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EXPENSES USED FOR PPP LOAN FORGIVENESS: DEDUCTIBLE OR NOT?

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The Paycheck Protection Program (PPP), created as part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act authorized loans to certain businesses affected by the COVID-19 pandemic. If businesses use their PPP loans for certain qualified business expenses, then some or all of the loan may be forgiven, subject to certain tests. CARES Act Section 1106(i) explicitly excludes the forgiveness of PPP loans from gross income.

While the CARES Act excludes the loan forgiveness from gross income, it does not specifically address whether the expenses used to achieve the loan forgiveness would continue to be deductible. 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). The notice cites Sec. 265 as the specific disallowance provision and also notes that case law and published rulings would disallow the deduction because the taxpayer has a reasonable expectation of reimbursement of those amounts.

On Nov. 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. Rev. Rul. 2020-27 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 on the basis of eligible expenses paid or incurred during the covered period. Rev. Proc. 2020-51 provides a safe harbor for taxpayers who paid these expenses, not claiming a deduction for such amounts, and in a subsequent year is informed that forgiveness of all or part of the loan is denied or decides not to apply for forgiveness. The safe harbor allows the borrower to deduct these expenses on an original or amended tax return for 2020 or a subsequent tax year and requires a specific statement to be attached to the income tax return on which the expenses are deducted.

In our opinion, Notice 2020-32 and Rev. Rul. 2020-27 are not a reasonable application of existing tax law. As such, Rev. Proc. 2020-51 is not needed. This article describes our position.

The Sec. 265 argument

Notice 2020-32 and Rev. Rul. 2020-27 state that to the extent the CARES Act excludes from gross income the amount of a covered loan forgiven, the nontaxable forgiveness results in a class of exempt income under Regs. Sec. 1.265-1(b)(1) and the amount of any payment used in

obtaining loan forgiveness is disallowed as a deduction because such payment is allocable to tax-exempt income.

The notice indicates that this outcome is consistent with Rev. Rul. 83-3, which stands for the proposition that where tax-exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, Sec. 265(a) applies because such deductions are allocable to the tax-exempt income. Rev. Rul. 83-3 looks to the direct link between the payment and the tax-exempt income. The notice also cites *Manocchio*, 78 T.C. 989 (1982), and discusses this case more in depth.

The taxpayer in *Manocchio* attended a flight training course that maintained and improved skills required in the taxpayer's trade or business. As a veteran, the taxpayer was entitled to an educational assistance allowance from the Veterans Administration (VA) equal to 90% of the costs incurred. Because the payments received were exempt from taxation, the taxpayer did not report them as income. The taxpayer did, however, deduct the entire cost of the flight training course, including the portion that had been reimbursed by the VA. In a reviewed opinion, the Tax Court held that the reimbursed flight training expenses were nondeductible under Sec. 265(a)(1).

We believe that the payroll and other expenses used to satisfy the loan forgiveness provisions for PPP loans are business expenses and are not a class of exempt income allocable to the PPP loan under Regs. Sec. 1.265-1(b)(1). In addition, while the loan can only be used for expenses that, if paid in the covered period, would support loan forgiveness, the loan is not earmarked for expenses incurred during the loan forgiveness period, and thus there is no direct link between the payment of the expenses and the tax-exempt income. Unlike in *Manocchio*, the taxpayer is not entitled to forgiveness of the loan by reason of incurring those expenses but rather only by reason of applying for and receiving approval for forgiveness.

The amounts received are a loan and remain such until the forgiveness application is approved by the U.S. Small Business Administration (SBA). The lack of required repayment comes from actions taken after the funds are received. The fact that intervening actions are required would seem to distinguish the close connection required in the case law and revenue rulings for amounts to be allocable to a class on income exempt from tax.

The reimbursement theory argument

Rev. Rul. 2020-27 expands on the notice's mention of the reimbursement theory as a reason for disallowing the deduction. This theory is most extensively detailed in Chief Counsel Advice (CCA) 200947035. In the CCA, an employer paid an employee disability income under an employment contract and also received proceeds under a disability insurance contract insuring that employee. The proceeds of the disability policy were received tax-free under Sec. 104(a)(3). The issue addressed in the CCA was whether the payment of the salary to the employee was deductible.

The CCA analyzed the transaction to determine whether the receipt of the disability proceeds by the employer was a "reimbursement" of the amounts paid to the employee. The CCA in reviewing the case law, including specifically *Burnett*, 356 F.2d 755 (5th Cir. 1966), described the

reimbursement theory as requiring a finding that the expense and reimbursement are "connected to each other." The CCA states that based on revenue rulings, the "expense deducted and the right to reimbursement must be such that the expense incurred must bear a close nexus to the reimbursement." In coming to this conclusion, the CCA cited Rev. Rul. 78-388 where a business's moving expenses were not deductible because it had a fixed right of reimbursement under a federal highway program. The CCA explained that both the moving expense and the reimbursement arose because the state highway authority had taken the taxpayer's premises and, thus, there was no reimbursement without the expense. For PPP loan forgiveness, there is a requirement that the forgiveness be applied for and granted. The forgiveness is not a foregone conclusion when the expense is incurred.

