CARES Act ? IRS Guidance Regarding M&A Transactions and Deductibility of PPP Loan Expenses

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The IRS recently released long overdue guidance removing certain CARES Act tax-related obstacles to merger and acquisition transactions.

Under the CARES Act, an employer is permitted to take advantage of either the Employee Retention Credit ("ERC") or a PPP loan, but not both. For this purpose, multiple entities may be treated as a single employer if they share common ownership. This rule created confusion in connection with mergers and acquisitions. For example, there was uncertainty whether a company that claimed the ERC would still be entitled to its ERC if it acquired a target company with an outstanding PPP loan. The IRS previously released frequently asked questions ("FAQ") No. 79 provided a safe harbor for any company which paid off its PPP loan by May 18, 2020 that it would be treated as if the company never received a PPP loan. However, many target companies had PPP loans outstanding post-May 18th and acquirors were hesitant to acquire such a target if the acquisition could jeopardize the acquiror's existing ERCs. Moreover, as a result of the employer aggregation rules, a private equity fund that acquired a company with a PPP loan could jeopardize the ERCs taken by other portfolio companies of the private equity fund. As a result of these rules, many acquisitions that would otherwise have been structured as stock purchases were structured as asset transactions.

To resolve this problem, the IRS released FAQ No. 81a. In this FAQ, the IRS allows an acquiror which has taken ERCs to acquire a target company with a PPP loan provided the target either (1) repays the PPP loan prior to being acquired or (2) submits a forgiveness application to the PPP lender and establishes an interest-bearing escrow account in accordance with paragraph 2.a of the SBA October 2, 2020 Notice. In this case, the acquiring group (including the target company) may claim the ERC for qualified wages paid on and after the closing date. In addition, any ERCs claimed by the acquiring company prior to the closing date will not be subject to recapture under the CARES Act.

Even if a target company is not in compliance with the preceding paragraph, an acquiror will still not be treated as having received a PPP loan, provided that the acquiror (including any member of the acquiror's group) had not received a PPP loan at any time and the acquiror will therefore still be eligible to claim ERCs. However, a target company that received a PPP loan prior to the transaction closing date and that continues to be obligated on the PPP loan after the closing date is ineligible for the ERC for any wages paid to any employee of the target company before or after the closing date.

There was also some uncertainty as to whether the PPP loan of a seller in an asset transaction would have an impact on the acquiror's ERC eligibility. The IRS clarified that if an acquiror does not assume the seller's PPP loan it will not be treated as having received a PPP loan. In addition, even if an acquiror assumes a seller's PPP loan in an asset acquisition, the acquiror is still not treated as having received a PPP loan, although it will be subject to a limitation that any wages paid to an employee previously employed by the seller will not be treated as qualified wages.

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Separately, the IRS also released Revenue Ruling 2020-27, providing valuable guidance on the deductibility of expenses paid with PPP loan proceeds. The Revenue Ruling elaborates on the IRS's earlier guidance that no deductions are allowed for an otherwise eligible expenseif the expense is used to support the forgiveness of a PPP loan. The Revenue Ruling clarifies that a taxpayer may not deduct the eligible expenses if it has a "reasonable expectation of forgiveness" of the PPP loan by the end of tax year 2020, even if the forgiveness will happen after the end of the tax year. The Revenue Ruling highlights that a taxpayer can have a reasonable expectation of forgiveness even if the taxpayer has not applied for forgiveness by the end of the year, if the taxpayer satisfied all the requirements for the PPP loan to be forgiven. While there are no factors or definitions as to the definition of a "reasonable expectation," if a taxpayer expects to request and obtain PPP loan forgiveness, they should not deduct the otherwise eligible expenses even if the loan forgiveness is expected to take place in a future year.

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