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PREPARING FOR AND DEFENDING AGAINST A POTENTIAL AUDIT OF YOUR CLIENT'S CARES ACT PPP LOAN

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Businesses with Paycheck Protection Program Loans ("PPP Loan") have used PPP loan funds despite the lack of clear guidance on several aspects of the Program. This article discusses three areas of potential review or audit by lenders, the SBA, and/or the IRS. First, applicants were required to make a good-faith certification concerning need for a PPP loan. This good-faith certification may be subject to review by the SBA, especially for borrowers with loans in excess of $2 million.[4] Second, when borrowers submit their application for loan forgiveness they must provide documentation substantiating eligible expenses.[5] Third, when the business completes its federal income tax return, it may decide to deduct under 162 of the Code business expenses that were forgiven as part of its PPP loan. If the business takes this deduction, it may be subject to audit by the IRS. These review/audit risks can be prepared for and are considered in turn.

Defending the Good-Faith Certification

Businesses must be ready to defend the good-faith certification made when they applied for their PPP loans and potentially when they signed their promissory notes.[6] The certification states, "that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient."[7] To make the certification in good faith, businesses must take into account two factors: (i) their business activity at the time the certification was made; and (ii) whether they had access to other sources of liquidity, the use of which would not be significantly detrimental to their business.[8]

Business Activity

Importantly, for purposes of the good-faith certification, business activity is determined at the time the application was made. A business will therefore want to show that its business activity was negatively affected 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. With regard to 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. With regard to 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 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.

Liquidity

The second factor, access to liquidity, is also important. With regard to private businesses, access to sources of liquidity will be a significant factor. Although there is not a requirement to utilize a line of credit to secure a PPP loan, a private business with access to a line of credit may determine the amount of available credit at the application date. If the line of credit is not fully exhausted, the business could argue that its historical use is for a certain purpose and shifting the funds away from such purpose would be significantly detrimental to the business. For example, a hypotheti-

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A DISCOMBOBULATED FALL

Sherre Sattler, Executive Director

Allegedly it is back to school time. But it didn't really feel like summer and as I stood in front of the school supplies in Target I wondered, "Do my sons really need any new supplies when so much of what they will be doing is online?" So I purchased more masks and hand sanitizer and called it done for now. Football has sort of started. The team had a scrimmage, but parents could not attend so we all watched from the fences. Many of us felt this might be the only time we get to see them play so we could not miss it. It is a weird fall.

At the Society, September is an action-packed month. It is membership dues time, the convention is happening, new CPAs are being welcomed into the Society, and committees are forming. Most of that is still happening but this too feels a bit discombobulated.

We are holding the CPA Convention but most of it will be fully virtual. The exceptions are the annual meeting and golf. The annual meeting will be September 21 at 9:55 at the Ramkota in Bismarck. For those who cannot join in person there is a virtual option. Watch your email for instructions on that or call our office at 701-775-7111 and we will get you the link to participate. For the golf, we are offering tournaments in Bismarck, Minot, Grand Forks and Fargo. You can register when you sign up for the convention. If you just want to golf, email cpe@ndcpas.org and our new education director, KaSaundra Peterson will get you signed up. (More to come on KaSaundra in November!)

Please note, there will also be a vote on changes to our bylaws at this meeting. See page 6 of this newsletter for more information.

While preparing for this unusual version of the convention is interesting, I cannot hide my disappointment for a virtual recognition program. This is a highlight of the year and a source of inspiration. We will do our best to recreate that celebration in a virtual format. Please watch our program on Tuesday, September 22 at 11:45.

This is also the time of year when we see a change in leadership for the Board of Directors. Dianna Kindseth will be moving from the President position to Past President. She was part of the transition team that formed when the Society and Board split staff and office space. Dianna was helpful with many of the logistical items like the employee handbook and reorganizing our new accounting system. However, our conversations about what it was like to be a female partner in the (not so distant) days when that was still rare may offer the most long-term value. It is easy to take progress for granted. I think her perspective will be helpful as we continue to strive to be a diverse and inclusive profession.

Clarence Sitter is completing his year as Past President and will now be leaving the board. He bravely agreed to step in the leadership chain knowing that he would be working with a new Executive Director, but I am certain he didn't realize all of the transition that would ensue. Our year of trials gave me a lifelong friend and mentor. There is proof that mentors can be younger than you!

Hope to "see" you at the convention and happy bizarro Fall!

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cal business might argue that it relies on the line of credit to purchase inventory before the busy summer season and to divert such funds to payroll would prevent 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.

Documenting Eligible Expenses

Businesses must be able to provide comprehensive documentation to substantiate all eligible expenses.[9] 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 8-week or 24-week covered period following the first disbursement of PPP loan funds,[10] 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.[11]

With regard to payroll costs, the business 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.[12]

With regard to non-payroll expenses, the business 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.[13] 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.[14] 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 verifying eligible payments.[15]

While a business may provide additional documentation if requested and file an appeal following a full or partial denial of loan forgiveness, the appeal process is unknown at this time.[16] Accordingly, businesses should try to avoid the appeal process by providing complete documentation with the forgiveness application.

