

IRS Clarifies Non-Deductibility of Expenses Paid With Forgiven PPP Loan Proceeds

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The Paycheck Protection Program (“PPP”) included in the CARES Act allows businesses with 500 or fewer employees to receive loans to pay payroll costs, rent and certain other expenses. PPP loans can later be forgiven if the employer retains its employees and satisfies other requirements.

The CARES Act provides that the amount of any PPP loan that is later forgiven does not give rise to taxable income. Without this provision, the forgiveness of the loan would constitute taxable income in the form of cancellation of indebtedness income.

One question that I repeatedly get asked is whether businesses that used PPP loan proceeds to pay deductible expenses (such as payroll or rent) are able to deduct these expenses if the PPP loan is later forgiven. Unsurprisingly, the IRS has answered that question with a resounding no.

In Notice 2020-32, issued yesterday, the IRS states that because the amount of the forgiven loan is excluded from income, the forgiven loan is a class of exempt income under Section 265 of the Internal Revenue Code. As a result, Section 265(a)(1) applies, which disallows a deduction otherwise allowable under the Internal Revenue Code if allocable to one or more classes of exempt income (other than interest income).

In other words, the IRS determined that any otherwise deductible expenses funded by PPP loan proceeds that are subsequently forgiven are not deductible. This position is not surprising, as otherwise businesses would have gotten a double tax benefit from the PPP loan forgiveness program.