Rev. Rul. 2020-27 and the CCA also cited Rev. Rul. 79-263, in which the taxpayer was disallowed a deduction for cattle feed that was partially reimbursed due to a drought. Rev. Rul. 80-348, which modified Rev. Rul. 78-209 and provided that travel expenses for union delegates were not deductible since those amounts were reimbursed, was cited by the notice and Rev. Rul. 2020-27. The CCA — but neither the notice nor Rev. Rul. 2020-27 — contrasted these results with Rev. Rul. 64-329, where a taxpayer who was the victim of a disaster received cash gifts to help rehabilitate his property and claimed a casualty loss deduction. Rev. Rul. 64-329 concluded the loss was deductible since the recipient had no limitation or directive relating to the manner in which the money was used. It contrasted this outcome with Rev. Rul. 131, where the casualty loss was disallowed because the recipient was required to use the money received to rehabilitate the property subject to the casualty. The different outcomes were due to the nexus between the receipt of the funds and the expenditures.

The CCA discussed *Manocchio*, explaining that the connection between the expense and the reimbursement was direct in that incurring the flight expenses preceded and was a condition precedent to the reimbursement. The CCA also discussed *Electric Tachometer Corp.*, 37 T.C. 158 (1961), a case in which the taxpayer was allowed a deduction for moving expenses because the taxpayer had only a general right to reimbursement. The court concluded that although the taxpayer had a general right to reimbursement, conflicting evidence regarding the amount of compensation indicated the lack of definiteness of the taxpayer's right. In this case, the state of Pennsylvania took the taxpayer's property by eminent domain, forcing the taxpayer to relocate. There was a trial to determine damages, and ultimately there was a settlement where the taxpayer was paid a fixed sum for all damages pursuant to the taking and the expenses of relocation. The IRS disallowed the moving expenses, deeming a portion of the settlement to be a reimbursement for those expenses. The Tax Court held that the right to reimbursement was not fixed and that the moving expenses were deductible.

The CCA then applies these principles to the specific facts in concluding that the deduction for the salary expense was not disallowed. It explains that because the insurance proceeds are not required to be paid to the employee and can be used for any other purpose, there is not a close enough nexus to the receipt and the payment. The CCA acknowledges that while the insurance proceeds were received by the employer as a result of an employee's disability, they were not received as a reimbursement for compensation paid to the employee, even though they may have been measured to some extent by the compensation to be paid under his employment contract.

The CCA summarized this by stating:

> This case differs from the revenue rulings where the taxpayer was reimbursed for the expense. In the rulings cited above, it is clear that if the expense is incurred, it would be reimbursed and the reimbursement depends on the expense. In situations where this nexus is not clear, the deduction has been allowed. In the case at issue here, Employer is receiving disability insurance payments under an insurance policy and paying salary payments under a separate employment contract. The right to the insurance proceeds derives from the insurance contract and the employee's disability and not from the legal obligation to make the salary payments. *The connection between the expense and the payment is not such that the receipt of the insurance payment depends on the salary expense having been incurred.* Because of this lack of a nexus, the insurance payment is not a reimbursement for the compensation expense. [Emphasis added]

While Notice 2020-32 and Rev. Rul. 2020-27 both cite *Burnett*, 356 F.2d 755 (5th Cir. 1966), *cert.* denied, 385 U.S. 832 (1966), and *Charles Baloian Co.*, 68 T.C. 620 (1977), the revenue ruling expands the discussion of the reimbursement theory by citing *Canelo*, 53 T.C. 217 (1966), aff'd, 447 F.2d 484 (9th Cir. 1971), as additional authority. *Burnett and Canelo* both involved attorneys who incurred expenses that would be recovered from clients with successful claims. Both courts denied the deductions, noting that the expenses were incurred with the expectation of reimbursement, as the attorney carefully screened its clients for claims likely to be successful. The court in *Charles Baloian Co.* denied a moving expense deduction, the reimbursement of which was authorized by the government agency requiring relocation prior to the expense's being incurred.

The issue in applying this reimbursement theory to PPP loan forgiveness is determining how closely the forgiveness is related to the expenses that are incurred. As the CCA and *Electric Tachometer Corp.* show, the expense must create the obligation to the reimbursement. Clearly the facts are not consistent with PPP loan forgiveness. The receipt of the loan is not in any way conditioned on the payment of any qualifying expense, although loan amounts are required to be spent only for certain expenses. While the forgiveness of the PPP loan may be conditioned on the expenses incurred, the receipt of the loan is not. All the cases and rulings cited in the notice look at the link between the receipt and the payment. The notice is trying to use the payment itself to link to the basis for the disallowance and not focusing on the reason for the receipt of the funds.

While this may seem to be a minor distinction, the lack of the formal obligation is exactly what caused the different outcome in Rev. Rul. 64-329 and Rev. Rul. 131. Thus, the reimbursement theory does not provide a basis for disallowing the deduction, as there is no reasonable expectation, based on judicial authorities and revenue rulings, of forgiveness when the loan is applied for or funded because the forgiveness has not been requested or approved by the SBA when the business expenses are incurred.

