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Partnership Taxation and the Paycheck Protection Program: Understanding Existing Guidance and How to Resolve Outstanding Issues

BLAKE BRACHT*

ABSTRACT:

When Congress established the Paycheck Protection Program as part of the response effort to the COVID-19 pandemic, it failed to anticipate the multiple tax uncertainties that resulted from tax-exempt loan forgiveness. Despite further legislation addressing various concerns, guidance by the Internal Revenue Service has been complex and confusing in some areas and wholly lacking in others. This article identifies tax issues raised by the Paycheck Protection Program, explains the existing IRS guidance, and suggests a framework for future guidance regarding the sale of a partnership interest.

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I. INTRODUCTION

American taxpayers, especially those with partnership-derived income, are in urgent need of guidance from the Internal Revenue Service. The Paycheck Protection Program (“PPP”) was among the many relief provisions enacted by Congress in response to the COVID-19 pandemic. The current statutory language governing the PPP and over-broad guidance from the Service creates uncertainty for partnerships on the correct reporting of certain income from forgiveness of loans extended under the PPP and other issues related to capital accounting in cases of sale of a partnership interest.

While Congress made clear that the forgiveness of PPP loans would be considered tax-exempt income for the purpose of partnership tax preparation, it was unclear when that income should be reported. Due to the timeline of the forgiveness process, loans taken in 2020 and used to pay for deductible expenses in 2020 may not be formally forgiven until a later tax year. For partnerships and other entities subject to Subchapter K of the Internal Revenue Code¹ and the corresponding regulations, the timing of tax-exempt income can affect a partner’s outside basis in the partnership at the end of a tax year, and thus when losses can be claimed on that partner’s income tax filing.² Furthermore, the nature of PPP loans creates significant capital accounting complexities in situations involving the sale of a partnership interest. This article will discuss the legislative history and basic provisions of the PPP, evaluate the problems created by current guidance about the timing of resulting tax-exempt income, and suggest new guidance to best reflect the intent of the PPP and economic reality.

II. LEGISLATIVE AND REGULATORY HISTORY

A. CARES Act and Paycheck Protection Program

On March 27, 2020, President Donald J. Trump signed into law the Coronavirus Aid, Relief and Economic Security Act (“CARES Act”).³ Among other provisions of the expansive legislation, the CARES Act established the Paycheck Protection Program.⁴ The PPP created a system of low-interest loans to small businesses as an incentive to keep workers on payroll during the COVID-19 pandemic, to be administered by the Small Business Administration (“SBA”).⁵ Although maintaining payroll costs and employee compensation was the primary purpose of the loans, loan proceeds could be used for certain other “covered” expenses, including

1. All section references or “Code” are to the Internal Revenue Code of 1986, codified as Title 26 of the United States Code, as amended, or the Treasury regulations promulgated thereunder unless otherwise specified.

2. A similar issue arises for S corporations; however, the scope of this comment is limited to the issue as it relates to partnerships.

3. Coronavirus Aid, Relief and Economic Security Act (CARES Act), Pub. L. No. 116-136, 134 Stat. 281 (2020).

4. *Id.* § 1102.

5. *First Draw PPP Loan*, SMALL BUS. ADMIN., <https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/first-draw-ppp-loan> (last visited Sep. 24, 2021).

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health benefit costs, mortgage interest, rent, utilities, and interest on other previously acquired loans.⁶

PPP loans carried certain eligibility requirements. In general, businesses with fewer than 500 employees were eligible for loans under the program.⁷ Borrowers were generally eligible for up to 24 months of their average monthly payroll cost from 2019, plus 25% of that amount, with an upper limit of \$10 million.⁸ PPP loans issued prior to June 5, 2020, have a maturity of two years, and loans issued after June 5, 2020, have a maturity of five years.⁹ All PPP loans carry a one-percent annual interest rate.¹⁰

Certain businesses that took out an initial PPP loan were eligible for a “second draw” PPP loan.¹¹ Second draw loans carried essentially the same terms as initial PPP loans but held extra eligibility requirements.¹² Businesses with fewer than 300 employees were eligible for second draw loans if they had already taken an initial PPP loan, spent the entirety of proceeds on eligible expenses, and could demonstrate at least a 25% reduction in gross receipts between comparable quarters in 2019 and 2020.¹³ Businesses eligible for a second draw loan were generally limited to 250% of monthly payroll costs in 2019 or 2020, with an upper limit of \$2 million.¹⁴ PPP loans closed to borrowers on May 31, 2021.¹⁵ By May 31, 2021, over 11.8 million loans were approved, with just short of \$800 billion in proceeds distributed.¹⁶ The overall average loan was \$42,000 per borrower.¹⁷

Importantly, PPP loans are eligible for forgiveness as long as the borrower meets certain criteria.¹⁸ The criteria include maintenance of the number of employees and pay, that proceeds were used to pay covered expenses, and at least 60% of proceeds were used for payroll costs.¹⁹ Furthermore, the proceeds must have been spent during the “covered period,” which was typically the 24 weeks following the origination of a PPP loan.²⁰ Congress saw fit to relieve borrowers of the tax burden normally assigned to discharge of indebtedness,²¹ and excluded forgiveness of PPP loans from gross income for purposes of the Internal Revenue Code of 1986.²²

6. *Id.*; CARES Act § 1102(a)(1)(F).

7. *First Draw PPP Loan*, *supra* note 5.

8. *Everything You Need to Know About the Paycheck Protection Program*, BENEFITS.GOV (May 27, 2020), <https://www.benefits.gov/news/article/399>.

9. *First Draw PPP Loan*, *supra* note 5.

10. *Id.*

11. *Second Draw PPP Loan*, SMALL BUS. ADMIN., <https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/second-draw-ppp-loan> (last visited Sep. 24, 2021).

12. *Id.*

13. *Id.*

14. *Id.*

15. *First Draw PPP Loan*, *supra* note 5.

16. SMALL BUS. ADMIN., *Paycheck Protection Program (PPP) Report: Approvals Through May 31, 2021*, https://www.sba.gov/sites/default/files/2021-06/PPP_Report_Public_210531-508.pdf.

