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IRS Releases Guidance on PPP Loans and Employee Retention Tax Credits

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The Internal Revenue Service (IRS) has issued several items of new guidance relating to loans under the Paycheck Protection Program (PPP), including two new FAQs addressing the interaction of PPP loans and employee retention tax credits (ERTCs) in M&A transactions, a Revenue Ruling holding that expenses funded by PPP loans that are expected to be forgiven in a subsequent taxable year are not deductible, and a Revenue Procedure covering how to claim deductions if such a PPP loan subsequently is not forgiven.

Interaction of PPP loans and ERTCs in mergers and acquisitions

The **IRS guidance** addressing the interaction of PPP loans and ERTCs in M&A transactions indicates that acquisitions of companies that have received PPP loans generally will not jeopardize the ERTCs of acquirers and their affiliates. The guidance was provided in the form of FAQs, which cannot be relied upon as legal authority, although they do provide insight into the IRS's current position. Several legislative proposals also have been advanced to harmonize the restrictions under the PPP loan and ERTC programs in the M&A context, which would provide additional certainty if passed into law.

Congress established the PPP and ERTC as part of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to incentivize employers to continue to pay their employees during the pandemic. The **PPP provides forgivable loans** for employers that use the proceeds to maintain payroll and pay other critical business expenses. The **ERTC is a refundable tax credit** available to certain employers adversely affected by the pandemic that continue to pay employees.

Under the CARES Act, an employer is not eligible for the ERTC if any member of its aggregated group has received a PPP loan, and previously claimed ERTCs are subject to recapture if a group member receives a PPP loan. The broad aggregation rules in the CARES Act (summarized in **IRS FAQ 25**) resulted in uncertainty in circumstances where a business claiming ERTCs acquired a company that received a PPP loan, or vice versa. Thus, parties to M&A transactions had to consider the possibility that acquiring a company with a PPP loan might jeopardize the ERTCs of the acquirer and its affiliates on both a prospective and retroactive basis, even if the target's PPP loan was repaid or forgiven prior to closing. This raised particular concerns for financial buyers because **IRS FAQ 80** had indicated that the receipt of a PPP loan by one portfolio company could jeopardize the ERTCs of a fund's other portfolio companies that were part of the same aggregated group.

Newly added **IRS FAQs 81a and 81b** cover M&A transactions structured as the purchase of the assets or stock (or other equity) of a company that has received a PPP loan, and addresses situations where the PPP loan is repaid or forgiven prior to closing, as well as those where the PPP loan remains outstanding. In general, assuming that the acquirer's pre-transaction group does not itself have or obtain a PPP loan, the target company's PPP loan will not taint the eligibility of the acquiring company and its aggregated group members (other than the target company) to claim ERTCs, and any ERTCs previously claimed by them will not be subject to recapture. Further, the target company may be eligible to claim ERTCs as part of the acquirer's group after the acquisition if its PPP loan is fully repaid or forgiven prior to closing, or if it complies with the **Small Business Administration's procedures** to submit a forgiveness application and escrow the amount of the PPP loan with the applicable lender prior to closing. Otherwise, the target company (but not the acquirer or its other group members) continues to be ineligible to claim ERTCs following the transaction.

The IRS guidance also provides that an asset acquisition from a company that received a PPP loan will not affect the ERTC eligibility of the acquiring company and its aggregated group unless the seller's PPP loan obligations are assumed. If the seller's PPP loan obligations are assumed, the acquirer and its aggregated group remain eligible for ERTCs, but the "qualified wages" used to calculate ERTCs will not include wages paid to the selling company's employees after the closing. Whether or not the seller's PPP loan obligations are assumed, the asset acquisition will not trigger recapture of ERTCs previously claimed by the acquiring company and its aggregated group members.

The IRS guidance provides welcome relief to buyers who were concerned about the impact of target companies with PPP loans in M&A transactions, as it generally ensures that such acquisitions will not by themselves result in disallowances of ERTCs claimed by the buyer's aggregated group.

