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Paycheck Protection Program (PPP) Loan Forgiveness Tax Issues

Chamberlain Hrdlicka Tax Alert - Paycheck Protection Program (PPP) Loan Forgiveness Tax Issues

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I.

Small Businesses with a Biweekly Payroll Schedule can Elect to use an Alternative Payroll Covered Period

SBA Form 3508, *Paycheck Protection Program Loan Forgiveness Application*, provides an optional alternative payroll covered period for small businesses with a biweekly (every other week) or more frequent payroll schedule. A small business may elect the alternative covered period only if it uses a biweekly or more frequent payroll schedule; those with monthly payroll schedules cannot make the election. If a small business makes the election, the eight-week period, for purposes of calculating eligible payroll costs, begins on the first day of the small business's first pay period after the loan was disbursed. This may prove beneficial for small businesses with more frequent payroll by easing the administrative burden of having to identify and substantiate eligible payroll expenses contained within a partial payroll period.

For example, if a small business using a biweekly payroll schedule pays its employees every other Thursday and its PPP loan is disbursed on a Monday, by electing to use the alternative covered period, the small business can wait to start the eight-week period, for purposes of calculating eligible payroll expenses, until Friday, the first day of its next pay period. On the other hand, if no election is made, the small business will continue to use the normal covered period, which starts on the first day the loan was disbursed, in this case the Monday that is part of a prior payroll period. Small businesses using the Alternative Payroll Covered Period should be aware that this period only applies for payroll costs, and other non-payroll costs continue to use the normal eight-week covered period.

II.

Payroll Costs Paid and Payroll Costs Incurred During the Covered Period are Eligible For Loan Forgiveness

Regarding eligible payroll expenses, Form 3508 broadly interprets the CARES Act to allow loan forgiveness for payroll costs paid and payroll costs incurred during the covered period. While this language still contains some ambiguity that will hopefully be resolved by additional SBA guidance, it leaves open the possibility that payroll costs that were incurred before the covered period are eligible for loan forgiveness if they are paid during the eight-week covered period. The application does confirm payroll costs that are incurred during the last pay period of the covered period are eligible for loan forgiveness if they are paid on or before the next regular payroll date following the end of the covered period.

III.

Non-Payroll Costs Paid or Incurred During the Covered Period are Eligible For Loan Forgiveness

Non-payroll costs (such as mortgage interest, rent, or utilities with service beginning before February 15, 2020) are eligible for loan forgiveness if they are paid during the covered period or incurred during the covered period, so long as they are paid before the next billing date, even if the billing date is after the covered period. But note, in order to receive the maximum amount of possible loan forgiveness, non-payroll costs are still limited to 25% of the total amount forgiven. In addition, it is important to keep in mind that the alternative payroll covered period discussed above does not apply to non-payroll costs. Small businesses that elect to use an alternative payroll covered period for their payroll expenses are still required to use the normal covered period for their non-payroll expenses, and will therefore have two different 8-week periods.

IV.

Full-Time Equivalent (FTE) Calculation

Neither the CARES Act nor subsequent SBA guidance defined how to calculate an FTE until Form 3508 did so 7 weeks after the CARES Act was signed into law. Before Form 3508, many small businesses have been conservatively using the FTE calculation found under the Affordable Care Act, which considers an employee working an average of 30 or more hours per week to be one FTE. Small businesses will now consider an employee who works on average 40 hours or more per week to be equal to one FTE. For employees who work on average less than 40 hours per week, small businesses can either divide the number of hours for each employee by 40; or count each employee who works on average less than 40 hours per week as 0.5 FTE.

V.

Applying for Loan Forgiveness

To apply for loan forgiveness, small businesses should submit their applications to the lender servicing their PPP loan. The application consists of (i) the PPP Loan Forgiveness Calculation Form; (ii) PPP Schedule A; (iii) the PPP Schedule A Worksheet; and (iv) the optional PPP Borrower Demographic Information Form. Small businesses should apply for loan forgiveness only after the covered period expires and the required loan documentation has been gathered.

Please note that the 75%-25% allocation of expenses issue as well as the eight-week covered period may change if regulatory and legislative fixes occur, as there is a significant push to further improve the flexibility of the Paycheck Protection Program. Following the lender's receipt of the application, the lender has up to 60 days to issue a decision on loan forgiveness. Each small business and their tax and legal advisors will want to work closely with the applicable lender to ensure that the appropriate amount of loan forgiveness is secured and that the tax treatment and reporting on a Form 1099-C, *Cancellation of Debt*, attributable to the PPP loan is correct.

VI.

Substantiating Eligible Expenses

Comprehensive documentation is required to substantiate all eligible expenses. With regard to payroll expenses, small businesses must provide:

1) Bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees.

2) Tax forms (or equivalent third-party payroll service provider reports) for the periods that overlap with the covered period, such as:

1. payroll tax filings reported, or that will be reported, to the IRS; and
2. State quarterly business and individual employee wage reporting and unemployment insurance tax filings reported or that will be reported to Texas. And

3) Payment receipts, cancelled checks, or account statements documenting the amount of any employer contributions to employee health insurance and retirement plans that the borrower included in the forgiveness amount.

With regard to non-payroll expenses, small businesses must provide documentation verifying the existence of the obligations and/or services prior to February 15, 2020 and eligible payments made during the covered period, such as:

1) For business mortgage interest payments:

1. copy of lender amortization schedule and receipts or cancelled checks verifying eligible payments from the covered period; or
2. lender account statements from February 2020 and the months of the covered period through one month after the covered period verifying interest amounts and eligible payments.

2) For business rent or lease payments:

1. copy of current lease agreement and receipts or cancelled checks verifying eligible payments from the covered period; or
2. lessor account statements from February 2020 and from the covered period through one month after the end of the covered period verifying eligible payments.

3) For business utility payments:

1. copy of invoices from February 2020 and those paid during the covered period; and
2. receipts, cancelled checks, or account statements verifying eligible payments.

Paycheck Protection Program (PPP) Loan Forgiveness Tax Issues, Continued

VII.

No Change to IRS Position Disallowing Deductions Related to Amounts Forgiven Under PPP

While the CARES Act allows small businesses to exclude from gross income expenses that are forgiven under a PPP loan, the IRS intends to offset this benefit, having taken the position that ordinary business expenses that were forgiven as part of a PPP loan are not deductible. This position appears contrary to Congressional intent and may be subject to court challenge, and/or it may change going forward, especially in light of recent filed legislation that would ensure deductibility of certain PPP loan amounts received and paid for covered expenses.

VIII.

Unpaid and/or Delinquent Taxes are not Disqualifying Factors for a PPP Loan

We have recently confirmed through interactions with the SBA that outstanding state and federal tax issues, including unpaid and/or delinquent taxes, are not disqualifying factors for a PPP loan under the CARES Act and related guidance. Accordingly, potential applicants that have tax-related debt should be eligible to apply for a PPP loan, so long as they meet the other requirements.

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