17. *Id.*

18. CARES Act § 1106; *PPP Loan Forgiveness*, SMALL BUS. ADMIN., <https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/ppp-loan-forgiveness> (last visited Nov. 1, 2021).

19. CARES Act § 1106; *PPP Loan Forgiveness*, *supra* note 18.

20. *PPP Loan Forgiveness*, *supra* note 18.

21. I.R.C. § 61(a)(11).

22. CARES Act § 1106(i).

The mechanism by which loan proceeds were distributed to borrowers and the formal forgiveness process is also crucial to understanding PPP loans. PPP loans were not issued directly by the federal government but rather were issued by more conventional lenders such as banks and credit unions.²³ The SBA guaranteed the amount of the loans using funds appropriated under the CARES Act.²⁴ Congress appropriated \$349 billion for the guarantee of PPP loans under the CARES Act, to be available until September 30, 2021.²⁵ Shortly after, Congress increased appropriations to the PPP under the CARES Act to \$670.335 billion.²⁶ Following the depletion of those available funds, Congress appropriated an additional \$284.45 billion for PPP loans in the 2021 Consolidated Appropriations Act.²⁷ These “guarantee” funds are the appropriations with which private lenders are reimbursed by the SBA.

Forgiveness is also processed by the commercial lender.²⁸ For a PPP loan to be forgiven, the borrower must submit an application to the lender servicing the loan, which must include documentation on the number of employees and compensation, as well as documentation for eligible expenses paid.²⁹ Lenders are prohibited from forgiveness for PPP loans without an application containing the appropriate documentation.³⁰ Lenders must issue a decision on forgiveness within 60 days from the receipt of an application.³¹

Functionally, this means that private lenders provide cash for the initial loan distribution to borrowers. Once some amount of a PPP loan is forgiven, the private lender is reimbursed for the amount forgiven by the SBA from the “guarantee” funds appropriated in the CARES Act. For amounts that are ineligible for forgiveness, the private lender would now collect on that debt pursuant to the terms of the loan, just as with any other commercial loan.

B. Initial IRS Guidance on PPP Loan Forgiveness

The CARES Act was silent on deductibility of expenses paid with loan proceeds which are expected to be forgiven, prompting guidance from the Service. Ordinarily, § 162 of the Code provides that certain expenses incurred in carrying on a trade or business are deductible.³² The Service released Notice 2020-32, which clarified that expenses paid by PPP loan proceeds result in the forgiveness of the loan are not deductible.³³ Notice 2020-32 relied primarily on § 265(a)(1) of the Code and section 1.265-1 of the Income Tax Regulations, which provide that no deduction is allowed when the ordinarily deductible expense is allocable to classes of income

23. Elizabeth Renter & Steve Nicastro, *Paycheck Protection Program 2.0: How to Apply for a New PPP Loan*, NERDWALLET (May 27, 2021), <https://www.nerdwallet.com/article/small-business/paycheck-protection-program>.

24. *Id.*; see also CARES Act § 1107(a)(1).

25. CARES Act § 1107(a)(1).

26. Paycheck Protection and Health Care Enhancement Act, Pub. L. No. 116-139, § 101(a)(2), 134 Stat. 620 (2020).

27. Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, § 323(d), 134 Stat. 1979 (2020).

28. CARES Act § 1106(e).

29. *Id.*

30. *Id.* § 1106(f).

31. *Id.* § 1106(g).

32. See I.R.C. § 162.

33. I.R.S. Notice 2020-32, 2020-21 IRB 837 (May 18, 2020) (obsolete due to subsequent legislation) <https://www.irs.gov/pub/irs-drop/n-20-32.pdf>.

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excluded from gross income.³⁴ Following Notice 2020-32, the Service released Revenue Ruling 2020-27, which further clarified that expenses were not deductible even if the forgiveness was expected in a subsequent tax year.³⁵

C. COVID-Related Tax Relief Act of 2020

Following general disapproval in the media and from the business community of the Service's rulings on deductibility,³⁶ Congress ultimately disagreed with the Service's application of the CARES Act and effectively overruled Notice 2020-32 and Rev. Rul. 2020-27 as part of the Consolidated Appropriations Act, 2021.³⁷ More specifically, § 276 of the COVID-Related Tax Relief Act of 2020 addressed these industry concerns.³⁸ Congress resolved the deductibility question by stating explicitly in the text: "no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income."³⁹ Furthermore, Congress clarified that for partnerships, the amount excluded from gross income due to PPP loan forgiveness is to be treated as tax-exempt income under § 705 of the Code.⁴⁰ In keeping with Congress's amendment to the PPP, the Service released Revenue Ruling 2021-2, which acknowledged Notice 2020-32 and Rev. Rul. 2020-27 obsolete as of the passage of the Consolidated Appropriations Act, 2021.⁴¹

III. PPP LOAN FORGIVENESS AND PARTNERSHIP BASIS

While Congress resolved the deductibility issue, it created a new issue for partnerships in the form of tax-exempt income. Section 276 of the COVID-Related Tax Relief Act of 2020 provides both that the amount of PPP loan forgiveness is effectively tax-exempt income for partnerships and that no basis increase is denied as a result.⁴² When a partnership receives tax-exempt income, each partner's basis in the partnership is increased by their share of the income for the taxable year in which it is received.⁴³

A partner's basis in the partnership entity, referred to as "outside basis," essentially serves the purpose of tracking a partner's investment in the partnership.⁴⁴ This measure serves the dual purpose of calculating gain or loss upon disposition of the partnership interest and ensuring that no income is improperly taxed more than once.⁴⁵ Outside basis is separate and distinct from "inside basis," which typically

34. *Id.*

35. Rev. Rul. 2020-27, 2020-50 IRB 1552 (Dec. 7, 2020) (obsolete due to subsequent legislation) <https://www.irs.gov/pub/irs-irbs/irb20-50.pdf>.

36. See e.g. Darla Mercado, *Trade Groups Push Lawmakers for Deductibility of PPP Loan Business Expenses*, CNBC (Dec. 7, 2020) <https://www.cnbc.com/2020/12/07/trade-groups-push-congress-to-deduct-ppp-loan-business-expenses.html>.

37. Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, § 276, 134 Stat. 1979 (2020).

