

## IRS Updates Guidance on Deductibility of Expenses Paid With PPP Loan Proceeds

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The IRS recently released additional guidance about the tax treatment of expenses paid with proceeds of Paycheck Protection Program loans. The PPP loans are a COVID relief program enacted as part of the CARES Act. If a borrower used the loan proceeds to continue to pay employees and pay other specified business-related expenses ("qualified expenses"), the loan could be forgiven in full or in part.

In the usual situation, loan forgiveness constitutes income to the recipient of the loan, but the forgiveness of PPP loans was statutorily declared not to be treated as income for tax purposes. The deductibility of the expenses was not addressed in the CARES Act.

In May, the IRS announced that the expenses paid with proceeds of the PPP loan could not be deducted if the payment resulted in forgiveness of the loan.

Many borrowers expected to have a determination of the amount of their loan that would be forgiven during this year. But, the forgiveness determinations have not yet been made in most cases. Many PPP loan borrowers have disbursed the funds to pay qualified expenses, but do not have assurance of the amount of the PPP loan that will be forgiven. A borrower is placed in the unenviable position of not having certainty about the amount of the loan that will be forgiven and consequently not knowing how much of the expenditures made with the proceeds of the loan can be deducted. A deduction is allowable only in the year in which the expense is incurred.

Last week, the IRS issued guidance to resolve the dilemma. To the extent that a borrower has a *reasonable expectation* of the amount of the loan forgiveness that will be received eventually, the borrower cannot deduct that amount of expenses paid with the PPP loan proceeds. Determining whether a taxpayer has a *reasonable expectation* is a familiar tax law concept applicable, among other situations, to the issuance of tax-exempt bonds, production payments (in an oil and gas setting) the determination of whether economic performance has occurred for a deduction or the determination of whether a particular financial instrument should be characterized as debt or equity. Those sources help a borrower determine if it has reasonable expectations.

If the borrower overestimates the amount of the loan that will be forgiven, the borrower may have taken too few deductions for the year in which the expenses were incurred. To address that possibility, the IRS issued a procedure (described in Revenue Procedure 2020-51) to permit the deduction of those amounts in a subsequent year, in an amended return for the year of the expense or in the originally filed return for the year of the expense. The procedure does not address the situation where the borrower underestimates the amount of forgiveness and deducts too much in the current year even though the deduction was based on the taxpayer's reasonable expectations.

Many commentators and leading politicians have complained about the position of the IRS that the expenses paid with the proceeds of the PPP loan that is or will be forgiven are not deductible. That conclusion seems to be inconsistent with the statutory directive that the forgiveness of the PPP loan was nontaxable. The usual rule is that loan forgiveness is treated as income but ordinary expenses paid with loan proceeds are deductible. Under the usual rule, a borrower ends up with the same result as under the IRS position. So, Congress would not need the statutory rule that the forgiveness of the PPP loan was not income. That being the case, it seems that Congress meant a different result (no taxable

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forgiveness but deductions still allowed). Even so, the recent IRS guidance shows that the Service is not changing its interpretation.

Please contact any of the authors or your Miller Canfield attorney if you have questions.