



March 15, 2021

Ms. Holly Porter
Associate Chief Counsel
Passthroughs & Special Industries
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Mr. John Moriarty
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

RE: Request for Additional Guidance and Proposed Solutions for the Tax Treatment of Tax-Exempt Income from Forgiven Paycheck Protection Program Loans to Partnerships and S Corporations

Dear Ms. Porter and Mr. Moriarty:

The American Institute of CPAs (AICPA) appreciates the continued efforts by the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) to issue guidance in response to the COVID-19 pandemic and accompanying legislation.

The Consolidated Appropriations Act, 2021 (CAA, 2021),¹ and specifically section 276 of the COVID-related Tax Relief Act of 2020 (CTRA) thereunder (“Section 276”), provides that expenses paid with forgiven Paycheck Protection Program (PPP) funds are deductible, that PPP borrowers are not to reduce any tax attributes, and that no basis increase shall be denied by reason of the exclusion of PPP forgiveness from gross income. Section 276 also provides S corporation and partnership PPP borrowers instructions for the tax treatment of the amount excluded from gross income due to PPP loan forgiveness. However, further and urgent guidance is required to apply these specific provisions. As tax filing deadlines rapidly approach, practitioners and taxpayers are facing significant uncertainties. The AICPA is pleased to submit these comments to highlight these practical uncertainties and propose solutions that are administrable for the tax system at large, inclusive of taxpayers, practitioners, and the IRS.

Our comments specifically address the following:

- I. Determination of “Ministerial Act” and Timing for Inclusion of Tax-Exempt Income
- II. Proper Treatment of “Related Expenses” for S Corporations
- III. Proper Reporting on Form 1065, *U.S. Return of Partnership Income*, and Form 1120-S, *U.S. Income Tax Return for an S Corporation*

¹ P.L. 116-260.

I. Determination of “Ministerial Act” and Timing for Inclusion of Tax-Exempt Income

Overview

Under Section 276, S corporations treat the exclusion from gross income as tax-exempt income for purposes of section 1366.² Similarly, partnerships treat the exclusion from gross income as tax-exempt income for purposes of section 705. The increase in a shareholder or partner’s tax basis in the entity is equal to the owner’s share of the tax-exempt income. However, there is underlying complexity in the application of this increase in that the period in which qualifying expenses were paid does not necessarily match the period for obtaining PPP loan forgiveness.

The Small Business Administration (SBA) Paycheck Protection Program accepted loan applications generally from April 3, 2020 through August 8, 2020. Once funds were disbursed, PPP borrowers generally had a 24-week covered period in which those funds must have been spent on qualifying expenses to be eligible for forgiveness. The majority of PPP borrowers consequently received the PPP loan in 2020 and paid or incurred qualified expenses in 2020.

The SBA released the initial loan forgiveness application on May 16, 2020. As of January 12, 2021, the SBA has received roughly 1.3 million loan forgiveness applications requesting approximately \$170.5 billion of loan forgiveness.³ Over 5.2 million PPP loans were issued totaling over \$525 billion,⁴ leaving 3.9 million borrowers that have not yet submitted applications for loan forgiveness, totaling approximately \$354.5 billion.

Many small businesses operate as passthrough entities and were the primary policy objective of the PPP program. According to the SBA data, the period in which PPP funds were spent on qualified expenses and eligible for loan forgiveness may not match the period in which the loan forgiveness application is processed by the lender and ultimately granted by SBA. This mismatch in periods creates potential issues for passthrough entity PPP borrowers.

Passthrough entities are conduits for reporting items of income and loss to their shareholders, members, or partners. These items are then reported by the taxpayers who own the interests in the entity and are subject to certain limitations at the taxpayer level.

Example

S corporation receives a PPP loan of \$1 million in 2020 and incurs an overall \$1 million loss in its 2020 tax year, passing that loss through to its only shareholder,

² All section references or (“Code”) are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder, unless otherwise specified.

