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PPP Forgiveness and Expense (DIS?) Allowance: Notice 2020-32

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Deducting expenses that result in forgiveness of a paycheck protection program (PPP) loan remains a thorny issue with which Congress and the IRS continue to grapple.

The CARES Act created the PPP, which is basically a federal grant in the form of a *forgivable*, low-interest, loan for employers with 500 or fewer employees (or that satisfied other eligibility criteria). Congress enacted the PPP to support small businesses grappling with the economic uncertainty caused by COVID-19. PPP accomplished this objective via both direct loan support to small businesses and by pumping cash into the economy. Significantly, PPP loans are generally forgivable to the extent the borrower uses the loan proceeds for certain *qualified covered costs* (payroll costs, mortgage interest, rent and utilities) during the *covered period*.

Tax law generally treats all “accessions to wealth” as taxable income unless an exception applies. Accordingly, subject to numerous exceptions, the forgiveness of a loan normally results in taxable income to the extent a taxpayer’s balance sheet is improved when it no longer has to repay the forgiven debt. Anticipating this issue, Congress included a provision in the CARES Act that specifically overrode this cancellation of debt (COD) rule so that forgiveness of PPP loans would not create taxable income. However, Congress remained silent about whether PPP borrowers could continue to claim a tax deduction for the otherwise deductible expenses that result in PPP loan forgiveness. That is, although Congress turned off the normal COD rules, it did not expressly turn off a different tax rule — IRC § 265 — that generally prevents taxpayers from claiming a tax deduction for expenses paid with tax-free income.

The IRS warned borrowers that IRC 265 precluded tax deductions for PPP covered expenses in [Notice 2020-32](#). We agreed that the IRS Notice reflected an appropriate application of tax law in this [article](#). Before the *ink was dry* (hopefully everyone still knows what that phrase means) on our article, several influential members of Congress expressed outrage at the IRS’s action. As we noted at the end of our article, those members of Congress thought that their legislative intent was clear: when Congress said PPP forgiveness should be tax free it meant fully tax free, not effectively taxable by making qualified PPP covered costs non-deductible.

Treasury Secretary Mnuchin promised reconsideration, but so far, the IRS has not changed its position.

The deductibility issue became increasingly complicated when Congress extended the covered period from eight weeks to 24 weeks in the PPPFA, as we described [here](#) and [here](#). After that legislation, the majority of PPP borrowers (most of whom are calendar year taxpayers) would now incur expenses in 2020 but not secure final PPP forgiveness until 2021. It is now unclear whether a business can deduct qualified expenses that have not been forgiven by the end of the tax year (or by the time the PPP borrower files the return for the year the PPP borrower paid the expense).

Absent clear IRS guidance, PPP borrowers that claim deductions for qualified expenses on their 2020 return, because the expenses had not yet resulted in forgiveness, will need to navigate the “tax benefit rule” when filing the tax returns in 2021. The tax benefit rule may require that income in a later year include an amount deducted in a prior year, when a subsequent event occurs that is fundamentally inconsistent with the premise on which the taxpayer claimed the original deduction. Arguably, forgiveness of a PPP loan in a subsequent year would be fundamentally inconsistent with claiming a deduction based on the PPP loan not having been forgiven in the prior year.

To further confuse the situation, several members of Congress have pushed for inclusion of a provision overriding the deduction disallowance rule of IRC § 265. Some of those Congress members argue that they really meant tax free when they said *tax free* in the CARES Act. Various iterations of the on-again/off-again fall *COVID-19* stimulus bills contained provisions that would have allowed full deductions for covered expenses, notwithstanding that those expenses were paid with tax-free (upon forgiveness) funds. Those stimulus bills never became law because the election got in the way. Senator Cornyn (Majority Whip), Senator Grassley (Finance Committee Chair), Senator Wyden (Ranking Member of the Finance Committee), Senator Rubio and Senator Carper also introduced the Small Business Expense Protection Act of 2020 ([S. 3612](#)), which would override Notice 2020-32. Passage of S. 3612 remains unclear despite the bipartisan firepower of its sponsors.

As we approach the end of the calendar year, the proper treatment of expenses that result in PPP loan forgiveness will become a more pressing issue, although many taxpayers have already struggled with this confusion when computing their estimated tax payments. News outlets report that Treasury/IRS are preparing to address these questions. If the IRS simply reiterates the position in Notice 2020-32 and addresses the *taxable year of deduction* issue, then business groups will undoubtedly increase pressure on Congress to legislatively reverse the IRS “interpretation.” We are not in

the business of making predictions on Congressional action, especially this year. But in a smackdown between proper implementation of tax law and deficit hawks on the one hand, and a Congress that believes its legislative intent was clear when it stated that PPP forgiveness should be tax free on the other, we would not bet against the latter.