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IRS Finalizes Guidelines on PPP Loan Forgiveness and Related Expenses

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On the heels of official guidance earlier this week that was very taxpayer friendly regarding state legislated workarounds to the limitation on itemized deductions for State and Local Taxes – on Wednesday, the IRS issued two documents with very unfavorable results for small businesses that received PPP loans earlier this year. The bottom line is that loan forgiveness will not be considered taxable income, however expenses paid related to the computations of loan forgiveness will not be tax deductible.

When Congress created the PPP loans, as part of their COVID relief package back in April, the promise was for a quick and simple application process followed by the almost guaranteed forgiveness of the loan itself if certain spending guidelines were met. Typically, if a bank forgives a loan, for any reason other than insolvency, the borrower must report that as income. A big part of what made these loans so attractive was that the forgiveness was not supposed to be treated as taxable income. Further, it was believed, by most observers, that the business receiving the loan would still be able to deduct the expenses that were paid for with the loan proceeds. Internal Revenue Code Section 265(a)(1) and Treasury Regulation 1.265-1 both provide that no deduction is allowed for expenses that are paid for out of funds, other than tax exempt interest, that is exempt from income tax. This approach was confirmed by the IRS, in May, in IRS Notice 2020-32.

The IRS has now issued Revenue Ruling 2020-27 which reinforces their position that any expenses paid for using a PPP loan will be non-deductible. In anticipation of this, some advisors had suggested clients postpone their loan forgiveness applications in order to take full deductions for these expenses in 2020 and then, if necessary, amend the returns later or simply pick up an offsetting amount of income in 2021 when the loan is forgiven. The IRS has addressed this creative thinking and specifically addressed the process stating that if you have a reasonable expectation that your loan will be forgiven in 2021 then you may not deduct the expenses in 2020.

There is some uncertainty remaining as to how these determinations will affect things like qualified business income deductions, R&D credits and other items which are calculated using the amount of deductible wages as part of the formula. Also take into consideration any possible tax rate increases due to the new administration, and you really need to scratch your head in confusion.

The best way to address these issues is to consult your tax advisor and fit the current rules and positions of the IRS into your business and personal tax plan to best prepare for the effects of this income, and the ever-changing tax landscape. We look forward to hearing from you soon.