

IRS Denies Deductions Paid with Forgiven PPP Loans

Principal

May 1, 2020

The IRS issued Notice 2020-32 on April 30, 2020 to address an important question regarding the Paycheck Protection Program (PPP).

Recall the PPP was enacted as part of the CARES Act on March 27, 2020 to provide relief to small- and medium-sized businesses in the form of low-interest loans that are forgivable to the extent they are used to pay certain expenses during the 8-week period after the loan is made.

Specifically, Notice 2020-32 provides guidance regarding the deductibility of expenses that are paid with funds that are forgiven under a PPP loan. The Notice states that no deduction is allowed for U.S. Federal income tax purposes for expenses that otherwise would be deductible if the income associated with the expenses is excluded from gross income under section 1106(i) of the CARES Act. That is the section providing an exclusion from income for any debt forgiveness that is obtained under a PPP loan.

Nothing in the CARES Act or in the Internal Revenue Code (Code) addresses this issue, but the Notice provides an expected outcome that is based on established Federal income tax principles and precedent under section 265 of the Code, as well as precedent relating to reimbursed expenses. The bottom line is that borrowers will have no income when all or part of their PPP loans are forgiven, and they will receive no deduction for the expenses that relate to the forgiven amounts. From a tax policy standpoint, this is the right outcome because the Federal government funded the payment of the expenses and the borrower did not bear the economic cost of them.

Some practitioners had hoped borrowers could receive tax-free income and also be able to deduct the expenses associated with such income, but that double tax benefit was not written into the CARES Act, though proponents argue it was implied. For example, if a taxpayer borrowed \$100 and all of it was forgiven because it was spent on permissible expenses during the 8-week period after the loan was made, then the hope was that the IRS would allow the taxpayer to deduct the \$100 of expenses, which for a corporation would generate tax savings of \$21. This is not the route taken by the IRS in Notice 2020-32.

If you have any questions regarding the Notice, please reach out to your Withum tax advisor or contact a member of Withum's Tax Group.

To review additional information regarding the PPP or the loan forgiveness process, please read the following Withum articles:

For a summary of the loan forgiveness rules under the PPP loan program, read our article entitled "Paycheck Protection Program: Analysis of Forgiveness."

For a summary of the ambiguities regarding the loan forgiveness calculation, read our article entitled "PPP and the Enigma of Loan Forgiveness."

For a summary of procedures and best practices around the PPP and loan forgiveness process, read our article entitled "Obligations for Borrowers and Lenders Under PPP."

For a summary of the rules regarding the employer payroll tax deferral provision of the CARES Act, and how it interacts with loan forgiveness under a PPP loan, read our article entitled "Should You Defer Payroll Taxes if You Apply for a PPP Loan?"