Client Alert: Deductions to be Limited for Expenses Covered by Forgiven PPP Loans

By Gary Bubb on May 4, 2020

Based on the latest guidance from the IRS in Notice 2020-32, businesses that use Paycheck Protection Program ("PPP") loan proceeds to pay payroll costs, mortgage interest, rent and utilities will not be allowed to deduct those expenses to the extent that the PPP loan is later forgiven.

Under the PPP, a business that gets a PPP loan can receive forgiveness of the PPP loan to the extent that the expenses listed above are paid during the 8-week period that begins on the PPP loan origination date. The amount of forgiveness is reduced if, during that period, the business reduces its average number of full-time employees, or reduces the wages of certain employees, but the general idea is that the loan forgiveness will contribute to badly-needed liquidity for the borrowers. The loan forgiveness is a key feature of the PPP.

Under general tax law principles, loan forgiveness is treated as taxable income to the borrower. The PPP anticipates this issue and provides that any amounts forgiven under the PPP will not be treated as cancellation of debt income to the PPP borrower.

Now the IRS has stepped in and helpfully pointed out that, under other tax law principles (specifically, Section 265(a)(1) of the Internal Revenue Code and related regulations), otherwise deductible business expenses are not deductible if they are "allocable" to a "class of exempt income" that is excluded from gross income. The IRS reasons that the PPP provision that excludes forgiven amounts from the borrower's gross income is the kind of thing that Section 265(a)(1) is talking about. As a result, deductions for payroll costs, mortgage interest, rent and utilities are prohibited because allowing these expenses as deductible items would constitute a form of "double dipping."

The IRS logic, while probably sound, is completely tone deaf. It's not clear that anyone would take the IRS to task if it permitted the deductions without raising the Section 265 issue. On the other hand, denying deductions for the covered expenses will only create additional pressure on businesses that desperately need to maintain liquidity while retaining their employees. Assuming that lawmakers are more in touch with the reality of the COVID-19 crisis and its destructive impact on all economic activity, PPP borrowers can only hope that this glitch will be addressed in the next round of relief legislation that comes out from Congress.

__Gary Bubb__ is an attorney in RIW's __Corporate & Business__, __Mergers & Acquisitions__, and __Tax__ Practice Groups. Gary can be reached at __gcb@riw.com__ or (617) 570-3538.

For regular updates, follow RIW on __LinkedIn__, __Twitter__, and __Facebook__.

PROFESSIONALS

Gary Bubb

PRACTICES

Business Tax

POSTED IN: **ARTICLES & QUOTES**, **COVID-19**, **NEWS**, **TAX LAW**