

November 2021

IRS Regs Clarifying PPP Loan & Other Federal COVID Grant Tax Free Income Recognition, Expense Deductions, and S Corp & Partnership Basis

The IRS released three new revenue procedures last week clarifying PPP loan and other federal COVID grant tax free income recognition, expense deductions, and confirming S corp and partnership basis is indeed increased by the tax-free income related to PPP loans and other federal COVID grants.

When to Recognize PPP Loan Tax Exempt Income

The first of the three new regs, **Rev. Proc. 2021-48**, addresses the timing of recognition of the tax-free income arising from 1st or 2nd draw PPP loans. Taxpayers have three options to recognize tax free PPP funds as received or incurred as follows:

1. Recognize tax free PPP income when PPP expenses are paid or incurred.
2. Recognize tax free PPP income when a PPP forgiveness application is filed.
3. Recognize tax free PPP income when a PPP forgiveness application is granted.

A fourth option is available for taxpayers who filed their 2020 taxes and excluded expenses paid with forgivable PPP loan funds and choose to use Rev. Proc. 2021-20.

4. Recognize tax free PPP income when 2020 PPP expenses are deducted on the subsequent year's, 2021, tax return.

An earlier revenue procedure, **Rev. Proc. 2021-20**, granted relief for taxpayers who filed their 2020 taxes and excluded expenses paid with the PPP loan funds. Rev. Proc. 2021-20 permits taxpayers to choose to amend their 2020 taxes to deduct the excluded 2020 expenses paid with PPP loan funds or deduct the expenses in the subsequent year, 2021.

When the COVID Tax Relief Act was enacted, it confirmed PPP loans were always intended to be tax free for federal tax purposes. Taxpayers who filed before the act was passed or were unaware of the tax-free PPP loan provision in the bill at the time they filed their 2020 taxes may have excluded expenses paid with the PPP loan funds, in accordance with IRS regs prior to the COVID Tax Relief Act.

Responsibility for Determining When to Recognize PPP Loan Tax Exempt Income

Business entities, partnerships, S corporations, and subsidiary members of consolidated groups must determine when the tax-exempt income from a PPP loan will be recognized as received or accrued by the entity and report this pass-through information on Schedule K-1, as applicable.

Effect of Timing for Recognition of PPP Loan Tax Exempt Income

The timing chosen by the business entity will primarily affect calculation of a partner's, S corp shareholder's, or subsidiary member of a controlled group's basis for the tax year.

Tax Exempt Treatment for Federal COVID Grants, Loans & Loan Payments

The second of the three new regs, **Rev. Proc. 2021-49**, provides guidance to partnerships and consolidated groups regarding allocating the tax attributes of the tax-exempt PPP loan funds to partners or subsidiary members. And also clarifies tax treatment for other federal COVID grants and benefits.

The following federal COVID grants and benefits are eligible for federal tax-exempt income treatment including increase in basis:

- PPP loan funds eligible for forgiveness
- Emergency EIDL Grants
- Principal & Interest payments of covered SBA 7(a) loans
- Principal & Interest payments of covered SBA Community Advantage Loans
- Principal & Interest payments of covered SBA Microloan products
- Shuttered Venue Operator Grants
- Extended EIDL grants
- Targeted EIDL Grants
- Restaurant Revitalization Grants

Partnerships May File Amended Returns for 2020 by December 31, 2021

The third of the new regs, **Rev. Proc. 2021-50**, offers relief for a partnership subject to BBA (Bipartisan Budget Act of 2015), by permitting the partnership to file an amended Form 1065 for 2020 instead of an AAR, administrative adjustment request, to take advantage of these new regs. And the partners receiving the new K-1s do not have the same time constraints to amend their individual taxes by December 31, 2021, they may file their amended return when convenient.

A BBA Partnership choosing to file an amended Form 1065 for tax year 2020 to take advantage of these new regs will file 2020 Form 1065 with the amended box checked on Form 1065 and all applicable K1s. They must also write "FILED PURSUANT TO REV PROC 2021-50" at the top of Form 1065 and attach a statement with the same verbiage to all applicable K1s. The amended 2020 Form 1065 may be e-filed, if your tax software supports the new rev proc verbiage, which it probably won't by December 31, 2021. Otherwise, the amended 2020 Form 1065 may be filed by mail.

A BBA Partnership currently under audit may file the amended Form 1065 and provide a copy to the auditor. If a BBA partnership has already filed an AAR for 2020 they may still file an amended 2020 Form 1065 to take advantage of the new regs.

Tax Planning for Tax Exempt Income Recognition Timing

Generally, the decision to amend the prior year 2020 business entity tax returns will depend on two issues:

1. The related partners and S corp shareholders opportunity to benefit from lower pass through taxable income for 2020 in the case of businesses who filed their 2020 tax returns and excluded expenses paid with PPP forgivable funds.
2. The related partners and S corp shareholders opportunity to benefit from increased basis from the tax-exempt income which may permit them to deduct a 2020 pass through K-1 loss which may have been limited by their original 2020 basis calculation before recognizing the basis increase from tax exempt income.

Consider each entity on a case by case basis, if the partners or shareholders didn't suffer a 2020 loss limitation due to basis issues, it will be simpler and easier to recognize the 2020 PPP or other COVID grant tax exempt income in 2021 as permitted by the new regs. Another consideration will be comparing the partners' or s corp shareholders' 2020 tax rates with their anticipated 2021 tax rates for determining the benefit of amending for changes to COVID benefit reporting.

Examples of Entities Which May Consider Amending 2020 Tax Returns

- Partnership or S corp which included the forgivable portion of the PPP loan on the 2020 Balance Sheet.
Amend to remove the forgivable PPP loan balance from the balance sheet and report the PPP forgivable funds as tax exempt income on Schedule M-1, which will increase the partners' or shareholders' basis for 2020.
- Partnership or S corp which excluded certain 2020 expenses paid with PPP forgivable loan funds as an M-1 adjustment.
Amend to deduct the 2020 PPP loan expenses previously excluded from the 2020 tax return if the entity chooses not to deduct the expenses in 2021 using Rev. Proc. 2021-20.
- Partnership or S corp which may have reported some other tax exempt COVID benefits as taxable income in error.
Amend to reclassify the tax exempt COVID benefit as non-taxable income and report it on Schedule M-1. Note, the IRS has not released regs that tax exempt income from EIDL advances and SBA principal and interest payments may be recognized in the subsequent tax year, so if these benefits were reported as taxable in error an amended 2020 tax return would need to be filed.

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