Deductibility of PPP expenses

The IRS also released guidance on the deductibility of expenses paid or incurred during a taxable year that are expected to be reimbursed through the forgiveness of a PPP loan after year-end. In Revenue Ruling 2020-27, the IRS concluded that a taxpayer may not deduct such expenses if, at the end of the taxable year, the taxpayer reasonably expects the loan to be forgiven on the basis of the expenses it paid or accrued. Revenue Procedure 2020-51 provides a safe harbor for deducting such expenses where PPP loans that were reasonably expected to be forgiven ultimately are not forgiven in whole or in part.

Under the CARES Act, a PPP loan may be forgiven to the extent of payments made for eligible expenses, consisting of payroll costs, mortgage interest, rent and utility payments. Loan amounts that are forgiven under the PPP are not included in the taxpayer's gross income. To prevent a double tax benefit, the IRS previously concluded in Notice 2020-32 that a deduction is not allowed for an otherwise deductible expense if payment of the expense results in forgiveness of a PPP loan. That notice, however, did not address the tax treatment of eligible expenses funded with a PPP loan where the loan will be forgiven (if at all) only in a later taxable year.

Revenue Ruling 2020-27 covers two common scenarios where calendar year taxpayers received PPP loans in 2020 and paid certain eligible expenses during the covered period. In Situation 1, a taxpayer applies for loan forgiveness in November 2020 and has satisfied all the requirements under the CARES Act for forgiveness of the PPP loan, but has not been informed by the lender before the end of 2020 whether the loan will be forgiven. In Situation 2, the taxpayer has satisfied all the requirements under the CARES Act for forgiveness of the PPP loan, but does not apply for forgiveness of the loan before the end of 2020. The taxpayer has a reasonable expectation of forgiveness of the PPP loan, and expects to apply for forgiveness in 2021.

Revenue Ruling 2020-27 holds that the taxpayer in each of the two situations is not permitted to deduct the eligible expenses funded with its PPP loan in the taxable year in which the expenses were paid or incurred if, at the end the taxable year in which the taxpayer receives the PPP loan, the taxpayer "reasonably expects" to receive forgiveness of the PPP loan as a result of having paid or accrued such eligible expenses. The holding applies even if the taxpayer has not submitted an application for forgiveness of the loan by the end of the taxable year in which the taxpayer incurs such expenses.

In its analysis, the IRS states that in both situations the taxpayer had a reasonable expectation of reimbursement in the form of loan forgiveness. The ruling explains that the provisions of the CARES Act and the loan forgiveness application procedures published by the Small Business Administration provide loan recipients "with clear and readily accessible guidance to apply for and receive covered loan forgiveness." As an alternative basis for its holding, the IRS relied on Internal Revenue Code Section 265(a)(1), which disallows deductions for otherwise deductible-eligible expenses if the expenses are allocable to tax-exempt income, such as reasonably expected loan forgiveness.

In **Revenue Procedure 2020-51**, the IRS establishes a safe harbor allowing a taxpayer that initially expected its PPP loan to be forgiven to claim deductions for eligible expenses paid or incurred during the 2020 taxable year where the loan ultimately is not forgiven, in whole or in part. This could occur because the taxpayer's application for loan forgiveness is wholly or partially denied or because the taxpayer irrevocably decides not to seek forgiveness for some or all of the loan, including where the taxpayer determines that it is not eligible for PPP loan forgiveness on the basis of guidance from the Small Business Administration and withdraws its application.

Taxpayers can rely on the safe harbor on an original or amended income tax return or information return (or administrative adjustment request) for the 2020 taxable year, or on an income tax return or information return for a subsequent taxable year in which the taxpayer's application for PPP loan forgiveness is denied or the taxpayer irrevocably decides not to seek loan forgiveness. taxpayer's application for forgiveness is denied in a subsequent year, the taxpayer may use the safe harbor to deduct the expenses in a subsequent year, but is not required to do so because the taxpayer instead may deduct the expenses in the subsequent year under general tax principles.

To apply the safe harbor, the taxpayer must attach to the relevant return a statement titled "Revenue Procedure 2020-51 Statement" that contains certain information about the taxpayer, including the total amount of PPP loan forgiveness that was denied or will not be sought. The taxpayer may not deduct eligible expenses in excess this amount. In addition, the Revenue Procedure states that it does not preclude the IRS from examining other issues relating to the claimed deductions or requesting additional information or documentation verifying any amounts described in the Revenue Procedure 2020-51 Statement.

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