The tax benefit rule

Rev. Rul. 2020-27 addresses the tax benefit rule as it deals with the appropriate tax year for the disallowed deduction. Under the tax benefit rule, expenses incurred in a tax year prior to the tax year in which forgiveness is granted are deducted, with income inclusion for that amount in the tax year in which forgiveness is granted. In *Electric Tachometer Corp.*, part of the reason for allowing the deduction was that the right to reimbursement was not fixed as of the end of the tax year. With PPP loans, the income forgiveness is not fixed until approved. If the PPP loan forgiveness is contingent as of the end of the taxpayer's tax year, some would argue that there is no requirement to disallow the deduction in the year incurred.

If a deduction is taken in one year and later found to be improper because of a subsequent event, then the Sec. 111 tax benefit rule would apply so that the deduction would be recaptured in the following year through income recognition. Generally, the tax benefit rule provides that the amount of an expense recovered shall be included in income in the year of recovery to the extent the expense resulted in a tax benefit to the taxpayer. Conversely, if the taxpayer did not receive a tax benefit when the expense was paid, then the taxpayer does not have to include an amount in income when the expense is later recovered.

Under the tax benefit rule, the recovery of a previously paid expense must be included in income if four requirements are met: (1) The amount was deducted in a year prior to the current year; (2) the deduction resulted in a tax benefit; (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based; and (4) a nonrecognition provision of the Internal Revenue Code does not prevent the inclusion in gross income. See *Renner*, T.C. Memo. 1994-263. A current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken. Rev. Rul. 2020-27 focuses on this inconsistent event, noting that the clear guidance issued by the SBA makes forgiveness of the loan assured when the expenses are incurred and thus not an inconsistent event. However, forgiveness by the SBA is not fundamentally inconsistent with incurring business expenses. In fact, the expenses would be incurred whether or not forgiveness occurred, so there is no current event in the subsequent year that makes the expense and its deduction inconsistent with the events in the earlier year. The two transactions are totally distinct.

Hillsboro National Bank, 460 U.S. 370 (1983), with the consolidated case *Bliss Dairy, Inc.*, laid out the parameters of the tax benefit rule, noting that it should be applied on a case-by-case basis, considering all the facts and circumstances of each case "in the light of the purpose and function of the provisions granting the deductions" (id. at 385).

In *Hillsboro National Bank*, the bank paid a tax imposed on the shareholders by the state of Illinois. There were challenges to that tax, and the tax payments were held in escrow by the taxing authority. The challenge was ultimately decided in favor of the shareholders, and the escrowed amounts were paid to the shareholders. The bank had deducted the payments under Sec. 164(e), which specifically allowed a deduction for the tax paid by the bank. The IRS argued that since the bank had deducted a tax that was no longer owed, the payment of the escrowed amount to the

shareholders was equivalent to a dividend, which would not be deductible. The Court concluded that under the tax benefit rule, Congress was concerned with the payment by the bank. Because the refunds did not go to the bank, there was no application of the tax benefit rule. In the case of a PPP loan and the incidence of business expenses that can support loan forgiveness, there is no change in the character of the expenses and, thus, no application of the tax benefit rule even in the arguments that the government was making in the notice.

In *Bliss Dairy*, a cash-basis corporation properly deducted cattle feed purchased right before year end. On the first day of the following tax year the corporation liquidated, and the shareholders received as part of their basis the cattle feed, which they were able to deduct. The Court concluded that the basis for the original deduction was the consumption of the cattle feed, but once that feed was distributed to the shareholders, the basis for the deduction was inconsistent with the original deduction and therefore the tax benefit rule applied. In the case of a PPP loan, the basis for the business expense deduction is not changed by the fact that amounts are used to support loan forgiveness.

Using the four requirements of *Renner*, which applied *Hillsboro National Bank* and *Bliss Dairy*, the tax benefit rule should not apply to the PPP loan forgiveness. There is nothing inconsistent about the forgiveness of the loan that then causes the expenses to be nondeductible. The loan is received and the fact that the loan is forgiven, if it is used in a certain way and an application for forgiveness is made, did not change any underlying facts to warrant the application of the tax benefit rule.

The IRS's position appears to be that the taxpayer has an absolute right to the forgiveness when the expense is incurred. However, this does not align with the PPP loan rules.

Final thoughts

In deciding whether to take a position contrary to Notice 2020-32 and Rev. Rul. 2020-27 by deducting expenses used for receiving forgiveness for a PPP loan, one should also keep in mind financial statement implications, including whether this is an uncertain tax position under FASB Accounting Standards Codification (ASC) Topic 740, *Income Taxes*, and, for many corporate taxpayers, a position that would need to be disclosed on Schedule UTP, *Uncertain Tax Position Statement*. It is important that taxpayers decide the tax position they want to take, with help from professional advisers, and that the professional adviser document the client's decision.

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