IRS Declares That Expenses Funded With Forgiven Paycheck Protection Program Loans Are Not Deductible

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On April 30, 2020, in Notice 2020-32, the IRS declared that expenses, including payroll expenses, are not deductible for federal income tax purposes if funded with forgiven Paycheck Protection Program ("PPP") loans. Under the PPP, businesses have been able to obtain loans to fund payroll costs and the payment of certain other vital expenses. If the proceeds of a PPP loan are used to fund payroll costs, interest on certain mortgage obligations, certain rent payments, and certain utility payments, all or a portion of the loan may be forgiven. Under SBA guidance, not more than 25% of the forgiven amount may be used for non-payroll costs, so the lion's share of PPP loan proceeds is expected to go to employees. While forgiveness of a non-PPP loan is generally taxable to a borrower, Section 1106(i) of the CARES Act specifically provides that the forgiveness of a PPP loan under Section 1106(b) of the CARES Act is excluded from gross income.

Notice 2020-32 has likely createdmore issues than it has resolved. For example, it is unclear what would happen if an employer were to deduct PPP funded payroll expenses before the PPP loan is forgiven. In light of the recent pronouncement by Treasury Secretary Mnuchin that eligibility for forgiveness of all loans over $2 million will be scrutinized, many taxpayers will be unsure whether their loans will be forgiven and will therefore be unsure whether they can deduct PPP funded expenses.

It is uncertain whether the courts would ultimately uphold the IRS's position, as it is arguably at odds with the underlying statutory provisions. Had Congress intended to disallow a tax benefit for expenses funded with PPP loans, it could have simply omitted Section 1106(i) from the CARES Act.

Congress may enact additional legislation to clarify the current tax ambiguity.