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Paycheck Protection Program Audits Have Started! Be Prepared for Audits, Appeal Process, and the Evolving Tax Consequences

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Now that the SBA's Paycheck Protection Program (PPP) Forgiveness Platform is open, the SBA is starting to review/audit borrowers' initial eligibility for PPP loans and PPP loan forgiveness determinations. While the PPP has buoyed millions of small businesses and supported countless more employees, the program has been marred by incomplete guidance forcing borrowers to make business decisions before relevant guidance is issued on a number of fundamental questions. Due to the delay in guidance, it is possible some businesses may receive adverse audit decisions from the SBA concerning their PPP loan eligibility and/or loan forgiveness requests. In order to challenge the SBA, these borrowers must understand and be able to navigate the appeal process, which was formalized months after the PPP started accepting applications and issuing PPP funds.

Borrowers should also be aware of the potential tax consequences associated with the SBA's review/audit and corresponding appeal processes. At this time, some aspects of the tax treatment of forgiven PPP loans are in flux. On December 21, 2020, Congress passed the Consolidated Appropriations Act, 2021

(Appropriations Act),¹ which, in addition to other general Covid-19 associated stimulus measures, modified the PPP and addressed the tax treatment of forgiven PPP loans. While Congress has passed the Appropriations Act, President Trump subsequently threatened to not sign (essentially veto) the legislation unless certain measures unrelated to the PPP were modified. As of December 23, 2020, the Appropriations Act has not been signed into law.

EXISTING TAX TREATMENT OF PPP LOANS

If the Appropriations Act is not signed by the president, existing law provides that the entire amount of the PPP loan forgiven is excluded from gross income under §1106(i) of the CARES Act.² For taxpayers considering deducting PPP expenses, the IRS recently released Rev. Rul. 2020-27 and Rev. Proc. 2020-51, which together outline its position on whether taxpayers with PPP loans may take deductions in 2020 for PPP expenses that have not yet been forgiven. According to Rev. Rul. 2020-27, a taxpayer with a PPP loan may not deduct PPP expenses that are otherwise deductible in 2020 if, at the end of the tax year, "the taxpayer reasonably expects to receive forgiveness. . . even if the taxpayer has not submitted an application for forgiveness by the end of the tax year." In the event that forgiveness is partially or fully denied in the future, Rev. Proc. 2020-51 provides a safe harbor so that impacted borrowers may claim deductions on their 2020 return, amended return, or 2021 return.

The IRS's position relies upon Notice 2020-32, which disallows deductions for expenses forgiven as part of a PPP loan. We previously addressed Notice 2020-32 in *IRS Undermines Congressional Intent for Payroll Protection Program Loans*,² in which we posited that the IRS's position appears contrary to Con-

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¹ H.R. 133, 116th Cong. (passed Senate).

² Pub. L. No. 116-136.

² Juan F. Vasquez Jr., Jaime Vasquez, Victor J. Viser, *IRS Undermines Congressional Intent for Payroll Protection Program Loans*, Daily Tax Rep. (July 23, 2020).

gressional intent, may not be supported by a plain reading of the statute, may violate the Administrative Procedure Act, and may be entitled to little or no deference. The Appropriations Act confirms Congress's intent in favor of taxpayers as discussed in the next section. Absent the Appropriations Act becoming law or additional congressional action, we anticipate borrowers will be forced to make a difficult decision: to not take the deductions at all; take the deductions without further support; take the deductions after securing requisite opinion letters; take the deductions and disclose on Form 8275, *Disclosure Statement*; or file an original return without taking the deductions and subsequently file a protective claim for refund to preserve the position.

TAX TREATMENT UNDER THE APPROPRIATIONS ACT

If the Appropriations Act is signed into law, borrowers with forgiven PPP loans are still able to exclude the forgiven amounts from gross income, however the relevant section is changed from §1106 of the CARES Act to §7A of the Small Business Act. For taxpayers considering deducting PPP expenses, the Appropriations Act provides that ordinary and necessary business expenses forgiven as part of a PPP loan are indeed deductible. IRS guidance prohibiting such deductions (Notice 2020-32, Rev. Rul. 2020-27, and Rev. Proc. 2020-51) would no longer be supportable, as this issue is resolved definitively in favor of all taxpayers.

