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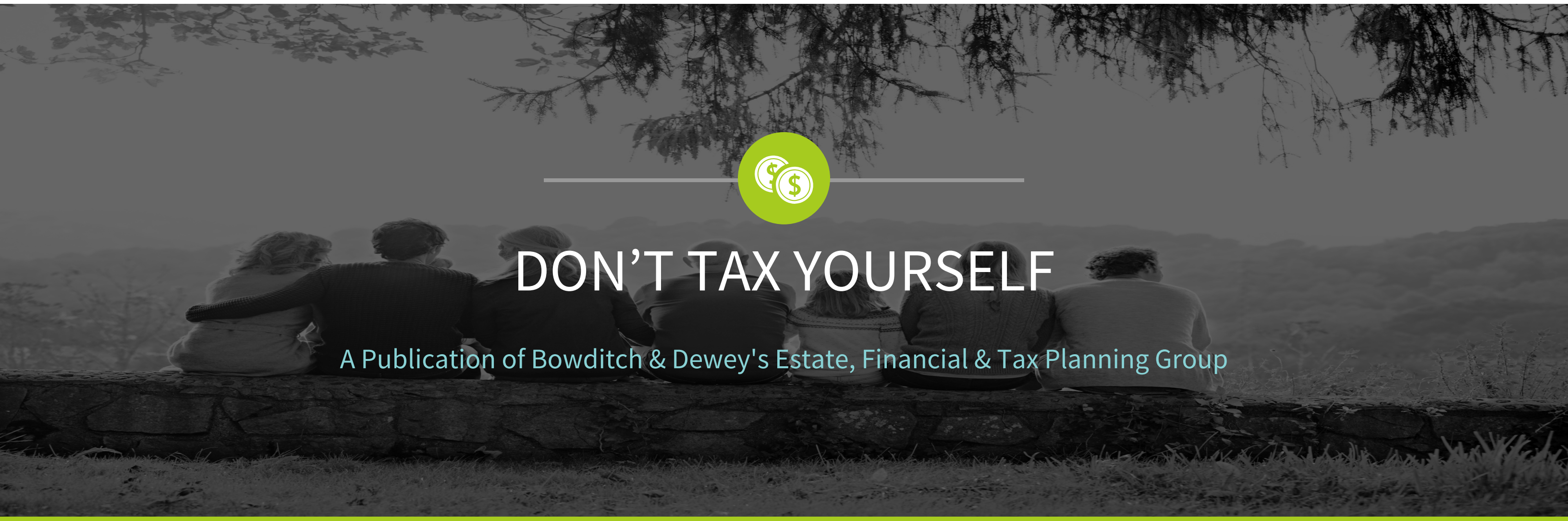

A Trap for the Unwary – IRS Denies Deductions for Expenses Paid with Forgiven PPP Loans

BY ANTHONY J. DRAGGA • SEPTEMBER 3, 2020

A central feature of the CARES Act, the Paycheck Protection Program (PPP), provided a lifeline to a multitude of small businesses during the early days of the Coronavirus pandemic. PPP loans were used to cover payroll expenses and other enumerated operating costs (e.g., rent, utilities) that can be forgiven if the borrower meets certain payroll and employment retention criteria.

While a forgiven loan might otherwise be treated as income to the borrower, the CARES Act provides that for federal income tax purposes, any amount of the PPP loan that is forgiven will be excluded from gross income and therefore from income tax.

With the funds long since spent to keep their businesses afloat, borrowers need to be aware of a potential negative tax risk to seeking loan forgiveness under the PPP. According to IRS Notice 2020-32, business expenses that would normally be deductible in computing taxable income may not be deductible if the taxpayer uses funds from a forgiven loan to pay such expenses. In the Notice, the IRS takes the position that section 265 of the Internal Revenue Code, “disallows any otherwise allowable deduction under any provision of the (Internal Revenue) Code…for the amount of any … (business) expense to the extent” said expense was paid for using forgivable PPP loan proceeds, “because such payment is allocable to tax-exempt income.” Section 265 of the Code provides that, “no deduction is allowed for any amount allocable to one or more classes of income… wholly exempt from the taxes imposed by this subtitle…”

In short, under the IRS’ position, businesses would be able to exclude forgiven disbursements from gross income, but would not be allowed to deduct such expenses for federal income tax purposes. Since the issuance of the Notice, legislators in both the U.S. House of Representatives and the Senate have expressed their displeasure with the IRS guidance, indicating that the CARES Act meant to provide exactly such relief. The House has currently included a legislative fix for the deductibility issue in the recently proposed HEROES Act legislation which is currently stalled in the Senate.

Because the Notice provided no opportunity for comment from taxpayers, it will be accorded limited deference in any legal proceeding. The Notice therefore provides taxpayers with a roadmap for the Service's position, but has little legal effect. The express language of the CARES Act provision runs counter to the IRS's interpretation in the Notice. The CARES Act specifically provides that "any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in subsection (b) shall be excluded from gross income." Denying a tax deduction for business expenses associated with the CARES Act PPP Loan eliminates the tax benefit the CARES Act provides. For example, if a corporation received a $1,000,000 PPP loan, without the CARES Act debt forgiveness provision, the business would pay $210,000 in corporate tax upon the loan's forgiveness. By denying a tax deduction for business expenses paid with the $1,000,000 PPP Loan, the IRS adds back this $210,000 tax (the tax benefit of a deduction is 21% of the $1,000,000 in expenses).

Should taxpayers wait until a legislative fix? Taxpayers may seek to challenge the IRS's position in Notice 2020-32. Consult with your tax adviser before accounting for any business expenses made with PPP Loan proceeds on your 2020 tax return.