

OBSERVATIONS

CARES Act – Business Tax Provisions 7

May 4, 2020

The first wave of PPP loans have been approved and funded and the second wave is in process. The loan funding started the clock on the eight-week measuring period for spending the funds. For borrowers, the focus should now be on the question of loan forgiveness. The rules surrounding the forgiveness process is still in flux. This is the first of several blogs that will address that process. However, any blog must be read with its date in mind. The rules are being issued in an ongoing and evolving basis and they are being issued by two agencies: Treasury and Small Business Administration. Always refer to the most recent material.

PPP started from ground zero and within a month there was software, forms and rules for facilitating the largest loan program in United States history. The SBA was charged with administering approximately 10 years' worth of loans in one month. There were software glitches and other technological problems. However, many (but not all) banks were able to adapt and the first wave of loans were funded, and a second wave has begun.

Then, stories of perceived abuses appeared, prominently among the publicly traded upscale restaurant chain that managed, within the first week, to get two \$10 million dollar (maximum amount) loans through its subsidiaries. Then people in Washington were walking around, like Alex Guinness at the end of *The Bridge Over the River Kwai*, muttering, "What have I done?"

The result has been a number of administrative rules and announcements that have raised more questions than answers but do require a careful reading.

- The Treasury Secretary announced that all loans over \$2 million will be audited
- The IRS ruled that all expenses paid with a PPP loan would not be deductible (Notice 2020-32)
- The SBA, in its FAQ releases, stated that public companies were unlikely to qualify
- The SBA also stated that borrowers owned by other companies should look first to its shareholder(s) for financing

Where does that leave the typical company that is just attempting to deal with the impact of the COVID shutdown economy?

1. Audits: The problem with the Treasury Secretary's announcement is that the audit function has been assigned to another agency, the SBA. Presumably, there will be an

ultimate resolution of turf wars. However, every borrower should proceed on the assumption that it could be audited. Therefore, the word of the day is: Documentation. All borrowers should become familiar with the rules and spend the time to document expenditures (down to cancelled checks and receipts).

2. **Deductibility:** There is a certain fairness in the IRS ruling. The problem is that it contravenes express language in the statute. Congress expressly said that the forgiveness of the loan would not be taxable income. The IRS ruling is clearly a back-door attempt to nullify that provision. Congress can easily remedy the issue by repealing the debt forgiveness exemption. If Congress does not enact clarifying legislation, and the IRS does not change its position, the issue will probably be litigated. Borrowers should assume that the IRS will prevail file tax returns accordingly. However, they should also be prepared to amend tax returns if the IRS loses.
3. **Public Companies:** The statute did not preclude public companies from participating in PPP. The Congressional leadership is not inexperienced in drafting legislation so presumably this issue that could have been settled with one line in an 800-plus page Bill was purposeful. In any event, this issue has no direct impact on most borrowers.
4. **Private Companies:** This is the danger zone. SBA FAQ 37 is as follows:

*37. Question: Do businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?
Answer: See response to FAQ #31. (added April 28)*

The question refers to “businesses owned by private companies.”; it does not refer to businesses owned by individuals. Presumably, it does not apply to businesses owned by individuals.

It also refers to these private companies as having “adequate sources of liquidity...” Presumably, this means private equity firms and similar investors. That would be consistent with public statements from the Treasury.

In SBA FAQ 31, however, provides the following language

...all borrowers should review carefully the required certification that “[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.” Borrowers must make this certification in good faith, taking into account their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business.

Further, just to make the language even more threatening, there is a provision that if borrowed PPP funds are returned by May 7, certification shall be deemed to have been made in good faith, i.e. absolution is granted.

What all this means is certainly open to interpretation. However, given the purpose of PPP (to protect jobs), the enormous surge in unemployment claims, and the inability of anyone to predict the impact of the COVID crisis (or even when businesses can resume normal operations), hopefully there will be flexibility by the SBA.

How to proceed?

- To repeat: Documentation. Document business discussions, budgets and forecasts, revised business plans, alternatives discussed (including potential layoffs), and anything else that establishes a good faith concern about the impact of the COVID crisis on the ongoing business operations.
- Be careful how payroll is spent. Layoffs and pay cuts/reduced hours for lower compensated employees and no adjustment, or increases, for highly compensated employees is an invitation for a review.
- Understand the rules regarding forgiveness and be careful to adhere to those rules.

The CARES Act and our interpretation are subject to any administrative interpretation issued by the Small Business Administration and the Internal Revenue Service. The administrative interpretations are ongoing so be aware of most recent interpretations.

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