38. *Id.*

39. *Id.* § 276(a)(1).

40. *Id.* § 276(a)(i)(3).

41. Rev. Rul. 2021-2, 2021-4 IRB 495.

42. COVID-Related Tax Relief Act of 2020 § 276(a)(1).

43. I.R.C. § 705(a)(1)(B); 26 C.F.R. § 1.705-1(a)(2)(ii).

44. McKee et al., *Federal Taxation of Partnerships and Partners* § 6.02(2) (2021).

45. *Id.*

refers to the partnership entity's basis in specific assets owned by the partnership.⁴⁶ By including tax-exempt income in the calculation of outside basis, section 705(a) effectively prevents the tax-exempt income from being taxed at the sale or disposition of the partnership interest.⁴⁷

A significant complexity in the calculation of outside basis is a partner's share of liabilities. Under section 752 principles, any increase in a partner's share of the liabilities of the partnership is considered a contribution to the partnership and increases outside basis.⁴⁸ Calculation of a partner's share of liabilities is a complex endeavor. As related to PPP loans, it is important to address that "recourse" and "nonrecourse" liabilities are treated differently when calculating a partner's share of liabilities.⁴⁹ Recourse liabilities are those liabilities for which any partner bears the economic risk of loss.⁵⁰ Economic risk of loss is essentially an application of economic reality as to who ultimately incurs a loss when a debt is either forgiven or becomes uncollectible.⁵¹ Nonrecourse liabilities are those for which no partner bears the economic risk of loss, or that no partner would be personally responsible for if all assets of the partnership were destroyed.⁵² For purposes of this calculation, PPP loans disbursed to eligible borrowers and used for covered expenses are considered nonrecourse liabilities.⁵³

The regulations governing the allocation of nonrecourse liabilities largely contemplate liabilities secured only by some kind of property, with no recourse beyond the value of that property.⁵⁴ However, as PPP loans are both nonrecourse and unsecured, much of the complexity underlying sharing of nonrecourse liabilities does not apply to PPP loans and falls under "excess nonrecourse liabilities."⁵⁵ Excess nonrecourse liabilities are treated with rather large deference to allocations in the partnership agreement but generally are shared in the same allocations as profit.⁵⁶

Outside basis is also a factor in calculating the amount of losses a partner may be entitled to recognize from the partnership in a given year. In general, a partner is allowed to take losses on their individual tax return in any one tax year only to the extent of that partner's available outside basis.⁵⁷ When a partner's distributive share of loss is in excess of available basis, the partner is only allowed to recognize loss for income tax purposes to the extent outside basis is available.⁵⁸ Any remaining losses are set aside and are carried over to be recognized in future years in which basis becomes available.⁵⁹ Outside basis can become available either by further

46. *Calculating Adjusted Tax Basis in a Partnership or LLC: Understanding Inside vs. Outside Basis*, AMERICAN INSTITUTE OF CERTIFIED TAX PLANNERS, <https://certifiedtaxcoach.org/calculating-adjusted-tax-basis-in-a-partnership-or-llc-understanding-inside-vs-outside-basis/>.

47. McKee, *supra* note 44.

48. I.R.C. § 752(a); I.R.C. § 722.

49. *See* Treas. Reg. § 1.752-1.

50. *Id.* § 1.752-1(a)(1).

51. *See id.* § 1.752-2.

52. *Id.* § 1.752-1(a)(2).

53. 15 U.S.C. § 636(a)(36)(F)(v) (loan proceeds that are not used for a covered purpose are recourse loans and, thus, only loans eligible for forgiveness are nonrecourse).

54. *See* Treas. Reg. § 1.752-3.

55. *Id.* § 1.752-3(a)(3).

56. *Id.*

57. I.R.C. § 704(d)(1).

58. *Id.* § 704(d)(2).

59. *Id.*

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contribution to the partnership by the partner, thus increasing basis, or by income in excess of losses in future years.⁶⁰

Available outside basis is not the only limitation on recognition of losses. Taxpayers are also limited to loss to the extent basis is considered “at-risk” by the Code.⁶¹ The amount at risk generally is the amount of money and basis of property contributed, as well as borrowed amounts for which the taxpayer is personally liable or has pledged some outside property unrelated to carrying on the trade or business to secure the borrowed amount.⁶² Because PPP loans are nonrecourse against partners and no property secures them, the amount of PPP loans are not considered “at-risk.” Even though the Code generally allows a partner to recognize losses to the extent outside basis is available, the at-risk provisions function to further limit allowable loss.⁶³ The regulations appear to create a distinction between tax basis and at-risk basis due to the limitation of loss principles.⁶⁴ Thus, any portion of outside basis attributable to PPP loans may be included in tax basis but would not be available as at-risk basis for purposes of determining allowable loss in the current year.⁶⁵

As a functional matter, the at-risk rules create a somewhat confusing scenario in which not all outside basis is available to a partner in calculating allowable losses. Consider the following illustration:

A is a 50% partner in AB Partnership. At the beginning of the year, A’s outside basis is zero. During the year, AB Partnership incurs a PPP loan of \$1 million. Of that liability, \$500,000 is allocated to A, increasing A’s outside basis to \$500,000. During the year, AB Partnership incurs operating losses of \$1 million. A is allocated 50% of those losses in accordance with the partnership agreement. However, even though A seems to have enough outside basis to deduct the loss under section 704(d), the \$500,000 loss is still suspended until future years because the PPP loan is nonrecourse and, therefore, not at-risk. A’s outside basis will still be reduced to zero, but A will not be able to recognize that loss until future years when at-risk basis becomes available.

Ultimately, this means that the tax-exempt income and corresponding change in at-risk treatment of outside basis resulting from forgiveness of a PPP loan may allow a partner to take a greater loss on income taxes in the year when the loss actually occurred, as opposed to carrying over the loss to future years. For example, in the illustration in the preceding paragraph, if AB Partnership’s PPP loan is deemed forgiven during the year, A’s outside basis is decreased to zero due to the reduction in share of liabilities but is simultaneously increased by \$500,000 due to recognition of tax-exempt income due to forgiveness of the loan. Thus, A’s outside basis has a net-zero change due to the forgiveness, but the \$500,000 basis can no longer be allocated to a nonrecourse liability and is therefore now considered at-risk. In this scenario, A would be allowed to recognize the full \$500,000 share of

60. *Id.* § 705(a)(1).

