The Unintended Consequences of the Paycheck Protection Program?

by Gregory L Buhrow, CPA; May 2, 2020

According to Sec 1106 of the CARES Act (HR 748) signed into law on March 27, 2020, borrowers may apply to their respective lenders for forgiveness of the loan received under Sec 1104 of the CARES Act, specifically the Paycheck Protection Program.

The Paycheck Protection Program provides a loan for eight weeks of certain expenses based on the historical amount of those same types of expenses. Within certain restrictions, the loan may be *fully forgivable* to the borrower if those expenses fall within certain parameters. Those parameters are described in the CARES Act Sec 1106(b).

SEC. 1106. LOAN FORGIVENESS. (*in pertinent part*)

(a) DEFINITIONS.—In this section—

> (3) the term ‘‘covered period’’ means the 8-week period beginning on the date of the origination of a covered loan;

(b) FORGIVENESS.—An eligible recipient shall be eligible for forgiveness of indebtedness on a covered loan in an amount equal to the sum of the following costs incurred and payments made during the covered period:

> (1) Payroll costs.
>
> (2) Any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation).
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> (3) Any payment on any covered rent obligation.
>
> (4) Any covered utility payment (c) TREATMENT OF AMOUNTS FORGIVEN.—

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> (1) IN GENERAL.—Amounts which have been forgiven under this section shall be considered canceled indebtedness by a lender authorized under section 7(a) of the Small Business Act (15 U.S.C. 636(a)).

(i) TAXABILITY.—For purposes of the Internal Revenue Code of 1986, any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in subsection (b) shall be excluded from gross income.

So, the focus of this article is: Does loan forgiveness and the resultant exclusion from gross income constitute "tax-exempt income" for purposes of IRC Sec 265(a)(1)?

Code Sec. 265. Expenses and interest relating to tax-exempt income

(a) General rule

No deduction shall be allowed for -

(1) Expenses

Any amount otherwise allowable as a deduction which is allocable to one or more classes of income ... wholly exempt from the taxes imposed by this subtitle

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Further, Reg Sec 1.265-1(c) states: "Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto."

Taxable income increase?

The potential exists for the expenses, for which the PPP loan was received, not to be deductible in 2020 due to the PPP loan reclassification as "tax-exempt income" under IRC Sec 265.

Let's take a look at an example of how this treatment would appear:

Assume for the purposes of this example the 2020 revenue and expenses were the same as 2019, the entity applied for a PPP loan and then received it sometime during April/May time period of 2020. Here is the 2019 Income Statement:

	2019
Revenues	1,000,000
Loan forgiveness	-
	1,000,000
Payroll	480,000
Payroll tax	37,464
Health insurance	90,000
Retirement	24,000
Rent	24,000
Office	9,000
Travel	30,000
Meals	6,000
Outside services	4,800
Dues & subs	1,800
Telephone	18,000
Repairs	3,000
	728,064
Operating income	271,936
Interest expense	9,000
Depreciation	10,000
Taxable income*	255,936

* Taxable income adjusted for 50% Meals deduction

The PPP loan was calculated as follows:

Description	Amount
Payroll	480,000
Health insurance	90,000
Retirement	24,000
State unemployment insurance	324
	594,324
Months	12
	49,527
Factor	2.5
PPP Loan	123,818

The entity was approved for the PPP loan and received the $123,818 in Apr/May.

The proceeds of the loan were used as follows:

Description	Amount
Payroll	100,000
Health insurance	18,750
Retirement	5,000
State unemployment insurance	68
	123,818

Thus, the complete proceeds of the loan were used for its intended purpose and the employment did not drop below 75% of its previous levels during the covered period. The entity requested from the SBA loan forgiveness and it was granted.

Remember that the assumption in this exercise is that revenue and expenses for 2020 were exactly the same as 2019. Although unrealistic, it is used to illustrate and quantify the possible tax ramifications of the forgiveness of the loan.

The PPP loan was originally booked as a long-term loan as follows:

	Dr	Cr
Cash	123,818	
PPP Loan		123,818
To record loan proceeds deposited to bank		
PPP Loan	123,818	
Loan forgiveness		123,818
To record loan forgiveness		

Subsequently the loan was reclassified to income when forgiven. This should be reflected as an M-1 adjustment on the firm's tax return for 2020.

Now, let's examine the difference in the two years with the debt forgiveness and the application of IRC Sec 265.

	2019	2020	Variance
Revenues	1,000,000	1,123,818	
Loan forgiveness	-	(123,818)	
	1,000,000	1,000,000	
Payroll	480,000	380,000	(100,000)
Payroll tax	37,464	37,397	(68)
Health insurance	90,000	71,250	(18,750)
Retirement	24,000	19,000	(5,000)
Rent	24,000	24,000	
Office	9,000	9,000	
Travel	30,000	30,000	
Meals	6,000	6,000	
Outside services	4,800	4,800	
Dues & subs	1,800	1,800	
Telephone	18,000	18,000	
Repairs	3,000	3,000	
	728,064	604,247	(123,818)
Operating income	271,936	395,754	
Interest expense	9,000	9,000	
Depreciation	10,000	10,000	
Taxable income*	255,936	379,754	
C Corp tax rate	21%	21%	
Tax	53,747	79,748	26,002
If S Corp:			
Potential QBID	51,187	75,951	
Net after QBID	204,749	303,803	

You will immediately notice that operating income has dropped by $123,818 since the expense items used by the proceeds of the PPP loan are no longer deductible under Sec 265 treatment.

Thus, the bottom-line reflects an increase in the tax liability of $26,002 or 21% of the PPP loan amount.

If this were an S-Corporation, the tentative Qualified Business Income Deduction (ignoring SSTB and other taxable income limitations) would certainly increase as would the net income after the QBID.

If not all of the PPP loan was used for allowable purposes or the employment threshold was not maintained, a lesser amount of the loan would be reclassified as tax-exempt

income and therefore the deductible portion of the accompanying expenses would increase.

However, according to Regs Sec 1.265-1(c), the expenses would have to be allocated between taxable and tax-exempt income and then according to Regs Sec 1.265-1(d) a statement would have to accompany the tax return reflecting the allocation, not to mention the non-allowable expenses would not be forgiven and that portion of the loan would have a maturity of not more than ten years at an interest rate not to exceed 4 percent. CARES Act Sec 1102(a)(K)(ii) and (L)

In conclusion, this could be an unintended consequence for firms forced to suffer through the economic downturn caused by the federal, state and local government shutdowns and result in higher taxes due to the loan forgiveness income being reclassified as tax-exempt income, unless Congress specifically issues regulations to the contrary.