact us with any further questions you might have on PPP loan forgiveness.

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