



New IRS guidance dampens benefits of coronavirus (COVID-19) relief under the Paycheck Protection Program

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On April 30, 2020, more than four weeks after the enactment of the CARES Act, the Internal Revenue Service (“IRS”) issued Notice 2020-32. This Notice addresses directly for the first time the question of whether certain proceeds received under the Paycheck Protection Program (“PPP”) will be eligible for a tax deduction, concluding that such deduction is disallowed under the Internal Revenue Code.¹

When the PPP was announced, many businesses, as the Treasury Department had expected, rushed to obtain a PPP loan. Indeed, the original \$349 billion in funding for PPP loans was exhausted in less than a week, which led Congress to fund a second, \$310 billion tranche on April 24, 2020.

One reason the PPP has been so popular was because the loan could essentially convert to a grant if certain conditions were met, which we previously discussed with respect to the [basics](#), [affiliation](#), and [need](#). Taxpayers had also hoped (not without cause) that Section 265 would not apply to the “grant” conversion of a PPP loan because application of this rule would deny taxpayers’ ability to deduct otherwise deductible expenses to the extent such expenses were paid with “tax-exempt income.” In Notice 2020-32, however, the IRS explains its view that loan forgiveness under the PPP will result in such “tax-exempt income.” In the IRS’s view, allowing a tax deduction for expenses paid with the “grant” money would result in the sort of “double tax benefit” that Section 265 aims to preclude. Further, in what may be viewed as an anticipatory defense of the IRS’s position, the Notice also provides that the “deductibility of payments . . . that result in loan forgiveness . . . is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement” (citations omitted). The well-developed reasoning in the Notice makes it clear that the IRS believes it will take a technical correction in order for Section 265 to be shut off in this context.

An example may be helpful in understanding application of the new Notice. Assume an effective tax rate of 30%, and two eligible employers (“X” and “Y”). Assume that both X and Y will pay \$7,000

¹ All references to “Code” or “Section” are to the Internal Revenue Code of 1986, as amended.

in wages to their employees. X pays \$7,000 in wages using otherwise taxable profits from the business. Y obtains a \$7,000 PPP loan and uses that money to pay the wages.

For employer X to pay \$7,000 in payroll, X would need \$10,000 in revenue (\$10,000 less the 30% tax). After using the \$7,000 for payroll, X can claim a deduction of \$7,000, reducing X's tax by \$2,100 for a net tax of \$900 (\$3,000 minus \$2,100).

On the other hand, if Y borrows \$7,000 under the PPP and uses that \$7,000 for payroll costs in order to qualify for loan forgiveness, Y will not be subject to tax when the loan is forgiven. Normally, forgiveness of \$7,000 in debt would result in \$7,000 in taxable income and a tax of \$2,100, but the PPP excuses this by not treating the \$7,000 as income. So Y has no tax cost in providing \$7,000 in payroll, compared to the \$900 in tax cost for X to provide that same payroll amount.

The IRS is asserting that allowing Y to also receive a tax deduction, would result in a "double dip" that should be precluded by Section 265. In effect, without application of Section 265, Y would go from paying no tax, to being able to offset other taxable income, for an additional \$2,100 benefit (\$7,000 x 30% tax rate), so that the total benefit as compared to X would be \$3,000 (\$900 + \$2,100).

Many, if not most, taxpayers probably did not expect this result from the PPP, given the announced overall goals of supporting both payroll and small business survival. The issuance of this Notice is a further reason for taxpayers to consider whether the Employee Retention Credit ("ERC") may be a better option for their businesses, as previously discussed [here](#).

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