61. *Id.* § 465(a)(1).

62. *Id.* § 465(b)(1)-(2).

63. See *Uri v. Comm’r*, 56 T.C.M. (CCH) 1217 (1989), *aff’d* 949 F.2d 371 (10th Cir. 1991) (applying basis rules to Subchapter S corporation, stating that at-risk analysis is only necessary if the basis was available due to assumption of liability, as it would be in a partnership).

64. See Vicki R. Carney & Tracy D. Lee, *Revisiting At-Risk Rules for Partnerships*, THE TAX ADVISER (Apr. 1, 2019), <https://www.thetaxadviser.com/issues/2019/apr/revisiting-at-risk-rules-partnerships.html>.

65. See Hunter Norton, *Application of Tax Basis and At-Risk Loss Limitations to Partners*, THE TAX ADVISER (Feb. 29, 2012), <https://www.thetaxadviser.com/issues/2012/mar/clinic-story-04.html>.

operating loss on that year's individual tax returns, and outside basis at the end of the year would be reduced to zero. No loss would be suspended and carried over into a future year, even though there has been no change in outside basis.

IV. RECENT GUIDANCE ON TIMING OF PPP LOAN FORGIVENESS INCOME

A. *Uncertainty Prior to November 2021*

Unfortunately, Congress failed to be explicit about the timing of tax-exempt income from PPP loan forgiveness. As illustrated previously in Rev. Rul. 2020-27, it has been perfectly foreseeable that loan proceeds distributed in 2020 that are reasonably expected to be forgiven may not be forgiven until a later tax year.⁶⁶ In fact, the SBA's data suggests that forgiveness in a later tax year is the reality for many borrowers. In 2020, the SBA approved over 5 million PPP loans and distributed over \$500 million of loan proceeds.⁶⁷ By January of 2021, the SBA approved forgiveness for 1.1 million loans with over \$100 million forgiven.⁶⁸ This leaves at least 3.9 million loans dispersed in 2020 that could not possibly be formally forgiven until 2021 or later. As of September 26, 2021, over 4.5 million, or roughly 89%, of 2020 PPP loans have been fully or partially forgiven.⁶⁹ For PPP loans taken in 2021, only 39% had been forgiven as of September 26, 2021.⁷⁰ This data suggests a similar problem is likely for loans taken in 2021 but not forgiven until 2022.

As pointed out in a letter from the American Institute of Certified Public Accountants ("AICPA") in March 2021, guidance available at that time was woefully insufficient to inform taxpayers with partnership-derived income of acceptable reporting practices regarding timing of tax-exempt income for partnerships.⁷¹ The AICPA letter provides helpful illustrations on the practical effect this timing issue can have on losses eligible to be taken in a given tax year but,⁷² due to focusing on S Corporations, the authors of the AICPA letter do not address the complexity added in a partnership scenario due to sharing of nonrecourse debt under income tax regulations and the effect of § 465 at-risk debt principles. Consider the following example illustrating how this issue might affect a partnership:

AB Partnership receives a PPP loan of \$1 million in 2020. A and B are general partners who share profits and losses equally. Both A and B have outside bases of zero at the beginning of 2020, which are increased to \$500,000 each due to the share

66. See Rev. Rul. 2020-27, 2020-50 IRB 837 (Dec. 7, 2020).

67. SMALL BUS. ADMIN., *Paycheck Protection Program (PPP) Report: Approvals Through January 24, 2021*, https://www.sba.gov/sites/default/files/2021-01/PPP_Report_2021_01_24-508.pdf.

68. SMALL BUS. ADMIN., *1.1 Million Paycheck Protection Program Loans Forgiven So Far Totaling Over \$100 Billion* (Jan. 12, 2021), <https://www.sba.gov/article/2021/jan/12/11-million-paycheck-protection-program-loans-forgiven-so-far-totaling-over-100-billion>.

69. SMALL BUS. ADMIN., *Forgiveness Platform Lender Submission Metrics* https://www.sba.gov/sites/default/files/2021-09/2021.09.27_Weekly%20Forgiveness%20Report_Public-508.pdf (Data as of September 26, 2021).

70. *Id.*

71. Letter from Christopher W. Hesse, Chair, AICPA Tax Executive Committee, to Holly Porter, Assoc. Chief Counsel Passthrough & Special Industries, IRS, & John Moriarty, Assoc. Chief Counsel Income Tax & Accounting, IRS (Mar. 15, 2021), <https://www.journalofaccountancy.com/content/dam/jofa/news/aicpa-ppp-forgiveness-s-corp-partnerships.pdf> (last accessed Sep. 22, 2021).

72. *See id.*

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of the nonrecourse PPP loan. With no other adjustments to A or B's bases, A will not be able to utilize any of their \$500,000 share of loss in 2020 because the entirety of their outside bases is attributable to nonrecourse debt and, therefore, not at-risk. Outside basis is still reduced to zero, and they must instead apply that loss in future years as at-risk basis becomes available, either through income or further capital contributions.

If the full \$1 million loan is forgiven in this example and the resulting tax-exempt income is applicable to the 2020 tax year, A and B would not see any change in the amount of their outside bases but would instead see an increase in the amount of their outside bases considered at-risk. They would each now have enough at-risk outside basis available to recognize the full amount of losses allocated in 2020, instead of deferring that tax benefit to future years.

B. November 2021 Guidance

After over a year of uncertainty for taxpayers, the Service released a trio of revenue procedures to address issues raised in the AICPA's letter in late 2021. The most important of these procedures is Revenue Procedure 2021-48, which is essentially the regulatory equivalent of a shoulder shrug.⁷³ Revenue Procedure 2021-48 states that "taxpayers may treat amounts that are excluded from gross income (tax-exempt income) in connection with the forgiveness of Paycheck Protection Program (PPP) Loans as received or accrued: (1) as eligible expenses are paid or incurred, (2) when an application for PPP Loan forgiveness is filed, or (3) when PPP Loan forgiveness is granted."⁷⁴ Instead of settling on a uniform procedure, the Service has informed taxpayers that they may report income however they please.

