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CARES Act Update: Internal Revenue Service Disallows Deduction of Certain Expenses Funded with PPP Loan Proceeds

Key Takeaway

- Deductions are disallowed for otherwise deductible expenses incurred by a taxpayer that receives a loan under the Paycheck Protection Program (“PPP Loan”) to the extent the PPP Loan is forgiven.

Under the Paycheck Protection Program created by the CARES Act, the proceeds of a PPP Loan can be used for certain business expenses, including payroll costs, certain employee healthcare benefits, mortgage interest, rent, utilities and interest on other existing debt obligations.

The CARES Act also provides that the portion of a PPP Loan used during the eight week period beginning on the PPP Loan funding date for certain payroll costs, interest on certain mortgage obligations, certain rent obligations and certain utility costs are eligible for forgiveness. In addition, whereas a taxpayer would ordinarily recognize income, for U.S. federal income tax purposes, upon the cancellation of indebtedness, the CARES Act specifically excludes forgiveness of a PPP Loan from a taxpayer’s gross income. The CARES Act does not directly address the deductibility of expenses paid with the proceeds of a PPP Loan.

Sections 162 and 163 of the Internal Revenue Code of 1986, as amended (the “Code”) allow an income tax deduction for ordinary and necessary expenses incurred in the carrying on of a trade or business and for certain interest payments. Accordingly, the type of expenses for which the proceeds of a PPP Loan are to be utilized would generally be deductible for U.S. federal income tax purposes.

In Notice 2020-32, 2020-21 IRB 1 (the “Notice”), however, the IRS denies taxpayers a deduction for any such expenses to the extent of the amount that such PPP Loan is forgiven. The IRS bases its holding on Section 265 of the Code, which disallows a deduction for expenses allocable to tax-exempt income, and Treasury regulations promulgated thereunder which clarify that tax-exempt income includes income exempt from U.S. federal income tax under the Internal Revenue Code or any other law.¹ We would note that the Notice has raised a significant amount of controversy and that senior Congressional leaders have

¹ Treasury Regulations Section 1.265-2(b).

expressed their disagreement with the IRS' position, claiming that it runs contrary to legislative intent,² and have introduced legislation in the Senate to override the Notice.³

The denial of a deduction is limited to only expenses that result in forgiveness of a PPP Loan under the CARES Act. Any other expenses incurred by a taxpayer and paid with the proceeds of a PPP Loan remain, subject to any other limitation provided by the Code, eligible for an income tax deduction.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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² United States, Congress, Senate, Comm. on Finance, *Grassley, Wyden, Neal Push Treasury to Allow Small Businesses To Deduct PPP Expenses*, (May 5, 2020) <https://www.finance.senate.gov/chairmans-news/grassley-wyden-neal-push-treasury-to-allow-small-businesses-to-deduct-ppp-expenses>.

³ United States, Congress, Senate, Comm. on Finance, *Bipartisan Senators Introduce Bill to Clarify Small Business Expense Deductions Under PPP*, (May 6, 2020) <https://www.finance.senate.gov/chairmans-news/bipartisan-senators-introduce-bill-to-clarify-small-business-expense-deductions-under-ppp>.