CARES ACT: IRS NOTICE 2020-32

Guidance on Deductibility of Expenses When a Loan is Forgiven Under the "Paycheck Protection Program" of the CARES Act[1]

This Client Alert discusses additional information and guidance published by the Treasury Department in IRS Notice 2020-32 issued on Thursday, April 30, 2020 (the "Notice"). The Notice generally provides that otherwise deductible expenses incurred in a taxpayer's trade or business are not deductible to the extent the taxpayer receives loan forgiveness under the Paycheck Protection Program ("PPP") through the payment of such expenses.[2]

OVERVIEW OF IRS NOTICE 2020-32

Section 1106(i) of the CARES Act expressly provides that properly forgiven PPP loan amounts, which would otherwise be included in gross income, instead "shall be excluded from gross income." However, the CARES Act does not address whether eligible expenses incurred under section 1106 of the CARES Act (which give rise to the loan forgiveness) are deductible. Unfortunately for taxpayers, the Notice concludes that no deduction is allowed for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a covered loan under the CARES Act and the income associated with the forgiveness is excluded from gross income pursuant to section 1106(i) of the CARES Act.

IRS REASONING

The Notice explains that section 161 of the Internal Revenue Code (the "Code") provides that, in computing taxable income, there shall be allowed as deductions certain items, including, for example, items allowable under section 162 (trade or business expenses) and section 163 (interest). However, section 161 of the Code provides that the allowance of these deductions is subject to certain exceptions, including section 265 of the Code.

[1] The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), Public Law 116-136, 134 Stat. 281, 286-93 (March 27, 2020).

[2] The PPP loan program provides cash-flow assistance through 100% federally guaranteed loans to qualified employers to encourage them to maintain their payroll during this emergency. PPP has a host of attractive features, such as forgiveness of loan amounts used to fund up to eight weeks of payroll and other expenses, a one percent interest rate, and six months of deferred principal and interest payments.

Section 265(a)(1) of the Code and §1.265-1 of the Income Tax Regulations provide that no deduction is allowed to a taxpayer for any amount otherwise allowable as a deduction that is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Code.[3] The purpose of section 265 of the Code is to prevent a double tax benefit.

The Notice concludes that 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 §1.265-1(b)(1) of the Regulations. Accordingly, the IRS concludes that section 265(a)(1) of the Code should disallow 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. The Notice states that this reasoning is consistent with prior guidance of the IRS that addresses the application of section 265(a) to otherwise deductible payments. Following this rationale, the deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement.

Additional Potential Issues

It is arguably unclear how the Notice may interact with other provisions of the Code. For example, it could be argued that the Notice and its application of section 265 is inconsistent with the overall operation of section 108 of the Code that deals with income from the discharge of indebtedness and contains various exclusions of such income from a taxpayer's gross income. Section 108 of the Code contains specific rules that require the reduction of various tax attributes of a taxpayer if an exception under section 108 (*e.g.*, a taxpayer has debt discharged in bankruptcy) results in income from the discharge of indebtedness being excluded from a taxpayer's gross income. Section 265, in contrast, does not apply to disallow all deductions claimed with respect to the expenditure of the loan proceeds to which section 108 applies.

Also, because of the low interest rate on PPP loans, borrowers may also want to consider waiting to apply for forgiveness as there seem to be some open issues. For example, if a borrower does not apply for forgiveness in 2020, will the deduction in 2020 be disallowed under the Notice? If, for example, a borrower decides to pay $100,000 annual interest charges on a $10 million loan and then applies for forgiveness in 2022, how does the Notice apply to what happens in 2022? These types of open issues could be addressed in future guidance.

[3] *See* generally section 265(a)(1); and Treasury Regulation §1.265-1.

Finally, the Notice could be viewed as inconsistent with Congressional intent. By including section 1106(i) in the CARES Act, did Congress intend to provide the additional tax benefit the IRS now seeks to deny? The after-tax economic effect of the position set forth in the Notice in many cases may be the same as if Congress had not added the non-taxability language in section 1106(i).

Following the release of the Notice, Senate Finance Committee Chair Chuck Grassley, R-Iowa, indicated his disappointment with the Notice. Senator Grassley said in a statement, "The intent was to maximize small businesses' ability to maintain liquidity, retain their employees and recover from this health crisis as quickly as possible… This notice is contrary to that intent." Senator Grassley did not indicate whether lawmakers would attempt to make changes to the PPP in future legislation. However, Erin Hatch, a spokesperson for Senator Grassley's counterpart in the House, Ways and Means Committee Chair Richard E. Neal, D-Mass., said, "We are planning to fix this in the next response legislation."

If you have any questions about the information contained in this Client Alert, please contact the Thompson & Knight attorney with whom you regularly work or one of the attorneys listed below. We will continue to update this Client Alert as new Treasury Department and SBA guidance becomes available.

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