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IRS Says Forgiven PPP Loans Result in Loss of Deductions; Congress May Change That Result

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The Coronavirus Aid, Relief, and Economic Security Act, or the CARES Act, was signed into law by President Trump on March 27, 2020. One of the key economic aid provisions for businesses contained in the Act was the Paycheck Protection Program ("PPP"), which authorized up to $349 billion in forgivable loans to small businesses to pay employee wages and certain other expenses during the economic crisis resulting from the COVID-19 pandemic. By April 16th, all $349 billion of PPP funds had been fully deployed. On April 24th, the President signed into law legislation providing an additional $310 billion in funding to replenish the Small Business Administration's PPP funds.

One feature that has made PPP loans so attractive to small businesses was that the CARES Act allowed PPP loans to be forgiven, if certain conditions were met, and such forgiveness would not be included in the borrower's gross income. Loan forgiveness was available for loan proceeds that were used during an eight-week period beginning on the date of the origination of the loan to make wage payments, certain mortgage interest and rent payments, and payments of utility expenses ("eligible PPP loan expenses"). Typically, such expenses would be deductible by a taxpayer for federal income tax purposes.

Although the CARES Act specified that PPP loan forgiveness would not result in the borrower having to include the forgiven amounts in gross income, the Act was silent on the issue of whether the expenses paid with PPP loan proceeds that are subsequently forgiven would be impacted by the potential tax-free nature of the PPP loan.

The IRS has now addressed this issue, and despite the seeming intent of the CARES Act, the IRS announced in Notice 2020-32 that no deduction is allowed for an expense that is otherwise deductible if payment of the expense results in forgiveness of a PPP loan. The IRS position is based on section 265 of the Internal Revenue Code, which provides that no deduction is allowed for amounts otherwise allowable as a deduction if it is allocable to income that is exempt from tax. The rationale behind section 265 is that permitting such deductions would effectively let taxpayers "double dip" on federal income tax benefits, receiving a tax deduction for payments made with income that was not taxable to them. Notice 2020-32 deems an expense to be allocable to tax-exempt income, and thus disallowed as a deduction under section 265, if the expense is "for the amount of any payment of an [eligible PPP loan expense] to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven)."

Receiving a PPP loan is still a valuable benefit to borrowers, but the IRS position significantly reduces the tax benefit to taxpayers since the loss of the associated deduction for wage, mortgage interest, rent or utility payments may not be different (and may actually be worse on a time value of money basis) than the effect of having cancellation of indebtedness income from the forgiveness of the PPP loan.

Shortly after the IRS issued Notice 2020-32, several members of Congress expressed their disappointment with the IRS position; but on May 4, 2020, Secretary of the Treasury Steven Mnuchin defended the position taken in Notice 2020-32 explaining that taxpayers should not be allowed to "double dip" by deducting expenses funded by loans that are forgiven without tax consequence. In response, on May 5, 2020, a bipartisan group of Senators introduced the Small Business Expense Protection Act of 2020 (S. 3612), which, if enacted, would retroactively override the holding in Notice 2020-32 and provide that expenses funded by forgiven PPP loans remain deductible as ordinary business expenses. Until that bill or similar legislation is enacted, however, PPP borrowers will have to plan for the possible loss of deductions associated with the forgiveness of their PPP loans.

If you have any questions regarding the topics discussed in this article, please contact **Daniel T. Sherlock,** Chair of Vedder Price's Tax & Estate Planning Group, at +1 (312) 609 7551, **Amy E. Lewis** at +1 (312) 609 7837, or any other Vedder Price attorney with whom you have worked.