One might argue that the flexibility offered under this system benefits taxpayers by reducing the need for amended returns. For example, a partnership that paid covered expenses in late 2020 but chose not to deduct those expenses until actual forgiveness in 2021 due to uncertainty would be under no obligation to file an amended 2020 return. In this case, either course of action would be correct under the Service's guidance. This flexibility is somewhat redundant, however, due to Revenue Procedure 2021-50, which expressly allows a partnership to file amended returns and K-1s reflecting the guidance in Rev. Proc. 2021-48.⁷⁵ This approach certainly alleviates any risk from guessing how best to report this income but does little to give partnerships concrete direction. Now, partnerships will need to rely on the assistance of their attorney or accountant to evaluate the best option for each individual situation instead of simply complying with clear guidance.

On the opposite end of the spectrum, the Service appears to take an unnecessarily rigid approach to amended returns in situations where the amount deducted is different than the amount actually forgiven.⁷⁶ The Service requires taxpayers who receive less forgiveness than was previously reported as deductible to amend or otherwise correct prior filings.⁷⁷ While certainly the "correct" response, this may steer taxpayers toward the most certain option for determining deductible expense

73. See Rev. Proc. 2021-48, 2021-49 IRB 835 (Dec. 6, 2021).

74. *Id.* at 835.

75. Rev. Proc. 2021-50, 2021-49 IRB 844 (Dec. 6, 2021).

76. See Rev. Proc. 2021-48, *supra* note 73.

77. *Id.*

amounts and inevitably the corresponding tax-exempt income: the time forgiveness is actually granted.

C. Unresolved Issues Involving the Sale of a Partnership Interest

Unfortunately, the Service's efforts to shore up outstanding issues resulting from PPP loan forgiveness remains incomplete. Loss on individual tax returns is not the only implication for the timing of the resulting income. If a partner chooses to sell or otherwise dispose of their interest in the partnership, the timing of the tax-exempt income and the corresponding increase in outside basis may affect the amount of gain or loss recognized upon the sale or disposition.⁷⁸ Depending on the timing of the transaction, the expected income from the forgiveness of a PPP loan may not yet be reflected in the selling partner's capital account.⁷⁹ Less sophisticated parties may not appreciate the uncertainty of the timing of this type of income and fail to include it in the sale price, possibly resulting in a windfall for one party.

To illustrate the issue raised by the preceding paragraph, consider the following example: A, a partner in AB Partnership, wishes to sell his 50% interest in the partnership to Z, and does so for \$1 million in accordance with the partnership agreement. At the time of sale, ABC Partnership has a \$1 million PPP loan, the full amount of which qualifies for forgiveness under the terms of the CARES Act. The forgiveness application has been properly submitted but has not yet been officially approved by the lender. A's outside basis at the time of sale is \$500,000. For purposes of the sale, A's proceeds are considered both the \$1 million cash received and \$500,000 for the liability assumed by the buyer.⁸⁰ Thus, A would recognize \$1 million in total gain on the sale of the partnership interest.

However, if the tax-exempt income from the forgiveness of the PPP loan is recognized prior to the sale, A's overall basis would see no net change due to the reduction in share of liabilities and corresponding tax-exempt income, but there would no longer be a liability outstanding. A's gain on the sale would now be only \$500,000. If the loan forgiveness was taxable as relief from debt ordinarily is, A would, in either case, recognize a total of \$1 million in income in 2020. However, because the forgiveness of the PPP loan debt is tax-exempt, the second scenario functionally results in A paying overall less tax on the disposition of the interest than the first.

The buyer of a partnership interest is governed by the general cost basis provisions of section 1012 of the Code, as adjusted by subchapter K.⁸¹ The buyer's initial cost basis is then adjusted by the deemed cash contribution of assumption of his share of liabilities.⁸² In the preceding illustration, if the tax-exempt income from the PPP loan is not yet forgiven as of the time of sale, Z would take an initial outside basis of \$1.5 million, resulting from the \$1 million cost basis plus the \$500,000 share of liability assumed, and eventually the \$500,000 tax-exempt income recognized upon the forgiveness of the loan. This outcome may not reflect the economic

78. See Letter from Christopher W. Hesse, *supra* note 71.

79. See Treas. Reg. § 1.704-1 for a detailed explanation of partner capital account maintenance requirements.

80. See I.R.S. Pub. 541, (March 2021), <https://www.irs.gov/pub/irs-pdf/p541.pdf>.

81. See I.R.C. § 742; I.R.C. § 1011(a); I.R.C. § 1012(a).

82. I.R.C. § 752(a).

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reality of the transaction if all loan proceeds were spent on covered expenses prior to the sale. As Z now has received no functional benefit from the existence of the outstanding loan balance, except for a tax-free increase in outside basis for which A has been taxed upon the sale. If the loan forgiveness is recognized prior to the sale, Z would only take an outside basis of \$1 million, reflecting cost basis with no outstanding liabilities assumed.

While uncertainty as to “correct” timing in such a transaction is no longer an issue, the cavalier approach taken by the Service still creates risk for complexity in filing and basis, especially in a situation where the entire amount of the loan is not forgiven. This inherent complexity may encourage taxpayers to once again opt to recognize income when forgiveness is actually received. As illustrated, this would result in taxation that does not reflect the economic reality of the underlying transaction.

This issue becomes even more complex in sale scenarios where perhaps loan proceeds have been dispersed but have not yet been used to pay expenses. Even if a partnership chooses to recognize income at the time expenses are paid, the selling partner would be saddled with the extra gain due to the outstanding loan balance, and the purchasing partner would ultimately receive a tax-free increase in basis once the expenses are actually paid. This would again create a tax burden on the selling partner on a balance sheet item that would have been entirely tax-free had no sale taken place.

V. WHY DID THE SERVICE IMPLEMENT A FLEXIBLE STANDARD?

Given the clear issues with existing guidance, one might wonder how the Service concluded that all of the three events listed in Rev. Proc. 2021-48 are appropriate for determining timing of income. Upon evaluation, it seems that the Service concluded that, under the current body of law, any of the three methods could be arguably correct and was unwilling to take a hard position.

