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**IRS: Forgiven PPP Loans Will Not Be Taxed, But Expenses Paid
With Money Is Not Deductible**

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To the extent a PPP Loan is forgiven, expenses paid from the loan will not be deductible

There has been uncertainty regarding the federal income tax consequences of income from loan forgiveness under the Paycheck Protection Program. The relevant off-Code provision merely stated that the forgiveness would not be included in the debtor's gross income, but it left several unanswered questions. Recently, the Service answered the most important question.

In short, the Service concluded that, to the extent a taxpayer has excluded income from discharge of a PPP loan, the expenses that were paid with the proceeds of that loan are not deductible because of section 265(a)(1). This was one of the possible outcomes that BDO identified two weeks ago. More details concerning the most recent guidance are set forth in the following paragraphs.

The Service issued [Notice 2020-32](#) last week providing guidance regarding the deductibility for federal income tax purposes of certain otherwise deductible expenses incurred in a taxpayer's trade or business when the taxpayer receives a loan ("covered loan") pursuant to the PPP.

The PPP was established by section 1102 of the CARES Act. Under the PPP, a recipient of a covered loan may use the proceeds to pay certain expenditures governed by sections 162 and 163 of the Code including (1) payroll costs, (2) certain employee benefits relating to healthcare, (3) interest on mortgage obligations, (4) rent, (5) utilities, and (6) interest on any other existing debt obligations.

Under section 1106(b) of the CARES Act, if certain conditions are met, a recipient of a covered loan can receive forgiveness of indebtedness on the loan ("covered loan forgiveness") in an amount equal to the sum of payments made for the following expenses during the eight-week "covered period" beginning on the covered loan's origination date (each, an "eligible section 1106 expense"): (1) payroll costs, (2) any payment of interest on any covered mortgage obligation, (3) any payment on any covered rent obligation, and (4) any covered utility payment.

The Notice clarifies that no deduction will be allowed for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a covered loan for which the income associated with the forgiveness is excluded from gross income under section 1106(i) of the CARES Act.

The Service indicated that section 161 provides that, in computing taxable income under various sections of the Code (*i.e.*, sections 162 and 163), otherwise-allowable deductions can be subject to

applicable exceptions, including section 265. Covered rent obligations, covered utility payments, and payroll costs consisting of wages and benefits paid to employees comprise typical trade or business expenses for which a deduction under section 162 of the Code generally is appropriate. Section 163(a) provides a deduction for certain interest paid or accrued during the taxable year on indebtedness, including interest paid or incurred on a mortgage obligation of a trade or business.

Section 265(a)(1) and Treas. Reg. § 1.265-1 disallow deductions of a taxpayer that are allocable to one or more classes of income (other than interest) that is exempt from income taxes. The purpose of section 265 is to prevent a double tax benefit. Section 265(a)(1) applies to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax-exempt income. It also applies where the tax exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose. In such event, it is proper to conclude that some or all of the deductions are allocable to the tax-exempt income.

Therefore, to the extent that section 1106(i) of the CARES Act operates to exclude from gross income the amount of a covered loan forgiven, the application of section 1106(i) results in a “class of exempt income” under Treas. Reg. § 1.265-1(b)(1). As a result, the Notice holds that section 265(a)(1) disallows any otherwise allowable deduction under any provision of the Code, including sections 162 and 163, for the amount of any payment of an eligible section 1106 expense to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven) because such payment is allocable to tax-exempt income, and the disallowance prevents a double tax benefit.

There may be other unresolved questions, particularly in the partnership and S corporation areas, but this Notice resolved the principal area of uncertainty.

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