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IRS doubles down on nondeductibility of PPP-funded expenses

By Sally P. Schreiber, J.D.
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In guidance issued late on Wednesday, the IRS reiterated its position that taxpayers cannot claim a deduction for any otherwise deductible expense if the payment of the expense results in forgiveness of a Paycheck Protection Program (PPP) loan because the income associated with the forgiveness is excluded from gross income under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136. The guidance came in the form of a revenue ruling (Rev. Rul. 2020-27 (https://www.irs.gov/pub/irs-drop/rr-20-27.pdf)), which addresses the issue of borrowers who pay expenses in 2020 but whose PPP loan is not forgiven until 2021, and a revenue procedure (Rev. Proc. 2020-51 (https://www.irs.gov/pub/irs-drop/rp-20-51.pdf)) that provides a safe harbor for PPP borrowers that have their loan forgiveness denied or who choose not to request loan forgiveness.

Under Section 1106(b) of the CARES Act, an eligible recipient of a covered PPP loan can receive forgiveness of indebtedness on the loan in an amount equal to the sum of payments made for the following expenses during the covered period beginning on the covered loan's origination date: (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. Section 1106(i) excludes from gross income any amount forgiven under the PPP.

In May, the IRS issued Notice 2020-32, providing that a taxpayer that receives a loan through the PPP is not permitted to deduct expenses that are normally deductible under the Code to the extent the payment of those expenses results in loan forgiveness under the CARES Act.

The CARES Act itself does not address whether deductions otherwise allowable under the Code for payments of eligible CARES Act Section 1106 expenses by a recipient of a covered loan are allowed if the covered loan is subsequently forgiven. The AICPA believes that the IRS's interpretation denying deductions of expenses forgiven under the PPP program is contrary to Congress's intent.

Expenses paid in a year before loan forgiveness

Rev. Rul. 2020-27 addresses the question of whether a taxpayer that received a PPP loan and that paid or incurred certain otherwise deductible expenses can deduct those expenses in the tax year in which the expenses were paid or incurred if, at the end of that tax year, the taxpayer reasonably expects to receive forgiveness of the covered loan based on the otherwise deductible expenses.

The revenue ruling discusses two situations in which a taxpayer receives a PPP loan in 2020 and pays expenses, including payroll, mortgage interest, and rent, that are eligible expenses under Section 1106(a) of the CARES Act. In one situation, the taxpayer applies for forgiveness of the PPP loan (and knew the amount of expenses that qualifies) in November 2020 but has not been informed by the lender at the end of 2020 whether the loan will be forgiven. In the second situation, the taxpayer has not applied for loan forgiveness by the end of 2020 but knew the amount of expenses that qualifies.

The IRS says in both situations, the taxpayer has a reasonable expectation of reimbursement (in the form of loan forgiveness) at the end of 2020; therefore, deduction of the expenses is inappropriate.

The IRS cites Sec. 265(a)(1), which disallows a deduction for otherwise eligible expenses to the extent the payment of those eligible expenses is allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness. The IRS says that "the fact that the tax-exempt income may not have been accrued or received by the end of the taxable year does not change this result because the disallowance applies whether or not any amount of tax-exempt income in the form of covered loan forgiveness and to which the eligible expenses are allocable is received or accrued."

Safe harbor where loan is not forgiven

In Rev. Proc. 2020-51, the IRS issued safe-harbor rules that allow a taxpayer to claim a deduction in the taxpayer's 2020 tax year for certain otherwise deductible eligible 2020 expenses if the taxpayer received a PPP loan that the taxpayer expects to be forgiven after its 2020 tax year and in a later year the taxpayer is denied PPP loan forgiveness, in whole or in part, or the taxpayer decides not to request PPP loan forgiveness. In that situation, under the revenue procedure's safe harbor, the taxpayer can deduct some or all of the expenses on (1) a timely filed (including extensions) original tax or information return for the 2020 tax year, (2) an amended 2020 return or administrative adjustment request, or (3) a timely filed original tax or information return for the subsequent tax year.

To qualify for the safe harbor, taxpayers must attach a statement to their return titled "Revenue Procedure 2020-51 Statement" that contains:

- The taxpayer's name, address, and Social Security number or employer identification number;
- A statement specifying whether the taxpayer is an eligible taxpayer under either Section 3.01 of the revenue procedure, for a taxpayer who applied for loan forgiveness in 2020 (or as of the end of the 2020 tax year intended to apply for loan forgiveness in a subsequent tax year) and the application was denied in whole or part, or under Section 3.02, for a taxpayer who applied for loan forgiveness in 2020 (or as of the end of the 2020 tax year intended to apply for loan forgiveness in a subsequent tax year) but in a later tax year decides to irrevocably withdraw its request for forgiveness;
- A statement that the taxpayer is applying the safe harbor in Section 4.01 of the revenue procedure for expenses claimed in 2020 or Section 4.02 for expenses claimed in a later year;
- The amount and date of disbursement of the taxpayer's loan;
- The total amount of covered loan forgiveness that the taxpayer was denied or decided to no longer seek;
- The date the taxpayer was denied or decided to no longer seek covered loan forgiveness; and
- The total amount of eligible expenses and nondeducted eligible expenses that are reported on the return.

Nothing in the revenue procedure prevents the IRS from examining tax returns to determine whether the taxpayers qualify to deduct the expenses in question.

The procedure is effective for tax years beginning in 2020.

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