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Congressional Pushback to Recent IRS Guidance on Deductibility of Expenses Related to PPP Loans

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The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") provided employers valuable relief from the economic stress caused by the COVID-19 pandemic, by creating access to loans under the Paycheck Protection Program ("PPP"). However, the Treasury Department and the Internal Revenue Service ("IRS") have issued guidance placing limitations on the tax deductibility of certain otherwise deductible expenses, if those expenses were paid by a PPP loan which was subsquently forgiven under the CARES Act. Two Senators, Senate Finance Committee Chair Chuck Grassley (R-Iowa) and Ranking Member Ron Wyden (D-Ore), have recently issued a joint statement objecting to this guidance and urging the Treasury Department and the IRS to reconsider their position. So stay tuned – relief may be coming!

1. Background

The CARES Act established the PPP, pursuant to which participating lenders could make federally-guaranteed loans to small businesses. Under the CARES Act, an eligible recipient of a PPP loan can receive loan forgiveness for the following costs incurred and payments made during the covered period: (1) payroll costs, (2) interest on covered mortgage obligations, (3) covered rent or lease obligation payment, and (4) covered utility payments. (For full forgiveness, at least 60% of the loan proceeds must have been spent on payroll costs, and the forgivable amount can be reduced if the recipient reduced the number of full-time employees or employee salaries or wages.) As we have previously noted in a prior publication, the forgiven loans are exempt from tax, so any amounts forgiven under the PPP effectively convert into a tax-free grant.

On May 2, 2020, the Treasury Department and the IRS released Notice 2020-32, which clarified that a tax deduction is not allowed for expenses that would otherwise qualify for a tax deduction under the Internal Revenue Code (the "Code") if the expenses were paid by a PPP loan that was subsequently forgiven under the CARES Act.

At the time, Senator Grassley, Senator Wyden, and House Ways and Means Committee Chair Richard E. Neal (D-MA) issued a joint letter objecting to this tax treatment and urging the Treasury Department and IRS to reconsider their position. This joint letter asserted, among other things, that the position expressed in Notice 2020-32 was contrary to congressional intent.

2. Recent Treasury Department and IRS Guidance

On November 18, 2020, the Treasury Department and the IRS released guidance in the form of Revenue Ruling 2020-27, which clarifies the tax treatment of expenses when a PPP loan has not been forgiven by the end of the year the loan was received, and Revenue Procedure 2020-51, which creates a safe harbor provision in the event that loan forgiveness is denied or an employer does not apply for loan forgiveness in a later tax year. In effect, this guidance confirmed the previous position taken in Notice 2020-32 limiting the tax deductibility of expenses paid by loans that would be forgiven under PPP, despite the previous objections voiced by certain members of Congress.

Revenue Ruling 2020-27 addresses two situations that could apply to a taxpayer that received a PPP loan in 2020. In Situation 1, Taxpayer A paid for expenses as described in Code section 161 (items for which a deduction is allowed) that were also eligible to be paid for by the PPP loan. Taxpayer A later applied to the lender for loan forgiveness with regard to the eligible expenses it paid during the covered period. At that time, Taxpayer A had satisfied all of the requirements under the CARES Act for those loan amounts to be forgiven. The lender did not inform Taxpayer A whether the loan would be forgiven before the end of 2020.

Similarly, in Situation 2 Taxpayer B had paid the same type of expenses as Taxpayer A, and would have otherwise satisfied all of the requirements under the CARES Act for its loan amounts to be forgiven, but Taxpayer B did not apply for loan forgiveness in 2020. Instead, Taxpayer B expected to apply for loan forgiveness in 2021.

The IRS held that both Taxpayer A and Taxpayer B had a reasonable expectation of reimbursement in the form of loan forgiveness. Thus, neither Taxpayer A nor Taxpayer B were able to take an otherwise allowable tax deduction for expenses that were potentially forgivable under the PPP.

Revenue Procedure 2020-51 provides a safe harbor that allows a taxpayer to claim a deduction for tax year 2020 for certain otherwise tax deductible expenses that are disallowed because they are potentially forgivable under the PPP. Pursuant to the Revenue Procedure, if the expenses are paid or incurred in 2020, and the taxpayer received a PPP loan that they expect to be forgiven after 2020, but in a subsequent tax year the taxpayer's request for loan forgiveness is denied (in whole or in part), or the taxpayer decides to never request forgiveness of the loan, then the taxpayer can claim a deduction for those expenses for tax year 2020. The Revenue Procedure reiterates the position that a tax deduction is not allowed if payment of the expenses would be forgivable under the PPP.

3. Congressional Pushback

Senator Grassley and Senator Wyden released a joint statement on November 19, 2020 objecting to the November 18 guidance released by the Treasury Department and the IRS. The joint statement stressed that, in the Senators' view, Congress intended "for small businesses receiving Paycheck Protection Program loans to receive the benefit of their deductions for ordinary and necessary business expenses."

The joint statement further expressed the Senators' belief that "Treasury has now doubled down on its position in new guidance that increases the tax burden on small businesses by accelerating their tax liability, all at a time when many businesses continue to struggle and some are again beginning to close." The joint statement further encouraged both the Treasury Department and the IRS to reconsider its position on the deductibility of PPP expenses, and the timing of those deductions, to provide relief to small businesses that need it most.

Given existing Internal Revenue Code provisions and regulations, as well as federal case law, regarding the tax deductibility of reimbursable expenses, it might be challenging for the Treasury Department and IRS to now stake out a rationale that directly opposes the position it has taken in Notice 2020-32, Revenue Ruling 2020-27, and Revenue Procedure 2020-51. However, the joint statement by Senators Grassley and Wyden indicates that there is bipartisan support for a potential legislative solution, which would certainly be welcomed by the many businesses that received a PPP loan. It is entirely possible that this issue could be addressed by Congress prior to the end of 2020, as COVID-19 relief legislation currently under consideration (the Bipartisan Emergency COVID Relief Act of 2020) specifically provides that business expenses paid for with PPP loans would be tax deductible.