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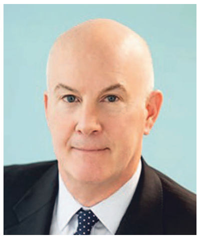
New IRS Restrictions on PPP Loans



By Bruce Hendrick, David Heidenreich, and Kylie Jennings

Small businesses who received PPP loans and used those funds to incur otherwise deductible eligible expenses *cannot* deduct the expenses if they *reasonably expect* to receive forgiveness of the PPP loan, even if they have not yet received or applied for forgiveness.

The CARES Act

The CARES Act (Public Law 116-136) established the Paycheck Protection Program (PPP) to assist small businesses negatively impacted by the Covid-19 pandemic. Small businesses who received PPP loans may forgive the full loan amount up to the eligible expenses incurred.

The CARES Act lists eligible expenses as: (1) payroll costs, (2) interest on a covered mortgage obligation, (3) any covered rent obligation payment, and (4) any covered utility payment. These expenses are otherwise deductible business expenses.

Revenue Ruling 2020-27 clarifies the deductibility of eligible expenses paid using PPP funds.

Year-End Tax Implications

The U.S. Department of the Treasury previously issued a notice providing that businesses cannot deduct eligible expenses if the PPP funds used for those eligible expenses are forgiven. Many taxpayers interpreted this guidance to mean that forgiveness must occur for the non-deductibility rule to apply, which for many businesses would not be until 2021, and should therefore permit deductions in 2020.

Last week's guidance from the IRS goes further and explicitly states that taxpayers cannot deduct otherwise deductible eligible expenses if they "reasonably expect" to receive PPP loan forgiveness, even if the borrower has not yet submitted an application for forgiveness by the end of the taxable year.

Many businesses who received PPP loans and used those funds for eligible expenses expected to deduct those expenses in the 2020 taxable year. For example, a taxpayer could deduct as business expenses those eligible expenses paid with PPP funds in 2020 and would expect to include as gross income the amount forgiven as a discharge of indebtedness in 2021. This would net to zero after the 2021 taxable year and still allow for small businesses struggling through the pandemic to receive beneficial tax treatment in 2020.

Now, Rev. Rul. 2020-27 creates a situation where businesses who needed PPP loans to help fund their eligible expenses will have higher taxable income for 2020. Accordingly, this ruling creates immediate concerns for businesses who are in the midst of, or have already completed a majority of, their year-end tax planning.

Congressional Changes Possible

Senior members of Congress agree that the IRS's interpretation creates an unfair burden on struggling businesses and may seek legislative changes. The Senate introduced the bipartisan Small Business Expense Protection Act of 2020 for proposed changes. The House may submit similar legislation to change the new IRS rule.

Congressional relief would help millions of taxpayers now facing the choice of a greater tax burden or foregoing forgiveness of their PPP loans. However, it is unlikely that Congress has sufficient time to enact legislation affecting the 2020 tax year, unless the legislation is retroactive.

Author Information

Bruce Hendrick and David Heidenreich are partners at Carrington Coleman in Dallas, and Kylie Jennings is an associate.

Bruce Hendrick 214.855.3033 bhendrick@ccsb.com
David Heidenreich 214.855.3031 dheidenreich@ccsb.com
Kylie Jennings 214.855.3080 kjennings@ccsb.com