Treasury regulations provide a number of “identifiable events” for determining the date of when a debt is deemed discharged for purposes of income taxes.⁸³ One of the enumerated events indicates that debt is discharged for income tax purposes “pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge debt.”⁸⁴ The United States Tax Court has recently had occasion to comment on the timing of forgiveness of debt income in plain language, stating that “[a] debt is deemed discharged the moment it becomes clear that the debt will never be repaid.”⁸⁵

So, what is the policy on forgiving PPP loans? At what point is it clear that the debt will never be repaid? The CARES Act prescribes specific rules for when a borrower is “eligible” for forgiveness, and in what amounts.⁸⁶ The CARES Act is also quite specific that no amount shall be forgiven without an appropriate application submitted to the lender.⁸⁷ But does the word “eligible” suggest that the lender (or the government) has some sort of discretion in which loans are forgiven?

83. See Treas. Reg. § 1.605P-1(b)(2).

84. *Id.* § 1.605P-1(b)(2)(i)(G).

85. *Newman v. Comm’r*, 111 T.C.M. (CCH) 1599, 2 (2016) (citing *Cozzi v. Comm’r*, 88 T.C. 435, 445 (1987)).

86. See CARES Act § 1106.

87. *Id.* § 1106(f).

Certainly, the answer would be much clearer had Congress used the phrase “shall be forgiven,” rather than “shall be eligible for forgiveness.”⁸⁸ Congress was very clear that loans are not to be forgiven without an appropriate application and supporting materials, except in some “de minimis” cases.⁸⁹

In context, however, much of the text of the CARES Act related to PPP loans seems to operate on the expectation that significant portions of PPP loan balances will be forgiven. For example, the CARES Act includes a definition for “expected forgiveness amount,” equaling the amount a lender reasonably expects a borrower to expend during the covered period on covered expenses.⁹⁰ The text of the CARES Act also permits a lender to report to the SBA the expected forgiveness amount of a pool of covered loans up to the full principal of the loan pool, which the SBA is then directed to purchase.⁹¹ For the law to direct such action on an amount of forgiveness “expected” seems to suggest an affirmative assumption that every dollar of a PPP loan “eligible” for forgiveness, in fact, will be forgiven.

Furthermore, the practice by lenders and the SBA seems to support the notion that any borrower who meets the requirements set forth by the CARES Act will, in fact, have the eligible amounts forgiven. As referenced previously, roughly 89% of forgiveness applications for PPP loans distributed in 2020 had been approved as of September 2021.⁹² This high percentage of forgiveness cannot by itself suggest that applicants who meet requirements are entitled to forgiveness. Instead, the important question is why the lenders or SBA denied the remaining 11% of applications. Reasons for denial seem to include incomplete applications, lack of supporting documentation, or use of funds for unauthorized means.⁹³ Possibly the most telling indication of the government’s intent, the rules issued by the SBA actually use the word “entitled” in discussing the SBA’s authority to review forgiveness applications.⁹⁴ Borrowers are also able to appeal denials to the SBA and, once all administrative remedies are exhausted, to the federal courts.⁹⁵ The standard of review during the administrative appeal process is clear error of a finding of fact or law by a preponderance of the evidence.⁹⁶ Such facts and law-based review further suggest a lack of discretion in determining loan forgiveness. Together, these factors suggest that forgiveness of eligible amounts of PPP loans is, in fact, an entitlement.

Still, the existence of an entitlement to forgiveness does not by itself solve the problem of timing of forgiveness income. At what point in time exactly is a

88. *Id.* § 1106(b).

89. *Id.* § 1106(d)(6); § 1106(e)-(f).

90. *Id.* § 1106(a)(7).

91. *Id.* § 1106(c)(4)(A)-(B).

92. *Forgiveness Platform Lender Submission Metrics*, *supra* note 69 at 2.

93. Andy Scauzillo, *Complying with PPP Loan Forgiveness Requirements*, AMERICAN BANKERS ASSOCIATION (May 13, 2021), <https://bankingjournal.aba.com/2021/05/complying-with-ppp-loan-forgiveness-requirements/>.

94. Business Loan Program Temporary Changes; Paycheck Protection Program—Loan Forgiveness Requirements and Loan Review Procedures as Amended by Economic Aid Act, 86 Fed. Reg. 8223, 8294 (Feb. 5, 2021) (to be codified at 13 C.F.R. pt. 120), <https://www.govinfo.gov/content/pkg/FR-2021-02-05/pdf/2021-02314.pdf> (“The Administrator may review whether a borrower is entitled to loan forgiveness in the amount claimed on the borrower’s Loan Forgiveness Application”).

95. *PPP Appeals*, Small Bus. Admin., <https://www.sba.gov/about-sba/oversight-advocacy/office-hearings-appeals/ppp-appeals> (last visited Nov. 2, 2021); *What to Know About PPP Appeals and Next Steps – After the Economic Aid Act: An Updated Guide to the PPP Loan Forgiveness Review and Appeals Process, Part 4*, JDSUPRA (Jan. 27, 2021), <https://www.jdsupra.com/legalnews/what-to-know-about-ppp-appeals-and-next-2318182/>.

96. *What to Know About PPP Appeals and Next Steps*, *supra* note 95.

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borrower entitled to forgiveness? It is clear from the text of the CARES Act that no loans will be forgiven without an appropriate application and supporting documentation.⁹⁷ Thus, it seems that the entitlement cannot exist until an appropriate application is at least filed with the lender or SBA. However, the mandated purchase of “expected forgiveness amounts” by the SBA suggests that Congress was willing to allow some functional flexibility in remittance of forgiven amounts to lenders from PPP appropriations.