³ U.S. Small Business Administration Press Release Number 21-06, “[1.1 Million Paycheck Protection Program Loans Forgiven So Far Totaling Over \\$100 Billion](#),” January 12, 2021. (Accessed February 10, 2021).

⁴ As of January 12, 2021.

T. At the beginning of 2020, T's basis in the S corporation stock was zero. Without any other adjustments to T's basis, T is allocated a loss of \$1 million, but T is not able to utilize any of that loss in the 2020 tax year on T's individual income tax return due to inadequate basis in the S corporation stock. The loss would be suspended until T has enough basis to utilize the loss.

The exclusion from gross income of the PPP loan forgiveness and the subsequent treatment of that exclusion as tax-exempt income under Section 276 would provide T with enough basis to utilize the \$1 million loss in 2020 if the PPP loan forgiveness is granted in 2020. However, it is not clear as to which taxable period T should include the tax-exempt income in the basis of the S corporation stock if the S corporation's PPP loan is not forgiven until 2021, as reflected in the example.

The covered period may have ended before the year-end of the borrower. The borrower may or may not have filed for PPP loan forgiveness by its year-end. Some PPP loan borrowers report taxable income based upon fiscal years. The fiscal year may have closed before or after the end of the covered period and in any case before PPP loan forgiveness was granted.

Timing issues may also arise in the case of the sale or purchase of a partnership or S corporation interest and the forgiveness has not yet occurred. For the seller, forgiveness may have been incorporated into the sale price, but the basis will not have been allocated to the seller until the forgiveness occurs, increasing taxable gain (or decreasing loss) for the seller, and would result in a permanent difference. The inverse is true for a buyer of S corporation stock or a partnership interest.⁵ The mismatch may also create limitations on distributions that an S corporation shareholder may receive without triggering a taxable event, discussed further in Part II.

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance stating that the proper period under the Code for the inclusion of the tax-exempt income due to Section 276 is when the PPP borrower pays or incurs qualifying expenses during the covered forgiveness period. Additionally, the guidance should state an intention of Treasury and the IRS not to challenge treating the loan forgiveness as a ministerial act. The timing of applying for or receiving approval for PPP loan forgiveness is not relevant for this matching determination regardless of whether a taxpayer is a cash basis or accrual basis taxpayer.

Analysis

Taking into account tax-exempt income at the time the PPP funds are expended on qualifying expenses during the covered period provides better matching of income and expenditures for the vast majority of PPP borrowers. The terms and conditions of the PPP are defined by Congress and

⁵ Additional issues present themselves in the case of partnership redemptions and section 743 treatment, such as goodwill or a tax-exempt receivable.

the SBA and the PPP borrower's obligations to obtain loan forgiveness are clear. Thus, submission of the PPP loan forgiveness application for many borrowers will be a ministerial process.

The determination of loan forgiveness is less clear in the case of a PPP borrower that, together with its affiliates, has a \$2 million or more PPP loan. These borrowers are subject to additional scrutiny before the SBA grants loan forgiveness. This additional scrutiny consists of a Loan Necessity Questionnaire whereby the SBA gathers information to assist it in making a determination of eligibility and that the PPP loan was necessary to support ongoing operations of the borrower, a required certification that every PPP borrower made.⁶

Significant taxpayer concern and uncertainty exists that this Loan Necessity Questionnaire and SBA review may be considered a condition precedent to a borrower's loan forgiveness, in essence, precluding the statutory intent. The SBA appears to be conducting a substantive review of eligibility and necessity of the PPP loan by reviewing certain items including a borrower's cash balances, capital expenditures, distributions in excess of tax distributions for passthrough entities, whether the borrower prepaid any outstanding debt, and the borrower's book value prior to obtaining the PPP loan. To date, the SBA has not provided any guidance or insight as to how it uses the information to make a loan forgiveness determination.

