**SUPPLEMENT TO ACCOMPANY**

**CORPORATE, PARTNERSHIP, ESTATE AND GIFT TAXATION**

**2022 EDITION**

**Pratt-Kulsrud-Burton**

**Changes introduced by the**

**American Rescue Plan Act of 2021**

**Pratt-Kulsrud-Burton Tax Series**

**Van-Griner**

**August 31, 2021**

*All rights reserved.* The contents or parts thereof, may be reproduced for classroom use with   
*Corporate, Partnership, Estate and Gift Taxation* 2022 Edition by Pratt, Kulsrud and Burton,   
provided such reproductions bear copyright notice and the number reproduced does not exceed  
 the number of students using the text, but may not be reproduced in any form for any  
 other purpose without written permission of the publisher

**INTRODUCTION**

At this writing, August 31, 2021, the United States and most of the world continue to grapple with the far-reaching effects of the Covid-19 pandemic. While health officials are doing what they can to contain the spread of the disease, the federal government also is trying to address the drastic toll the pandemic has had on the U.S. economy. During 2020, Congress and President Trump worked together to enact five pieces of legislation that impact the tax laws. They include:

1. March 6, 2020: *Coronavirus Preparedness and Response Supplemental Appropriations Act of 2020* (CPRSAA).
2. March 18, 2020: *Families First Coronavirus Response Act* (FFCRA) and two of its component parts, the *Emergency Paid Sick Leave Act* (EPSLA) and the *Emergency Family and Medical Leave Expansion Act* (EFMLEA)
3. March 27, 2020, *Coronavirus Aid, Relief, and Economic Security Act* (CARES).
4. April 24, 2020, *Paycheck Protection Program and Health Care Enhancement Act* (PPP).
5. June 5, 2020, *Paycheck Protection Program Flexibility Act of 2020* (PPFA)
6. December 27, 2020, *Consolidated Appropriations Act of 2020* (CAA), which included the *Taxpayer Certainty and Disaster Tax Relief Act of 2020* (TCDTRA)

The relevant changes of the 2020 legislation are incorporated in the 2022 edition. However, certain provisions are included in this supplement for reference.

More recently, on March 11, 2021, President Biden signed into law the *American Rescue Plan Act of 2021* (ARPA). ARPA provides $1.9 trillion of aid, slightly larger than the previous year’s most generous package, the CARES Act of 2020, that provided $1.8 trillion. ARPA, like the CARES Act, contains many provisions with tax ramifications that are discussed in this supplement.

As we complete this document, President Biden released his 2022 tax proposal, the *American Jobs Plan and the American Families Plan*. These proposals include:

(1) a return to the pre-TCJA top income tax rate of 39.6% (for 2022, the proposed 39.6% rate would affect married filing joint taxpayers with taxable income over $509,300 (over $452,700 for single taxpayers, over $481,000 for heads of households, and over $254,650 for married filing separate);

(2) more generous child tax credits, expansion of the earned income tax credit and the child and dependent care tax credit, and more generous premium tax credits;

(3) taxing capital gains of high-income earners at ordinary rates to the extent income exceeds $1 million; increase the maximum tax on long-term capital gains and qualified dividends from 20% to the top rate on ordinary income (39.6%), which when factoring in the 3.8% net investment income tax, effectively raises the tax rate on long-term capital gains and qualified dividends to 43.4%;

(4) elimination of the like-kind real estate preference for those with the highest incomes; similarly caps the amount of gain that can be deferred in a like-kind exchange at $500,000 per taxpayer, per year ($1 million for joint return);

(5) treating certain transfers of appreciated property by gift or on death as realization events (i.e., as if they sold the property transferred for its fair market value); taxpayers would have a $1 million (adjusted for inflation after 2022) per-person exemption available. The proposed change would be effective for property transferred by gift after 12/31/2021, and for property owned at death by decedents dying after that date;

(6) tax appreciation on certain assets held in a trust, partnership or other noncorporate entity. An entity would be subject to tax if the assets it holds have not been subject to a recognition event within the prior 90 years. The 90-year period begins 1/1/1940, making 12/31/2030 the earliest date that a taxpayer might have to recognize gain in this situation.

(7) increasing the rates on C corporations from 21% to 28% as well as a 15% minimum tax on corporations with book income of more than $2 billion;

(8) eliminating all fossil fuel tax subsidies;

(9) expanding tax incentives that encourage clean energy sources. The document is available online at <https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals>

(10) creation of a new general business credit of up to 10% of the eligible cost of *onshoring* a trade or business (onshoring refers to reducing or eliminating a trade or business (or a line of business) currently conducted outside the U.S. and starting up, expanding, or otherwise moving the same trade or business to the U.S. and creating jobs in the process;

As always, as new legislation is enacted, we will do our best to provide a timely supplement.

**Table of Contents.** The changes made by the recent legislation are discussed in the following pages and are referenced to the 2022 edition by chapter and page. A Table of Contents can be found on **page 5** of this supplement.

**Special Thank You:** The editors would like to acknowledge and thank Professors Jim Angelini of Suffolk University and Ramon Fernandez of the University of St. Thomas-Houston. Their thoughtful insights and comments helped not only us, but hopefully you, gain a better understanding of how this new legislation with all of its complications affects individuals and businesses.

Tax Highlights of the

*Coronavirus Preparedness and Response Supplemental Appropriations Act* (P.L. 116-123, 3/6/2020)

*Families First Coronavirus Response Act*  (P.L. 116-127, 3/18/20)

*Coronavirus Aid, Relief, and Economic Security Act* (P.L. 116-136, 3/27/20),

*Paycheck Protection Program and Health Care Enhancement Act* (P.L. 116-139, 4/24/20)

*Paycheck Protection Program Flexibility Act* (P.L. 116-142, 6/5/20)

*Consolidated Appropriations Act of 2021* (P.L. 116-260, 12/27/20)

*American Rescue Plan Act of 2021* (P.L. 117 1, 3/11/2021)

The legislation above made numerous changes designed to provide relief to individuals and businesses affected by the coronavirus pandemic. Many have tax ramifications. The legislation:

* Establishes the Paycheck Protection Program that provides federal loans to help struggling businesses. Moreover, in most cases, businesses are not required to repay these loans. Additional funding was provided by the Enhancement Act. ARPA made it clear that expenses paid with these are deductible notwithstanding the fact they are paid with tax-exempt funds.
* Reduces or eliminates payroll taxes for businesses (i.e., their share of FICA). Any employer, self-employed individual or nonprofit whose activity was fully or partially suspended in 2020 due to government orders associated with COVID-19 or that experienced a significant decline in gross receipts may be eligible for relief. The CARES Act creates an employee retention credit of as much as $5,000 per employee to offset payroll tax costs (i.e., the 6.2% tax on wages or self-employment income) paid after March 12, 2020, and before January 1, 2021. If the credit amount exceeds the employer’s liability, the excess is refundable to the employer. The estimated benefit was about $54.6 billion. The credit is not available for 2021.
* Requires businesses to make sick and family leave payments for up to 10 weeks. Exceptions exist for businesses that have (1) more than 500 employees or (2) 50 or fewer employees.
* Allows penalty-free access to retirement accounts if for virus-related financial hardships.
* Provides that employer payments of student loans of their employees are nontaxable.
* Gives nonitemizers a charitable deduction of up to $300 (i.e., for AGI in 2020 but a deduction of up to $600 from taxable income in 2021).
* Suspends the required minimum distribution (RMD) rules for retirement plans for 2020.
* Allows taxpayers to withdraw up to $100,000 from retirement plans without the 10% additional tax penalty for early distributions if they are coronavirus-related.
* Temporarily suspends the 80% taxable income limitation for NOLs.
* Eliminates the carryforward rule for NOLs arising in 2018, 2019, and 2020 so they can be carried back to the five previous tax years to provide immediate relief.
* Suspends the excess business loss rules.
* Accelerates refunds of previously generated corporate alternative minimum tax credits.
* Relaxes the business interest limitation of §163(j), increasing it from 30% to 50% of income.
* Makes a technical correction so that “qualified improvement property” (QIP) is now properly classified as MACRS 15-year assets and, therefore, eligible for 100% bonus depreciation.
* Provides an “employee retention credit” to encourage employers to retain employees even if employees cannot report to work because of issues related to the coronavirus.
* Includes a variety of non-tax provisions to assist with mitigation and response as follows:
* Expansion of unemployment benefits; funding for health care providers; aid to state and local governments
* Large supplemental funding package for agencies of the federal government

**Table of Contents**

2022 Text Supplement   
 Page Page

**Chapter 1: Income Taxation of Corporations** 1-1 7  
 Comparison of Corporate and Individual Income Taxation 1-8 7  
 Gross Income 1-9 7  
 Stimulus Payments for individuals 1-9 7  
 Child Tax Credit and ARPA 1-9 8  
 Credit Increase and Phaseout Rules 8  
 Unemployment benefits 9  
 Increased Benefits 9  
 Exclusion 9 Economic Injury Disaster Loans (EIDLs). 1-9 10  
 Paycheck Protection Program (PPP Loans) 1-9 10  
 PPP Loans in General 10  
 PPP Loan Application Form 11  
 PPP Loans: Eligible Recipients—Who Can Apply for a PPP Loan 12  
 PPP Loans: Authorized Uses 13  
 PPP Loans: Computation of Amount 14  
 PPP Loans: Amount of Tax-Free Cancellation 15  
 PPP Loans: Loan Forgiveness Application 15   
 PPP Loans: Loan Forgiveness Application Form 16  
 PPP Loan Fraud 18  
 PPP Loans: Payroll Costs for Self-employed Individuals and Partnerships 19 PPP Loans: Guaranty 20  
 PPP Loans: A Final Problem 21   
 Deductions 1-10 21 Reasonable Compensation for Highly Compensated Employees 1-17 21  
 100% Deduction for Food and Beverages 21  
 Deductibility of Business Expenses Paid with PPP Loans 21  
 Deductions for Family and Medical Leave Payments and Sick Pay 22  
 Paid Sick Leave: Background 23  
 FFCRA and Sick Leave 23 Which Employees Are Covered 23  
 Which Employers Are Required to Pay Sick Leave 24  
 Sick Pay Required 25  
 Family and Medical Leave Payments and Sick Pay 25 Summary Tables: Sick Pay and Family and Medical Leave 26  
 Credits for Sick Leave 28  
 FFCRA Credits for Sick Pay 28   
 Employer Disaster Relief Payments for Employees and Exclusion (§ 139) 28   
 Employer Payment of Student Loans: Educational Assistance Plans 29   
 Health Savings Accounts 29   
 Qualified Expenses: Over-the-Counter Drugs, Telehealth, Menstrual Needs 29  
 Group Health Plans: Required Coverage of COVID-19 Expenses 30  
 High Deductible Health Plans 30  
 Employment Taxes: Deferral of Payment of Employer Share 31   
 Effect of PPP Loans on Deferral of Payroll Taxes 31 Leasehold Improvements 32  
 Limitation on Deduction of Interest of Businesses 1-17 32  
 Net Operating Loss 1-18 33  
 NOL Deduction: Carryback for 5 Years and No 80% Limitation. 33  
 NOLs: Temporary Repeal of 80% of Taxable Income Limit 33

**Table of Contents (Continued)**

2022 Text Supplement   
 Page Page

Charitable Contributions 1-21 34  
 Deduction Limitations: Corporations 1-21 34 Increase Limits on Contributions of Food Inventory 1-21 34 Individuals: $300 Deduction from Taxable Income 1-21 34  
 Individuals: Unlimited Itemized Deduction for Individuals 1-21 35  
 Alternative Minimum Tax 1-30 35  
 Minimum AMT Credit 1-30 35  
 Tax Credits 1-31 35  
 Employee Retention Credit 35   
 Filing Requirements 1-40 38  
 Due Dates for Filing Individual Returns (2019, 2020 2021 Returns) 1-40 38

**Chapter 9: Taxation of Partnerships and Partners** 9-138 Deductibility of Business Interest Expense 38  
 Excess Business Loss Limitations for Partnerships 9-38 38  
 Deduction for Qualified Business Income 9-39 38  
  
**Chapter 11: S Corporations: General Rules** 11-139  
 Qualified Business Income Deduction 11-22 39  
 Limitation on Business Losses 11-39 39

CHAPTER 1: INCOME TAXATION OF CORPORATIONS

**Note:** Several topics below are not specifically discussed in the text but are relevant in computing the taxable income of a business (i.e., the taxable income of C corporations, S corporations, partnerships, and self-employed taxpayers). These topics generally apply to all businesses.

**Page 1-8 Comparison of Corporate and Individual Income Taxation**

**Gross Income**

**Stimulus Payments (also known as Recovery Rebates or Economic Impact Payments).** From the outset of the pandemic, Congress has authorized several direct payments from the government to individuals. For 2020, the CARES Act provided for a payment to most Americans, generally referred to as a “recovery rebate.” Such payments were subject to phaseout at higher levels of AGI. Technically, the payments were an advanced payment of the “recovery rebate” credit that phased out at higher AGI levels. The payments were not considered taxable to the recipient. As a result, in 2020, individual taxpayers received a first round of payments of $1,200 while joint filers received $2,400 with another $500 for a child under age 17.

