

IRS to Disallow Deductions for Expenses Paid Using Forgiven PPP Loan Funds

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In [Notice 2020-32](#), the IRS answered one of the previously open questions for recipients of loans under the Small Business Administration's (SBA) Paycheck Protection Program (PPP), namely whether businesses may deduct payroll costs and other eligible expenses funded with the proceeds of a PPP loan that is ultimately forgiven. To the detriment of struggling businesses, the IRS announced its position that such deductions are not allowed under existing federal income tax law.

Under the PPP, recipients of loans may obtain forgiveness of the loan to the extent the loan proceeds are used for payroll costs and other eligible expenses during the eight-week period after receipt of the proceeds. While the forgiveness of a loan generally results in a business realizing cancellation of indebtedness income under general tax principles, the CARES Act expressly provided that any such income realized as a result of forgiveness of the loan is excluded from the business' income. As a result, businesses will not be hit with an unwelcome tax bill due to the SBA's forgiving the PPP loan.

However, the question left unanswered by the CARES Act was whether businesses would be allowed to deduct the payroll costs and other eligible expenses they paid using PPP loan proceeds. Relying on regulations issued under Section 265 of the Internal Revenue Code and guidance that is almost 40 years old, the IRS concluded that permitting such a deduction would be a "double tax benefit," allowing businesses to receive funds tax-free and deduct expenditures paid with those funds.

Despite the clear intent of the CARES Act to provide benefits to struggling businesses, the IRS' current position is that permitting businesses to exclude PPP loan proceeds from income and deduct expenses funded with those proceeds would provide more benefit than was intended by the CARES Act.

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