Notwithstanding, the SBA has forgiven over 99% of all loan forgiveness applications to date, with a 99.7% forgiveness rate for loans over \$1 million.⁷ In addition, a PPP borrower that is applying for a second draw loan and has its first draw PPP loan under review by the SBA may be considered an "unresolved borrower" by the SBA. In its guidance, the SBA states that the unresolved borrowers will not receive a second draw loan until the borrower's issues are resolved. However, the SBA also states that many flags in the SBA system will be resolved to the benefit of the borrower.⁸

The IRS's guidance in Notice 2020-32⁹ implied that loan forgiveness is ministerial if the borrower has complied with the stated terms and conditions of the PPP. Notice 2020-32 did not distinguish a PPP borrower by its loan size. The filing of the PPP loan forgiveness application did not matter with respect to the "reasonable expectation" determination of Notice 2020-32. Instead, all PPP borrowers were denied deductions of expenses paid with PPP funds, even if the PPP loan was forgiven in a year subsequent to the year qualified expenses were paid or incurred. While this guidance predates the release of the SBA Loan Necessity Questionnaires, Rev. Rul. 2020-27 does not. The loan necessity questionnaires were published in the Federal Register on October 26, 2020

⁶ See SBA Form 3509, *Paycheck Protection Program Loan Necessity Questionnaire (For-Profit Borrowers)*, and SBA Form 3510, *Paycheck Protection Program Loan Necessity Questionnaire (Non-Profit Borrowers)*.

⁷ [U.S. Small Business Administration PPP Data](#), Feb. 18, 2021. (Accessed February 22, 2021).

⁸ Small Business Administration, *Business Loan Program Temporary Changes; Paycheck Protection Program Second Draw Loans*, 86 FR 3712 at 3717.

⁹ Notice 2020-32 was obsoleted due to the CTRA changes to the PPP.

and Rev. Rul. 2020-27 was issued on November 18, 2020.¹⁰ Accordingly, it could be inferred that the IRS determined the loan forgiveness process to be ministerial for all PPP borrowers.¹¹

II. Proper Treatment of “Related Expenses” for S Corporations

Overview

The full deductibility of qualified expenses associated with the PPP loan forgiveness has further implications for S corporations. Although associated with tax-exempt income, these expenses are not separately stated items on the S corporation tax return. The accumulated adjustment account (AAA) is adjusted “in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax ...” The AAA is reduced by any non-separately computed loss and items of loss or deduction.¹² Nondeductible expenses related to tax-exempt income do not reduce AAA. Instead, those nondeductible expenses reduce the other adjustments account (OAA).¹³

The Code contains no references to the OAA; it is created as a “holding pen” for items that increase basis in stock for the shareholders, but are not available for distribution until the S corporation has fully distributed its accumulated earnings and profits (AE&P).¹⁴ In general, because the qualified expenses associated with PPP loan forgiveness are deductible, they would normally reduce AAA, not OAA.

Unlike shareholder basis, AAA may be a negative amount.¹⁵ The AAA is decreased, but not below zero, by distributions.¹⁶ Distributions from an S corporation are not made from AE&P (taxable as a dividend to the shareholders) to the extent of the AAA.¹⁷ Distributions of AAA are tax-free to the shareholder to the extent of the shareholder’s stock basis.¹⁸

Example 1

X, Y, and Z are each one-third shareholders in an S corporation. Assume that the S corporation does not have AE&P from a C corporation year. The beginning of the year stock basis is as displayed below. The S corporation borrowed \$105,000 from the PPP program, spending it on qualified expenses. Otherwise, the S

¹⁰ 85 FR 67809. Borrowers began receiving the questionnaires in early November 2020.

¹¹ Other inferences may be drawn and interpreted differently; however, this uncertainty significantly underscores the need for clarity and guidance for both proper timing and assisting taxpayers with proper compliance.

¹² See Treas. Reg. § 1.1368-2(a)(3)(i)(A), (B).

¹³ Treas. Reg. § 1.1368-2(a)(3)(i)(C).