The Consolidation Appropriations Act (CAA) authorized a second round of payments in 2020. Under the CAA, individual taxpayers received a payment of $600 while joint filers received $1,200 with another $600 for each child under age 17. Like the payments of the CARES Act, the CAA payments were an advance payment of the recovery rebate credit that phased out at higher income levels. Like the CARES payments, the CAA payments were not considered taxable income to the recipient.

For 2021, ARPA, like both the CARES Act and the CAA, provided for a third round of stimulus payments. In addition, ARPA increased the amounts. For 2021, ARPA provides individuals with a payment of $1,400 ($2,800 for married taxpayers filing jointly) plus another $1,400 for each dependent (as defined in Code §152). Moreover, for this purpose, ARPA expands the definition of dependents to include college students and “qualifying relatives” who are claimed as dependents. The inclusion of dependents is significant. The CARES Act provided $500 to dependents for which the $2,000 child tax credit could be claimed (i.e., those dependents under age 17 as of the last day of the tax year). In contrast, ARPA authorizes stimulus checks of $1,400 for all dependents. Like its predecessors, the ARPA credit is fully refundable so taxpayers will receive the credit when filing their 2021 Form 1040 regardless of whether any tax is owed. Like the 2020 payments, the 2021 payments are not taxable income to the recipient. The Act did not provide any equivalent payment or credit for businesses (e.g., C or S corporations, partnerships).

The amount of stimulus payments that a person receives under ARPA (2021) phases out based on the individual’s filing status and AGI. As a result, fewer individuals are likely to qualify for the ARPA payments. As seen in the table below, the AGI thresholds at which phase out begins start at the same income levels as previous payments, but the range is much narrower than with prior stimulus payments.

2021 Stimulus Payment 2021 AGI  
 Status Amount Phase-out

Single or head of household $1,400 $ 75,000 - $ 80,000  
 Eligible to file jointly 2,800 150,000 - 160,000  
 Each dependent 1,400 112,500 - 120,000

For example, a married couple with four dependents and AGI less than $150,000 would receive a payment of $8,400 ($2,800 for the couple +$5,600 for the children (4 x $1,400 = $5,600). However, if the couple’s AGI exceeded $160,000, the entire $8,400 would be phased out and the family would receive nothing at all. From a planning perspective, those who can, might want to take steps to lower their AGI (e.g., maximize the deduction for contributions to Individual Retirement Accounts).

As suggested above, technically, the payments are an advanced payment of a refundable credit against taxes that will otherwise be due for the tax year. For example, assuming a taxpayer actually receives the advanced payment of the credit to which he or she is entitled for 2021, no credit is claimed on the 2021 tax return. Recall, however, that taxpayers will not have to wait until they file their returns for 2021 to obtain this credit. An advance payment of the credit will be deposited directly in the taxpayer’s account or mailed in the form of a check. As discussed further below, when the IRS computes the stimulus payment, it uses the AGI that they have available when it computes the credit (i.e., AGI for 2020 if the 2020 return has been filed, otherwise the AGI for 2019).

Since the payment represents a refundable credit, taxpayers receive a check regardless of whether they have a tax liability for the year equal to (or greater than) the amount of the check received. As noted above, the payment will not need to be repaid, nor is it includible in the recipient’s gross income (i.e., it is not taxable). As the IRS website suggests, individuals who have no income at all, as well as those whose income is entirely derived from “non-taxable means-tested benefit programs” such as Supplemental Security Income (SSI) benefits, are eligible for the advance rebate (or credit).

**Child Tax Credit and ARPA.**

**Credit Increase and Phaseout Rules***.* For 2021,ARPA substantially boosts the child tax credit.

*Credit Amount.* The amount of the increase depends on the age of the child. Such credit is subject to phaseout at higher levels of AGI.

* **Children Under Age 6.** For each qualifying child under age 6, the child tax credit is potentially $3,600 (an increase of $1,600 per child, up from $2,000).
* **Children Ages** **6 through 17.** For each qualifying child ages 6 through 16, the credit is potentially $3,000 (an increase of $1,000, up from $2,000).

*Credit Phaseout.* For 2021, the child tax credit is subject to two separate sets of phaseout rules. The increased credit amount (i.e., the additional $1,600, or $1,000) phases out for taxpayers with modified AGI (MAGI) over $150,000 for joint fillers, $112,500 for heads of household, and $75,000 for others. The increased portion of the credit (i.e., $1,600 or $1.000 increase in contrast to $2,000 overall under prior law) is reduced by $50 for each $1,000 of MAGI over those limits. Thus, a family with four children under age 6 would be entitled to a credit of $14,400 ($3,600 x 4). Those who are not eligible for the additional $1,000 or $1,600 amounts due to their MAGI can still claim the $2,000 credit under the pre-ARPA rules for each qualifying child 16 and under. The pre-ARPA rules allowed the $2,000 credit amount for taxpayers with MAGI up to $200,000, or $400,000 for married filing jointly.

**Example 1**: H and W are married and file a joint return in 2021. They have a qualifying child, who is 5 years old. Their MAGI is $160,000. For the additional credit of $1,600, the phaseout amount would be $500 ([($160,000 - $150,000)/$1,000] x $50). As a result, their child tax credit would be $3,100 ($2,000 + ($1,600 - $500 = $1,100).

**Example 2**: Same facts as in the previous example, except the couple’s MAGI is $190,000.

The phaseout amount would be $2,000 ([($190,000 - $150,000 = $40,000) / $1,000] x $50), which completely eliminates ARPA’s additional credit of $1,600. However, since their MAGI is under $400,000, they would receive the regular $2,000 credit.

*Refundable Portion of Credit.* Another benefit—but only for 2021—is that the credit is fully refundable. Previously, only $1,400 of the overall $2,000 credit was refundable (see pages 4-13 and 13-59).

Taxpayers can receive half of their estimated total child tax credit in advance in six payments spread over the last half of 2021. The estimated amount is based on their 2019 income tax return (or 2020, if filed). However, taxpayers who receive advance payments in excess of their allowable 2021 child tax credit must pay back the excess by increasing their 2021 tax liability.

*Revised Definition of Qualifying Child.* As may be apparent, ARPA expands the child tax credit in several ways. ARPA makes 17-year-olds eligible (i.e., they are “qualifying children” as opposed to only those children under age 17 as of the last day of the tax year). Technically, ARPA defines a “qualifying child” as an under-age-18 child, whom the taxpayer could claim as a dependent (i.e., a child related to the taxpayer who, generally, lived with the taxpayer for at least six months during the year), and who was a U.S. citizen or national, or a U.S. resident.

For 2021, taxpayers can claim a $500 nonrefundable credit for a dependent who does not meet the ARPA’s expanded definition of a qualifying child (e.g., a dependent child who will be age 18 or older as of December 31, 2021).

**Unemployment Benefits**

**Increased Benefits.** To aid the unemployed, the Cares Act expanded unemployment benefits and ARPA continued this approach. For 2021, ARPA increased the amount of the weekly unemployment checks as well as the total number of weeks that benefits are paid. The new law added $300 to weekly unemployment payments through September 6, 2021. Self-employed and gig economy workers are eligible for the increase as well.

**Exclusion**. Before 1979, unemployment benefits were not considered taxable income. But that changed when Congress made the benefits fully taxable in 1979. However, considering the hardships brought about by the pandemic, Congress allowed certain taxpayers to exclude a portion of their unemployment benefits. ARPA retroactively makes the first $10,200 of unemployment benefits received in 2020 tax-free but only for taxpayers with *modified AGI* less than $150,000 per year (§ 85). If married, each spouse receiving unemployment benefits may exclude up to $10,200 or a total of $20,400 for both. For example, if a taxpayer received $25,000 in benefits and his or her spouse received $7,000, they could exclude $17,200 of unemployment benefits on their joint 2020 return ($10,200 husband and $7,000 wife). The $150,000 threshold is the same regardless of filing status (e.g., single taxpayer, head of household, or jointly). In addition, the law does not provide for any phaseout mechanism. For taxpayers with $150,000 or more of AGI, their unemployment benefits would be fully taxable. Perhaps Congress (or, the IRS) will act to clarify this provision, but at this point that is how the new law reads.

Modified AGI for this purpose is determined after including taxable Social Security and railroad retirement benefits; excluding U.S. savings bond interest and the nontaxable portion of qualified adoption assistance; and deducting qualified retirement plan contributions, student loan interest, and qualified tuition and related expenses (which was repealed for tax years beginning after 2020).

Another problem concerns taxpayers whose unemployment benefits were delayed and not received until after December 31, 2020. If the taxpayer were to receive benefits for a week in 2020, but did not receive the payment until 2021, such amounts would be taxable. Only time will tell whether Congress addresses this inconsistency. Also note that the treatment of unemployment benefits for state tax purposes can differ, depending on where the taxpayer lives. In some states, such as California, benefits are not taxed at all. However, many other states follow federal law, so the first $10,200 of benefits may be excluded on state tax returns, as well.

**Economic Injury Disaster Loans (EIDLs).**

Beginning March 30, 2020, businesses that suffered due to the pandemic could seek financial assistance by applying to the Small Business Administration (SBA) for a so-called Economic Injury Disaster Loan (EIDL or disaster loan). Such loans were added by CPRSAA, the first piece of legislation concerning COVID-19. Only businesses with 500 or fewer employees are eligible to apply. Before the coronavirus, these loans were intended for businesses that have suffered due to natural disasters (e.g., hurricanes) but the Act extends them to businesses that can show they have suffered severe economic hardship because of the coronavirus pandemic. In the past, a business was required to prove that it was unable to obtain loans elsewhere. However, this requirement has been waived.

The EIDL program allows eligible businesses to borrow up to $2 million dollars at an interest rate of 3.75% or less. One of the attractive features of a disaster loan is that borrowers are eligible to request an emergency advance while their application is being processed. Originally, the SBA would advance the business up to $10,000. However, on April 14, 2020: the SBA reduced the amount of the advance to $1,000. In addition, the $10,000 (or $1,000) advance does not have to be repaid even if the application is ultimately denied. The SBA tries to provide the advance within three days of receipt of a borrower’s application.

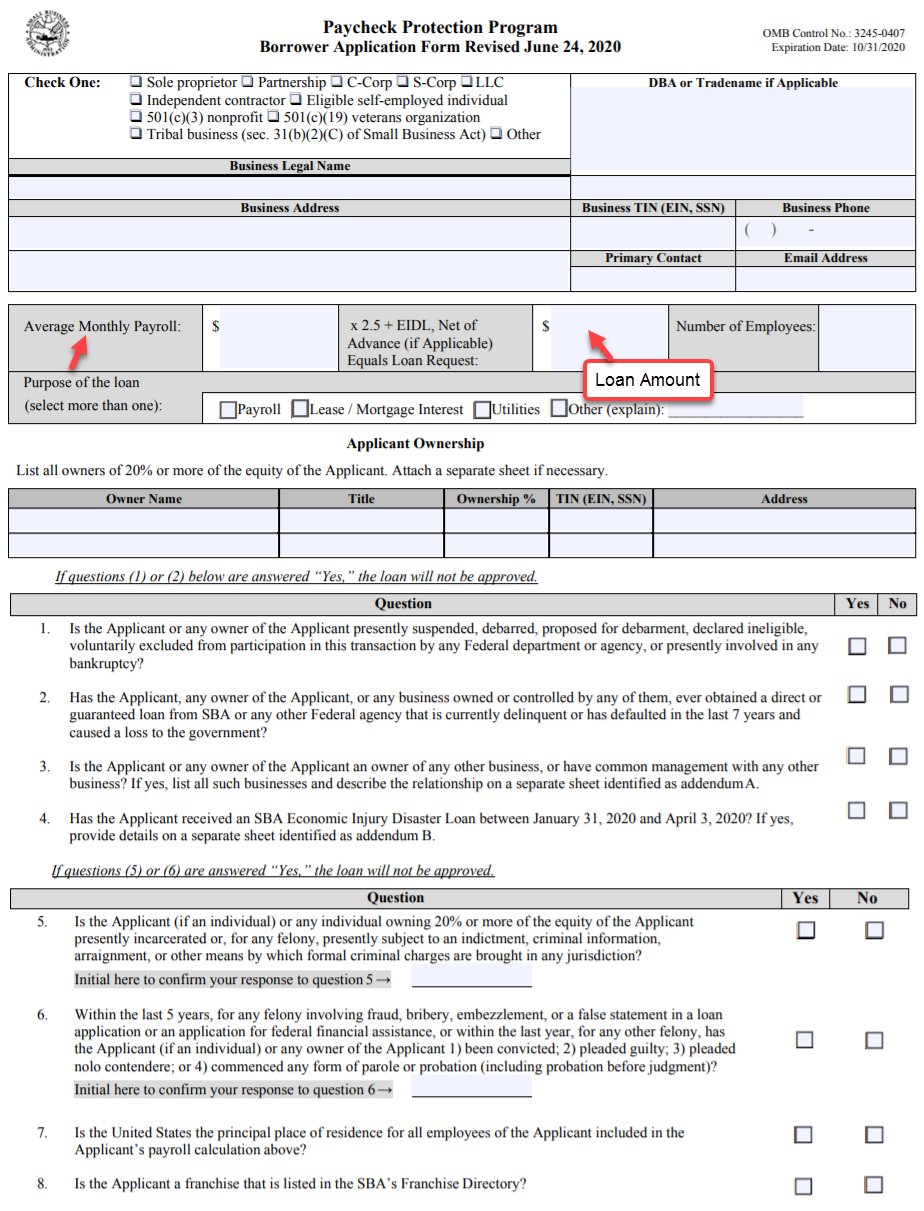
Independent contractors who work for a separate business (e.g. real estate brokers) can qualify for an EIDL if they are able to prove they are separate from that business (e.g. the brokerage firm). Businesses that have obtained a disaster loan must take these loans into account when applying for a loan under the Paycheck Protection Program as discussed below.