PPP ELIGIBILITY

When borrowers submit their applications for loan forgiveness, some may be surprised to learn that the SBA may also review/audit (or seemingly re-review) whether they were eligible for their PPP loan at all. Most borrowers are understandably and correctly under the impression that the SBA previously reviewed and signed off on the potentially forgivable loans on the front end before the funds were disbursed. While this may be concerning considering borrowers may be on the hook for PPP funds they have already used and that they were expecting to be forgiven, most of the eligibility requirements are relatively straightforward and should have been discovered by the lender and the SBA during the application process (such as the type of entity or size limitations). However, there is one area of concern, particularly for borrowers with PPP loans greater than \$2 million, as these loans are subject to an automatic review/audit process. Section 1102(a) of the CARES Act requires borrowers to make various certifications on their PPP loan applications, including the certification concerning economic

need, which states as follows: “An eligible recipient applying for a covered loan shall make a good faith certification that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient.”

The SBA has issued guidance regarding the certification concerning economic need primarily through its Frequently Asked Questions (numbers 31, 43, 46, and 47) on its website. To make the certification in good faith, “all borrowers must assess their economic need for a PPP loan under the standard established by the CARES Act, and the PPP regulations *at the time of the loan application* [emphasis added].” To assess their economic need, the borrowers, “must [take] into account their *current business activity* [emphasis added] 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.” Borrowers, many of whom applied for PPP loans in March and April of 2020, had until May 18, 2020, to repay their loans in full if they did not satisfy the certification based on existing guidance. The SBA also noted that, “borrowers with loans greater than \$2 million. . . may still have an adequate basis for making the required good-faith certification, based on their individual circumstances in light of the language of the certification and SBA guidance.”

The CARES Act and subsequent SBA guidance confirms that a borrower must assess its economic need based on the current economic conditions *at the time* of the PPP loan application. The certification itself uses the phrase “current economic conditions” and SBA guidance reinforces this position by providing that borrowers must assess their economic need “at the time of the loan application.” This interpretation also makes sense in the real world, as borrowers did not have the benefit of knowing how the Covid-19 pandemic would affect their businesses after their applications were made and so could not consider these ex-post facts when making their certification.

At first glance, it appears that the SBA may not agree with this “at the time” interpretation based on its recently issued Form 3509, *Paycheck Protection Program Loan Necessity Questionnaire (For-Profit Borrowers)* (the Questionnaire), which requests information that will be used by SBA loan reviewers to evaluate the certification concerning economic need. The SBA solicited comments on the Questionnaire through November 25, 2020, as required by the Paperwork Reduction Act, but has yet to address the comments or update the form. The applicable borrower's lender must submit the Form 3509 and will provide a 10-business day period to respond with the completed form to facilitate the SBA's review process. The Questionnaire, which was released in late October, does not limit the scope of its requests to information

related to the then current economic conditions “at the time” of the PPP loan application. It also asks for information and documentation that occurred *after* the date of the PPP loan application, including:

1. A comparison of gross revenue between the second quarters of 2019 and 2020;
2. Whether the borrower was ordered to shut down or to significantly alter its operations by a state or local authority due to Covid-19 since March 13, 2020;
3. Whether the borrower voluntarily ceased, reduced, or altered its operations due to Covid-19;
4. Whether the borrower began any new capital improvement projects not due to Covid-19 between March 13, 2020, and the end of the covered period;
5. Whether the borrower paid any dividends or other capital distributions between March 13, 2020, and the end of the covered period;
6. Whether the borrower prepaid any outstanding debt between March 13, 2020, and the end of the covered period; and
7. Whether any employee or owner received compensation exceeding \$250,000 annualized during the covered period.

