



Business Expense Deductions and Paycheck Protection Program Loan Forgiveness

On April 30, 2020, the Internal Revenue Service issued Notice 2020-32 which provides guidance regarding the deductibility for Federal income tax purposes of certain otherwise deductible expenses incurred in a taxpayer's trade or business when the taxpayer receives a loan pursuant to the Paycheck Protection Program ("PPP") as authorized by the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act").

Specifically, Notice 2020-32 clarifies that no deduction is allowed under the Internal Revenue Code (the "Code") for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a covered loan pursuant to section 1106(b) of the CARES Act.

Under section 1106(b) of the CARES Act, a recipient of a covered 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 8-week "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(d) of the CARES Act provides that the amount of the covered loan forgiveness is reduced, however, if, during the covered period, (1) the average number of full-time equivalent employees of the recipient is reduced as compared to the number of full-time employees in a specified base period, or (2) the salary or wages of certain employees is reduced by more than 25 percent as compared to the last full quarter before the covered period. Additionally, no more than 25 percent of the amount forgiven can be attributable to non-payroll costs.

Section 1106(i) of the CARES Act addresses certain Federal income tax consequences resulting from covered loan forgiveness. Specifically, that subsection provides that any amount that (but for that subsection) would be includible in gross income of the recipient by reason of the loan forgiveness offered under the PPP shall be excluded from gross income.

Generally, section 162 of the Code provides for a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Covered rent obligations, covered utility payments, and payroll costs consisting of wages and benefits paid to employees all constitute trade or business expenses for which a deduction under section 162 of the Code generally is appropriate.

Section 265(a)(1) of the Code and its corresponding Treasury Regulations generally provide that no deduction is allowed to a taxpayer for any amount otherwise allowable as a deduction to such taxpayer that is allocable to one or more classes of income (other than interest) where such income is exempt from taxes.

Notice 2020-32 provides 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 under section 1106(b) of the CARES Act, the application results in exempt income under §1.265- 1(b)(1) of the Regulations. Accordingly, section 265(a)(1) of the Code disallows any otherwise allowable deduction under any provision of the Code, including a deduction under section 162, 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. Consistent with the purpose of Code section 265, this treatment prevents any taxpayer from obtaining a double tax benefit.

In short, to the extent otherwise deductible expenses such as payroll, rent, interest expense and the like are funded by a PPP loan that is subsequently forgiven, the good news is that the loan forgiveness does not result in any realization of taxable income but the taxpayer is likewise also denied a deduction for such expenses funded by the portion of the loan being forgiven. In essence, IRS Notice 2020-32 is merely applying the long-standing quintessential no double dipping or no double benefit rule.

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