**Paycheck Protection Program (PPP Loans)**

**PPP Loans in General.** At this juncture, it is clear that the pandemic has devastated many small businesses and other organizations. Many have struggled and were forced to close their doors and layoff their employees. To help them survive and help their employees keep their jobs, Congress provided a loan opportunity through the so-called Paycheck Protection Program (PPP) (Act § 1102 amending the Small Business Act § 7(a)). As the name of the Act suggests, the purpose of the law is to ensure that people’s paychecks are protected. This government loan—up to $10 million per business—was intended to help companies cover eight weeks of their payroll costs.

The PPP loans were run through the Small Business Administration (SBA). The SBA approved the loans according to certain criteria. However, the actual loan was made by authorized lenders (e.g., federally insured depository institutions (banks), or lenders approved by the SBA).

**PPP Loan Application Form.** Businesses started the application process by contacting a lender and submitting an application form by June 30, 2020 (a deadline extended to August 8, 2020). The application form (as revised on June 24, 2020) is shown below and can be found at <https://www.sba.gov/sites/default/files/2020-07/PPP-Borrower-Application-Form-508.pdf>.



The primary advantage of PPP loans is that amounts borrowed could turn out to be a loan in name only. As explained below, if an employer meets certain standards, e.g., it keeps its employees on the payroll (i.e., it does not fire or layoff employees) and uses the funds for qualified expenses (e.g., salaries, rent, mortgage interest, or utilities), the employer is not required to repay the loan. Moreover, unlike the normal rule, the forgiveness of debt is nontaxable and, as clarified by ARPA, the expenses paid with such funds are still deductible.

The normal treatment of debt cancellation is found in § 61(a)(11). It provides that the reduction or cancellation of indebtedness results in cancellation of debt (COD) income to the debtor. Such income normally is taxable. An "identifiable event" determines when a debt has been reduced or canceled. For example, an identifiable event includes a creditor accepting less than full payment as a complete discharge of a debt or events or simply circumstances result that remove the likelihood that a debt will be paid. The PPP program creates a significant exception to this basic rule, generally providing that the debt forgiveness is not considered taxable income. The PPP program provides special rules for determining the amount of eligible forgiveness.

At first glance, it may appear that the PPP is too good to be true. However, this cloud does indeed have a silver lining. Tony Nitti, the famous tax-guru who writes for Forbes, summed up the PPP perfectly. According to Nitti, “free money is hard to pass up, and so last week, businesses were clamoring for Friday to arrive so they could grab their piece of the pie.” (See Tony Nitti, “Paycheck Protection Program Loans: Three Things The SBA And Banks Need To Agree On Now.” *Forbes*, April 5, 2020) <https://www.forbes.com/sites/anthonynitti/2020/04/05/paycheck-protection-program-loans-three-things-the-sba-and-banks-need-to-agree-on-now/#573860c21a32>.

Nitti was right. The rush for the loans was so great that the money—about $349 billion—quickly ran out. According to Treasury Secretary Steven Mnuchin and SBA Administrator Jovita Carranza there were “more than 14 years’ worth of loans in less than 14 days,” before the funds ran dry. But, on April 24, 2020, Congress approved another round of funding and enacted the Paycheck Protection Program and Health Care Enhancement Act that added $321 billion. (See Anne Sraders, “14 years in 14 days: Inside the chaotic rollout of the SBA’s PPP loan plan to save America’s small businesses.” *Fortune*, April 29, 2020. See <https://fortune.com/2020/04/29/sba-ppp-paycheck-protection-program-loans-small-business-administration-inside-chaos/>

There is a long list of requirements that police the road to tax-free forgiveness under the PPP. To get a sense of these requirements, see the discussion below and loan application form in full at <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Application-3-30-2020-v3.pdf>.

**PPP Loans: Eligible Recipients: Who Can Apply for a PPP Loan?** The Paycheck Protection Plan (PPP) loans are available to eligible recipients, including businesses (e.g., corporations, partnerships, self-employed persons), nonprofits, veterans’ organizations, and Tribal businesses. Only loan applications from small businesses are considered , i.e., the applicant has no more than 500 employees at any time during the 25 weeks starting on the date the loan was originated (when the taxpayer and the bank sign the loan agreement). The organization can apply only if it meets the following requirements (Act § 1102(a)(2)(A)(iv) and ((v)):

(1) The business was operational as of February 15, 2020;

(2) The principal place of business is in the U.S. and

(3) The qualified organization has no more than 500 employees (subject to certain exceptions).

The 500-employee limit was intended to restrict the loans to small businesses but initially it was applied to each location. This approach did not necessarily restrict loans to small businesses since a company might have multiple locations, none of which had more than 500 employees (e.g., Ruth’s Chris Steak House has over 100 restaurants in different locations and each location employs no more than 500), (Act §1102(a)(1)(D)(i)(I) and §1102(a)(1)(D)(iii)).

The implementation of this rule sparked significant controversy (see Davis and Haddon, “How Ruth’s Chris Got an Extra Helping of Small Business Aid Money.” *Wall Street Journal*, April 4, 2020 and Pcheco and Francis, “Public Companies Got $500 Million in Small Business Loans.” *Wall Street Journal*, April 20, 2020). According to SEC filings, 424 publicly traded companies received PPP loans (e.g., Ruth Chris, Shake Shack, Potbelly; for a complete list see <https://factba.se/sba-loans> ). Apparently, Treasury Secretary Steven Mnuchin objected, explaining that the “intent of this money was not for big, public companies that have access to capital.” No doubt succumbing to public pressure, Ruth Chris, Shake Shack and other companies ultimately returned $20 million (see Sarah Hansen, “Ruth’s Chris Steak House Returns $20 Million PPP Loan As Treasury Issues New Guidance.” *Forbes,* April 23, 2020).

But Mnuchin had more to say On May 5, 2020, he announced that any company that received a PPP loan of more than $2 million would be audited for compliance with the program’s terms before any loan forgiveness would be permitted. Apparently, five *publicly* held companies were given a specific deadline to return their money, May 14, to give the money back with no questions asked. Otherwise, Mnuchin wanted them to explain why they should be allowed to keep the money. After the uproar, the SBA issued new guidance making it less likely that publicly traded companies could access the second round of funding created by the Enhancement Act (see <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf>.

**PPP Loans: Authorized Uses.** As seen in the application form above, the loans can be used for

• Payroll costs (see below), including benefits but not federal taxes;

• Interest on mortgage obligations, incurred before February 15, 2020;

• Rent, under lease agreements in force before February 15, 2020; and

• Utilities, for which service began before February 15, 2020.

The SBA also cautioned, that the loan application should not include any costs for health benefits, retirement benefits or state and local taxes on income.

It is worth noting, the Inspector General reported that the SBA ignored certain Congressional mandates in implementing the loan program. The report chastised the SBA for failing to issue guidance to lenders that should have instructed them to give priority to borrowers in underserved and rural markets, including minority and women owned businesses. Moreover, the report found that the SBA issued rules that required borrowers to use the majority of their loan funds (75%) on payroll costs to receive full forgiveness even though the Act did not mandate any specific amount be dedicated for payroll expenses. See Amara Omeokwe. “SBA Veered From Guidelines on Small Business Loans, Report Says.” *Wall Street Journal*, May 8, 2020 <https://www.wsj.com/articles/sba-veered-from-guidelines-on-small-business-loans-report-says-11588971101>

**PPP Loans: Computation of Amount and Maximum.** Under the CARES Act (§1106(b)), the taxpayer’s PPP loan is limited. As seen in the application form above, the loan cannot exceed ***2.5 times the employer’s average monthly payroll costs*** (see calculation below) plus any disaster loans obtained after January 31, 2020 that are refinanced into a PPP loan. The maximum loan is $10 million. Note that prior to the SBA guidance, a single company could obtain the maximum loan for each business location so a business with multiple locations could obtain multiple loans.

The average monthly payroll normally is calculated based on the employer’s 12 months of payroll costs prior to the application date—although some applicants have reported that they have used and the banks have accepted the 2019 calendar year average. That *average* monthly payroll number is then multiplied by 2.5. The multiplier of 2.5 or 250% represents the fact that the loan is designed to cover 2 ½ months of payroll costs. For example, assume the employer’s total payroll cost for the year was $240,000, in which case the average monthly payroll cost for the prior 12 months would be $20,000 ($240,000/12). As a result, the employer would qualify for a $50,000 PPP Loan (2.5 x $20,000 average payroll cost).

For purposes of computing the loan, payroll costs are limited to certain expenses incurred during the 8 weeks that begins when the loan originated (the “covered period”).

`

Payroll costs include (Act § 1102(a)(1)(A)(viii))

* Wages, salary, or similar compensation to an employee or independent contractor (up to $100,000 plus amounts paid for unemployment taxes, premiums for group health plans, contributions to retirement plans and state or local taxes asses on compensation such as unemployment taxes)
* Cash tips or equivalent
* Vacation, parental, family, medical or sick leave
* Allowances for dismissal or separation

Payroll costs do not include:

* Compensation of any individual employee in excess of an annual salary of $100,000
* Federal payroll taxes
* Compensation of an employee whose principal place of residence is outside the U.S.
* Qualified sick leave or family medical leave for which a credit is allowed under the PPP rules
* Payments to independent contractors

***PPP Loan Amount*.** The maximum amount of a PPP loan is limited to the lesser of (a) or (b):

a. (1) 250% of the employer’s ***average*** ***monthly*** ***payroll costs*** (listed above) for the 1-year period   
 ending on the loan application date

+ (2) Any disaster loan taken out after January 31, 2020 that has been refinanced into a   
 paycheck protection loan.

Payroll costs and disaster loans

b. $10 million

**Example 4.**  THX Inc. (an S or C corporation) applies for a PPP loan from First Bank on April 1, 2020. The business had payroll costs of $600,000 for the prior 12 months (April 1, 2019, through March 31, 2020), a monthly average of $50,000 ($600,000/12). Using the guidelines above, the business is entitled to a fully guaranteed federal loan of $125,000, the lesser of:

(1) $125,000 ($50,000 of average monthly payroll costs x 250%) or

(2) $10 million.

In effect, the loan covers 2 ½ months of payroll costs based on the average of the prior 12 months.

**PPP Loans: Amount of Tax-Free Cancellation.** No doubt the key feature of PPP loans is that borrowers may never have to repay their loans. The SBA generally forgives PPP loans if employers keep their employees on the payroll for eight weeks and the loan proceeds are used for authorized expenses. These expenses include not only the costs of payroll, but also those for rent, mortgage interest, or utilities. Moreover, as noted above, the debt forgiveness is not treated as taxable income to the employer (Act §1106(i)) and ARPA makes the expenses deductible!

Technically, a business (an “eligible recipient”) that seeks forgiveness of the PPP loan must be able to verify that the amount of the loan for which forgiveness is requested “was used to retain employees, make interest payments on a covered mortgage obligation, make payments on a covered lease obligation or to make covered utility payments.” (Act §1106(e)). If the business fails to meet these standards, the business must repay the loan. In that regard, the loan has a modest interest rate of 1% and a maturity of 2 years. (Act §1106(d)(2)).

The CARES Act provides that the amount of the PPP loan that is eligible for forgiveness is the sum of the certain “costs incurred and payments made” during the “covered period” (the 8-week period beginning on the date a PPP loan originates). However, some employers found it difficult to spend all of the proceeds on authorized expenses, thereby forfeiting the forgiveness privilege. Importantly, the PPPFA extended the period for eligible payments to 24-weeks. Qualifying costs include:

* Payroll costs;
* Any payment of interest on any mortgage obligation (not including any prepayment of or payment of principal on a mortgage obligation) that was incurred before February 15, 2020;
* Any payment of rent under a leasing agreement in force before February 15, 2020;
* Any utility payment, including payment for distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020.

