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Second Draw PPP Loans Are On the Way: Consolidated Appropriations Act Modifies the PPP and Rev. Rul. 2021-2 Reverses IRS Guidance on Tax Treatment of PPP Loans

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On December 27, 2020, the President signed into law the Consolidated Appropriations Act, 2021 (Appropriations Act),[1] which, in addition to other general Covid-19 stimulus measures, modifies the Paycheck Protection Program (PPP) and addresses the tax treatment of forgiven PPP loans and associated expenses. The Appropriations Act allocates approximately $285 billion to restart and expand the PPP. First-time borrowers looking for an initial PPP loan and certain eligible borrowers with existing PPP loans have through March 31, 2021, to apply for the next round of PPP loans (once the SBA starts accepting applications). Borrowers with existing PPP loans may be eligible for a second loan, referred to as a Second Draw loan, if they satisfy stricter eligibility requirements. The Appropriations Act also provides a simplified forgiveness application process for borrowers with PPP loans up to $150,000, expands the types of expenses eligible for forgiveness and clarifies, once and for all, that forgiven PPP loans are excluded from gross income and the expenses paid with those loans are deductible.

TAX TREATMENT OF PPP LOANS

The Appropriations Act provides that ordinary business expenses paid for with a forgiven PPP loan, including a Second Draw loan, are deductible.[2] Under the CARES Act,[3] while forgiven loans are excluded from gross income the CARES act did not directly address whether associated ordinary business expenses were still deductible. Prior to the enactment of the Appropriations Act, the IRS noted in Notice 2020-32, Rev. Rul. 2020-27, and Rev. Proc. 2020-51 that it would not allow such deductions. This position is no longer an accurate statement of law due to Division N, §276 of the Appropriations Act. We previously argued in *IRS Undermines Congressional Intent for Payroll Protection Program Loans*[4] that the IRS position was wrong because it went against Congressional intent, and was inconsistent with the plain language of the statute and other authorities, among other reasons. Congress has now made clear this issue should be definitively resolved in favor of all taxpayers.

On January 4, 2021, the IRS updated its position on the deductibility of ordinary business expenses to reflect changes to the law contained in Division N, §276 of the Appropriations Act. In Rev. Rul. 2021-2, the IRS declared its prior guidance (Notice 2020-32 and Rev. Rul. 2020-27) obsolete as of March 27, 2020. Under Rev. Rul. 2021-2, deductions for ordinary business expenses are allowed when the loans are forgiven or are expected to be forgiven as part of a PPP loan. This serves as a big win for all taxpayers and prevents what would have otherwise been an unauthorized and unintended clawback.

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[1] Pub. L. No, 116-260.

[2] *See generally* Appropriations Act, Div. N §276.

[3] Pub. L. No. 116-136.

[4] Vasquez, Vasquez, and Viser, *IRS Undermines Congressional Intent for Payroll Protection Program Loans*, Daily Tax Rep. (July 23, 2020).

ELIGIBILITY FOR A SECOND DRAW LOAN

In general, to be eligible for a Second Draw loan, a business must have used, or will use, the full amount of its initial PPP loan on or before the date the Second Draw loan is disbursed, and must:[5]

1. Employ 300 or fewer employees; and
2. Experience at least a 25% decline in gross receipts in Q1, Q2, Q3, or Q4 of 2020 when compared to the same quarter in 2019.[6]

While this is a more straightforward test than what was laid out in the CARES Act for initial PPP loans, it imposes more stringent requirements on the applicant, reducing the maximum number of employees a business can employ to 300 from 500 and requiring a year-over-year decline in gross receipts.

A business with more than one physical location is eligible for a Second Draw loan if, in addition to fully using its initial PPP loan, it:[7]

1. Is assigned an NAICS code of 72 (associated with hotels and restaurants);
2. Employs 300 or fewer employees *per physical location*; and
3. Experiences at least a 25% decline in gross receipts in Q1, Q2, Q3, or Q4 of 2020 when compared to the same quarter in 2019.