Ordinary Business Expense Deduction

Under IRS Notice 2020-32, the IRS took the position that business expenses are not deductible to the extent they were paid with forgiven PPP loan funds. Shortly after the IRS disclosed its position, Senate Finance Committee Chairman Chuck Grassley stated, "[w]hen we developed and passed the Paycheck Protection Program, our intent was clearly to make sure small businesses had the liquidity and the help they needed to get through [the Covid-19 pandemic]. Unfortunately, Treasury and the IRS interpreted the law in a way that's preventing businesses from deducting expenses associated with PPP loans. That's just the opposite of what we intended and should be fixed."[17] The bipartisan Small Business Expense Protection Act of 2020 was introduced in the Senate shortly after IRS Notice 2020-32 was issued,[18] confirming that business expenses forgiven as part of a PPP loan would be deductible under 162 of the Code as ordinary business expenses.[19] As of August 20, 2020, the bill is currently with the Senate Finance Committee and the House Committee on Ways and Means.

If the Small Business Expense Protection Act of 2020 or similar legislation is not passed, the IRS position laid out in Notice 2020-32 will be subject to Court challenge as being inconsistent with Congressional intent, in addition to other legal challenges and may ultimately be entitled to little or no deference.[20] Notices are not afforded the same level of legal precedent as a statute or regulation and courts are not bound by them.[21] Further, there will be an added element of confusion to an already interesting 2020 filing season. Consider, for example, a CPA tax preparer taking a return position that PPP loan amounts forgiven were also deductible business expenses. Technically that position would be inconsistent with IRS guidance contained in IRS Notice 2020-32. Would the CPA need to report the position on a Form 8275 Disclosure Statement? Should the CPA request an opinion of counsel that the position is supported by the plain language of the statute and/or comports with legislative intent?

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ENDNOTES:

[4]SBA, Paycheck Protection Program Loans Frequently Asked Questions (FAQs), § 39 (as of May 27, 2020).

[5]Pub. L. 116-136, Coronavirus Aid, Relief, and Economic Security Act, § 1106(f) (Mar. 27, 2020) (hereinafter "CARES Act"). "Eligible expenses" are expenses made for payroll and non-payroll costs during the covered period with are subject to loan forgiveness, so long as 60% or more are for payroll costs, they are paid or incurred during the covered period, and various

[6]Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, Preparing for a Potential Audit of Your Client's Paycheck Protection Program Loan, TODAY'S CPA (July 2020).

[7]Supra note 4, at § 31.

[8]*Id*

[9]CARES Act § 1106(e); See also, Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, INSIGHT: Tax Issues Associated with the Paycheck Protection Program Loan Forgiveness Process, BLOOMBERG TAX DAILY TAX REPORT (May 21, 2020).

[10]If a borrower received a PPP loan before June 5, 2020 it may choose either the 8-week or 24-week covered period. A borrower that receives a PPP loan on or after June 5, 2020 must use the 24-week covered period. Pub. L. 116-142, Paycheck Protection Program Flexibility Act of 2020 § 3(b)(1) (June 5, 2020) (hereinafter "Flexibility Act"). See also Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, INSIGHT: Congress Adds 'Flexibility' to Loan Forgiveness and Corresponding Tax Consequences, BLOOMBERG TAX DAILY TAX REPORT (June 5, 2020).

[11]85 FR 20811, 20814; SBA IFR 2020-37; Flexibility Act § 3(b)(1).

[12]CARES Act § 1106(e); SBA Form 3508, Loan Forgiveness Application, 10 (revised June 16, 2020) (hereinafter "SBA Form").

[13]SBA Form at 10.

[14]*Id*

[15]*Id*

[16]IFR 2020-33.

[17]Chuck Grassley, Bipartisan Senators Introduce Bill to Clarify Small Business Expense Deductions Under PPP (May 6, 2020); Here are 3 Things to Know About the Extended Paycheck Protection Program, ABC 13 EYEWITNESS NEWS HOUSTON (July 18, 2020) (Interview with Juan F. Vasquez, Jr.).

[18]S. 3612, Small Business Protection Act of 2020, 116th Cong. (May 5, 2020).

[19]*Id*

[20]Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, IRS Undermines Congressional Intent for Paycheck Protection Program Loans, BLOOMBERG TAX DAILY TAX REPORT (July 23, 2020); Juan F. Vasquez, Jr., Judicial Deference for Revenue Rulings in a Post-Mead World, J. Tax Practice & Proc. (Aug/Sep 2004). See also, Juan F. Vasquez, Jr. and Peter A. Lowy, Challenging Temporary Treasury Regulations: An Analysis of the Administrative Procedure Act, Legislative Reenactment Doctrine, Deference, and Invalidity, III Hous. Bus. Tax L. J. 248 (2003) (showing that when the IRS issues guidance that is inconsistent with congressional intent, such item may be challenged and invalidated. "In the tax arena, wide arrays of regulations (without regard to the level of deference) have been declared invalid. This array includes legislative regulations, interpretive regulations, and temporary questions.").

[21]Rev. Proc. 89-14. See also, Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, Who CARES About Tax Issues for Small Business: A Review of the Tax Forgiveness, Tax Deduction, and Other Tax Issues Associated with the CARES Act's Paycheck Protection Program ("PPP"), 47 Tex. Tax Lawyer 1 (Spring 2020).