**PPP Loans: Loan Forgiveness Application (Form 3508 Revised July 30, 2021) .**  To compute the amount a borrower must repay, the borrower completes and submits Form 3508 PPP Loan Forgiveness Application Form Revised July 30, 2021 to the banker or lender from whom the loan was obtained (see below). The borrower uses this form to compute the amount of the loan to be forgiven and, at the same time, how much must be repaid. The loan application instructions contain a number of clarifications including, calculation of FTEs, rent, utility expenses, documentation and more.

**PPP Loan Forgiveness Application Form Revised March 18, 2021. See the form below and at** <https://www.sba.gov/sites/default/files/2021-07/PPP%20--%20Forgiveness%20Application%20and%20Instructions%20--%203508%20%287.30.2021%29-508.pdf>

Graphical user interface, application, table

Description automatically generated

The Application above (Form 3508) reflects the SBA’s three-step approach to compute the amount of forgiveness. In effect, if 100% of the loan was used properly, 100% of the loan is cancelled. To the extent that the loan was not used properly, the forgiveness is reduced proportionately, and repayment is required. As noted earlier, cancellation of the debt is considered nontaxable and, just as important, ARPA allows a deduction for the expenses paid by the loan proceeds. Completion of lines 1-15 and the accompanying schedules yields the amount that is forgiven.

***Computing the Potential Forgiveness Amount (Lines 1-8).***

Consistent with the requirement that the loan must be used for certain expenses, the first step in completing the application is determining the total *payroll and qualifying non-payroll costs* (e.g., interest, rent and utilities) (lines 1-8). These include only such costs that the business has spent over the 8-week period since it received its PPP funds (extended to 24 weeks by the PPPFA). The sum of these costs becomes part of the determination of the “potential forgiveness amount” (lines 12-14). The final Forgiveness Amount is found on line 15.

***Reduction for Cutting Employees and Salary Cuts (Line 5).***

This tentative forgiveness amount is then adjusted to the extent the employer lays off workers or cuts salaries (line 5). The tentative amount to be forgiven is reduced if the employer (1) reduced the pay for returning employees more than 25% or (2) failed to bring back the same number of full-time equivalent employees (FTEs) that it had before the pandemic. The application waives this reduction if the business later brought back the same number of employees by June 30, 2020 (extended to December 31 by the PPPFA). Adjustments are allowed for employees that declined to return to their jobs. The result is the “Potential Forgiveness Amounts (lines 12-14).”

***Reduction for Cutting Payroll (Line 8 -10).***

The third and final step ensures that 75% of loan forgiveness is attributable to payroll costs. To illustrate, assume a business had a PPP loan of $100,000. It secures total forgiveness if it used $75,000 for payroll. However, its actual payroll costs were $70,000 and eligible non-payroll costs were $30,000. In such case, the payroll costs are only 70% of the $100,000 total and do not meet the 75% rule. Thus, the $30,000 in non-payroll costs are reduced so that payroll costs are 75% of the amount forgiven. As a result, the maximum forgiveness is $93,333 ($70,000/75% = $93,333). This calculation effectively trims the non-payroll costs from $30,000 to $23,333 such that the forgiveness request of $93,333 consists of 75% payroll costs ($70,000) and 25% non-payroll costs ($23,333).

**Example 7**. KWL Inc., a C corporation, has payroll costs over the prior 12-month period of $240,000. Its average monthly payroll is $20,000 ($240,000/12). The maximum loan amount is 2.5 times the average monthly payroll or $50,000 ($20,000 by 2.5). The company applied and received a loan of $50,000. For the 8-week period after it received the loan, the company uses $40,000 for payroll costs, $9,000 for rent and $2,000 on utilities for total qualifying expenses of $51,000. In this case, the company has qualifying expenses of $51,000 (including payroll costs that exceed 75% of the loan) that exceed the $50,000 loan. Consequently, the entire loan is forgiven. In addition, the debt forgiveness in this case is nontaxable.

**Example 8.** Same facts as Example 7 above. KWL borrowed $125,000 but incurred only $100,000 in payroll costs (80% of the loan amount), mortgage interest, and utility payments during the 8 week period after the loan origination date. The business is eligible to have only $100,000 of the $125,000 loan forgiven. The forgiveness of $100,000 of the debt does not result in any COD income for tax purposes. Payments on the remaining $25,000 of the loan will not be due for two years. The interest rate on the $25,000 loan remaining cannot exceed 1% annually.

**Example 9.** Same facts as in Example 8 above. If the employer reduced its average workforce during the covered period, the amount of forgiveness is reduced. For example, if the employer employed 80 employees during the covered period and when it normally employed 100, only 80% of the loan would be forgiven. A special calculation is used to determine the average number of employees (Act § 1106(d)(2)(B)).

**PPP Loan Fraud.** As many predicted, the Paycheck Protection Program would be an easy target for crooks. For those who were willing to risk going to jail, all they had to do was find a lender who would fund their PPP loan application and voila, free money. For the most part, the lender had no risk since the loan was backed by the federal government. Lenders were guaranteed that they would be repaid one way or another. However, the SBA recognized the problem early on and issued warnings, promising that it would bring enforcement actions against any engaged in fraud. It didn’t take long. Here are a few examples.

* May 5, 2020: the Criminal Division of the Department of Justice brought the first (of what appears to be many) charges against suspects who made fraudulent loan requests of over $500,000. (See Kelly Phillips Erb, "Feds Announce First Arrests In Country Linked To PPP Loan Fraud." *Forbes*, May 10, 2020 <https://www.forbes.com/sites/kellyphillipserb/2020/05/10/feds-announce-first-arrests-in-country-linked-to-ppp-loan-fraud/#17149dcd59de>).
* May 13, 2020: Federal prosecutors struck again, charging a sole proprietor of a Texas business with “wire fraud, bank fraud, false statements to a financial institution, and false statements to the SBA.” Apparently, the proprietor “allegedly sought $10 million in PPP loan proceeds by fraudulently claiming to have 250 employees with an average monthly payroll of $4 million.” In addition he “sought approximately $3 million in PPP loan proceeds by fraudulently claiming to have 250 employees with an average monthly payroll of approximately $1.2 million.” However, the Texas Workforce Commission had no records of employee wages paid in 2020 by the accused or his business. (See Bruce Brumberg, “Federal Charges Of PPP Loan Fraud Are Here To Remind You These Loans Are Not “Free Money.” Forbes, May 14, 2020 <https://www.forbes.com/sites/brucebrumberg/2020/05/14/federal-charges-of-ppp-loan-fraud-are-here-to-remind-you-these-loans-are-not-free-money/#3bdeecaded53>).
* May 21, 2020: Charges were brought against a Chinese national with trying to fraudulently obtain $20 million in PPP loans. According to numerous reports, Mr. Muge Ma, a 36-year-old known as "Hummer Mars" residing in Manhattan, allegedly presented applications to five banks saying he had two companies with hundreds of employees who needed help. Ma represented himself and one of his companies as a test-kit manufacturer for COVID-19 and a medical supplier, neither of which were true, prosecutors said. The bulk of the loans which were approved before the fraud was found were frozen by investigators before Ma could receive them.

Given how quickly the program was rolled out, there were those who inadvertently did not follow the rules. Unfortunately, these businesses will find themselves trying to distinguish their legitimate claims from those who have committed actual fraud.

**PPP Loans: Payroll Costs for Self Employed Individuals and Partners in General.** Taxpayers can get a PPP loan equal to 250% of their average monthly payroll costs. Payroll costs generally include wages and salary and other benefits up to $100,000 per employee. However, self-employed individuals (sole proprietorships) and partners in partnerships do not receive wages or salaries or a “paycheck” in the normal sense. Consequently, the computation of their payroll cost is a bit different. On April 14, 2020, the SBA issued guidance on how the maximum PPP loans for self-employed individuals and partners are to be computed.

***Payroll Costs for Self-Employed Individuals*.**  In determining the maximum PPP loan that a self-employed person can obtain, the total payroll cost is the sum of two components:

(1) Schedule C net income, not to exceed $100,000, and

(2) Payroll costs for other employees

The computation is shown below.

Schedule C Income for 2019 < $100,000)/12 = Average monthly net profit  
 Outstanding amount of any disaster loan (EIDL) to be refinanced  
+ Payroll costs for other employees/12 = Average payroll cost  
= Total payroll cost   
x 250% or 2.5  
= Maximum PPP Loan for self-employed person not to exceed $10 million

If a self-employed person does not have employees or a disaster loan outstanding, then the total annual payroll cost is simply the individual’s self-employment income reported on Schedule C. Note that the annual limit in computing payroll costs for a self-employed person as well as an employee is $100,000 per person.

**Example 10.** Sam Smart, a CPA, teaches continuing education tax courses for accounting firms and also holds his own workshops. To make ends meet, he also drives for Uber and takes jobs from Taskrabbit. His net income shown on his Schedule C for 2019 was $96,000. He has no employees so there are no additional payroll costs to be considered. His maximum PPP loan is $20,000 [($96,000/12 = $8,000 average payroll cost) x 2.5)].

***Payroll Costs for Partners in Partnerships*.** Unlike self-employed individuals, partners (including LLC members) do not apply for a loan individually. The partnership makes the application. For purposes of computing payroll costs for the partnership loan amount, the partnership includes (1) the net income of the partnership plus (2) the payments made to the partners plus (3) payroll costs for other employees. For this purpose, payments to partners are included only if they are active participants in the business as evidenced by the fact they have self-employment income from the partnership as reported in Box 14 of their K-1. Payments made to partners who are merely passive investors are not included in the calculation. The computation of the PPP loan is shown below.

Partnership net income/12  
+ Average payroll costs for other employees/12)  
= Total average monthly payroll cost   
x 250% or 2.5  
= Maximum PPP Loan for partnership not to exceed $10 million

As seen in the example below, all things being equal, the amount qualifying as payroll costs (and, therefore, the amount of the PPP loan) can differ depending on whether the individual operated as a partnership or an S Corporation.

**Example 11**. Assume a partner has reported at least $100,000 of self-employment income in Box 14 of her K-1 (which is a combination of Box 1 “Ordinary Business Income” and Box 4 “Guaranteed Payments”). On the other hand, assume an owner/employee of an S corporation pays herself $50,000 in wages (i.e., as shown on Form 1120S, Line 7), while having $50,000 in Box 1 “Ordinary Business Income” of the K-1. In this case, the partner and the shareholder both have the same total income of $100,000. However, as calculated below, the partner would have twice the amount eligible for a PPP loan as compared to the S corporation owner/employee who only includes wages in the computation (and may have been trying to minimize the salary amount so as to save on employment taxes).

Partner: [($100,000/12 = $8,333) x 2.5] = $20,833.33 Maximum PPP Loan

S shareholder [($ 50,000/12 = $4,166) x 2.5] = $10,416.67 Maximum PPP Loan

**PPP Loans: Guaranty.** To encourage lenders to make these loans, the loans are fully guaranteed by the federal government through December 31, 2020. Collateral is not required nor are personal guarantees. Thus, if a business defaults on the loan, the government repays the loan.

**PPP Loans: A Final Problem.** While the PPP program seems to be on target, as many have note, there is one major drawback: when businesses receive their loan, they may not be operating. As Mr. Nitti points out, (see Nitti, Tony. “Ten Things We Need To Know About Paycheck Protection Program Loan Forgiveness.” *Forbes*, April 15, 2020 <https://www.forbes.com/sites/anthonynitti/2020/04/15/ten-things-we-need-to-know-about-paycheck-protection-program-loan-forgiveness/#3e3a64603291>

business owners who rushed to get a PPP loan will be faced with the realization that to achieve full forgiveness, they will need to pay employees NOT to work. And given the recent increase to unemployment pay, those same employees may prefer not to be paid by their employer, as in many cases, collecting unemployment will prove more lucrative. Given this reality, many business owners were hopeful that they would have flexibility in choosing their 8-week covered period, allowing them to wait out the shelter-in-place order, get their employees back to work, and maximize the payroll that would be incurred during that stretch, and by extension, the subsequent debt forgiveness.

That won’t be the case. The SBA clarified that the 8-week period begins on the date the borrower receives the disbursement of the loan, and the bank must make the disbursement within 10 days of loan approval. Thus, a business that took out a PPP loan in the past week has to start the clock immediately upon receipt of the funds, regardless of whether their business has even restarted operations.

**Page 1-17 Deductions**

# **Reasonable Compensation for Highly Compensated Employees.**

# For years after 2026, ARPA amends §162(m) to add a corporation’s five highest-compensated employees (i.e., besides the employees already covered by Code §162(m)) to the list of individuals subject to the $1 million cap on deductible compensation.

**100% Deduction for Food and Beverages**

The IRS issued new guidance for deductions of the costs of food or beverages obtained from restaurants and bars. The TCDTRA (2020) added a temporary exception to the 50% limit on the amount that businesses may deduct for food or beverages. Beginning in 2021 through 2022, the new exception allows a 100% deduction for food or beverages from restaurants, if the business owner (or an employee of the business) is present when food or beverages are provided, and the expense is not lavish or extravagant under the circumstances. Under the temporary provision, restaurants include businesses that prepare and sell food or beverages to retail customers for immediate on-premises and/or off-premises consumption. However, restaurants do not include businesses that primarily sell pre-packaged goods not for immediate consumption, such as grocery stores and convenience stores. See News Release IR 2021-79 and Notice 2021-25.

