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The IRS Has Determined That Taxpayers Who Obtain PPP Loan Forgiveness Cannot Have Their Cake and Eat It Too

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In Notice 2020-32, issued yesterday, the IRS emphatically pronounced that taxpayers receiving Paycheck Protection Program ("PPP") loans do not get to have their cake and eat it too!

As we discussed in a recent blog post, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), signed into law on March 27, 2020, created the PPP under which the Small Business Administration is authorized to make up to $349 billion in forgivable loans to small businesses to enable them to meet payroll costs, benefits, rent and utility payments. On April 24, 2020, Congress increased the amount of available funds under the PPP to $659 billion when the Paycheck Protection Program and Health Care Enhancement Act was signed into law.

The CARES Act expressly excludes from gross income any amount forgiven under the PPP. The question left unanswered by the CARES Act is whether the amounts forgiven that were spent by borrowers on otherwise allowable business expenses (i.e., payroll costs, rent, utilities, transportation and interest) are deductible under Code Section 162.

Notice 2020-32 quickly points out to taxpayers and tax advisers - not so fast - there are no free lunches. In essence, if the loan is forgiven and, as a result of the CARES Act, a taxpayer has no cancellation of debt income as he/she/it would otherwise have under Code Section 61(a)(11), the taxpayer certainly does not get to deduct the business expenses for which it used the forgiven loan proceeds.

The IRS cites Code Section 265 and Treasury Regulations promulgated thereunder to support its conclusion. In its broadest sense, Code Section 265 tells us that taxpayers are not entitled to deductions allocable to income that is excluded from gross income. It provides in part:

No deduction shall be allowed for-

Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle, or any amount otherwise allowable under

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section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.

The government's conclusion, from a purely academic perspective, makes some sense. In normal times, taxpayers should not get a double tax benefit from a forgiven debt (i.e., a deduction with respect to expenses paid from the loan proceeds and an exemption from tax on the forgiven loan). However, we are not living in normal times.

The CARES Act created the PPP to help businesses survive these horrific times and to enable them to keep their workforces in place. Giving these businesses a double tax benefit makes perfect sense in this context. In drafting the PPP loan forgiveness provision, Congress chose to create a new loan forgiveness mechanism within the CARES Act, distinct from Code Section 108, which already provides an income exclusion from cancellation of debt income. Congress could have just modified Code Section 108 to sweep forgiven PPP loans within the existing income exclusion. However, it did not go that path. Congress' unusual approach to PPP loan forgiveness seems to support a conclusion that it did not contemplate the application of Code Section 265 when it passed the CARES Act and that it intended taxpayers receiving PPP loan forgiveness would be able to have their cake and eat it too (i.e., tax exempt loan forgiveness and deductibility of amounts used for otherwise allowable business expenses).

We suspect many business owners will be taken aback when they learn about Notice 2020-32. For most taxpayers, their PPP loan, if completely forgiven, will cost them 21 cents to 37 cents for each dollar forgiven in federal income tax. On top of that, there will likely be state and local income taxes owing by these taxpayers. Ouch! If not planned for, these taxpayers may find themselves not being able to pay the resulting taxes.

Posted in Federal Law, IRS, Tax Planning

Tagged as Business Expenses, cancellation of debt income, CARES Act, Coronavirus, COVID-19, forgivable loans, Internal Revenue Service, Paycheck Protection Program, Taxpayer

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