PREPARING FOR A POTENTIAL AUDIT OF YOUR CLIENT'S PAYCHECK PROTECTION PROGRAM LOAN

By Juan F. Vasquez, Jr., Jaime Vasquez and Victor J. Viser

Businesses with Paycheck Protection Program loans 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. Second, when borrowers submit their application for loan forgiveness, they must provide documentation substantiating eligible expenses. 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. The certification states, "that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient." To make the certification in good faith, businesses must take into account two factors:

- Their business activity at the time the certification was made; and
- Whether they had access to other sources of liquidity, the use of which would not be significantly detrimental to their business.

Business Activity

Importantly, for purposes of the good-faith certification, business activity is determined as of the date of the application. A business, therefore, will want to support the narrative by showing that its business activity was negatively affected by COVID-19 at the time of its application. Part of this can be the number of jobs potentially impacted. 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 the prior year, as well as highlighting 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, 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 should 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 hypothetical business might argue that it relies on the line of credit to purchase inventory before its 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. 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 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.

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. 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 verifying eligible payments.

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.

Ordinary Business Expense Deduction

Following IRS Notice 2020-32, 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."

The Small Business Expense Protection Act of 2020 was introduced in the Senate shortly after IRS Notice 2020-32 was issued, confirming that business expenses forgiven as part of a PPP loan would be deductible under 162 of the Code as ordinary business expenses. As of this writing on June 19, 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 IRS Notice 2020-32 will be subject to Court challenge as being inconsistent with Congressional intent and may ultimately be entitled to little or no deference. Notices carry less weight and may not be relied upon by courts in their analysis.

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

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is supported by the plain language of the statute and/or comports with legislative intent?

ABOUT THE AUTHORS

Juan F. Vasquez, Jr. is a shareholder in the Houston and San Antonio offices of Chamberlain Hrdlicka and serves as the co-chair of the firm's nationwide Tax Controversy Section. He concentrates his practice on federal, state and local tax controversy matters. He also serves as an adjunct professor at the University of Houston Law Center.

Jaime Vasquez is a shareholder with Chamberlain Hrdlicka in San Antonio. He concentrates his practice on federal, state and international transactional and tax controversy matters. He is also a CPA and, prior to entering the practice of law, worked with a Big Four public accounting firm.

Victor J. Viser is a tax associate with Chamberlain Hrdlicka in San Antonio. His practice focuses on federal, state and international tax planning and controversy matters. He is a graduate of New York University School of Law with an LL.M. in Taxation and holds a J.D. from the University of Virginia School of Law.

ENDNOTES

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

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 that 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.

Supra note 4, at § 31.

CARES Act § 1106(e)

If a borrower received a PPP loan before June 5, 2020, it may choose either the eight-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.

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

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

SBA Form at 10.

IFR 2020-33.

Chuck Grassley, Bipartisan Senators Introduce Bill to Clarify Small Business Expense Deductions Under PPP (May 6, 2020).

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

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).