**Deductibility of Business Expenses Paid with PPP Loans.**

As discussed earlier in this supplement (material for Page 6-51 of the text), forgiveness of PPP loans is generally nontaxable if the loan is used for qualified expenses (e.g., payroll costs, mortgage interest, rent and utilities.) At first glance, this seemed quite favorable, but there was trouble lingering below the surface. As noted in the text, § 265 provides that no deduction is allowed for expenses related to tax-exempt income. Early in the continuing saga of PPP loans, tax pundits pointed out that if expenses related to PPP loan forgiveness are not allowed, this puts taxpayers in the same position as if their forgiven PPP loan were included in income and they were able to deduct all expenses. On April 30, 2020, Notice 2020-32, IRB 2020-21, 05/01/2020 takes that position. The Notice specifically explains that a taxpayer that receives a loan through the Paycheck Protection Program (PPP) is not permitted to deduct expenses that are normally deductible under the Code to the extent the expenses were reimbursed by a PPP loan that was later forgiven. None of the legislation relating to the COVID-19 addressed the issue (e.g., FFCRA and CARES).

As might be expected, the Notice was met with great hissing and moaning. The AICPA indicated that it believes strongly that the position of the Notice is contrary to Congressional intent. Chris Hesse, CPA, chair of the AICPA Tax Executive Committee, said: “In effect, the IRS guidance means that the taxability provision [Act § 1106(i)] has no meaning. Why waste the ink to say that for purposes of the Code, the loan forgiveness is not includible in income, if the government will just take away deductions in the same amount?” See Sally P. Schreiber. "AICPA Challenging Nondeductibility of PPP-Related Expenses.” *Journal of Accountancy*, May 1, 2020, <https://www.journalofaccountancy.com/news/2020/may/expenses-reimbursed-by-ppp-not-tax-deductible-paycheck-protection-program.html> In a letter dated August 4, the AICPA joined over 170 organizations to urge Congress to “include a technical correction addressing the tax treatment of loan forgiveness.”

The outcries worked. ARPA provides a deduction for expenses paid out of PPP loan proceeds. In Rev. Proc. 2021-20, the IRS allows taxpayers who filed a tax year 2020 return on or before December 27, 2020, to deduct those expenses on their 2021 tax return rather than file amended returns or administrative adjustment requests.

**Deductions for Family and Medical Leave Payments and Sick Pay.**

In the world of work, the relationship between employers and employees is not always rosy. Indeed, there are labor laws designed to regulate that relationship to ensure that employers observe the rights of their employees and treat them fairly. One area that causes confusion and tension is that of leaves for family and medical purposes. The problem is simple: can employees temporarily leave their job due to medical and family circumstances without fear of losing it? Of course, the related question is whether employees should be entitled to paid sick leave. (*Note: the text does not discuss this issue but is added here in light of recent developments.*)

Congress initially addressed the issue of sick leave with the enactment of the Family and Medical Leave Act (FMLA) in 1993. The FMLA applies only to employers with more than 50 employees. In such case, employers *must allow* their employees up to 12 weeks of ***unpaid*** leave for qualified medical and family reasons without fear of losing their jobs. The FMLA did not contain any tax provisions.

It should be noted that the FMLA of 1993 did not require employers to pay employees while they were on leave. To emphasize, it did not require **paid sick leave,** although some employers offered it and some states required it. What the FMLA did do was mandate that employers must grant their employees up to 12 weeks of job protected sick leave. Thus, employees legally can take up to 12 weeks of leave due to health reason and not worry about losing their jobs.

Perhaps, the first tax development with respect to sick leave occurred with the enactment of the TCJA of 2017 that created a special credit to help subsidize an employer’s cost of paying for family and medical leave. Section 45S allows eligible employers to claim a general business credit equal to 12.5% of the wages paid. In addition, the credit is increased by 0.25 percentage points for each percentage point by which the rate of payment exceeds 50% of the employee’s normal wages (but not more than 25% or a maximum of 37.5%). Employers who claim the credit must reduce their deduction for wages by the amount of the credit.

No doubt some hoped that the credit would encourage more employers to offer paid sick leave programs. The dramatic upheaval brought by COVID-19 prompted Congress to revisit this area in the enactment of FFCRA (*Families First Coronavirus Response Act*), the first piece of legislation in response to COVID-19. FFCRA generally requires certain employers to provide sick pay. ARPA codified the credits for payment of sick pay and family leave. It also increased the credit to $12,000.

**Paid Sick Leave: Background.** As noted above, prior to FFCRA, there was no federal law in the U.S. that required sick pay for the private sector employees (except for an executive order signed by President Obama for businesses that do business with the federal government). Still, it is not uncommon to hear employees say that they are taking a sick day, for which they may or may not be paid. However, payments for sick leave are usually required for public sector workers—both federal and state employees, who are provided paid sick leave as part of their employment agreements.

As reported by Workest, (<https://www.zenefits.com/workest/the-definitive-list-of-states-and-cities-with-paid-sick-leave-laws/>, an analysis in 2018 by the Bureau of Labor Statistics found that about 61 percent of Americans workers in the private sector had sick pay while 39 percent of American did not. In that regard, currently 11 states and Washington D.C., as well as over 30 localities, require paid sick leave. However, things are changing. For example, recently, on April 3, 2020, the state of New York, in response to the millions of jobs lost due to COVID-19, amended its labor laws to require all New York employers to provide paid (or unpaid) sick leave for their employees See <https://www.littler.com/publication-press/publication/new-york-enacts-statewide-sick-leave-law>.

**FFCRA and Required Payment of Sick Leave.** On the federal front, the enactment of FFCRA was a milestone concerning sick leave. FFCRA now **requires** most employers to provide **paid sick leave** but only if its employees are directly impacted by the COVID-19. As a result, most of America’s nearly 159 million workers will be able to get *paid* time off if they or their families are directly affected by COVID-19. Moreover, FFCRA modifies the tax law to give employers credits for these payments that can be used to reduce their payroll tax liabilities. This arrangement effectively eliminates the employer’s cost of the sick pay that they are required to pay under federal law.

Technically, FFCRA contains two pieces of legislation that require paid sick leave. The new law is confusing because there are two separate programs that concern sick pay and there are subtle differences between them. Note that at the conclusion of this discussion, there are charts that summarize and compare the two programs. The two programs are:

(1) **The Emergency Paid Sick Leave Act** (**EPSLA**, Act § 5101) that requires certain employers to provide up totwo weeks of *paid sick leave*and.

(2) **The Emergency Family and Medical Leave Expansion Act** (**EFMLEA**, Act § 3101), which, in its so-called *family and medical leave*program, expands the Family and Medical Leave Act of 1993 (FMLA) mentioned above. In so doing, the EFMLEA increases the benefits beyond those required by the paid sick leave rules of EPSLA (i.e., two weeks of sick pay). EFMLEA’s family and medical leave program generally requires 12 weeks of leave (10 of them paid) for certain COVID-19 related reasons. [**Note:** the FMLA of 1993 requires up to 12 weeks of *unpaid* leave (see FMLA of 1993 (29 United States Code § 2611(a)(1) that provides that an “employee shall be entitled to a total of 12 workweeks of leaving . . .”)).

These two acts, EPSLA and EFMLEA, work in different ways to assist working families facing health emergencies arising out of the coronavirus.

**Which Employees Are Covered?** The criteria for which employees are covered by EPSLA’s **paid sick leave** requirement and the criteria for which employees are covered by EFMLEA’s **family and medical leave** program are not identical. For the paid sick leave program of EPSLA, all employees are covered, regardless of how long they have worked (even a day) or whether they are part-time. On the other hand, EFMLEA’s expanded family and medical leave program only covers those employees who have worked for at least 30 days. Both Acts, both programs, apply to part-time employees. **Note**: neither program requires employers to provide paid sick leave for employees who are health care providers or emergency responders.

**Which Employers Are Required to Pay Sick Leave?** Generally, FFCRA covers both private employers with less than 500 employees and certain public employers (“covered employers”). However, as discussed below, small businesses (less than 50 employees) who do not want to pay for sick leave can elect to exempt themselves from certain provisions of FFCRA.

***Large Employers (More than 500 Employees)*.** The new legislation does not necessarily reach the nation’s larger companies. Neither EPSLA’s paid sick leave requirement nor EFMLEA’s family and medical leave program apply to employers with more than 500 employees. These businesses, which may or may not already offer paid time off, are not subject to the legislation. However, some large businesses that had not offered these benefits in the past--including Walmart and McDonald’s—have announced temporary coronavirus-related sick pay policies. While the federal rules do not apply to larger companies, a number of states who are adopting their own emergency sick leave statutes are thinking otherwise. Interestingly, some of these states do not exempt large employers. In addition, proposals in Congress would remove this 500-employee cap and force such businesses to pay sick leave. For this reason, experts are cautioning employers with more than 500 employees to monitor potential legislation at the state and federal levels.

***Small Business Exemption.*** Similar to its treatment of large employers, FFCRA does not always reach the workers of the country’s smaller businesses. Under certain circumstances, employers with fewer than 50 employees (small businesses) are *not* required to provide paid leave when an employee’s leave is necessary to care for a child whose school or place of care is closed, or whose childcare provider is unavailable due to COVID–19 related reasons. In other words, these businesses are exempt from having to pay sick pay in these situations. However, this exemption is available only if the leave payments would jeopardize the viability of the business as a going concern. If businesses wish to avoid paying sick leave based on the viability argument, the regulations of the Department of Labor indicate that an officer of the business must document that one or more of the following is true:

(1) The requested leave causes the business’s expenses and financial obligations to exceed its available revenues and prevents the business from operating at even a minimal capacity;

(2) The absence of the employees requesting leave would entail a substantial risk to the financial health or operational capabilities of the business because of their specialized skills, knowledge of the business, or responsibilities; and

(3) There are not sufficient workers who are able, willing, and qualified, and who will be available at the time and place needed, to perform the labor or services provided by the employee or employees requesting leave, and this labor or services are needed for the small business to operate at a minimal capacity.

To emphasize, the exemption for small businesses is only an exception from the obligation to provide paid leave to an employee who requests leave due to school or childcare closures (e.g., so the employee can be home to take care of his or her child because the child’s school or facility that provided childcare is closed). Small businesses must still provide paid sick leave to an employee who needs leave because he or she: (1) is subject to a quarantine or an isolation order; (2) has been advised by a health care provider to self-quarantine; (3) is experiencing COVID-19 symptoms and is seeking a medical diagnosis; or (4) is caring for an individual subject to a quarantine order or has been advised to quarantine. There is no exception for small businesses in these situations. They are required to pay sick leave. They are only exempt from paying sick leave to those where schools or daycare facilities have closed.

***Number of Employees*.** The number of employees is critical since the small business exemption is available only if the employer has less than 50 employees. Moreover, FFCRA does not apply to employers with more than 500 employees. For these purposes, the following employees are counted: all full- and part-time employees, employees on leave, temporary employees who are jointly employed by the employer and another employer (a staffing company), and day laborers supplied by a temporary agency when the employee’s leave is taken.

**Sick Pay Required.** For employers with 50 but not more than 500 employees, the small business exemption is not available and sick pay is required. FFCRA’s paid sick pay program (i.e., EPSLA (FFCRA Act § 5101(a))) *requires* covered employers (those with at least 50 and less than 500 employees) to provide all **eligible** employees up to **2 weeks** (10 days or 80 hours) of **paid sick leave** at **full** **pay**, up to a **specified cap ($511/day) or a total of $5,110 (10 days x $511/day)**, An employee is **eligible** for sick leave payments if he or she is unable to work (or telework) because he or she:

(1) is subject to a Federal, State, or local quarantine or isolation order related to COVID-19,

(2) has been advised by a health care provider to self-quarantine due to concerns related to COVID-19,

(3) is experiencing symptoms of COVID-19 and seeking a medical diagnosis,

(4) is caring for an individual who is subject to a Federal, State, or local quarantine or isolation order related to COVID-19,

(5) is caring for a son or daughter under 18 because the child’s school or place of care has been closed or the child care provider is unavailable due to COVID-19, or

(6) is experiencing any other substantially similar condition specified by Health and Human Services

**Family and Medical Leave Payments and Sick Pay.** FFCRA’s family and medical leave program (i.e., EFMLEA (FFCRA Act § 3101)) expands the benefits from 2 weeks (per EPSLA) to 10 weeks for an employee in one particular situation, i.e., he or she is unable to work (or telework) due to a need for leave to care for a son or daughter under 18 years if the school or place of care has been closed, or the child care provider of such son or daughter is unavailable. (The IRS generally refers to wages in this case as “qualified leave wages.”)

