



# 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 for payroll expenses and certain operating costs, which are forgiven if the borrower meets certain criteria.

On April 30, 2020, the Internal Revenue Service (IRS) issued [Notice 2020-32](#), stating that PPP recipients cannot claim a deduction for expenses funded from forgiven PPP loans. On December 27, 2020, President Trump signed H.R. 133, the COVID-related Tax Relief Act of 2020 (Subtitle B of Title II of Division N of the Consolidated Appropriations Act of 2021), which nullifies the IRS's guidance and allows borrowers to deduct expenses paid out of 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 PPP 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 ordinary or necessary business expenses. However, IRC [Section 265\(a\)\(1\)](#) states that an expense cannot be deducted if it is allocable to income exempt from taxation.

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## 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 analysis, assuming a \$100,000 forgiven loan, \$100,000 in deductible business expenses, and a 37% tax rate.

## IRS Guidance

IRS issued multiple guidance documents, prior to the enactment of H.R. 133, that would have denied taxpayers from deducting ordinary and necessary business expenses paid out of forgiven PPP loans. IRS [Notice 2020-32](#) (April 30, 2020) disallowed deductions for expenses paid for by forgiven PPP loans. IRS [Rev. Rul. 2020-27](#) (November 18, 2020) stated that a taxpayer could not deduct expenses paid in 2020 if they “reasonably expect” those expenses to be forgiven at a later date. IRS [Rev. Proc. 2020-51](#) (November 18, 2020) would have provided a safe harbor for PPP borrowers whose loan forgiveness has been denied in part or full, and who wish to file an amended return to claim business deductions.

Some policymakers expressed concerns with IRS’s position, including the [chairs of the House Ways and Means and Senate Finance Committees](#), who [stated](#) that IRS’s interpretation is contrary to congressional intent. The ranking member on the Ways and Means Committee, however, [stated](#) that there was not a clear congressional intent to allow a deduction.

## Treatment in Revenue Estimates

According to [media reports](#), the Joint Committee on Taxation (JCT) indicated in a July 27, 2020, letter to Senator John Cornyn 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. [JCT's score](#) of H.R. 133 confirmed this assumption.

## Economic Benefit of PPP Loans

IRS's position would reduce the economic benefit of PPP loans to taxpayers. Businesses could lay off employees and not apply for PPP loan forgiveness. With that said, businesses could still find PPP loans are the [most preferable option](#) for short-term economic relief compared to [alternative COVID-19 assistance measures](#).

## Legislative Action

On December 27, 2020, President Trump signed H.R. 133, the COVID-related Tax Relief Act of 2020 (Subtitle B of Title II of Division N of the Consolidated Appropriations Act of 2021), which nullifies the IRS's guidance and allows borrowers to deduct expenses paid out of forgiven PPP loans. In other words, PPP borrowers can benefit from the exclusion of CODI (provided by Section 1002 of the CARES Act) and deduct ordinary and necessary business expenses under IRC Section 162 (i.e., scenario 2 in **Table 1**). If a taxpayer made changes to their income tax withholding based on IRS's prior guidance, they can adjust their 2020 taxes paid on their annual tax filings during the 2021 tax filing season.

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