



Insights

IRS Deflates the Hope Balloon of PPP Borrowers

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On November 18, 2020, the Internal Revenue Service (IRS) issued Revenue Ruling 2020-27 and Revenue Procedure 2020-51, which, respectively, provided additional guidance regarding the IRS position on the non-deductibility of expenses funded with Paycheck Protection Program (PPP) loan proceeds and a “safe harbor” for taxpayers wishing to deduct those expenses after either being denied PPP loan forgiveness or ultimately deciding not to file for forgiveness. The guidance makes clear that taxpayers that received a PPP loan in a taxable year, and paid or incurred otherwise deductible expenses in that year, may not deduct those expenses if, at the end of such year, the taxpayer reasonably expects to receive forgiveness of the PPP loan. The expenses are not deductible even if the taxpayer has not applied for loan forgiveness by the end of such year but expects to do so and expects to receive some forgiveness. This guidance fans concerns that the PPP will not provide “free money” to the borrower due to the tax costs of dealing with non-deductible expenses when calculating the borrower’s taxes for 2020.

Background

As described in more detail in our earlier alert available [here](#), section 1102 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) established the PPP, which allowed qualifying small businesses to obtain loans administered and guaranteed by the Small Business Administration under section 7(a)(36) of the Small Business Act (15 U.S.C. §636(a)(36)). Under section 1106 of the CARES Act, a recipient of a PPP loan is eligible for forgiveness of indebtedness for all or a portion of the stated principal amount of the loan if certain conditions are satisfied, including use of the PPP proceeds for salaries and maintaining employee headcount.

In April of 2020, the IRS released an advance version of Notice 2020-32, in which it said expenses funded with forgiven PPP loans were not deductible so as to avoid a double tax benefit for loan recipients. See our alert [here](#) for additional information. The IRS position led many tax and business advisers to suggest that if such loans hadn’t been forgiven by the end of a taxpayer’s tax year, deducting them would not technically violate the guidance in Notice 2020-32. The IRS position on deductibility received almost immediate backlash from Senate Finance Committee Chair Chuck Grassley, R-Iowa and House Ways and Means Committee Chair Richard E. Neal, D-Mass. A bipartisan group of lawmakers is pushing legislation (S. 3612) that would allow businesses to deduct expenses incurred that are the basis for forgiveness associated with their PPP loans.

Revenue Ruling 2020-27 – Non-Deductibility of Expenses

In Revenue Ruling 2020-27, the IRS amplified guidance provided in Notice 2020-32 regarding the non-deductibility of expenses paid or incurred by a taxpayer that received a loan guaranteed under the PPP by analyzing two hypothetical scenarios involving taxpayers who received a PPP loan from a private lender in 2020. In “Situation 1,” the taxpayer paid “eligible expenses” (as described in section 1106(a)(8) of the CARES



Act), including payroll costs, interest on a mortgage, utility payments, and rent. Under the facts assumed by the IRS, the taxpayer applied for PPP loan forgiveness in November of 2020, and satisfied all requirements for forgiveness under section 1106 of the CARES Act. However, in this scenario, the taxpayer was not informed by the end of 2020 whether the loan would be forgiven. “Situation 2” provided the same set of facts. However, in this scenario, the taxpayer did not apply for forgiveness of the PPP loan before the end of 2020. Instead, the taxpayer expected to apply for forgiveness in 2021.

In holding that the taxpayers described in Situations 1 and 2 may not deduct the expenses paid or incurred in 2020, the IRS reiterated supporting guidance it relied upon in Notice 2020-32. Specifically, section 265(a)(1) of the Internal Revenue Code (Code) and related Treasury Regulations, which provide that no deduction is allowed (for otherwise deductible expenses) to the extent the amount paid is allocable to income that is tax exempt under the Code, whether or not such income is received or accrued. In addition, the IRS noted case law and rulings holding that deductions for expenses are disallowed where a taxpayer receives reimbursement for such expenses or has a reasonable expectation of reimbursement.

The IRS found that in both Situations 1 and 2, the taxpayers had a reasonable expectation of reimbursement, citing the loan forgiveness application procedures published by the SBA which provide clear guidance for calculating the amount of covered loan forgiveness. The IRS went on to cite section 265 of the Code as further supporting a ruling of non-deductibility, given the expenses were allocable to tax-exempt income in the form of the reasonably expected PPP loan forgiveness. The IRS specifically noted that, under section 265(a)(1) of the Code, the disallowance applies whether or not this tax-exempt income (i.e., the loan forgiveness) is received by the end of the taxable year.

Revenue Procedure 2020-51 – Safe Harbor for Deductions After Forgiveness Denied or Foregone

In Revenue Procedure 2020-51, which was released along with related Revenue Ruling 2020-27, the IRS provides a safe harbor for allowing a taxpayer to deduct “eligible expenses” (as defined under the CARES Act) incurred in the taxpayer’s 2020 tax year even though the taxpayer receives PPP loan proceeds. The safe harbor treatment is available for eligible taxpayers that (a) submit an application for PPP loan forgiveness (either in 2020 or a later year) and are notified that forgiveness of all or part of the loan is denied, or (b) in a later year, irrevocably decide not to seek forgiveness for some or all of the covered loan.

Under the safe harbor procedures provided, qualifying taxpayers may deduct the expenses on returns for either their 2020 tax year or subsequent tax years. Revenue Procedure 2020-51 limits the amount of deductions that may be claimed to no more than the amount of the principal amount of the PPP loan for which forgiveness was denied or will no longer be sought. Taxpayers wishing to apply the safe harbor must attach a statement to their return titled “Revenue Procedure 2020-51 Statement,” and provide specified identifying information, expense amounts and the amount of denied or foregone PPP loan forgiveness.

Observations

Many borrowers may feel that the rules of the PPP game are being changed midstream and that the results painted by the IRS in these just released Revenue Ruling and Revenue Procedure could be seen as a bit of a “bait and switch” for this program. Much of the initial dialogue about the PPP involved the concept of helping small businesses navigate and survive the challenges they were facing due to COVID-19 by providing loans that would be eligible for forgiveness if used for authorized purposes and that the amount of the forgiven loan would not be considered taxable income. Many read this to mean that they would have no adverse economic consequences from participating in the PPP and then seeking forgiveness. Perhaps they overlooked the Notice from the IRS last April or hoped that this risk would be taken away in subsequent legislation. In any event, borrowers now face the double-whammy of still suffering the economic harm caused by the pandemic plus a likely higher tax burden than anticipated because they are not able to deduct the expenses supporting the loan forgiveness.



This issue was recognized by Senators Grassley and Neal, but Congress so far has not moved forward on a “fix” for this conundrum. Perhaps with the election now behind, Congress will take action to relieve small businesses from these additional tax costs.

If you have any questions regarding the deductibility of eligible expenses pursuant to the CARES Act, PPP loan forgiveness or the CARES Act in general, please contact **Robert A. Greising** or **Kendall A. Schnurpel**.