Unlike the sick pay program of EPSLA, the Medical and Family Leave program provides that the first two weeks of leave (usually ten workdays) are unpaid. However, an employee may get paid sick leave under EPSLA, which requires two weeks of paid sick leave. Alternatively, an employee may be able to obtain sick pay provided to the employee pursuant to the employer’s preexisting policies for these two weeks of unpaid leave (e.g., vacation pay).

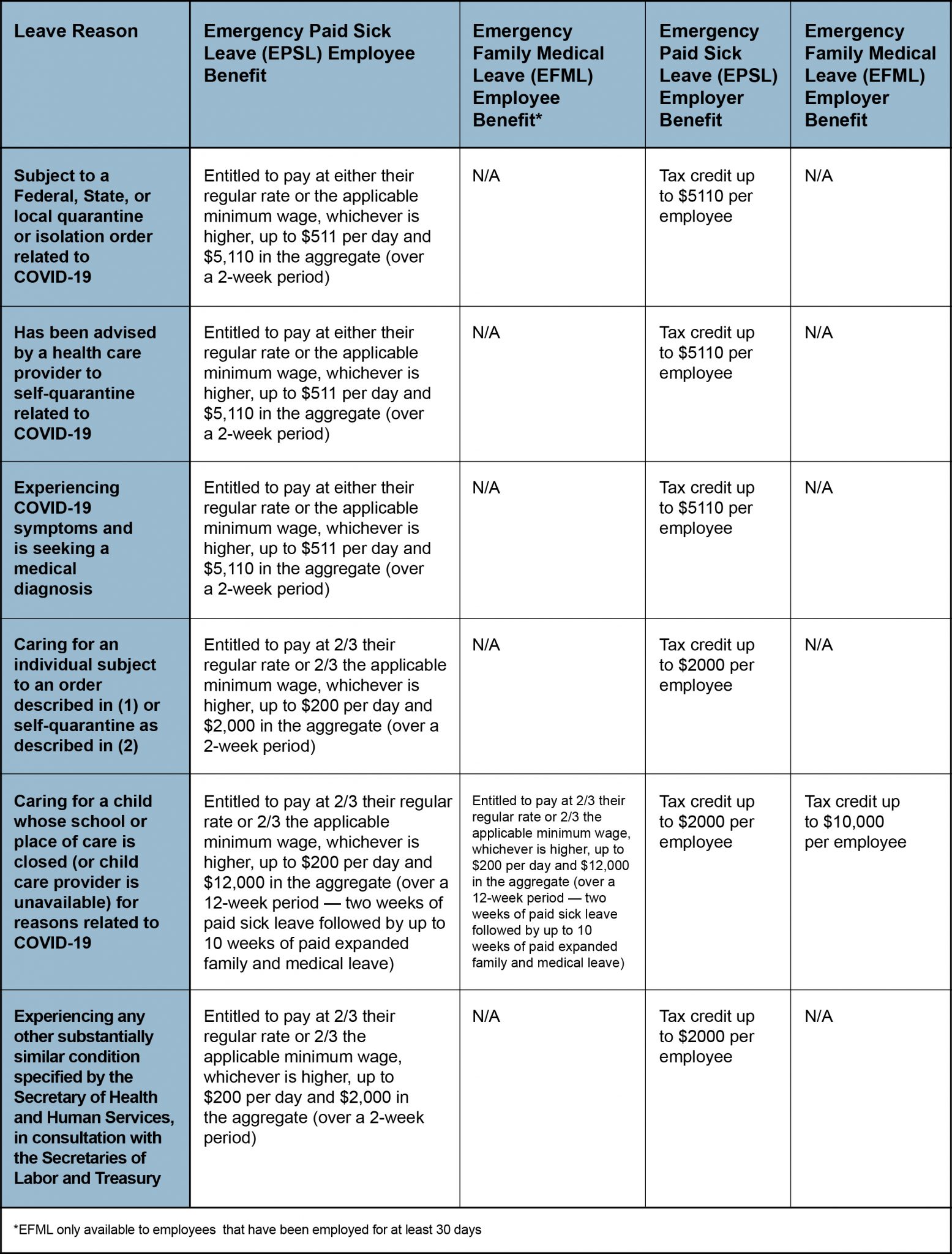
While the Medical and Family Leave program of EFMLEA does not provide paid sick leave for the first two weeks of leave, it does provide payment for the following period of up to ten weeks. The employee must be paid sick leave at **2/3 of the employee’s regular rate of pay** ***up to $200 per******day****.*  The total EFMLEA payment per employee for this ten-week period is **capped at $10,000** in the aggregate. As a result, assuming the employee could obtain two weeks of paid leave taken under EPSLA (10 days x $200 = $2,000) and $10,000 under EFMLEA, the total potential sick pay is $12,000. As noted above, an eligible employee may elect to use (or an employer may require that an employee use), expanded family and medical leave concurrently with any leave offered under the employer’s other policies that would be available for the employee to take to care for his or her child, such as policies for vacation or personal leave or paid time off.

***Employer Social Security Taxes on Qualified Wages.***  The qualified family leave wages are not subject to the employer portion of social security tax.

**Summary Tables: Sick Pay and Family and Medical Leave.** These two programs are summarized below and a similar table on the next page. Note that the table on the following page also identifies the credit that an employer can get for sick pay. This is discussed later below.

|  |  |
| --- | --- |
| **Sick pay**  **(EPSLA)** | **Family and Medical Leave (EFMLEA)** |
| Employee unable to work or telework due to | Employee unable to work (telework) due to |
| 1. Federal, state, local quarantine or isolation order | Must be employed (on payroll) for 30 days |
| 2. Self quarantining under advice of healthcare provider due to Covid-19 concerns | 1. Caring for child if school closed |
| 3. Obtaining diagnosis due to Covid-19 symptoms | 2. Caring for child if child care provider closed or unavailable due to Covid-19 |
| 4. Assisting a family member quarantined under order or advice of healthcare provider |  |
| 5. Caring for child if school closed or child care provider closed or unavailable due to Covid-19 |  |
| 6. Additional categories added by HHS |  |

|  |  |
| --- | --- |
| **Amount of  Sick Pay** | **Amount of  Family and Medical Leave Pay** |
| 1. Up to 2 weeks (80 hours) sick leave, maximum of $511 per day capped at $5,110 total. | 1. 2/3 of compensation up to $200/day for 10 weeks capped at $10,000 |
| 2. Care for family member w/coronavirus or child after school or day care closing,  $200/day ($2,000 per employee cap) | 2. Caring for child if child care provider closed or unavailable due to Covid-19, $200/day ($2,000 per employee cap) |



See <https://www.cshco.com/articles/summary-of-families-first-coronavirus-response-act/>)

**Credits for Sick Pay.**

**(Note:** While tax credits are normally addressed with the general discussion of credits, for purposes of this supplement, the credits related to FFCRA’s sick pay requirements discussed above are considered below).

**FFCRA Credits for Sick Pay.** As noted above, FFCRA provides businesses with refundable tax credits to reimburse 100% of the costs of providing employees with required paid sick leave and expanded family and medical leave for reasons related to COVID-19. In effect, these credits operate such that employers should not incur any cost for the payments. The credits include the employer’s share of Medicare taxes as well as expenses to provide and maintain a group health plan (to the extent that the amounts are excluded from the employee’s gross income under § 106(a)). ARPA codifies these credits.

According to the IRS, “Eligible Employers” can obtain the benefit of these payroll tax credits almost immediately by applying them against their federal payroll taxes that normally are paid quarterly (i.e., amounts withheld for employee income taxes, employment taxes including the employee and employer share for Social Security and Medicare). Generally, employers can claim the credits on their federal employment tax returns filed quarterly (e.g., Form 941, Employer's Quarterly Federal Tax Return). Form 941 is due by the last day of the month that follows the end of the quarter as follows:

The Quarter Includes . , , , . . Quarter Ends Form 941 Is Due

1. January, February, March March 31 April 30  
 2. April, May, June June 30 July 31  
 3. July, August, September September 30 October 31  
 4. October, November, December December 31 January 31

Depending on the total taxes withheld, taxes normally are deposited monthly or semi-weekly (every two weeks). If there are insufficient federal employment taxes to cover the amount of the credits, employers may request an advance payment of the credits from the IRS by submitting Form 7200, Advance Payment of Employer Credits Due to COVID-19.

The IRS also explains that “Eligible Employers claiming the credits for qualified leave wages (and allocable qualified health plan expenses and the Eligible Employer’s share of Medicare taxes) must retain records and documentation related to and supporting each employee’s leave to substantiate the claim for the credits.

**Employer Disaster Relief Payments for Employees and Exclusion (§ 139)**

Employers can help employees who have suffered financial loss due to the pandemic by creating a program that utilizes qualified disaster relief payments. Section 139 and its special rules provide that so-called qualified disaster payments are not taxable. Moreover, the costs of such payments are deductible by the employer as an ordinary and necessary business expenses.

Section. 139(b)(1) defines a qualified disaster relief payment as any amount paid to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster (provided amounts are not reimbursed by insurance or otherwise). Under this definition, childcare expenses resulting from school closures and costs incurred to enable an employee to work from home would most likely qualify.

In addition, qualified payments include those for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster,

A qualified disaster eligible for this treatment includes an event declared a major disaster or an emergency under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act) (Rev. Rul. 2003-29). On 3/13/20, President Trump made an emergency declaration under the Stafford Act regarding the COVID-19 pandemic. Therefore, qualified disaster relief payments related to COVID-19 are eligible for tax-free treatment under § 139.

**Employer Payment of Student Loans: Educational Assistance Plans.**

Under current law (§ 127), an employee may exclude up to $5,250 of tuition payments made by an employer sponsored educational assistance program. The exclusion is not available for payment of the education for the employee’s spouse or dependents. In addition, the payment is not only excluded for income tax purposes but also is exempt from payroll taxes (employer and employee). The CARES Act expands the reach of this program to include employer payments of existing student loan debt. Thus, if an employer agrees to pay a student’s loans and does it before 2021, the benefit is not taxable. The limitation of $5,250 was not changed. The provision is effective for student loan payments made before January 1, 2021. Obviously, this rule provides a potentially huge benefit for employers and employees but it expires on December 31.

**Example 7**. An accounting firm pays $3,000 for an MST course taken by one of its employees during 2020. In addition, the firm pays off $4,000 of the employee’s outstanding student loans. Given the $5,250 cap, the employee can exclude $5,250 while the remaining $1,750 ($3,000 + $4,000 = $7,000 - $5,250 = $1,750) would be included in the employee’s wages. The employer can deduct the payment just like compensation except it is not subject to employment taxes.

“Eligible student loan repayments” are payments by the employer of principal or interest with respect to any “qualified higher education loan” for the education of the employee (but not of a spouse or dependent). The payment may be paid to the employee or directly to a lender. See  
§ 221(d)(1) and § 127(c)(1)(B).

Section 221 allows a deduction for up to $2,500 of interest on student loans per year. To prevent a double benefit, a taxpayer cannot deduct interest on a student loan that is paid by an employer for which the exclusion is allowable. Note that the deduction for student loan interest phases out once the taxpayer’s AGI (computed with certain modifications) exceeds $140,000 for joint returns or $70,000 for all other returns.

**Health Savings Accounts**

**Qualified Expenses: Over-the-Counter Drugs, Telehealth and Menstrual Needs.** The tax law generally allows taxpayers to pay for medical expenses with pretax dollars through a Health Savings Account (HSA). For example, taxpayers can instruct their employer to withhold amounts from their paycheck that are stored in an HSA. In this way, the amounts are never subject to an income tax nor an employment tax (and most state income taxes). Alternatively, taxpayers can simply make contributions to an HSA and deduct them for AGI.

The predecessor to health savings accounts was created in 1996 to entice people to be more conscious of health care costs, and hence, use less of it. Proponents of HSAs believe that they are an important vehicle that help reduce the growth of health care costs and increase the efficiency of the health care system. Some have said that they are the most tax-preferred savings vehicle in American history.

The major drawback of an HSA is that it comes with a qualified High-Deductible Health Plan (HDHP). An HDHP typically has lower premiums but higher deductibles meaning higher out-of-pocket costs than a traditional health plan. Also, HSAs must be created before old age sets in. Taxpayers enrolled in Medicare Parts A or B, or those that file for Social Security benefits after age 65, cannot make contributions to an HSA.

Payments of medical expenses by an HSA do not impact the individual’s taxable income if the distribution is used for qualified medical expenses (§ 223(d)). If any portion of a distribution is not used for qualified medical expenses, that portion is considered taxable income and is subject to a 20 percent penalty. The Act makes several changes to HSAs:

First, the Act eliminated the requirement that medical expenses must be prescribed in order to qualify. This appears to make payment of over-the-counter remedies qualified medical expenses but only for purposes of HSA distributions.

Second, the Act expands the definition of qualified medical expenses to include amounts paid for “menstrual care products” (Act § 233(d)(2)). The Act explains that “menstrual care products” include tampons, pads, liners, cups, sponges, or similar products used by individuals with respect to menstruation or other genital-tract secretions. As a result, taxpayers who have a health savings accounts (HSAs), health reimbursement arrangements (HRAs), health flexible spending accounts (health FSAs), and Archer medical savings accounts (Archer MSAs) can contribute to such accounts and use those funds for such expenses on a pretax basis.