So, should that reasonable expectation standard be extended to borrowers in the context of income taxes? Clearly, the approval of an application for forgiveness would create a clear and unambiguous time to recognize income as a “decision by the creditor,” as outlined in the Regulations.⁹⁸ This would be the latest possible time when the income could be recognized. The more flexible standard articulated by the Tax Court of “when it becomes clear that the debt will never be repaid” could result in forgiveness well before the formal issuance of a decision by the lender or the SBA. It seems clear from administrative rules and practice that borrowers are entitled to forgiveness on the amount spent on covered expenses, so long as documentation requirements are met. Furthermore, the CARES Act operates, to some degree, on a reasonable expectation of forgiveness amounts, so it would seem inconsistent to apply a rigid cutoff to a borrower who at no point in time had any expectation that the loan would ever be repaid. The existing law does not seem to unambiguously create a clear time when income must be reported.

Without an unambiguous directive from existing regulations and case law, the Service was apparently unwilling to take a position, instead conceding that any of the suggested times could be considered correct. However, by not taking a position, the Service has done little to clarify for taxpayers what the correct treatment is, only that none of the proposed methods are incorrect.

VI. WHAT FURTHER GUIDANCE SHOULD THE SERVICE ISSUE?

The Service’s failure to settle on a clear direction does not create adequate clarity for taxpayers. While taxpayers now do not seem to have significant reason to worry that the Service will deem whatever method they choose to be incorrect, they are still left to attempt to determine how to report their own income without clear direction. As such, the Service should re-evaluate its existing guidance, particularly Rev. Proc. 2021-48, and issue concrete guidance with regard to timing of forgiveness income. There are a number of options that the Service could implement to create a uniform standard of reporting for taxpayers.

A. AICPA Recommendation

One option for the Service is to adopt the recommendation by the AICPA in its entirety. The AICPA letter recommends a ruling that corresponding tax-exempt income should be recognized in the year when “the PPP borrower pays or incurs qualifying expenses during the covered forgiveness period.”⁹⁹ The AICPA infers from the language of the CARES Act, the IRS’s evaluation in Rev. Rul. 2020-27, and the

97. CARES Act § 1106(e)-(f).

98. Treas. Reg. § 1.605P-1(b)(2)(i)(G).

99. Letter from Christopher W. Hesse, *supra* note 71 at 3.

reality of forgiveness data coming from the Small Business Administration is that PPP loan forgiveness is a ministerial act, and thus, essentially all PPP loan proceeds used for covered expenses can be expected by a borrower to be forgiven.¹⁰⁰ The AICPA's logic appears to be that when a covered expense was paid with loan proceeds expected to be forgiven, that was the actual time of enrichment to the borrower. Therefore, the proper time for income to be recognized and available at-risk basis is adjusted accordingly.¹⁰¹ At one point in the letter, the AICPA recommends that PPP loans not be treated as debt, but it appears this is to refer to amounts of PPP proceeds already forgiven or expected to be forgiven due to expenditure on covered expenses, not treatment of the entire balance as non-debt.¹⁰²

The AICPA's letter uses the term "ministerial act" to support the assertion that the proper time of income is when deductible expenses are paid for using PPP loan proceeds.¹⁰³ A "ministerial act" in the context of tax law is a procedural or mechanical act that does not involve any exercise of discretion or any interpretation of law.¹⁰⁴ The AICPA essentially seeks confirmation from the Service that forgiveness of a PPP loan is merely mechanical once a borrower has complied with the terms for forgiveness.¹⁰⁵ Typically, the relevance of a ministerial act in a tax context is the waiver of interest accrued due to delay as a result of an officer or employee of the Service erroneously performing a ministerial act due to no fault of the taxpayer.¹⁰⁶ This serves the purpose of abating punishment to a taxpayer for wrongful delay outside of his control.

By analogy, a ministerial act could apply to PPP loan forgiveness because the formal forgiveness process of submission of an application, review by the lender, and any subsequent appeal may take time. If the taxpayer becomes entitled under the law to forgiveness at some point prior, they should not be punished for the time it takes to process forgiveness to which he is entitled. This has logical support from the flexible standard used by the Tax Court that income should be recognized when it becomes clear that the debt will never be paid.¹⁰⁷ A taxpayer can be certain from the moment that a covered expense is paid that so long as they submit an application within the appropriate time to the lender, that amount is entitled to be forgiven.

Under the proposition that loan forgiveness is a ministerial act, the AICPA's recommendation is largely consistent with the body of law on the subject. It would be perfectly reasonable for the Service to interpret the SBA's forgiveness of PPP debt once applied for, coupled with the clearly defined requirements under the CARES Act for which debt is to be canceled, as a "defined policy of the creditor to discontinue collection activity and discharge debt."¹⁰⁸ Furthermore, such a decision would be consistent with case law articulated by the Tax Court.¹⁰⁹ Once again, given the clearly defined criteria for forgiveness of all or part of a PPP loan and the near-universal approval of forgiveness applications, it is essentially clear that the debt will never be repaid when the borrower pays covered expenses as defined under the

100. *Id.*

101. *See id.*

102. *Id.* at 8.

103. *Id.* at 3.

104. *See Lee v. Comm'r*, 113 T.C. 145, 150 (1999).

105. *See Letter from Christopher W. Hesse, supra* note 71 at 4.

106. *Lee*, 113 T.C. at 148.

107. *See Newman*, 111 T.C.M. (CCH) 1599 at 2.

108. Treas. Reg. § 1.605P-1(b)(2)(i)(G).

109. *See Newman*, 111 T.C.M. (CCH) 1599.

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CARES Act and the borrower has intent to submit an application for forgiveness. Arguably, the most significant merit of this approach is that it more accurately reflects the economic reality of when the benefit from the loan was recognized.

However, this proposal is not without drawbacks. First, the data suggest that lenders deny around 11% of forgiveness applications. Certainly, at least some of these borrowers reasonably expected all or a portion of the loans to be forgiven, or they likely would not have applied for forgiveness in the first place. No data appears to be available for the success of appeals at this time, so it is difficult to say just how reasonable these borrowers may be. The AICPA's standard may result in some portion of borrowers reporting income in one year, fully expecting forgiveness to be confirmed, only to learn that the application for forgiveness has been denied for one reason or another. They then must either amend their tax returns or wade through the appeals process in the hope of confirming the existence of their entitlement. However, this concern could be lessened by the adoption of a *de minimis* standard for when amendments are required due to differences between amounts reported as deductible in good faith and actual forgiveness amounts.

