To Deduct or Not Deduct? How The Recent Stimulus Bill Impacts PPP Borrowers

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For many firms, the Paycheck Protection Program offered a short-term solution to the financial uncertainty created by the COVID-19 pandemic. With jury trials screeching to a halt, corporate clients clinging to cash, and remote worker productivity in question, many employers with fewer than 500 employees applied for forgivable loans from the Small Business Administration as a lifeline.

The loans did not require collateral or personal guarantees and could be requested in amounts totaling up to eight weeks of payroll costs, including benefits. In addition to covering payroll, the funds could be also be used to pay interest on mortgages, rent, and utilities over a period of up to 24 weeks. What made these loans incredibly attractive was the fact that if businesses used their PPP loans for certain qualified business expenses, some or all of the loan may be forgiven. Even unforgiven portions of PPP loans had favorable terms, including an interest rate of only 1%. Over 14,000 law firms across the country participated in the PPP, with AmLaw 200 Firms receiving $370 million in loans.

While the CARES Act Section 1106(i) explicitly excludes the forgiveness of PPP loans from gross income, the Act did not address whether the expenses used toward forgiveness would be deductible. This open question wreaked havoc on financial year-end planning: can firms deduct otherwise deductible business expenses if they were paid were PPP funds? If yes, some would argue that the PPP funds amounted to double-dipping (i.e. non-taxable income coupled with no commensurate loss in deductions). If no, the loss in deductions could create an unexpected tax liability during an already difficult year for small businesses.

On April 30, 2020, the IRS issued Notice 2020-32 to provide guidance regarding the deductibility for federal income tax purposes of certain otherwise deductible expenses incurred in a taxpayer's trade or business that the taxpayer uses to support loan forgiveness. The notice states that no deduction is allowed under the Internal Revenue Code for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a PPP loan because the income associated with the forgiveness is excluded from gross income for purposes of the Code under CARES Act Section 1106(i).

On November 18, 2020, the IRS issued Rev. Rul. 2020-27, clarifying the tax year for which the deduction would be disallowed, and Rev. Proc. 2020-51, providing a safe harbor for taxpayers who did not claim deductions for expenses intended to be used for loan forgiveness but whose loan is not forgiven. The Ruling states, "A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period, even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year."

Essentially, the Ruling holds that a taxpayer computing taxable income on the basis of a calendar year may not deduct eligible expenses in its 2020 tax year if, at the end of the tax year, the taxpayer has a reasonable expectation of reimbursement in the form of loan forgiveness (whenever forgiveness is sought) on the basis of eligible expenses paid or incurred during the covered period. The Revenue Ruling sent many small businesses running to their elected officials.

During the recent negotiations over the second COVID relief bill, the issue regarding PPP deductibility was at the top of the list. With fervent deductibility disapproval coming from the Treasury, it was unclear until the final hours whether Congress would provide businesses with the relief they needed. On Monday December 21, 2020 Congress passed another emergency stimulus package, providing the following with respect to the PPP:

1. Expansion of expenses eligible for loan forgiveness to include supplier costs and investment costs related to modifying facilities and obtaining personal protective equipment for safety.
2. Simplified loan forgiveness process for businesses that have borrowed $150,000 or less in PPP loans.
3. Confirmation that business expenses paid for with PPP loan funds <u>are</u> tax deductible.

Specifically, Section 276 clarifies that gross income does not include any amount that would otherwise arise from the forgiveness of a Paycheck Protection Program (PPP) loan. This provision also clarifies that deductions are allowed for otherwise deductible expenses paid with the proceeds of a PPP loan that is forgiven, and that the tax basis and other attributes of the borrower's assets will not be reduced as a result of the loan forgiveness. The provision is effective as of the date of enactment of the CARES Act. The provision provides similar treatment for Second Draw PPP loans, effective for tax years ending after the date of enactment of the provision.

The bill was signed by President Trump last Sunday.