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INSIGHT

IRS Guidance Says No Deduction Is Allowed for Business Expenses Paid with Forgiven PPP Loans

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The Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) created Small Business Administration (SBA) Paycheck Protection Program (PPP) loans that can be used to cover payroll expenses and certain operating costs and can be forgiven if the borrower meets certain criteria.

On April 30, 2020, IRS issued Notice 2020-32, stating that PPP-recipients cannot claim a deduction for expenses funded from the forgiven PPP loans.

PPP Forgiveness

Borrowers can apply for forgiveness on the principal and accrued interest, if the borrower maintains employment and limits wage decreases.

In general, forgiven debt—"cancellation of indebtedness income" or CODI—is subject to income taxation, unless specifically excluded. Section 1002 of the CARES Act, excludes forgiven loan amounts.

Tax Deductibility of Business Expenses

The CARES Act has no language on the deductibility of PPP expenses. Under Internal Revenue Code (IRC) Sections 162 and 163, taxpayers can deduct any ordinary or necessary trade or business expenses, which would include PPP-eligible expenses.

However, IRC Section 265(a)(1) states that an expense cannot be deducted if it is allocable to a class of income which is exempt from taxation.

Tax Practitioners' Concerns About Deductibility of Forgiven PPP Loans

In an April 8, 2020, email to the U.S. Department of the Treasury (link requires paid subscription), Cornell Law School Professor Richard L. Reinhold argued that legislation could be needed if Congress intended to allow a deduction for covered expenses incurred by a taxpayer whose loans are forgiven. In contrast, others argue (links requires paid subscription) that Section 265 should not apply.

Double Benefit

A "double benefit" arises when a taxpayer receives tax-free income (like a forgiven loan) and is also able to claim a tax benefit (like a deduction or a credit) using that income. For example, assume a taxpayer faces a top marginal income tax rate of 37% and takes out a PPP loan for $100,000 that is forgiven by the lender and not subject to tax. The first benefit is a tax-free grant of $100,000. If the taxpayer can also deduct the loan amount as business expenses, a second benefit is $37,000 in tax savings ($100,000 * 37%).

If Congress meant to disallow this "double benefit," a question can be raised as to why the exclusion of the loan forgiveness was explicitly provided in the legislation. To illustrate, **Table 1** assumes a $100,000 forgiven loan, $100,000 of deductible expenses, and a 37% tax rate. The normal treatment in the tax code (the forgiven loan is taxable, and the associated business expenses paid from that loan are deductible) would generate a $37,000 tax liability from that taxation of the CODI (scenario 1). But that amount would be entirely offset by a $37,000 tax savings from deducting the business expenses. Excluding the forgiven loan results in no tax on the income, but allowing deductions provides a tax saving of $37,000 (scenario 2). If, however, the forgiven loan is not taxed and deductions are disallowed, there is no tax on the income or benefit from the deduction. Including the loan in income and allowing deductions (scenario 1) leads to the same outcome as excluding the loan and disallowing deductions (scenario 3). Hence, one could argue that this exclusion was included in the law because it was Congress's intent to provide this additional benefit.

Table 1. Hypothetical Example of Tax Effect of Disallowing Deductions for Business Expenses on PPP Loans

Tax Scenario	Tax On Income	Tax Savings from the Deduction	Net Tax Effect
1. Normal Tax Treatment	$37,000	-$37,000	0
2. Treatment w/ Exclusion on Forgiven Debt	0	-$37,000	-$37,000
3. Treatment w/ Exclusion on Forgiven Debt and No Deduction	0	0	0

Source: CRS calculations, assuming a $100,000 forgiven loan, $100,000 in deductible business expenses, and a 37% tax rate.

April 30, 2020, IRS Guidance

IRS Notice 2020-32 disallows deductions for expenses paid for by forgiven PPP loans. Tax filers may need to amend quarterly filings or might challenge this decision in court, although it is not clear what the outcome of that option would be. Some policymakers have expressed concerns with IRS's guidance, including the chairs of the House Ways and Means and Senate Finance Committees.

Treatment in Revenue Estimates

According to media reports, the Joint Committee on Taxation—in a July 27, 2020, letter to Senator John Cornyn—indicated that the revenue estimate for the CARES Act was consistent with its interpretation of the intent of allowing deductibility of expenses, and that legislation affirming the deductibility of expenses would have no revenue effect.

Economic Benefit of PPP Loans

IRS's position would reduce the economic benefit of PPP loans to taxpayers who thought they could continue to take deductions for PPP-eligible expenses. Businesses could lay off employees and not apply for PPP loan forgiveness. With that said, businesses could still find that PPP loans are the most preferable option for short-term economic relief compared to alternative COVID-19 assistance measures.

Options for Congress

If Congress decides that Section 265(a)(1) should be waived for business expenses funded by forgiven PPP loans, it could enact subsequent legislation. Congress has enacted some exemptions, such as those in IRC Section 265(a)(6) (mortgage interest and property taxes deductible on a home receiving a tax-free military housing allowance or a parsonage allowance for religious clergy). The Safeguarding Small Business Act (S. 3596), the Heroes Act (H.R. 6800), the Small Business Emergency Protection Act (H.R. 6821; S. 3612), and the Safeguarding Small Business Act (S. 3596) would amend the CARES Act to allow taxpayers to receive PPP loan forgiveness without affecting their ability to claim expense deductions. An updated version of the Heroes Act (H.R. 925), which allows deductibility, passed the House on October 1.

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