Finally, the Act addresses telemedicine. Many employers have utilized telemedicine as a part of their group medical program, either integrated with the group health plan or as a separate benefit. This is particularly true since the arrival of COVID-19. Prior to the Act, the IRS did not allow those expenses (e.g., the cost of telemedicine) to be reimbursed under a high-deductible health plan (HDHP) until the plan’s deductible was satisfied**.** In other words, if the deductible had not been satisfied, the cost of the televisit (i.e., a word so new that it’s not in most dictionaries) would not be a qualified medical expense. In such case, payment for a televisit by the HSA would be considered a taxable distribution and a 20% penalty also would be assessed. In effect, the cost of the televisit would be paid with after-tax dollars plus 20%. The Act alters that approach and allows a high deductible health plan to provide telehealth and remote care services before the deductible is reached for 2020 and 2021.

**Group Health Plans: Required Coverage of COVID-19 Expenses**.

The Act requires that all group health plans must cover COVID-19 diagnostic testing and any related visits at no cost to consumers. The Act expands this coverage to include in vitro diagnostic testing for the detection of SARS, CoV-2 as well as COVID-19 provided such tests are approved, cleared or authorized by the FDA, furnished to a participant during an office visit (in person or by telehealth), urgent care visit, or emergency room visit resulting in an order for or administration of such test. The Act also requires group health plans to cover “qualifying coronavirus preventive service.” A qualifying coronavirus preventive service is an item, service or immunization that is intended to prevent or mitigate COVID-19. The requirement to cover a qualifying coronavirus preventive service takes effect 14 business days after the date on which a recommendation is made relating to such service.

**High Deductible Health Plans** (HDHPs)

According to IRS Notice 2020-15, a high deductible health plan’s payment of testing or treatment for COVID-19 without a deductible will not affect such plan’s status as a high deductible health plan. High-deductible health plans (HDHPs) can pay for COVID-19 related testing and treatment without jeopardizing their status, regardless of whether the plan’s deductible has been met (Notice 2020-15 (03/11/20)).

**Employment Taxes: Deferral of Payment of Employer Share of Payroll Taxes.**

As a general rule, employers as well as self-employed individuals are required to pay employment taxes. Such taxes are deductible since they are ordinary and necessary business expenses. The Act does not change the deduction for such expenses. However, the CARES Act does allow employers and self-employed individual to postpone their payment. The Act generally allows most employers and self-employed individuals to defer payment of the employer share of Social Security taxes (the 6.2% portion up to the maximum wage base of $137,700 for 2020 (up to $8,537.40)) incurred between the date the Act became law, March 27, 2020 and December 31, 2020. The payroll tax deferral does not include the employer’s portion of Medicare taxes or any amounts withheld from the pay of employees (income tax withholdings and employee’s share of Social Security and Medicare).

Taxes that were due to be submitted on March 27, 2020 or later are eligible for deferral. There is no maximum amount of qualifying payroll taxes that can be deferred. Such amounts are to be paid over the following two years, with half due on December 31, 2021, and the other half due on December 31, 2022. (Act §2302(a)(1) and (b)). Unlike other provisions in the CARES Act, the size of the employer (e.g., number of employees) is irrelevant

**Example 8.** For the first three months of 2020, FXG Corporation paid its employees total wages of $400,000. It’s share of Social Security taxes was $24,800 (6.2% x $400,000). The corporation is allowed to postpone payment of the tax over the next two years, $12,400 (50% x $2,480) is due on December 31, 2021 and the remaining $12,400 is due on December 31, 2022.

**Example 9.**  Andrea, a self-employed taxpayer, has $100,000 of net profit from a Schedule C business. Therefore, her self-employment tax is $15,300 (15.3% x $100,000). Under this new provision, if elected, she can choose to pay 50% of this tax, $7,650, by 12/31/21 and the other 50% by 12/31/22 (i.e., without incurring any interest or penalties).

As the examples above illustrate, the benefits of postponing payment of the payroll taxes are potentially huge. Initially, there was uncertainty about certain aspects of the calculation. As mentioned above and discussed below, employers generally are allowed to reduce the payroll taxes they must pay by the amount of any sick pay they are required to pay under FFCRA (i.e., the payroll tax credit). In addition, employers are entitled to a credit based on employee retention (i.e., the employee retention credit). The question in computing the amount of employment taxes that could be deferred (above) was whether such taxes had to be reduced by these credits. The IRS has explained that such credits are not taken into account.

**Effect of Paycheck Protection Program Loans (PPP Loans) on Deferral of Payroll Taxes.** Special rules may impact the employer’s deferral of payroll taxes. As discussed below, businesses may apply and receive loans from the Small Business Administration to help them stay afloat during the coronavirus pandemic. Generally, a business is not required to repay these loans as long it does not layoff employees and uses the funds for qualified expenses (e.g., salaries, rent, mortgage interest, or utilities), Moreover, the cancellation of these loans does produce cancellation of indebtedness income (i.e., the cancellation does not yield taxable income).

Employers that have applied for a PPP loan can continue to defer the payment of its payroll taxes until that point when they receive a decision from their lender that its PPP loan is forgiven. At that point, the employer is no longer able to defer additional payroll taxes. However, the payroll taxes that were deferred until that time continue to be deferred and are due on the applicable dates described above. If the application for a PPP loan is denied, the employer can continue to defer any obligation for employment taxes under the rules above.

**Leasehold Improvements Qualify for Bonus Depreciation.**

The CARES Act includes a technical correction to the TCJA that allows the interior improvements of buildings (qualified improvement property or QIP as defined in § 168(e)(6)) to qualify for 100% bonus depreciation. The QIP amendments made by §2307 of the Act are retroactively effective for property placed in service after Dec. 31, 2017. In other words, it is as if this QIP provision had been included in the original version of the TCJA.

Technically, the CARES Act provides a correction to the TCJA, and specifically designates QIP as MACRS 15-year property, making it now eligible for bonus depreciation purposes (§ 168(e)(3)(E)(vii)). Also, QIP is assigned a 20-year class life for the Alternative Depreciation System (§ 168(g)(3)(B)). This designation for ADS purposes has implications where the taxpayer has made a “real estate trade or business election” to avoid the interest expense limitation under § 163(j). If the taxpayer makes such election, then the real estate involved (i.e., 27.5-year residential or 39-year commercial) as well as the QIP would have to be depreciated under the ADS.

**Example 10.**  JKB LLC, a partnership, purchased a warehouse in 1995 that now stands idle. They (or, their tenants) then proceed to do substantial improvements (i.e., QIP) to the interior of the building as the various units are rented out. These QIP assets would be classified as MACRS 15-year property and would, therefore, be eligible for bonus depreciation.

While this new rule is a significant development, it should be noted that QIP generally is eligible for immediate expensing under § 179 ($2,590,000 in 2020), assuming the activity qualified as a trade or business.

Note that § 179 immediate expensing, as well as bonus depreciation, for QIP requires that the commercial building to which these improvements relate must have previously been placed in service before these improvements are made. As a result, a new commercial building in which the improvements are made before receiving, for example, a certificate of occupancy would not be eligible to be classified as 15- year MACRS “qualified improvement property.”

**Page 1-17**

**Limitation on Deduction of Interest of Businesses**

As noted in the text, the TCJA limited the deduction of business interest to 30% of adjusted taxable income or ATI (§ 163(j)(10)). The total cap is the sum of (1) the taxpayer’s business interest income (if any); (2) 30% of the taxpayer’s adjusted taxable income; and (3) the taxpayer’s floor plan financing interest expense for the taxable year. The disallowed interest can be carried over indefinitely.

The CARES Act temporarily modified this provision for tax years that begin in 2019 or 2020. The Act increases the ATI limitation, from 30% to 50%. In addition, the Act allows corporations to elect to use their 2019 ATI as their ATI in 2020 for purposes of this increased 50% threshold. This ensures that even though their earnings may be harmed by the COVID-19 outbreak, their otherwise increased business interest deduction will not be.

**Example 11.** CDB Inc. had adjusted taxable income (ATI) of $5 million in 2019 but a negative ATI in 2020. As a result, it normally would have no deduction for its business interest in 2020 since ATI was negative (50% x ATI $0 = $0). However, under the CARES Act, the business could elect to use its 2019 ATI of $5,000,000 for 2020. In such case, it could deduct $2.5 million of interest expense in 2020 (50% x $5 million ATI from 2019 instead of 2020). This may in turn generate a larger loss, and the company could use the favorable new NOL provisions to carry back the loss to 2019 and receive a refund on some or all of the taxes otherwise paid.

**Page 1-18**

**Net Operating Loss**

**NOL Deduction: Carryback for 5 Years and No 80% Limitation.** The CARES Act addresses several changes made by the TCJA concerning the use of NOLs.

Under the TCJA, beginning in 2018 (i.e., NOLs arising after 2017):

* The 2-year carryback period (except for farming businesses) was eliminated. Therefore, NOLs occurring in 2018 and beyond could only be carried forward.
* NOLs occurring in 2018 and beyond were carried forward indefinitely. The 20-year carryover period was eliminated.
* The NOL deduction for NOLs occurring in 2018 and beyond was limited to 80% of taxable income.  However, NOL carryovers existing prior to 2018 were not subject to the 80% limit.

The CARES Act revises the TCJA rule (footnote 55). As noted above, under the TCJA, § 172(b)(1)generallyprovides that an NOL for any tax year must be carried *forward*.However, the CARES Actalters that approach and provides that NOLs arising in a tax year beginning *after* Dec. 31, 2017 and *before* Jan. 1, 2021 (i.e., losses for 2018, 2019 and 2020) can now be carried *back* to each of the *five* previoustax years (e.g., a 2018 NOL could be carried back to 2013). The hope of the legislation is that it might help businesses who have suffered due to the coronavirus pandemic.

**NOLs: Temporary Repeal of 80% of Taxable Income Limitation.** As noted above, the CARES Act provides additional relief for businesses affected by COVID-19 by *temporarily* removing the 80% taxable income limitation on the use of NOLs for taxable years beginning *before* January 1, 2021. However, the 80% limitation is reinstated for 2021. See footnote 55.

The temporary repeal of the 80% limitation, when coupled with the new five-year NOL carryback period is aimed at businesses that may struggle given the current economic conditions. The Act gives taxpayers the ability to utilize NOLs in prior taxable years beginning as early as in 2013 (e.g., an NOL incurred in a 2018 tax year could be carried back 5 years) without limitation. In so doing, the Act allows businesses to use NOLs to offset taxable income in those prior years that had been subject to a marginal tax rate as high as 35% for corporations (rather than 21%) and 39.6% for individuals. This, in turn, might provide additional cash flow and liquidity that may help businesses survive.

Although the net effect of easing the NOL rules will be positive for many businesses with applicable losses, that may not be true for all business owners. Some businesses may find that using the new 5-year NOL carryback rule limits their ability to use other deductions or credits based on taxable income that they may have claimed on prior year returns (e.g., foreign tax credits). For this reason, taxpayers that do not want to carry back any NOLs have that option. Taxpayer can make an election (i.e., under §172(b)(3)) to forego this carryback option by the extended due date of their return “for the first tax year ending after the enactment date (i.e., 3/27/20) of this law change.” In other words, an election made for a 2020 calendar tax year return wouldapply to any NOLs arising in either 2018 or 2019 that otherwise would be carried back for five years.

The amendments made by Act § 2303(b) apply to NOLs arising in tax years beginning after December. 31, 2017 and to tax years beginning before, on or after such date to which such NOLs are carried (Act § 2303(d)(2)).

**Page 1-21**

**Charitable Contributions: Limitations on Deductions**

**Deduction** **Limitations: Corporations**. The charitable contribution deduction for C corporations generally is limited to 10% of taxable income. If a corporation's charitable contributions for a year did exceed the 10% limitation, the excess was carried over and deducted for each of the five succeeding years on a FIFO basis. The CARES Act changes the limitation for C corporations to 25% of taxable income for 2020 only.

**Increase in Limits on Contributions of Food Inventory.** Previously, a donation of “apparently wholesome food inventory” to a charitable organization that was used for the care of the ill, the needy, or infants was deductible in an amount up to its basis plus half the gain that would be realized had the food been sold (not to exceed twice the basis). In the case of a C corporation, the deduction could not exceed 15% of the corporation's income. In the case of a taxpayer other than a C corporation, the deduction could not exceed 15% of the taxpayer’s aggregate net income for that tax year from all businesses from which those contributions were made, computed without regard to the taxpayer's charitable deductions for the year (§ 170(e)(3)(C)).

