



## Federal Tax ADVISORY ■

**DECEMBER 3, 2020**

### IRS Issues CARES Act Guidance Addressing Tax Issues Prevalent in M&A Transactions

In a series of guidance taking various forms, all issued in the same week, the IRS has provided much-needed clarity on the interaction of two significant, but mutually exclusive, benefits offered under the Coronavirus Aid, Relief, and Economic Security (CARES) Act and also reaffirmed its position on the nondeductibility of expenses funded with loan proceeds under the Paycheck Protection Program (PPP).

#### **PPP Loans and Employee Retention Credits**

Under the CARES Act, a PPP loan borrower cannot also claim employee retention credits (ERTCs). In fact, no member of a PPP loan borrower's "aggregated group" can claim ERTCs.

Since the CARES Act was enacted, M&A practitioners have struggled with how the ERTC and PPP loan provisions interact with one another when a target is a PPP loan borrower and the buyer (or a member of its aggregated group) has claimed ERTCs. The concern is that when the PPP loan borrower becomes part of the buyer's aggregated group, it could taint the group, causing potential recapture of prior ERTCs claimed by the group and prohibiting members of the group (that did not otherwise receive a PPP loan) from claiming ERTCs going forward. This issue is especially acute for private equity funds, which can have numerous portfolio companies treated as part of an acquiring fund's aggregated group for ERTC purposes. When considering a new target with a PPP loan (even if the loan was ultimately returned by May 18, 2020, in which case the borrower is treated as never having received a PPP loan for ERTC purposes, but nevertheless gave rise to lingering recapture risk in the view of the most cautious of advisors), these ERTC risks often caused the parties to restructure transactions in an effort to mitigate potential adverse tax consequences, often reverting from stock to assets sales with significant corporate and tax implications.

On November 16, 2020, the IRS added [FAQs 81a and 81b](#) to its list of guidance on ERTCs, which provides guidance that will help buyers and sellers better understand the implications of acquiring a target that has (or that has taken but returned, paid off, or had forgiven) a PPP loan.

The guidance addresses circumstances when an acquiring employer acquires either (1) the stock or other equity interests; or (2) the assets and liabilities of an entity (a target employer) that has received a PPP loan.

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## **Equity acquisitions**

When a target employer, before an equity acquisition, either (1) fully satisfies its PPP loan in accordance with Section 1 of the [Small Business Administration's October 2, 2020 notice](#) (via repayment or forgiveness in full); or (2) submits a forgiveness application and establishes an escrow account in accordance with Section 2.a of the SBA notice, then after the acquisition date, the acquiring employer (and its aggregated group, including the target employer) will not be treated as having obtained a PPP loan, provided the acquiring employer (and any member of its pre-transaction aggregated group) had not received a PPP loan before the closing date and no member of its aggregated group receives a PPP loan on or after the closing date. In this circumstance, the acquiring employer and any member of its aggregated group (including the target employer after the acquisition) can claim ERTCs for qualified wages paid on and after the closing date. Furthermore, ERTCs for qualified wages paid by the acquiring employer and any member of its aggregated group before the closing date will not be subject to recapture.

Relief is also provided in the case of equity acquisitions even if the PPP loan is not fully satisfied or if a forgiveness application is not submitted (and an escrow account is not established) before the closing date in accordance with Section 1 or 2.a of the SBA notice. However, in these circumstances, the target employer that received the PPP loan before the acquisition date but that remains obligated under the loan after the closing date is ineligible for ERTCs on any qualifying wages it pays before or after the closing date. This raises additional issues and open questions. Buyers should be aware that, while an acquisition of a target that is a PPP loan borrower in this circumstance will not cause its ERTCs to be recaptured, it will not be able to have the target employer claim ERTCs for its own qualified wages. Also, what happens once the PPP loan is fully satisfied after closing – could the target employer claim ERTCs for qualifying wages paid after the loan is fully satisfied? Also, how is this limitation applied after post-closing restructurings (i.e., moving employees to a new entity via a post-closing merger)?

## **Asset acquisitions**

When an acquiring employer acquires the assets and liabilities of a target employer, but does not assume its obligations under the PPP loan, any ERTCs claimed by the acquiring employer before the closing date will not be subject to recapture, and the acquiring employer will also be eligible to claim ERTCs after the closing date, provided the acquiring employer (or any member of its aggregated group) did not receive a PPP loan before, and does not receive a PPP loan after, the acquisition. However, in an asset sale where the acquiring employer assumes a target employer's obligations under the PPP loan, the acquiring employer cannot claim ERTCs for qualifying wages paid post-closing to any individual employed by the target employer on the closing date. Subject to this limitation, however, the acquiring employer can otherwise claim ERTCs after the closing date. Additional guidance may be necessary, for example, to address circumstances when an employee is let go by the target employer before the closing date (and thus not employed by the target on that date) and rehired by the acquiring employer post-closing.

## **Nondeductibility of PPP Loan Expenses**

In [Rev. Rul. 2020-27](#), the IRS confirmed its position (issued earlier this year in [Notice 2020-32](#)) that expenses paid or incurred from proceeds of forgiven PPP loans cannot be deducted. The ruling clarifies that such expenses are nondeductible even if a PPP loan is forgiven in a later tax year. In one scenario described in the ruling, a PPP loan borrower pays "eligible expenses" (meeting the requirements under the CARES Act to be eligible for loan forgiveness) and applies for forgiveness in November 2020 but does not receive a determination from the lender by the end of 2020. In a second scenario, the facts are the same except the borrower does not apply for forgiveness in 2020 but expects to apply in 2021. The IRS ruled that in both scenarios the taxpayer had a reasonable expectation of forgiveness and could not deduct those expenses.

Congress has criticized the IRS on its position in no uncertain terms. One day after the ruling was released, the Senate Finance Committee issued a bipartisan [statement](#) affirming that their intent in the CARES Act was not to deny taxpayers these deductions, urging the IRS to reconsider its position, and expressing an expectation that Congress would clarify this intent in subsequent legislation.

In companion guidance, the IRS in [Rev. Proc. 2020-51](#) provided a safe harbor for PPP loan borrowers who have had their forgiveness requests fully or partially denied (or who decide to withdraw requests). These borrowers *are* allowed to claim deductions for covered expenses and can claim these deductions on their 2020 original tax return, on a 2020 amended tax return or administrative adjustment request, or on their original tax return for the subsequent tax year in which the forgiveness request was denied or withdrawn.

Buyers often request representations from sellers with PPP loans that no proceeds from such loans have been improperly deducted. In light of the safe harbor, sellers in appropriate circumstances should consider provisions that recapture the benefit of permitted deductions if a forgiveness application is denied or withdrawn after closing (or if the IRS's position is superseded by Congress).

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In case you missed it, hear what our panel of tax attorneys had to say about the key tax provisions of the CARES Act and other developments currently affecting foreign multinationals and high-net-worth individuals, including how taxpayers are reacting to the new environment. Click for our [Japan-focused discussion](#) or click for our [Europe-focused discussion](#).

Our tax team also joined our Intellectual Property Group for a webinar to discuss "[Tax and Litigation Implications of Intellectual Property Ownership & Licensing](#)."

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

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