In order to answer each of these requests, the borrower must provide information and documentation that the borrower (1) did not know, (2) was uncertain, or (3) did not exist when the PPP application was made. In fact, all seven requests in the Form 3509 ask for information which covers periods after the May 18, 2020, deadline to repay the loan in full. This after the fact information required by Form 3509 will then be used by SBA loan reviewers to “evaluate” whether the certification concerning economic need was made in good-faith, despite the contradictory statutory language and SBA guidance mandating that the certification and assessment of economic need be made *at the time* of the PPP loan application.

This situation may end up being unfair to borrowers, as just having access to this ex-post information could seemingly impact an SBA loan reviewer’s evaluation of the certification concerning economic need. Whereas the borrower was experiencing economic uncertainty and attempting to predict Covid-19’s effect on its business going forward as of March or April 2020, or some other approximate date when they took out their PPP loan, the SBA loan reviewer may now use hindsight to determine whether the certification for the loan was made in good faith, or whether such loan is in fact forgiven, but now knowing Covid-19’s ultimate impact on the borrower with certainty.

In light of the fact that borrowers have already been receiving the Questionnaire as part of the SBA’s review/audit process for loans over \$2 million, and considering that the SBA has yet to incorporate comments and objections received in response to the originally issued Form 3509, absent the SBA updating the Form 3509, it is vitally important to supplement responses to the Questionnaire with information and documentation pertaining to the borrower’s economic need as of the date of the PPP loan application.

With regard to business activity, the borrower will want to show that its business activity was negatively affected, or anticipated to be negatively impacted, by the Covid-19 pandemic when its application was signed. This should be done through a combination of financial records and analysis and secondary sources. For financial records, year-over-year comparisons of revenue, sales, or other industry-specific metrics can be used to show the decline relative to 2019 and the days leading up to the application date to further emphasize the declines in business activity. For secondary sources, consider referencing ordinances that prohibited business activity and/or specifically targeted the business. Note that multiple ordinances were likely in effect before the application date. Industry-wide or regional trends/projections published by newspapers, magazines, and/or trade associations around the application date are also relevant. Finally, if applicable, a business should note whether it was experiencing, or expected to experience, reductions in the number of jobs, furloughs, or supply chain disruptions. In fact, many businesses, but for their receipt of the PPP loan, would have undoubtedly laid off or furloughed many more millions or workers. Such inquiry is unfortunately lacking from the existing Form 3509.

The second factor, access to liquidity, is also important. Public companies were deemed to have access to the capital markets and therefore a rebuttable presumption against public companies making the certification concerning economic need in good faith exists. For private businesses, access to sources of liquidity can be a pertinent factor. There is no explicit requirement to utilize a line of credit before securing a PPP loan. For example, some businesses would have preferred to lay off or furlough workers rather than to access a high interest rate line of credit. If a business’s line of credit was not fully exhausted at the time of the PPP loan, the business could argue that its designated rate was too high given the uncertainty created by the Covid-19 pandemic, or that its historical use of the line of credit is for a certain purpose and shifting the funds away from such purpose would be significantly detrimental to the business. For example, a hypothetical business might argue that it relies on the line of credit to purchase inventory before the busy season and to divert such funds to payroll would pre-

vent the business from being able to meet demand. Additionally, the business should review the terms for the line of credit in case there are any restrictions that would be applicable.

LOAN FORGIVENESS AUDIT SUPPORT

Most borrowers have already submitted, or will submit in the near future, loan forgiveness applications. No matter what application is used, all borrowers must be able to provide comprehensive documentation to substantiate all eligible expenses. This documentation will be reviewed by the lender servicing the PPP loan and possibly the SBA during the loan forgiveness application process. Potential loan forgiveness is primarily based on the total amount of eligible expenses made during the eight-week or 24-week covered period following the first disbursement of PPP loan funds, subject to the requirement that 60% or more of such expenses be for eligible payroll costs (paid or incurred during the covered period) and up to 40% of eligible expenses for non-payroll costs.

With regard to payroll costs, the borrower must provide: bank account statements; tax forms, including federal payroll tax filings, and state wage reporting, and unemployment insurance tax filings; and payment receipts, cancelled checks, or account statements documenting employer contributions to employee health and retirement plans.

