

TYPES NOT MAPPED YET May 07, 2020 | TTR not mapped yet | Edward J. Buchholz, Richard L. Lawton, Victoria A. Gilbert, David J. Kaufman

Effect of “forgiven” PPP loan on the deductibility of covered expenses

One of the principal benefits of the Paycheck Protection Program (“PPP”) is that the principal and interest from any loan forgiven is not includable in a taxpayer’s gross income. In what has developed into a major controversy, the Internal Revenue Service (“IRS”) issued [Notice 2020-32](#) on April 30, 2020, and concluded that the payment of otherwise eligible expenses under the PPP program (e.g., payroll costs, rent, and utilities) will not be deductible for U.S. federal income tax purposes.

The controversy related to Notice 2020-32 results from negating the exclusion of the PPP loan forgiveness amount from income, which the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) specifically stated. For example, assume that a C corporation borrows \$200,000 under the PPP program and the C corporation uses the entire PPP loan to pay 8 weeks of payroll costs and, thus, the entire amount of the PPP loan is eligible for forgiveness. Also, assume that the C corporation has \$500,000 of taxable income during those 8 weeks (excluding the payroll costs). See the alternative results below.

	Loan Forgiveness Taxable But Deduction Available	Loan Forgiveness NOT Taxable and NO Deduction Available
Taxable Income (Excluding Payroll Costs)	\$500,000	\$500,000
Less: Deduction for Payroll Costs	(\$200,000)	N/A
Plus: Loan Forgiveness Income	\$200,000	N/A
Net Taxable Income	\$500,000	\$500,000
U.S. Federal Income Taxes (Assume 26%)	\$130,000	\$130,000

As the above example illustrates, denying the deduction for payroll costs results in the same tax liability as including the forgiven PPP loan amount in income.

As a result of Notice 2020-32, obtaining the PPP loan may prove not as beneficial as a taxpayer originally expected. The maximum after-tax benefit from a PPP loan (pending any change in the IRS’s position or corrective legislation) currently equals the amount of the PPP loan multiplied by a percentage (1 - applicable tax rate). Moreover, a taxpayer obtaining a PPP loan may have altered its planning with respect to its work force. For instance, assume the same facts as above except that the C corporation had the option to reduce its payroll costs to \$50,000 (five employees each making \$10,000 for 8 weeks) and not obtain a PPP loan.

	PPP Loan Obtained (Full Work Force) and Deduction Available	PPP Loan Obtained (Full Work Force) and No Deduction Available	No PPP Loan Obtained (Reduced Work Force)
Taxable Income (Excluding Payroll Costs)	\$500,000	\$500,000	\$500,000
Less: Deduction for Payroll Costs	(\$200,000)	\$0	(\$50,000)
Plus: Loan Forgiveness	\$0	\$0	N/A
Net Taxable Income	\$300,000	\$500,000	\$450,000
U.S. Federal Income Taxes (Assume 26%)	\$78,000	\$130,000	\$117,000
Net Cash (Excluding Payroll Costs)	\$500,000	\$500,000	\$500,000
PPP Loan Proceeds	\$200,000	\$200,000	\$0
Less: Payroll Costs	(\$200,000)	(\$200,000)	(\$50,000)
Less: Taxes	(\$78,000)	(\$130,000)	(\$117,000)
Net Cash	\$422,000	\$370,000	\$333,000

As the example immediately above illustrates, the C corporation contemplating obtaining a PPP loan and originally deciding between \$422,000 of after-tax cash and \$333,000 of after-tax cash (a \$89,000 benefit) is now, because of Notice 2020-32, deciding between \$370,000 of after-tax cash and \$333,000 of after-tax cash (a \$37,000 benefit). In other words, after Notice 2020-32, the C corporation receives only a \$37,000 cash benefit if it obtains a PPP loan (as compared to reducing its work force and not obtaining a PPP loan).

The \$37,000 cash benefit is even lower if the C corporation was eligible for the employee retention payroll tax credit (50% of qualified wages). If the entire \$50,000 of payroll costs is assumed to be treated as qualified wages (i.e., \$10,000 paid to five different employees) and the C corporation is otherwise an eligible employer, the C corporation would generally be entitled to a \$25,000 employee retention payroll tax credit. Therefore, in this case, the PPP loan actually provides the C corporation with only a \$18,500 cash benefit (as compared to reducing its work force and not obtaining a PPP loan, foregoing a tax deduction with respect to a portion of the payroll costs, and claiming the employee retention payroll tax credit).

Some argue that denying a deduction in exchange for tax-free forgiveness of a PPP loan conflicts with the legislative intent of the CARES Act. On the other hand, Treasury Secretary Steven Mnuchin defended the IRS's position as intentionally preventing a "double dip" for taxpayers given that the PPP loans will not trigger taxable income when forgiven. Senate Finance Committee Chair Chuck Grassley (R-Iowa), ranking member Ron Wyden (D-Ore.), and House Ways and Means Committee Chair Richard E. Neal (D-Mass.) have indicated that Notice 2020-32 conflicts with the intent of the CARES Act, and that Congress intended for PPP loans to constitute a grant to taxpayers. On May 5, 2020, the three Congress members wrote a joint letter to Mnuchin requesting the reversal of Notice 2020-32. Rep. Neal and Rep. Lizzie Fletcher (D-Tex), among other Congress members, have indicated that they will push for legislation to reverse Notice 2020-32 to allow the deduction of eligible expenses under the PPP program. On May 6, 2020, Rep. Grassley and Rep. Wyden introduced bipartisan legislation to reverse Notice 2020-32.

Notice 2020-32 only controls deductibility of expenses paid by a taxpayer with a PPP loan for U.S. federal income tax purposes. For state tax purposes, the taxation of PPP loan forgiveness and the deductibility of expenses paid with PPP loans will vary by state. Taxpayers granted a PPP loan should consider Notice 2020-32 and the prospect of potential legislative changes, and should discuss all the implications with their tax advisors. Stay tuned for further updates regarding the deductibility of expenses paid by a taxpayer with a PPP loan.

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