

COVID-19: TAX IMPLICATIONS OF PAYCHECK PROTECTION LOAN FORGIVENESS

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Recent legislation under the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act) modifies several tax provisions in the Internal Revenue Code (the Code) to provide relief to businesses and individuals from the economic effects of the COVID-19 crisis. Section 1106 of the CARES Act provides that loans taken out under the Paycheck Protection Program (PPP) may be forgiven without incurring cancellation of debt income (CODI) to the extent that such loans are used for payroll and other qualifying expenses. However, there are a number of other nuances to the tax effects of such loan forgiveness that are explored in this alert.

CANCELLATION OF DEBT INCOME?

Under the PPP, certain small businesses may receive loans from the Small Business Administration to cover the cost of payroll and certain operating expenses. The program is intended to provide employers with the resources necessary to keep employees on the payroll and the business operating. If the business complies with the terms of the loan, a loan amount of up to eight weeks of eligible expenses can be forgiven. Typically, when a lender cancels debt owed by a borrower, the amount of canceled debt must be included in the debtor's income. However, Section 1106 of the CARES Act explicitly excludes the amount of the PPP loan that is forgiven from the employer's income.

DEDUCTIBILITY OF LOAN EXPENSES?

Although the CARES Act is silent on the deductibility of expenses paid with loan proceeds that are forgiven, the Internal Revenue Service (IRS) has taken the position in Notice 2020-32 that such costs are not deductible. The IRS relies on Code Section 265 to prohibit deductions for payroll and other expenses financed by PPP loans to the extent that such loans are forgiven.

Code Section 265 generally prohibits a deduction for expenses allocable to tax-exempt income. A common practical example of Code Section 265 is its disallowance of deductions for investment expenses related to tax-exempt bond interest – because the income produced by tax-exempt bonds is not included in a taxpayer's federal taxable income, federal income tax deductions against such tax-exempt income are not permitted. This overarching theory has been applied to a variety of classes of tax-exempt income. To avoid granting taxpayers a double benefit, expenses related to nontaxable income are generally not deductible.

The IRS position has proven to be controversial. Many expected that in keeping with the policy of PPP to provide liquidity for businesses a deduction for the expenses would be allowed, even though it would effectively provide a double benefit by allowing a deduction for income that was not taxed. House Ways and Means Committee Chairman Richard Neal (D-MA) stated that he hopes such deductions will be made permissible in the next round

of COVID-19 response legislation. Trade associations and other stakeholders also are weighing in with the Treasury Department and Congress to urge them to reconsider this policy. However, Treasury Secretary Mnuchin has stated that “you can’t double dip.” Notice 2020-32 remains controlling at this time, but taxpayers will want to monitor this situation closely going forward in case a change is made legislatively or administratively.

REDUCTION IN NOLS?

As with the interplay between PPP loan forgiveness and Code Section 265 noted above, the CARES Act is silent on how PPP loan forgiveness interacts with the Net Operating Loss (NOL) reduction provisions in Code Section 108, which generally reduce certain beneficial tax attributes (including NOLs) to the extent that a taxpayer has an exclusion from CODI as a result of certain exclusions provided under Code Section 108. In this case, a taxpayer must reduce (but not below zero) the amount of its claimed NOL by the amount of tax-exempt CODI on a dollar-for-dollar basis under Code Section 108(b)(3)(A).

Because the CARES Act does not change Code Section 108, it appears that the loan forgiveness provisions of Section 1106 of the CARES Act may not result in a reduction of available NOLs under Code Section 108(b)(2). For this reason, PPP debt forgiven under the CARES Act may not reduce the available benefit from the provisions in the CARES Act that extend the availability of NOL carrybacks and suspend the 80 percent NOL limit. Income resulting from canceled debt as delineated in Code Section 108(b) would continue to reduce other tax attributes. Again, without legislative history, subsequent Treasury Department guidance, or legislative action, it is unclear how these provisions are intended to work together, and as currently drafted, the loan forgiveness provisions do not squarely fit within the attribute reduction rules of Code Section 108.

PARTNERSHIP CAPITAL GAINS?

The CARES Act is also silent on the interplay between PPP loan forgiveness and CODI's effect on partnership income allocation under Code Section 752. Under current law, when a partnership receives CODI, this income is allocated among the partners in accordance with the partnership agreement, increasing each partner's basis in the partnership under Code Section 705(a)(1). This is offset by a corresponding decrease in basis equal to the amount of each partner's distributive share of the partnership's decrease in liabilities under Code Section 752(b). Even with the exclusion of PPP loan forgiveness amounts from the partnership's income, partners may still be required to reduce their basis in the partnership by their distributive share of the partnership's reduction in liabilities resulting from the forgiveness of a PPP loan. If Congress acts to nullify Notice 2020-32 (related to deductible expenses as described above), proceeds from PPP loans may create deductible expenses that would cause a corresponding decrease in a partner's basis and create a net reduction in a partner's basis. Such a requirement could trigger a capital gain on the loan forgiveness or cause an increase in the amount of capital gain realized upon the dissolution of, or the partner's exit from, a partnership receiving PPP loan forgiveness. The IRS has not yet issued guidance on these issues.

NAVIGATING AN EVOLVING LANDSCAPE

Other ramifications of these provisions are still being discovered, and continuing guidance from the Treasury Department is likely to affect interpretation and administration. Until Congress clarifies these matters through new legislation or the issues are resolved through guidance or litigation, taxpayers should carefully consider their positions with respect to these evolving areas of law. The uncertainty regarding the federal treatment of the issues

discussed herein will also undoubtedly carry over to state tax compliance as states struggle to meet revenue gaps caused by COVID-19. The tax practitioners of K&L Gates LLP are available to assist you in determining how these provisions may affect your business's particular facts.

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