The CARES Act provides that in the case of charitable contribution of food during 2020, the taxable income limit is also 25% rather than 15%. (Act § 2205(b)). The CARES Act emphasizes that the food donations must be made to a charity. Thus, it would appear that, for instance, a restaurant that wanted to give excess food that would otherwise spoil would need to donate it first to a church or a school to be distributed, instead of inviting the general public to consume the food at the business’s location (or picking the food up and eating it elsewhere). The Consolidated Appropriations Act of 2021 (§ 213), signed into law on December 28, 2020, maintains and expands the charitable incentives originally enacted by the CARES Act).

**Charitable Contributions for Individuals: $300 Deduction from Taxable Income.** The CARES Actallowed individual taxpayers to claim contributions of up to $300 of *cash* contributions to public charities as a deduction for AGI (i.e., an above-the-line deduction) in 2020. In short, nonitemizers were allowed to claim up to a $300 deduction. Moreover, a taxpayer choosing to take the standard deduction in 2020 effectively increased this amount by $300 by making $300 of charitable contributions. In 2020, the deduction reduced AGI and, therefore, slightly impacts deductions whose calculation involves AGI (§ 62(a)(22)). The Consolidated Appropriations Act of 2021 continues the $300 deduction; however, it is not a deduction for AGI or an itemized deduction but simply a reduction in taxable income (much like the qualified business income deduction).

**Charitable Contributions: Unlimited Itemized Deduction for Individuals.** As discussed in the text, for large contributions and contributions of property there is a long list of complex interrelated limitations that can apply (e.g., cash contributions subject to 60% of AGI, non-cash donations subject to 30% of AGI or 20% for certain others and more). However, the Act generally provides that for 2020 the limitation for cash contributions does not apply. In other words, after considering other current charitable contributions that are subject to various AGI limitations, individuals can claim an itemized deduction for charitable contributions of cash equal to 100% of their AGI. However, this 100% of AGI limit applies to cash contributions made directly to charitable organizations, not to contributions to donor advised funds, supporting organizations or private foundations. Moreover, any cash contributions that exceed the taxpayer’s AGI and which, therefore, are not deducted in 2020 generally can be carried forward subject to the 60% of AGI limit in the succeeding 5 years.

**Page 1-30**

**Alternative Minimum Tax**

**Minimum AMT Credit.** As noted in the text, the Tax Cuts and Jobs Act of 2017 eliminated the alternative minimum tax for C corporations, starting in 2018. Although not discussed in this chapter, upon repeal of the AMT, corporations were allowed to utilize any unused minimum tax credits for the AMT to reduce their tax liability over a four-year stretch through 2021. The Cares Act goes one step further, letting companies immediately claim a refund of any unused AMT credits on their return for either 2018 or 2019, rather than having to wait.

**Page 1-31**

**Tax Credits**

**Employee Retention Credit of $5,000 for Employers Subject to Closure Due to COVID-19**.

**Note.** At this writing, the infrastructure bill known as the Infrastructure Investment and Jobs Act passed by the Senate on August 10, 2021,would end the employee retention credit (ERC) discussed below. Under the CARES Act, only wages paid through **September 30, 2021**, would be eligible for the credit (except for wages paid by an eligible recovery startup business).

To help employers and employees during the crisis, Congress created several tax credits. Among these is one for businesses and nonprofit organizations that were required to suspend or close its operations due to COVID-19, but that continue to pay its employees during the shut-down in hopes of retaining them. This so-called *retention credit* and the PPP loans are key elements of the CARES relief package (see Act § 2301 Employee Retention Credit for Employers Subject to Closure Due to COVID-19).

As noted below, the effect of this credit is to reduce or eliminate the employer’s share of FICA taxes attributable to employee wages and other compensation (i.e., 6.2% of wages). In short, it reduces or eliminates the amount of FICA taxes that the employer must pay. However, ***the credit is not available* if the taxpayer has received a PPP loan** (generally a loan equal to 2.5 times the businesses’ average monthly payroll but not to exceed $10 million). Consequently, the taxpayer must choose between one or the other. Interestingly, it is estimated that the credit will provide an aggregate benefit to businesses of about $54.6 billion**.**

***Eligible Employer****.* An employer is eligible for the retention credit if it meets *either* of two tests:

(1) *COVID-19 Shutdown*. The employer’s operations were fully or partially suspended due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious or other purpose) due to the virus; or

(2 *Gross-Receipts-Decline (GRD)*. The employer’s gross receipts declined by more than 50% when compared to the same quarter in the prior year. Once an employer becomes an “eligible employer” on account of a “significant decline in gross receipts,” the employer remains an eligible employer for any succeeding calendar quarter until the employer’s gross receipts during that calendar quarter are 80% or more than the gross receipts in the comparable calendar quarter in the preceding year.

For tax exempt organizations, only the “fully or partially suspended operations” condition applies to receive the credit.

***Amount of Employee Retention Credit (ERC)****.* Eligible employers (e.g., those that shut down or have a significant decline in gross receipts) are allowed a refundable credit against its 6.2% cost of Social Security taxes (IRC § 3111(a). The amount of the credit is equal to   
**50% of** ***qualified* *wages*** **up to $10,000 of wages** or a **maximum credit of $5,000 *per employee*** (50% x qualified wages of $10,000). Assuming the employer qualifies for a full year of the credit, the employer has a full credit against employee wages for employees whose total wages are equal to or less than $80,645.16 ($5,000/6.2%). The credit is computed based on qualified wages paid or incurred for each employee between March 13, 2020, and December 31, 2020. The fact that the employee may have been dismissed or furloughed is ignored. The amount of qualified wages taken into account for this purpose differs depending on whether the employer had more than 100 employees. ARPA codified the ERC in § 3134 and extended it through 2021. It also increased the credit from $5,000 to $28,000 in 2021.

*Qualified Wages: More than 100 Employees.* In computing qualified wages, special rules apply if the business had an average of more than 100 full-time employees during 2019. First, qualified wages include *only* the wages of employees “who are furloughed or face reduced hours as a result of their employers' closure or reduced gross receipts.” Second, wages are qualified only if they were paid by the employer during the quarter for the period the business was shut down and the employees were not working due to COVID-19. (Act § 2301)

*Qualified Wages: No More than 100 Employees.* If the business had no more than 100 employees (100 or less) for 2019, the credit is calculated on all qualified wages paid after March 12, 2020. Qualified wages include (1) wages paid to employees during a shut-down and (2) wages paid for each quarter that the business suffered a sharp decline in year-over-year receipts, as described above (see *gross receipts decline)*.

In computing the amount of qualified wages in both situations, qualified wages include any “qualified health plan expenses” allocable to the wages, such as amounts paid to maintain a group health plan. In either case, however, the amount of qualified wages for each employee for all quarters may not exceed $10,000.

The retention credit is subject to numerous rules to prevent double-dipping.

* An employer's deduction for wages must be reduced by the amount of any retention credit.
* An employer may not take into account the following wages:
  + Wages of an employee for whom a work opportunity tax credit is claimed.
  + Wages taken into account under § 45S (income tax credit for paid family and medical leave).
  + Wages taken into account under §§ 7001 and 7003 of the Families First Act, which provides payroll tax credits for paid leave required to be provided by small employers.
  + Wages paid to certain related individuals specified in § 51(i)(1)

The retention credit requires an analysis of how a business has been affected by COVID-19 and if the COVID-19 shutdown or the gross-receipts-decline (GRD) tests have been met. The shutdown test requires that a business has been fully or partially suspended due to government action. If the business does not meet the GRD test, it may be unclear whether a business’ operations has been partially suspended. The GRD test also presents unique challenges. For example, employers must analyze gross receipts across all aggregated entities rather than by location (a change from rules associated with prior employee retention credits related to natural disasters).

The CARES Act requires employers to make a choice: obtain a PPP loan that is potentially forgivable or take the retention credit. In making the choice, there are two aspects of retention credit that deserve special consideration. First, the retention credit may substantially reduce or eliminate the FICA tax. Second, any tax that is due can be postponed to 2021 and 2022 (recall discussion for page 1-22 of this supplement concerning when 2020 payroll taxes are due: 50% due on December 31, 2021, and the other half due on December 31, 2022).

**Example 12.**  Alan Smith, CPA, conducts CPE workshops. He is the sole owner and employee of his own S corporation. This year he had to “partially suspend operations” due to the government-imposed restrictions on group meetings for May and June, 2020. This year the corporation paid him $80,645.16 in wages. Note that the FICA taxes paid exactly equal the maximum allowable credit of $5,000 (i.e., 6.2% x $80,645.16 salary = $5,000). The taxpayer must determine whether he should seek a PPP loan or claim the retention credit of $5,000.

The taxpayer computes his retention credit under the rule for businesses with no more than 100 employees. Therefore, qualified wages include not only those paid to employees during a shut-down, but also wages paid for each quarter that the business suffered a sharp decline in year-over-year receipts. In this case, the business was shut down, so the wages are qualified. Thus, the credit is $5,000 (50% x qualified wages up to $10,000 of wages per employee or $5,000). Here, the retention credit of $5,000 is exactly equal to the FICA tax that must be paid and, consequently, would eliminate the expense.

The tax savings increases the company’s profits by a corresponding $5,000. Assuming that the taxpayer is the sole owner and employee of this S corporation and faces a marginal tax rate of 20% for federal income taxes and 5% for state income taxes, this $5,000 of additional profit flowing through on the K-1 would result in an increase of after-tax income of $3,750 (i.e., $5,000 – [(20% + 5% = 25%) x $5,000 =$1,250 in applicable income taxes]).

The taxpayer must determine whether he should obtain a forgivable PPP loan or claim the credit that puts $3,750 in his pocket after tax. Recall that the PPP loan helps cover payroll costs (wages up to $100,000 per employee, employee benefits, and state and local taxes). Employers can also use some of the funds (25%) to cover interest on mortgages, rent, and utilities. If the taxpayer got a PPP loan and uses it to pay the wages, he would not be required to repay the loan. In this situation, it appears that the taxpayer would be better off by seeking a PPP loan.

**Page 1-40**

**Filing Requirements**

**Due Dates for Filing Individual Returns (2019, 2020 and 2021 Returns).** There were no changes to the due dates for corporate tax returns. However, to help individuals during the pandemic, Congress temporarily moved the due dates of individual tax returns (Form 1040). The due date of the 2019 individual tax return was moved from the traditional April 15, 2020, to July15, 2020. The 2020 return due date was moved from April 15, 2021, to May 17, 2021. An extension could be obtained until October 15, 2021. However, the due dates for other returns remained unchanged. At this point, it appears that the normal filing dates for 2021 returns will apply.

CHAPTER 9: TAXATION OF PARTNERSHIPS AND PARTNERS

**Page 9-38**

**Excess Business Losses (EBLs)**

**EBLs and ARPA.** ARPA extends the §461(l) limitation on excess business losses of noncorporate taxpayers for one year, through 2027. As noted above, the rule concerns the $250,000/500,000 limit on business losses (whether passing through on a K-1, or from a Schedule C or F proprietorship) which was part of the TCJA but which was delayed until the 2021 tax year.

**Page 9-39**

**Deduction for Qualified Business Income (QBI): Taxable Income Limitation.** The qualified business income deduction is generally limited to 20% of taxable income before any consideration of the deduction for NOLs (except for any portion of the NOL that is attributable to excess business losses). As noted above, for taxable years beginning *after* December 31, *2020*, the 80% of taxable income limitation on NOLs is reinstated. When determining taxable income for purposes of calculating the 80% limitation on NOLs, the QBI deduction is ignored.

**Example 13.** The year is 2021 and NOLs are generally limited to 80% of taxable income. A married couple has taxable income in 2021 of $100,000 before considering a QBI deduction of $15,000. They also have a pre-2018 NOL of $150,000. With the reinstatement of the 80% of taxable income limitation in 2021, the NOL would be limited to $80,000 (80% x $100,000 of taxable income before the QBI deduction).

CHAPTER 11: S CORPORATIONS

**Page 11-22.**

**Qualified Business Income Deduction.** The qualified business income deduction is generally limited to 20% of taxable income before any consideration of the deduction for NOLs (except for any portion of the NOL that is attributable to excess business losses). As noted above, for taxable years beginning *after* December 31, *2020*, the 80% of taxable income limitation on NOLs is reinstated. When determining taxable income for purposes of calculating the 80% limitation on NOLs, the QBI deduction is ignored.

**Example 13.** The year is 2021 and NOLs are generally limited to 80% of taxable income. A married couple has taxable income in 2021 of $100,000 before considering a QBI deduction of $15,000. They also have a pre-2018 NOL of $150,000. With the reinstatement of the 80% of taxable income limitation in 2021, the NOL would be limited to $80,000 (80% x $100,000 of taxable income before the QBI deduction).

**Page 11-39.**

**Limitation on Business Losses for S Corporations.** As noted in Chapter 9 for this supplement relating to partnerships (comments for page 9-38 on page 38 this supplement above), the Act creates an additional limitation on the deduction of so-called excess business losses (§ 461(l)). The effect is to limit the amount of net business losses (e.g., losses from a sole proprietorship, an S corporation or partnership) that can be deducted from an active—in contrast to passive—owner’s return. This is yet another barrier partners or S shareholders must navigate before they can deduct any losses that flow through.

\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*