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PPP Loan Forgiveness Should Not Cause Discharge of Indebtedness Income or Generate a Form 1099-C

Bankers participating in the Paycheck Protection Program (PPP) must be aware of their reporting obligations to the Internal Revenue Service and borrowers when the upcoming wave of loan forgiveness decisions hit their banks. We previously discussed the theory behind discharge of indebtedness income: unless exempted by Congress, the receipt of cash or other benefit is taxable income. An exception is made for money received as a loan because the recipient/borrower/taxpayer will repay the money and the factual basis for that exception ceases to exist if the repayment requirement is forgiven.^[1] See [When a Lender Must File and Send a Form 1099-C to Report Debt Forgiveness](#) (04/26/19),

Many businesses and non-profits that never sought or received loan forgiveness desperately seek and hope for relief from the obligation to repay a PPP loan received from a financial institution. If loan forgiveness is received, (a) the lender will then determine if it must issue a Form 1099 to the borrower and (b) the borrower must determine if the forgiven debt is taxable income. This post will address those two questions for (i) debt-forgiven borrowers/taxpayers who receive forgiveness of a PPP loan, and (ii) lenders who made the forgiven loan.

Getting right to the point: taxpayers who are PPP loan borrowers and receive forgiveness of that loan do not have forgiveness of indebtedness taxable income assuming the PPP loan forgiveness was appropriate and no Form 1099-C needs to be issued by the lender. The CARES Act^[2] which authorized the PPP loan program explicitly provides that a forgiven PPP Loan will not cause debt forgiveness income. See section 1106(i) of the CARES Act.

Banks, businesses, and lawyers all know that there will be a panoply of varying circumstances amongst the approximately 5,000,000 PPP loan borrowers. The remainder of this post will be devoted to nuances concerning discharge of indebtedness income arising from

PPP loans so that borrowers can analyze their individual situations.

Analysis of any legal concern best starts with the relevant statutes. Here, that means the general rule in Section 61(a) of the Internal Revenue Code [28 U.S.C. Section 61(a)] which states:

Except as otherwise provided in this subtitle, gross income means **all income from whatever source derived**, including (but not limited to) the following items: (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Annuities; (9) Income from life insurance and endowment contracts; (10) Pensions; (11) **Income from discharge of indebtedness**; (12) Distributive share of partnership gross income; (13) Income in respect of a decedent; and (14) Income from an interest in an estate or trust.

(emphases added).^[3] The second relevant statute needed to understand PPP loans and debt forgiveness income is Section 108(e)(2) titled “**Income not realized to extent of lost deductions.**” That section states, “[no] income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.”

It was announced with great fanfare that PPP loans would be forgiven – that is, repayment would be waived – if the funds were used for government-approved expenses. Stated generally, the requirements are at least 60% of the loaned funds must be spent on employee payroll costs, and the other 40% of funds are allowed to be used for mortgage interest, rent and utility payments. These are all typically deductible expenses for businesses’ determination of taxable income. See Section 161 of the Internal Revenue Code. In ordinary times, a businesses’ gross receipts earned from the sale of goods or provision of services are included in gross taxable income ^[4] and gross income is reduced to taxable income by deducting business expenses – including the types of expenses that can be paid from PPP loan funds that qualify for repayment waiver. It is not a surprise, therefore, that the Internal Revenue Service (IRS) has

directed that businesses may not reduce their taxable income (that is deducted from taxable gross income) the expenses paid using the PPP loan funds. In April of 2020, the IRS' Notice 2020-32 stated that expenses associated with the tax-free income caused by PPP loan forgiveness are not deductible.^[5] While not surprising, some argue that the IRS' Notice has the net effect of essentially reversing the tax-free benefit of the exclusion on the loan forgiveness.

The other topic worth mentioning at this point is: must lenders issue a Form 1099-C to borrowers whose PPP loan is forgiven? In many circumstances, when debt is forgiven the forgiving lender must issue a Form 1099-C to the borrower. See the blog post mentioned at the top of this article. For PPP forgiven loans, the answer is that no Form 1099-C needs to be issued. Specifically, IRS Announcement 2020-12^[6] states:

When all or a portion of the stated principal amount of a covered loan is forgiven because the eligible recipient satisfies the forgiveness requirements under section 1106 of the CARES Act, an applicable entity [lender] is not required to, for federal income tax purposes only, and **should not, file a Form 1099-C information return with the IRS or provide a payee statement to the eligible recipient** under section 6050P of the Code as a result of the qualifying forgiveness. The filing of such information returns with the IRS could result in the issuance of underreporter notices (IRS Letter CP2000) to eligible recipients, and the furnishing of such payee statements to eligible recipients could cause confusion. This announcement is intended to prevent any such confusion. (emphasis added).

Above, we stated that loans would be forgiven if the funds were "used for government approved expenses." That same restriction applies to the IRS' statement that a lender need not issue a Form 1099-C because that statement is limited to situations where an eligible recipient meets the loan forgiveness requirements in the CARES Act.

In situations where the PPP loan program works as intended, it will have no tax impact: loaned funds received by the borrower are not taxed; expenses paid using loaned funds will not be deducted from other taxable income; the forgiven debt will not cause the issuance

of a Form 1099-C; and the forgiven borrower will not have forgiveness of indebtedness income.

Frost Brown Todd invites our clients and friends to address any concerns to us.

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[1] Chasing further down this "rabbit hole" leads to exceptions from this exception – no discharge of indebtedness income for debts not repaid due to bankruptcy, situations where the taxpayer is insolvent, and certain other limited cases.

[2] "CARES" stands for Coronavirus Aid, Relief, and Economic Security.

[3] Discharge of Indebtedness income is discussed in detail in IRC Section 108.

[4] This is distinguished from the receipts from other sources that are not included in gross income. Classic examples are capital contributions, including the sale of stock by businesses that are structured as corporations.

[5] IRS Notice 2020-32 can be found here <https://www.irs.gov/pub/irs-drop/n-20-32.pdf>.

[6] Do not confuse IRS "Notices" with IRS "Announcements." According to the IRS, a "notice is a public pronouncement that may contain guidance that involves substantive interpretations of the Internal Revenue Code or other provisions of the law" while an announcement "is a public pronouncement that has only immediate or short-term value. For example, announcements can be used to summarize the law or regulations without making any substantive interpretation."

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