With regard to non-payroll expenses (such as rent, mortgage interest, and utilities), the borrower 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. For business mortgage interest payments, this includes a copy of the lender amortization schedule and receipts or cancelled checks or lender account statements from February 2020 and the months of the covered period through one month after the covered period. For business rent or lease payments, this includes a copy of the current lease agreement and receipts or cancelled checks; or lessor account statements from February 2020 and from the covered period through one month after the end of the covered period. For business utility payments, this includes a copy of invoices from February 2020 and those paid during the covered period; and receipts, cancelled checks, or account statements.

APPEAL PROCESS

Once a borrower submits its loan forgiveness application to the lender servicing its loan, the lender has 60 days to issue its decision to the SBA, and the lender will generally inform the borrower of such de-

cision and the matter being forwarded to the SBA. The SBA then has 90 days to remit the appropriate amount of forgiveness to the lender, subject to its review of the forgiveness application or PPP loan eligibility. Neither the CARES Act nor SBA guidance contemplates what would happen if the SBA exceeded the 90-day period without conducting a review/audit. The end of the 90-day period does not necessarily mean that the SBA will not undertake a review in the future, as the PPP loan forgiveness application provides that borrowers are required to retain PPP documentation for six years after the date the loan is forgiven or repaid in full, and permit the SBA to access such documentation upon request. If a lender denies forgiveness, whether partially or in full, it must notify the borrower in writing that it has issued a decision to the SBA denying the forgiveness application. The borrower cannot appeal this decision, but may request SBA review within 30 days.

Similar to many aspects of the PPP, the process for appealing lender and/or SBA decisions regarding PPP loan eligibility and forgiveness was not formalized in the CARES Act or when borrowers originally applied for their PPP loans in the spring. Since June, the SBA has gradually laid out the structure of the appeal process through various interim final rules, in particular “SBA Loan Review Procedures and Related Borrower and Lender Responsibilities” and “Appeals of SBA Loan Review Decisions Under the PPP.” We now know that the appeal process is complex and moves relatively quickly. Borrowers must have an understanding of what it looks like in order to challenge successive adverse decisions in a timely manner.

The appeal process can be broken down into five distinct steps. First, the borrower applies for loan forgiveness. Second, the borrower requests SBA review of a lender’s partial or complete denial of loan forgiveness or the SBA conducts its own review/audit. Third, the borrower appeals the SBA decision to the SBA Office of Hearings and Appeals (OHA). Fourth, the OHA judge issues an initial decision and the borrower files either a request for review or request for reconsideration of this initial decision. Fifth, the borrower files a complaint in federal district court contesting the final decision resulting from its request for review or request for reconsideration.

A borrower can appeal an SBA decision finding that it was not eligible for (1) the PPP loan, (2) the PPP loan amount, or (3) the PPP loan forgiveness amount by filing an appeal petition with the SBA Office of Hearings and Appeals (OHA) within 30 days after the borrower receives the SBA decision or is notified of the SBA decision by the lender, whichever is earlier. The borrower must prove by a preponderance of the evidence that the SBA decision was based on clear error of fact or law. This standard is significantly

deferential, generally requiring that the SBA's factual determinations are plausible in light of the record as a whole. The judge will base the initial decision on a review of the written administrative record, the appeal petition and responses, admitted evidence, and a possible oral hearing.

A borrower can file a request for review or request for reconsideration of this initial decision within 30 days after its service, after which time if neither request is filed the initial decision becomes a final decision. It is crucial for the borrower to file a request for review or request for reconsideration if they intend to seek review in federal district court, as these requests are administrative remedies that must be exhausted before judicial review in federal district court can be sought.

CONCLUSION

While the PPP has given millions of businesses and their employees the opportunity to survive the economic effects of the Covid-19 pandemic, unfortunately (and perhaps understandably), the program has not provided essential guidance in a timely manner. Now that the SBA is starting to conduct its reviews/audit of PPP loan forgiveness determinations and PPP eligibility, borrowers must understand their rights in the appeal process and be able to defend their certifications concerning economic need and PPP loan forgiveness requests. Borrowers should also stay informed about the evolving tax consequences associated with loan forgiveness should the Appropriations Act become law.

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