PPP Loan Confusion: IRS at Odds with Congress Over Deduction for Expenses

05.05.2020 | By Douglas W. Schwartz

The IRS last Thursday in Notice 2020-32 badly frayed the financial lifelines for floundering businesses under the SBA's Paycheck Protection Program ("**PPP**"). In Notice 2020-32 the IRS stated its position that a taxpayer cannot claim a tax deduction for payroll, rent, utilities, and other business expenses funded with a PPP loan that is forgiven. The IRS position reduces the attractiveness and utility of PPP loans to businesses struggling from the COVID-19 pandemic, and complicates tax reporting for those businesses that do take advantage of the program. Congress probably will need to enact further legislation confirming that businesses can deduct these expenses, because the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, which created the PPP, did not address this issue (hence the need for IRS interpretation).

What Notice 2020-32 Says

As our eAlerts of April 3, 2020 and April 23, 2020 discuss, PPP loans are available from April 3, 2020 until June 30, 2020 for eligible businesses to cover the cost of payroll, insurance premiums and group health care benefits, rent and utilities, and interest on most business debt. Under section 1106 of the CARES Act, a PPP borrower can apply for forgiveness of the loan to the extent of amounts spent during the 8-week period after the loan origination date for the foregoing "**eligible**" expenses. The amount that may be forgiven is decreased if the business has laid off employees or decreased employee compensation by more than a certain amount during this 8-week period, but this reduction penalty does not apply to the extent the business restores its employee count and compensation by June 30, 2020.

Usually a forgiven loan results in taxable cancellation of debt income ("**CODI**") under Internal Revenue Code ("**Code**") section 61(a)(11), subject to modifications and exclusions under Code section 108. (Section 108 among other provisions excludes CODI to the extent the taxpayer is insolvent; if the debt discharge occurs in a bankruptcy proceeding; for certain debt incurred in a farming business; or for certain debt incurred in a real estate business if the taxpayer makes a special election.) However, section 1106(i) of the CARES Act provides that CODI otherwise arising from forgiveness of a PPP loan under section 1106 “shall be excluded from gross income.”

As the IRS noted in Notice 2020-32, Congress in the CARES Act did not similarly address whether the eligible expenses funded by a forgiven PPP loan were deductible under Code section 162. Therefore, the IRS said, the regular deduction rules of the Code applied, including Code section 265, which denies a deduction for “[a]ny amount … which is allocable to one or more classes of income …wholly exempt from …taxes.” The purpose of section 265 is to prevent a double tax benefit – *i.e*., income exempt from tax, and a deduction for expenses incurred to generate that income or funded by that income. The IRS cited regulations, case law, and rulings to the effect that Code section 265 applied not only to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax-exempt income, but also where tax exempt income was earmarked for a specific purpose and deductions were incurred in carrying out that purpose. Here, the IRS said, the express intent of the PPP loan was to enable the taxpayer to pay the eligible expenses listed in the CARES Act, and forgiveness of the loan was conditioned on the amount of eligible expenses incurred during the 8-week period following the loan origination date. This nexus between the eligible expenses and the CODI exemption for the forgiveness of the underlying PPP loan brought these expenses within the ambit of section 265, thereby denying a deduction. The IRS also cited case law outside the section 265 context to the effect that one cannot claim a deduction for an expense that is reimbursed.

What To Do?

The consensus among tax professionals and commentators is that the IRS was in a bad position regardless (had it concluded that the expenses were deductible, one could have accused the IRS of stepping outside its authority by legislating to fill a statutory hole left by Congress) and that there are valid arguments both for and against its conclusion in Notice 2020-32. (The IRS position also can lead to unfair results. For example, a borrower who “breaches” the CARES Act conditions for getting a PPP loan forgiven, but gets debt forgiven otherwise and excludes the CODI under Code section 108 or simply does not pay back the PPP loan while delaying the “forgiveness” event which would trigger CODI, could be in a better tax position than the taxpayer who “follows the rules” and gets the loan forgiven under section 1106 of the CARES Act.) Oversights and ambiguities like this issue are common and not surprising given the pressure under which Congress negotiated the CARES Act to deal with the burgeoning COVID-19 pandemic. Congressional Democrats and Republicans stated Friday and over the weekend that the IRS position does not reflect their intent, but Congress probably will need to enact tax corrections legislation to reverse the IRS’ position.

Pending further Congressional action – which, given the politically-charged atmosphere in Washington, could take some time – taxpayers are in a bind about how to treat eligible expenses funded by a PPP loan. Their position is particularly complicated because it is possible – particularly for a taxpayer with a fiscal year ending shortly after the date that it obtains a PPP loan – that a taxpayer may take out a PPP loan and pay the eligible expenses in one year but have the PPP loan forgiven in a later year.

Taxpayers are not bound by the IRS’s position in Notice 2020-32. They may wish to claim deductions for eligible expenses funded by a PPP loan, rather than forego such deductions and then be forced to file an amended return later if the tax landscape changes so as to support deductions (through Congressional action, the IRS’ reversing its position, or favorable decisions from the United States Tax Court or other judicial bodies). However, one should take a return position contrary to published IRS guidance only after thoroughly vetting with tax advisors the legal support for that position and the risks of an IRS examination.

To avoid penalties (generally 20% of back taxes), for example, a taxpayer cannot just ignore the IRS' position: The taxpayer must have a well-developed, considered argument with legal authorities as to why the IRS is wrong and probably will need to disclose its position to the IRS in a return footnote or attached statement. Note that the foregoing cautions address *penalties only:* The taxpayer still would need to pay back taxes and interest in an IRS examination, and would do well to set aside reserves for those amounts if possible. A taxpayer can also put its return on extension and hope that the issue is resolved favorably before the extended due date (but would still need to pay estimated taxes by the original due date, taking Notice 2020-32 into account).

State Conformity

Yet another issue for taxpayers with PPP loans is the extent to which their respective states have conformed or may conform to the CARES Act provisions or subsequent Congressional legislation. The California legislature, for example, has yet to address the extent to which the state can or will conform to the CARES Act provisions; and the California Franchise Tax Board has confirmed in its May 2020 Tax News that California currently does not follow the CARES Act CODI exclusion and certain other tax changes. For now, a California taxpayer appears to be in the Kafkaesque position where for state tax purposes forgiveness of a PPP loan can generate CODI, but the expenses funded with the loan may still be deductible (*i.e.,* the mirror image of the federal treatment).

Stay tuned for updates on these issues, including the status of any Congressional fixes and California conformity.