SMITH MOORE

Providing financial advice since 1913
Member FINRA | SIPC

To our clients and colleagues, please see guidance provided by Smith Moore's legal counsel, Greensfelder Attorneys at Law, concerning additional information released by the IRS as it relates to the reduction of the potential benefit of loans under the Paycheck Protection Act ("PPP").

GREENSFELDER
ATTORNEYS AT LAW

IRS Reduces Benefit of PPP Loans – Provides Notice that Expenses Funded with Forgiven Loans are not Deductible

By Phil Stanton and Jay Nathanson
Published May 1, 2020

Late Thursday evening, the Internal Revenue Service released guidance that greatly reduces the potential benefit of loans under the Paycheck Protection Act ("PPP") for many taxpayers.

The PPP was created under the CARES Act and provides loans to small business, all or part of which may be forgiven to the extent used to fund up to eight weeks of payroll expenses, utilities, rent and interest on certain debt. For additional background on PPP, please read Greensfelder's earlier blog post. Section 1106(j) of the CARES Act specifically provides that the amount of forgiven debt is *not* includable in taxable income for purposes of federal income tax.

Questions had been raised by lawyers and commentators soon after enactment of the PPP concerning whether expenses funded with loans forgiven on a tax-free basis would still be deductible. However, the IRS remained silent for weeks while tens of thousands of borrowers obtained loans that were intended to provide economic security during the COVID-19 pandemic. This latest guidance diminishes the economic benefit of a PPP loan that will qualify for tax-free forgiveness except possibly in the case of taxpayers that have suffered such large tax losses that deductibility of the expenses funded with the loans is no longer significant.

Under Sections 162 and 163 of the Internal Revenue Code, the categories of expenses for which PPP loans may be used are typically deductible by a taxpayer. Section 162 provides for a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. This would usually include the rent, utility, and payroll costs for which PPP loans are intended. Section 163(a), although subject to many limitations, generally provides a deduction for certain interest paid or accrued, including interest paid or incurred on a mortgage obligation of a trade or business, also an intended use of PPP loans. In short, payroll costs, utilities, rent and interest expenses are all common deductions for many, if not most, businesses in America.

The questions about whether Sections 162 and 163 would allow deduction of these expenses in the context of a PPP loan arose because of Section 265(a)(1) of the Code. This section provides that no deduction is allowed to a taxpayer for any otherwise permitted deduction that is allocable to one or more classes of income that is tax exempt. The purpose of Section 265 of the Code is to prevent a double tax benefit where a taxpayer receives tax exempt income to pay expenses that would otherwise be deductible.

At the heart of Thursday's guidance, the IRS reasoned that the exclusion of the forgiven amount of a PPP loan from gross income under Section 1106(i) of the CARES Act results in a "class of exempt income" under §1.265-1(b)(1) of IRS Regulations. As a result, Section 265(a)(1) of the Code disallows any otherwise allowable deduction under Sections 162 and 163 for the amount of any payment of an eligible expense described in Section 1106 of the CARES Act to the extent of the forgiven amount of a PPP loan because such payment is allocable to tax-exempt income. The IRS concluded that "[c]onsistent with the purpose of Section 265, this treatment prevents a double tax benefit."

As a result, PPP borrowers who receive forgiveness of a loan will not be able to deduct expenses for payroll, utilities, rent or interest payments to the extent of the forgiven amount of the loan. For example, a taxpayer who has a total of $50,000 in payroll, utilities, rent and interest expense in calendar year 2020, but uses a PPP loan, which is forgiven, to fund $10,000 of these expenses, will only have $40,000 in related deductions. If the taxpayer in this example was in a 30% income tax bracket, the lack of deduction would in effect make the forgiven loan worth $7,000 (only 70 cents on the dollar) as opposed to $10,000 (a full dollar of value for each dollar of loan forgiven). If the taxpayer in the example was in a significant loss situation and, accordingly paid no taxes, the forgiven loan would add the full $10,000 to the bottom line, but that would of course be the case even if the forgiven loan was fully taxable.

It is possible that Congress may undo this decision with legislative action, but that will require action on a third bailout act. At this time, negotiations between Democrats and Republicans are not moving quickly. Businesses in desperate need of liquidity will now need to consider this additional factor when deciding the merits of taking a PPP loan.

Link to Greensfelder's COVID-19 Resources page