¹⁴ Section 1368(c)(1).

¹⁵ Section 1368(e)(1).

¹⁶ Treas. Reg. § 1.1368-2(a)(3)(iii).

¹⁷ Section 1368(c)(1).

¹⁸ Section 1368(b)(1).

corporation broke even for the year. The PPP loan is forgiven in 2021. Distributions of \$60,000 were paid during 2020 to each shareholder. Z's share of the distributions exceeded Z's tax basis, triggering capital gain of \$5,000. Because the \$105,000 operating loss (due to the deducted PPP expenditures) exceeded their tax bases in the stock, the operating loss allocated to Y and Z created suspended loss carryovers of \$20,000 and \$35,000, respectively.

		Shareholders		
	Total	X	Y	Z
Basis, 1/1/20		95,000	35,000	15,000
Distributions	60,000	(20,000)	(20,000)	(15,000)
Operating loss	105,000	<u>(35,000)</u>	<u>(15,000)</u>	<u>-</u>
Basis, 12/31/20		40,000	-	-
Capital gain				5,000 ¹⁹
Suspended Loss			20,000	35,000

However, a taxable event could result in this unexpected outcome if the qualified PPP expenses were deducted and the S corporation had inadequate AAA and also AE&P. This outcome results in two levels of tax; counter-intuitive to both subchapter S and Congressional intent in expressly mandating the qualified PPP expenses deductible, and the loan forgiveness exempted from income. This taxable event occurs because although associated with tax-exempt income, these qualified expenses are not separately stated items on the S corporation tax return. The AAA is reduced by any non-separately computed loss and items of loss or deduction described in section 1366(a)(1). Nondeductible expenses related to tax-exempt income do not reduce AAA.²⁰

Example 2: S Corporation with Accumulated Earnings and Profits

Assume the same shareholder basis, distributions and operating loss as in Example 1. The S corporation has AE&P of \$40,000 from periods it operated as a C corporation. It also has AAA of \$57,000.

	Total	AAA	AE&P	Shareholders		
				X	Y	Z
January 1, 2020		57,000	40,000	95,000	35,000	15,000
Distributions	60,000	(57,000)	(3,000)	(19,000)	(19,000)	(15,000)
Operating loss	105,000	<u>(105,000)</u>	<u>-</u>	<u>(35,000)</u>	<u>(16,000)</u>	<u>-</u>
2021 Forgiveness		(105,000)	37,000	41,000	-	-

¹⁹ Note, of the \$20,000 distribution to Z, \$15,000 reduces basis with the remaining \$5,000 treated as a capital gain.

²⁰ Treas. Reg. § 1.1368-2(a)(3)(i)(A), (B).

Dividend income	1,000	1,000	1,000
Capital gain			4,000
Suspended loss		19,000	35,000

The AAA may be negative due to the operating loss. Assume the shareholders receive a basis increase when the PPP loan is forgiven in 2021, which may free-up the suspended loss. However, because distributions exceeded AAA, the shareholders have received taxable dividends, despite X having sufficient tax basis in X's stock, leading to both the unexpected and counter-intuitive result of X receiving a second level of tax due to the PPP.²¹

Recommendation

The AICPA recommends that the "related expenses" (qualified PPP expenses) that are deducted and attributed to the PPP loan are not taken into account for AAA pursuant to section 1368(e)(1)(A). The OAA should include those related expenses as they directly relate to the tax-exempt income by operation of Section 276 due to PPP loan forgiveness. Treasury and the IRS should issue guidance reflecting this proper treatment and disregard Treas. Reg. § 1.1368-2(a)(3)(i) for this limited purpose.

Analysis

The primary policy goal of subchapter S is to treat S corporations as a passthrough entity and ensure a single level of tax for S corporation shareholders. Section 276 explicitly provided for the deductibility of qualified PPP expenses, that PPP borrowers are not to reduce any tax attributes, and that no basis increase shall be denied by reason of the exclusion of PPP forgiveness from gross income. Section 276 intended to accomplish this statutory scheme by treating the PPP loan forgiveness as tax-exempt income for passthrough entities.

