

IRS DENIES DEDUCTIONS FOR EXPENSES PAID WITH FORGIVEN PPP LOANS

Hodgson Russ Federal-International Tax Alert
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On April 30, 2020, the IRS issued Notice 2020-32 which provides that expenses paid with proceeds from a Paycheck Protection Program (“PPP”) loan are nondeductible for federal income tax purposes to the extent the payment of those expenses results in the forgiveness of the PPP loan.

Section 1106(b) of the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) generally provides that a taxpayer would be eligible for forgiveness of the PPP loan in an amount equal to the sum spent for the eight weeks after the loan origination date on (i) payroll costs (excluding employees with compensation in excess of \$100,000 per year); (ii) group healthcare benefit costs and insurance premiums; (iii) interest payment on any mortgage incurred before 02/15/2020; (iv) rent on any lease in force before 02/15/2020; and (v) utilities for which service began before 02/15/2020. Subsequent guidance stated that no more than 25% of such spending can relate to non-payroll related items described above.

Importantly, section 1106(i) of CARES Act excludes the forgiven loan amount from the taxpayer’s gross income for federal income tax purposes. The CARES Act, however, did not directly address the deductibility of expenses paid by a taxpayer with the proceeds of a PPP loan which, as a result of the payment of those expenses, is later forgiven. This omission has left tax experts speculating as to the proper result. Of course, if such expenses were deductible, then a taxpayer would receive the tax benefit of both exclusion of the forgiven debt from the taxpayer’s income as well as the deduction of such expenses against other income. However, it is not entirely clear that this was not intended by the legislation (or, for that matter, if it was even considered by Congress at all in the haste to launch the CARES Act).

Notice 2020-32 reached the not entirely unexpected outcome regarding the deductibility of such expenses. Specifically, Notice 2020-32 concludes that, under the Internal Revenue Code (“Code”) and existing guidance thereunder, section 1106 (i) of the CARES Act creates a “class of exempt income” under Code section 265; expenses allocable to such exempt income are nondeductible. As a result, no deduction is allowed for federal income tax purposes for otherwise deductible expenses if the payment of the expense results in forgiveness of the PPP loan. Thus, overall, a taxpayer will have no income inclusion with respect to the forgiven PPP loan amount, and it will receive no deduction for the expenses related to the

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forgiven amount. The result raises the obvious question of why Congress bothered at all to exclude the forgiven amount from income only to deny the corresponding deduction, when a similar result likely would have been achieved simply by not drafting the exclusion from income into the CARES Act and allowing taxpayers to take the normal deduction against income.

Notably, on May 1, 2020, Senator Chuck Grassley expressed his disappointment with the IRS's conclusion in Notice 2020-32 and suggested it was contrary to the legislative intent. As such, it remains to be seen whether legislation will be enacted to override the IRS's position and, thereby, allow taxpayers to deduct such expenses.

Please contact Brad Birmingham (716.848.1511) or William Turkovich (716.848.1212) for any questions you may have regarding the above IRS guidance.

Please check our Coronavirus Resource Center and our CARES Act page to access information related to both of these rapidly evolving topics.

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