

PPP LOANS: CURRENT DEVELOPMENTS AND STRATEGIES FOR A/E FIRMS

At a Glance

The Paycheck Protection Program (PPP) within the CARES Act has had a profound impact on nearly every small business in America. While this program has generally been met with hope and optimism from those that have received the loans, the Engineering community is gravely concerned about some serious unintended consequences.

There are many different situations that a firm must think about, and unfortunately there are no clear-cut answers because not every business is in the same position. Within are some of the more common questions that have been presented and some potential strategies. As every individual situation is different please don't hesitate to contact us if you have any questions.

Scott Sutton, CPA, CDA, MSA

Senior Manager

Cell: 765-438-6570

Email: ssutton@somersetcpas.com**Jenny Ray, CPA**

Principal

Cell: 765-215-3231

Email: jray@somersetcpas.com

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Q1: Is there a due date to ask for forgiveness?

A: With the passage of the PPP Flexibility Act, your first loan payment is not due until 10 months after your 24-week covered period. For most firms this would be the August/September 2021 timeframe. While this may be a practical deadline, technically you may ask for forgiveness at any point before the final loan payment is made.

Q2: The CARES Act said that forgiven loans were not taxable income. Why is the IRS saying otherwise?

A: If your loan is forgiven then the forgiven amount is not taxable income. However, according to IRS Notice 2020-32 and further clarified in Revenue Ruling 2020-27, the IRS holds that any expenses used paid with the money that was forgiven are not deductible for income tax purposes. Therefore, the forgiven loan is, indirectly, taxable income.

Q3: What happens if we are not granted forgiveness until 2021?

A: Unfortunately, there are different answers for both tax and book purposes. For taxes, regardless of when you are granted forgiveness, the expenses associated with forgiveness were spent in 2020 and therefore it is a 2020 taxable event. There is a potential that a firm could deduct the expenses in 2020, but that would require the taxpayer to believe that their eligibility for forgiveness is in doubt at the time of filing the return. It is not an election that can be made. We believe that sets a bad precedent though when eventually applying for forgiveness and may impact the decision to forgive the loan by the SBA.

For book purposes, if you have elected to treat the PPP loan and related forgiveness in accordance with traditional forgiveness of debt accounting (ASC 470), then you would not recognize the income on your Statement of Operations until the loan is formally forgiven by the SBA. That means there will be a book/tax timing difference on your 2020 and your 2021 financials and tax returns.

Q4: What happens if we do not apply for forgiveness at all?

A: If you do not apply for forgiveness, then the loan will stay on your books and be re-paid similar to any other bank note. For those firms that received loans before the passage of the PPP Flexibility Act, that bank loan is due 2 years after the 10-month deferral period. There is a possibility that the bank may be willing to extend the period to 5 years, but this seems unlikely due to the bank's pressure to get these loans off of their own books. Under this scenario the loan would not be a taxable event and would not have an impact to the firm's overhead.

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Q5: How would a forgiven loan impact my overhead rate?

A: According to FAR 31.201-5 Credits: “The applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund.” Therefore, a forgiven loan would need to be treated as a credit to your overhead rate or a cash refund would need to be provided to the governmental agency on the work performed over the 24-week covered period (see question below).

Q6: We spent the PPP funds on both direct and indirect expenses. Should we allocate between the two on our overhead?

A: Currently there is no clear answer to this question. Some CPAs/Agencies believe that the entire amount should be recorded as a credit to overhead expenses regardless of what they were spent on. Others, including Somerset, believe that the credits should follow along with what the expenses were actually spent on. However, according to FAR 31.203 Indirect Costs: “the contractor shall not fragment the base by removing individual elements.” This means that while you would allocate a portion of the forgiven funds to direct labor, you would not post a credit to the overhead schedule.

Q7: Why do we have to credit our overhead at all? Isn't the PPP loan program outside of the original purview of the FAR Credits section?

A: This is the exact issue that ACEC is trying to reverse. Many firms do very little, if any, Federal contracting and don't think that State/Local agencies should get the benefit of lower rates when it was the Federal Government who paid the PPP money.

Q8: Is there any way we can keep this out of our overhead rate completely?

A: Outside of legislation that will supersede FAR 31.201-5 there is one other option, the “cash refund” option. Under this option, a firm would analyze the billings over the covered period and determine the percentage of the costs used for forgiveness on government contracts. The firm would then reimburse the agencies through a reduction in future billings and thus incur no ill impacts to overhead. An example of this follows

- The firm receives a \$1M PPP loan
- Over the covered period, the firm invoices \$2M to government clients and \$2M to private clients

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- Based on this 50/50 split, the firm would reduce future billings to those government clients by \$500k

This method allows firms avoid impacts to their overhead rate that will affect future contracts. It also has the benefit of matching the funds received to the specific Agencies/contracts for which work was performed during the covered period.

Q9: If we are planning to apply for forgiveness in 2021, we should not take the deduction for tax purposes in 2020 according to the IRS. But what if we don't know if we are going to ask for forgiveness?

A: For this reason, we are advocates of extending your tax returns due next spring so that you have more time to make the decision on forgiveness (see question below).

Q10: Should we extend our Corporate and Individual tax returns (for flow-through entities)?

A: Many firms are looking to do just that for their 2020YE tax returns in order to gain a little extra time before filing in the hopes that Congress passes legislation to fix the tax deductibility issue. With an extension, firms will not have to amend their 2020 tax returns later on if it takes congress a while to fix these issues. The only problem with this is that while you can extend your returns, you cannot extend any tax payments that are due. For flow-through entities, that means that the individual shareholders would have to pay their share of the 2020 tax liability by 4/15/21 even though the extended return would not be due until 10/15/21. This creates a potential headache for firms that pay a specific shareholder distribution to cover this tax liability, but who ultimately end up not seeking forgiveness. There would have to be good communication between the shareholders that this additional distribution should be applied to the shareholder's 2021 tax return rather than refunded to the shareholder.

Q11: What if we don't take the deduction in 2020 and then we end up paying back the loan in 2021?

A: If you did file your return and did not deduct the expenses associated with forgiveness then the IRS allows you to amend your 2020 tax return to take the deduction. Extending your return will help to avoid this issue. This strategy brings up another issue: What happens if you make additional shareholder distributions to cover the potential tax liability then end up not asking for forgiveness? In that case, the additional distribution should most likely be applied to each shareholder's 2021 tax liability. This will call for good communication between the shareholders to make sure that everyone is aware of the issues.

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Q12: If the loan is forgiven, how does that affect the payroll expenses used to calculate my R&D credit?

A: There has been significant discussion about this recently and unfortunately, we believe there will be an adverse impact on the R&D credit calculation. The thinking is that if the IRS does not allow the payroll used to achieve forgiveness as deductible for income tax purposes then they are unlikely to allow those same payroll expenses to calculate the R&D credits even though they are still W-2 wages to the employees.

Q13: Do we need a Company policy to document our position?

A: Yes. The Company should create a written policy for how they will handle the PPP Loan forgiveness and then stick with that policy. The policy and a disclosure of the amount of the PPP Loan and forgiveness should be included in *all* contract negotiations for the next year. Also, you should disclose the forgiveness in notes for billings of cost plus fixed fee contracts. Even if the Company doesn't ask for forgiveness, the Company should disclose this so the DOT's understand the Company's policy.