IRS NOTICE RE: PPP DEDUCTIONS

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Our thoughts are with our clients, friends and their families. We are here and available to help. Together we will get through this difficult time and gather strength from each other.

May 6, 2020

The Paycheck Protection Program ("PPP"), enacted by Congress as part of the CARES Act, provides for loans to small businesses affected by the COVID-19 pandemic to fund certain expenses. Loans made under the PPP are eligible to be forgiven as long as a company uses the proceeds in compliance with the Act. The loan proceeds must be used to retain workers and maintain payroll or make mortgage interest payments, lease payments, and utility payments, as specified under the PPP rules. Loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities during the 8 week period following loan disbursement, and not more than 25% of the forgiven amount may be for non-payroll costs.

One common question is whether the expenses funded by a PPP loan may be deducted for income tax purposes. Usually these expenses would be deductible as an expense. However, on April 30, 2020, the IRS took the unusual move to issue Notice 2020-32 (the "Notice," available here), staking its position that such expenses, to the extent forgiven pursuant to the PPP rules, cannot be deducted.

For several reasons, the IRS position has many critics:

- First, the IRS has undermined Congressional intent in the CARES Act by restricting companies' liquidity to fund payroll.
- Second, the Notice is difficult to reconcile with specific provisions in the CARES Act legislation; although a forgiven loan is generally treated as taxable income to the borrower, Section 1106(i) of the CARES Act explicitly provides that forgiven PPP loans are not considered to be income for federal tax purposes. By issuing the Notice, the IRS essentially taxes companies on the loan proceeds by denying the related deduction.
- Finally, the Notice creates very peculiar results for companies by increasing the liabilities on their balance sheets. Payment of income taxes is not a permitted use of the loan proceeds under the PPP. Therefore, in order to obtain loan forgiveness, companies will find themselves in an unenviable position. To obtain loan forgiveness, a company must spend the proceeds on qualifying expenses as required by the PPP, but doing so will itself create a liability for income taxes (i.e. because the payment of qualifying expenses is not deductible) that the company would not otherwise have.

It is important to note that an IRS notice does not carry the force of law, but rather only sets forth the IRS' position and interpretation of the tax law. Judges are not required to follow IRS' notices, and often taxpayers justifiably take tax positions that are contrary to IRS notices. Given the amount of companies in need of cash and reliant on the PPP loans, the Notice will surely wind up as the subject of litigation.

Companies that have received PPP loans and wish to consider taking a position contrary to the Notice should understand their tax-reporting obligations and possible tax penalty implications.

PROFESSIONALS

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CAPABILITIES

Tax