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INSIGHT

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

Updated May 12, 2020

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) created Small Business Administration (SBA) Paycheck Protection Program (PPP) loans to provide short-term, economic relief to certain small businesses and nonprofits.

PPP loans can be used to cover payroll expenses and other enumerated operating costs (e.g., rent, utilities) and can be forgiven if the borrower meets certain payroll and employment retention criteria. The loans are capped at $10 million per borrower.

The initial authorization of $349 billion for PPP loans was exhausted by April 16, 2020. Congress authorized another $310 billion ($659 billion total) for PPP loans in the Paycheck Protection Program and Health Care Enhancement Act (P.L. 116-139).

On April 30, 2020, IRS issued Notice 2020-32, which clarifies the IRS position, under Internal Revenue Code (IRC) Section 265(a)(1), that PPP-recipients cannot claim a deduction for expenses funded from the forgiven PPP loans.

IRS's guidance could reduce the perceived economic benefit of PPP loans, and require some taxpayers to alter how they compute their taxes for 2020 compared to previous years. With this said, many businesses could still find that the economic benefits of PPP loans outweigh the potential costs.

Background on PPP Forgiveness

By regulation, payments on interest and principal are deferred for the first six months of the loan. Before that deferment period is over, borrowers can apply for forgiveness on the principal and accrued interest for eight weeks of expenses. According to the CARES Act, full forgiveness of eight weeks of expenses is available as long as the borrower: (1) maintains the same number of full-time equivalent employees during defined time periods and (2) does not decrease salaries and wages by more than 25% for employees that make less than $100,000 in annualized compensation. By regulation, at least 75% of the

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IN11378

loan must be used for payroll costs. To date, SBA has yet to issue comprehensive guidance on PPP forgiveness.

Forgiven PPP loans are exempt from taxation. Generally, forgiven debt—referred to as "cancellation of indebtedness income" or CODI—is included as income to the borrower and subject to income taxation, unless specifically excluded. However, under Section 1002 of the CARES Act, forgiven loan amounts are not to be included in the borrower's taxable gross income and hence are not taxable.

Tax Deductibility of Business Expenses

The CARES Act has no language referring to the deductibility of PPP expenses. Under Internal Revenue Code (IRC) Sections 162 and 163, taxpayers are allowed to deduct any ordinary or necessary trade or business expenses from their gross income. This would include PPP-eligible expenses like wages or other compensation, paid employee leave and fringe benefits, rent or utility payments associated with a business facility, interest on a business debt, and state tax payments.

However, IRC Section 265(a)(1) states that an expense that would otherwise be deductible from gross income as a business or nonbusiness 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 under the PPP. Absent a statutory change, Reinhold's analysis concluded that the deductions would be barred under IRC Section 265(a)(1). 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 loan is used to fund eligible business expenses, is ultimately forgiven by the lender, and is not subject to tax. The first benefit is that the taxpayer effectively receives a tax-free grant of $100,000. If the taxpayer can also deduct the entire loan amount—because it covered deductible business expenses—the taxpayer would also receive a second benefit of $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 benefit (i.e., tax savings) from deducting the business expenses, for a net tax liability of zero. In contrast, 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 then there is no tax on the income but no benefit from the deduction. In short, requiring the excluded loan amount to be included in income and allowing deductions (scenario 1) leads to the same outcome as allowing the loan to be excluded 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 $100,000 in deductible business expenses and a 37% top, marginal tax rate.

April 30, 2020, IRS Guidance

IRS issued Notice 2020-32, which takes the position that taxpayers are barred under IRC Section 265 from deducting expenses paid for by a PPP loan that is ultimately forgiven. The IRS notice does not provide instructions for taxpayers who unknowingly assumed a deduction in any quarterly income tax filings. Tax filers may need to amend any returns not in compliance with Notice 2020-32. Taxpayers 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.

Economic Benefit of PPP Loans

IRS's position would reduce the perceived economic benefit of PPP loans to taxpayers who thought they could continue to take deductions for PPP-eligible expenses. Alternatively, businesses that feel they are better off laying off their employees could do so 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 tax-excluded, forgiven PPP loans, then it could enact subsequent legislation. Congress has enacted some specific exemptions to Section 265(a)(1), such as those in IRC Section 265(a)(6) allowing a deduction for mortgage interest or real property taxes on the home of a taxpayer receiving a tax-free military housing allowance or a parsonage allowance for religious clergy. 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.

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