SECOND DRAW LOAN CHARACTERISTICS

Section 311 of Division N of the Appropriations Act limits each borrower, including borrowers with more than one physical location, to one Second Draw loan. For most borrowers, a Second Draw loan can be up to the **lesser** of $2 million or 2.5 times the average monthly payroll costs during either (i) the one-year period before the date the loan is made or (ii) 2019, whichever the borrower elects to use. For borrowers with an NAICS code of 72 (associated with hotels and restaurants), the 2.5x multiplier is increased to 3.5x, potentially resulting in such businesses receiving greater loan amounts than other businesses with similar monthly payroll costs. For seasonal employers, the one-year period is reduced to any 12-week period between February 15, 2019, and February 15, 2020, but the multiplier stays at 2.5x.

EXPANSION OF EXPENSES ELIGIBLE FOR FORGIVENESS

Forgiveness for any PPP loan, including a Second Draw loan, is still limited to 60% payroll costs and 40% nonpayroll costs, as Congress first provided in the Flexibility Act. In addition to payroll costs, mortgage interest, rent/lease payments, and certain utility payments, the following expenses are also eligible for forgiveness (counting as non-payroll costs):[8]

- **Operations Expenditures**: Payments for any business software or cloud computing service that facilitates business operations, product or service delivery, the processing, payment, or tracking of payroll expenses, human resources, sales and billing functions, or accounting or tracking of supplies, inventory, records, and expenses.
- **Property Damage Cost**: Costs related to property damage and vandalism or looting due to public disturbances that occurred during 2020 that was not covered by insurance or other compensation.
- **Supplier Cost**: Expenditures made to a supplier for goods that are essential to the operations of the entity at the time at which the expenditure is made. These expenditures must be made pursuant to a contract, order, or purchase order in effect before the Second Draw loan Covered Period or if for perishable goods, before *or during* the Second Draw loan Covered Period.
- **Worker Protection Expenditures**: Operating or capital expenditures to facilitate the adaptation of business activities to comply with Covid-19 requirements/guidance issued by HHS, CDC, OSHA, or equivalent State/local guidance from March 1, 2020, to the end of Covid-19 national emergency. Needs to be related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to Covid-19.

SIMPLIFIED FORGIVENESS APPLICATION

Borrowers with PPP loans up to $150,000 are not required to submit any application or documentation in order to receive forgiveness so long as they sign and submit a certification to their lender which provides (i) the number of employees retained because of the PPP loan, (ii) the amount spent on payroll costs, and (iii) the total value of the PPP loan.[9] Eligible borrowers should nevertheless maintain relevant employment records for four years and other records for three years following submission of the certification.

[5] *See generally* Appropriations Act, Div. N, §311.

[6] Q4 of 2020 is only considered for loan applications submitted on or after January 1, 2021.

[7] *See generally* Appropriations Act, Div. N, §311.

[8] *See* Appropriations Act, Div. N, §304.

[9] *See* Appropriations Act, Div. N, §307.

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Overall, the Appropriations Act is a positive next step for the PPP. It clarifies the tax treatment of forgiven expenses in favor of the taxpayer, allocates approximately $285 billion to the PPP and reopens the application period through March 31, 2021. The Appropriations Act provides a simplified forgiveness application process for borrowers with PPP loans up to $150,000, and allows certain borrowers with existing PPP loans to apply for Second Draw loans up to $2 million if they satisfy stricter eligibility requirements. At this time, the forgiveness application process and SBA review process for existing PPP loans has not changed, so borrowers with such loans should make sure they have an understanding of what to expect. We discussed the forgiveness application, review, and audit processes in a prior article.[10]

[10] Vasquez, Vasquez, and Viser, *Paycheck Protection Program Audits Have Started! Be Prepared for Audits, Appeal Process, and Tax Consequences*, Daily Tax Rep. (Dec. 10, 2020).

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