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Can Your Business Deduct Business Expenses Covered by a PPP Loan?

While the Paycheck Protection Program (PPP) created by the federal CARES Act in response to the COVID-19 crisis put money in the hands of struggling businesses quickly and with little negative short-term effect, it is becoming quite clear that the Act has provided little guidance as to how these loans will impact the overall financial success of businesses in the long term. One example is whether businesses will be able to deduct normal business expenses, such as wages, if these costs were covered by a forgivable PPP loan.

Under the Internal Revenue Code (IRC), typically any amount of loan forgiveness is considered taxable income unless it falls under an exception listed in Section 108. These exceptions are typically for bankrupt or insolvent taxpayers receiving loan forgiveness. Notably, the CARES Act accounted for this and included, in its provisions on the expansion of the SBA's PPP loan program, that loans forgiven in accordance with the Act *will not* be subject to inclusion of income for tax purposes. CARES Act Section 1106(i) provides, "For purposes of the Internal Revenue Code of 1986, any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness describes in subsection (b) shall be excluded from gross income."

What the Act *does not* address, however, is how or if businesses are able to deduct business expenses that were covered by forgivable PPP loans. Section 265 of the IRC bars taxpayers from deducting expenses and interest from tax-exempt income. Section 265 only prohibits deductions if the taxpayer knows when it files its return that the expense it is deducting is associated with wholly exempt income.

While the entirety of a PPP loan has the potential to be forgiven, the borrower must meet certain requirements for the loan to actually be forgiven in any way. The CARES Act requires that 75% of the PPP loan must be used to cover payroll costs in which its employees were retained and paid at the same rate, while the other 25% can be

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used for certain other business expenses in order for the loan to be forgiven. So, a taxpayer does not necessarily know when it accepts its PPP loan how much, if any, of the loan balance will actually be forgiven. However, the argument could be made that the taxpayer will know by the time it files its 2020 or 2021 returns if the money it used from its PPP loan will be forgiven. This raises the concern that the expenses paid with the PPP proceeds are potentially barred under Section 265 from being deducted as a business expense.

Since Congress enacted the CARES Act, tax professionals have debated the implications of the explicit exclusion of PPP loan forgiveness from taxable income, yet there has been silence as to the effect of Section 265. This week the Internal Revenue Service (IRS) finally announced where it stands on the topic. On April 30, the IRS released Notice 2020-32, which provides that income derived from PPP loan forgiveness is considered a "class of exempt income," and thus the deduction restrictions included in Section 265 apply. The IRS noted that such provisions are to prevent a double tax benefit and that, if Congress intends to waive the restrictions of Section 265, it must expressly do so. Many practitioners were surprised by the IRS's position on the issue, considering the practical implications of providing grant-like financial relief to businesses, truly forgiving the loan by excluding it from income, but then expecting the same struggling businesses to "pay it back" in the form of a non-deduction of expenses that would otherwise be deducted. This has left many to wonder, what was the point of excluding the income in the first place?

On the one hand, the language of Section 265 is clear that expenses arising from income which is wholly exempt is a clear bar to a business expense deduction. That surface level interpretation would encompass PPP loans provided by the CARES Act. But, when considered on a practical level and within the overriding CARES Act policy context, it does not seem fair to provide financial aid to businesses, but not extend it in the form of real tax relief.

When considering the practicality of the situation, for a government program designed to help businesses and employees stay afloat during an economic crisis, disallowing normal business deductions would be counterproductive. For many businesses, their financial

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health is at least partially dependent on deducting business expenses, so to provide aid and then disallow these deductions would put many taxpayers in just as severe of a financial situation as not receiving the federal relief at all. Additionally, for those that argue a taxpayer will know *before* filing returns whether it has met the requirements for PPP loan forgiveness, with the continued uncertainty around how and when economic markets will reopen, this argument poses the threat of treating similarly situated taxpayers differently, as there is a high likelihood that some businesses will suffer additional financial losses through the remainder of 2020 and may not know with certainty if they will be able to have the full amount of their PPP loans forgiven. Lastly, it is argued that because the CARES Act does not expressly bar deductions of normal business expenses nor provide that Section 265 specifically applies, this should be interpreted to mean that such practices are allowed. Just as Congress has waived the inclusion of forgiveness of debt in gross income, one could reason that it should be interpreted that if it intended to disallow normal business deductions to be taken against forgivable PPP loans, it would have expressly addressed it.

Now that the IRS has voiced its opinion, it will be interesting to see if Congress backs this position or provides supplemental guidance. As for now, businesses should consider this tax consequence when applying for and using PPP loan funds.

We continue to monitor and report the development of guidance and legislation as the novel coronavirus continues to shape the economic climate. For more information as to how the COVID-19 pandemic may be affecting your business, please contact Mark Sommer, Rachel Chamberlain, Elizabeth Mosley or any member of Frost Brown Todd's Tax practice. You can also visit our Tax Law Defined Blog to get the latest updates on federal, state and local tax administration.

To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a Coronavirus Response Team. Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats

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