Second, the proposal fails to address that the CARES Act is quite clear that no amount is to be forgiven without an appropriate application. Regardless of if the full amount is spent on covered expenses, the loan cannot be forgiven without an application and supporting documentation. For it to be clear that the amount attributable to each expense is to be forgiven, there must at least be some kind of subjective intent to apply for forgiveness, and the taxpayer must follow through with that intent.

Lastly, this approach does not address the issue of a sale of a partnership interest, as illustrated before, when a loan balance still exists but is fully expected to be utilized to pay covered expenses following the sale of the partnership interest. If deductible expenses have not been incurred yet, but the loan is ultimately forgiven, the seller is saddled with extra taxable income attributable to a loan that was never expected to be taxed, resulting in a disparity between taxation and the economic reality of the transaction.

B. Income Recognized When Forgiveness Application Submitted

The same analysis could be applied to adopting a standard in which proceeds are deemed income at the time the application for forgiveness is submitted. However, this approach has all the same negatives as recognizing income when deductible expenses are paid while not reflecting the economic reality of the transaction that the AICPA's recommendation does. While the submission of the application for forgiveness is clearly a crucial part of obtaining forgiveness and, at that point, removes all remaining action from the borrower's hands, the failure to address economic reality leaves this option with significantly less merit than other proposals.

C. Income Recognized Only When Forgiveness Application Approved

An approach that loans are only forgiven when formal forgiveness is confirmed by the lender or the government is the most rigid, simplest to apply, and entirely

avoids the discussion of when the entitlement arises. The Service's current guidance on amended returns also makes an election of this method quite attractive for taxpayers who wish to avoid any uncertainty. This approach would leave no ambiguity at all and would result in essentially no amended returns due to a disparity in what the borrower expects and the ultimate reality of amounts forgiven. As a practical matter for the Service, this approach may be the most attractive as the number of borrowers likely to be affected by such specific circumstances seems rather small.

Simple as it may be, this approach completely ignores the economic reality created by PPP loans. It would force affected borrowers to defer losses incurred due to the payment of deductible expenses to later years, not reflecting the year in which the loss actually occurred. Furthermore, it would ignore the problem posed of the seller, who is saddled with extra taxable gain due to an outstanding loan balance which may never, in fact, be subject to tax. This solution, while the simplest, seems contrary to the overall approach found in subchapter K of allocating gains or losses to reflect economic reality at the cost of simplicity.

D. An Alternative Hybrid Approach

A better approach may be to incorporate both the general principles of the AICPA's recommendation with an "expected forgiveness amount" approach in the case of a sale of a partnership interest. In a case with no sale of a partnership, the AICPA's recommendation of recognition of income as covered expenses are paid best reflects the economic reality of the transaction; that is, expenditure on a covered expense with subjective intent to apply for forgiveness in compliance with prescribed application rules creates such a certainty that the amount will be forgiven that the treatment under the Code should reflect that certainty. At the time of sale of a partnership interest, however, the tax treatment of a transaction should not effectively tax the seller for the assumption of the obligation by the buyer, some amount of which may not ultimately be taxable. For sale transactions, the taxable proceeds should be reduced by the amount of the PPP loan allocable to the seller, which the partnership reasonably expects to be expended on covered expenses, and thus forgiven.

This would treat the expected tax-free income from the PPP obligation in a similar manner to how ordinary income assets such as inventory or accounts receivable may make some amount of gain on sale of a partnership taxable as ordinary income, as opposed to the more favorable capital gains rate.¹¹⁰ In some sense, this would treat the amount expected to ultimately be forgiven, less the amounts already spent on covered expenses and thus eligible for forgiveness, as an "unrealized tax-exempt receivable" at the time of sale, as opposed to a liability.¹¹¹ Just as § 751 prevents a seller of a partnership interest from realizing only capital gains on amounts for which they would have expected to realize ordinary income had no sale occurred, guidance by the Service should prevent saddling a seller with capital gains on amounts that would be entirely tax-free to the seller in the absence of a sale. The buyer's treatment of assumption of liabilities will need to be adjusted to reflect

110. See I.R.C. § 751; see also LAURA E. CUNNINGHAM & NOËL B. CUNNINGHAM, THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS, 203-209 (6th ed. 2020).

111. The term "unrealized tax-exempt receivable" is a term of the author's invention, taken from the similarly treated "unrealized receivables" for ordinary income purposes in § 751(c).

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amounts treated as “unrealized tax-exempt receivables” to avoid the problem of the new partner still ending up with too much outside basis. However, this would only provide a complication in the very short term, given the short duration of the PPP.

Issues may arise in cases where the amount declared by the seller as reasonably expected to be expended on covered expenses differs in fact from the final amount of forgiveness. In such a case, the Service would be best served by implementing some *de minimis* allowance for differences, so long as the initially declared amount is reasonable. Of course, any standard involving the word “reasonable” may well lead to dispute, but a *de minimis* allowance and the expense of potential litigation should deter affected borrowers from making estimates in bad faith. Such a small risk of necessary enforcement action should not deter the Service from adopting this approach. It not only best represents economic reality but is also consistent with existing approaches under Subchapter K.

Furthermore, this approach should result in no adverse or abnormal consequences to existing partners not involved in the sale of the partnership interest. This may result in other partners realizing the ultimate tax-exempt income from PPP loan forgiveness in a different year than the selling partner. While perhaps conceptually odd, this would still best represent the economic reality for each individual partner. The selling partner would realize the benefit at the time sold, while the purchasing new partner would not be allocated outside basis, which does not, in fact, represent his contribution. The remaining partners would still realize the benefit of the tax-exempt income at the time of actual payment of covered expenses, which seems the most economically accurate time to realize the resulting tax-exempt income.

VII. CONCLUSION

To solve this problem, the Service should issue new guidance adopting more certain provisions to direct taxpayers in reporting income from PPP loan forgiveness. The Service should apply the hybrid approach suggested, reflecting in large part the AICPA’s guidance with tax-exempt treatment of any remaining portion of loan proceeds expected to be used for covered expenses characterized as an “unrealized tax-exempt receivable.” This guidance would bring uniformity to reporting PPP loan forgiveness, and best reflect the economic reality of the underlying transactions.