To effectuate the statutory intent of Section 276, the OAA should reflect the "related expenses" (i.e., the deductible PPP expenses) as provided for under section 1368(e)(1)(A). In this particular instance, the clear statutory intent of Section 276 (i.e., not creating a taxable event) and overarching policy goal of subchapter S should supersede Treas. Reg. § 1.1368-2(a)(3)(i), and allow the deductible PPP expenses as reducing OAA, eliminating this unexpected outcome of taxable dividends. The qualified PPP expenses would directly match the tax-exempt income, not affecting the AAA balance, while also appropriately increasing S corporation shareholder stock basis.

²¹ In this example shareholder Y also has a taxable event.

III. Proper Reporting on Form 1065, *U.S. Return of Partnership Income*, and Form 1120-S, *U.S. Income Tax Return for an S Corporation*

Overview

There is uncertainty regarding the proper tax reporting for deducting qualified PPP expenses and subsequent loan forgiveness. For example, there is no clear or uniform method to record forgiven PPP loans on a taxpayer's return, such as how and where they are reported (i.e., on a particular line or schedule). In particular, the basis questions on Form 1065 and Form 1120-S are a concern for many PPP borrowers as this is a new and still quickly evolving program:

- 2020 Partnership Form 1065, Page 2, Schedule B, Question 6 – “During the tax year, did the partnership have any debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?”
- 2020 S Corporation Form 1120-S, Page 3 Schedule B, Questions 12 – “During the tax year, did the corporation have any non-shareholder debt that was canceled, was forgiven, or had the terms modified so as to reduce the principal amount of the debt?”

Recommendation

The AICPA recommends that Treasury and the IRS issue immediate guidance on the proper reporting and expectation in answering these basis questions for passthrough entities that have, or will have, their PPP loans forgiven.²² This guidance should provide that PPP loans are not debt for the purpose of these questions.

Analysis

In our self-reporting system, taxpayers and practitioners want to report correctly. There are uncertainties and differences of opinion on the IRS position of what would constitute proper reporting of PPP expenses and loan forgiveness. The question is intended to guide taxpayers as to the proper reporting of debt discharge income under sections 61(a)(11) and 108, neither of which is implicated by PPP loan forgiveness due to the exclusion from gross income.²³

The AICPA is the world's largest member association representing the CPA profession, with more than 431,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and

²² As is customary during the filing season, FAQs in this instance may be useful until official administrative guidance can be issued due to the urgent nature of proper reporting and the March 15, 2021 due date.

²³ CARES Act section 1106(i).

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Mr. John Moriarty
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prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Ryan Corcoran, Associate Member, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 370-8235 or Ryan.Corcoran@rsmus.com; Sarah Allen-Anthony, Chair, AICPA Partnership Taxation Technical Resource Panel, at (574) 235-6818 or Sarah.Allen-Anthony@crowe.com; Robert Keller, Chair, AICPA S corporation Taxation Technical Resource Panel, at (504) 584-1030 or rkeller@kpmg.com; Alexander Scott, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9204 or Alexander.Scott@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,



Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: Mr. Mark Mazur, Acting Assistant Secretary, Tax Policy, Department of the Treasury
Mr. William M. Paul, Acting Chief Counsel and Deputy Chief Counsel (Technical), IRS
Mr. Thomas West, Deputy Assistant Secretary, Tax Policy, Department of the Treasury
Ms. Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Timothy Powell, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Ms. Julie Hanlon-Bolton, Deputy Associate Chief Counsel, Office of Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Mr. Charles Gorham, Special Counsel to the Associate Chief Counsel, Office of Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Mr. Samuel P. Starr, Special Counsel to the Associate Chief Counsel, Office of Chief Counsel (Passthroughs & Special Industries), Internal Revenue Service