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Dear friends and clients,

On Wednesday, November 18, the IRS issued further guidance regarding the tax deductibility of business expenses paid with Paycheck Protection Program loan proceeds.  The article below published in Forbes.com and written by their frequent contributor Brian Thompson does an excellent of summarizing the IRS stance and how it may impact business taxes for 2020.  We will continue to monitor developments out of Washington DC regarding PPP loans and work with you on planning strategies as we approach the end of 2020.  Please contact us with any questions once you have an opportunity to review the information.

Regards,

Isler Northwest LLC

# IRS Clarifies Stance On No Deductibility Of Expenses Paid With PPP Funds

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If we've learned anything in 2020, it's to take life one day at a time. That goes double for business owners who participated in the Paycheck Protection Program (PPP). The program was supposed to make the lives of business owners easier during the pandemic, but after 11 pages of FAQs and 26 Interim Final Rules, it has just added to their burden.  And we're not done yet. The IRS just released Revenue Ruling 2020-27 and Revenue Procedure 2020-51 to clarify the rules for deducting expenses paid with PPP funds. Here's what you need to know.

## Some background

In May, IRS notice 2020-32 informed us that "no deduction is allowed for an eligible expense that is otherwise deductible if the payment of the eligible expense results in forgiveness of the covered loan." That meant that a loan that was supposed to be excluded from income was now getting brought back in through the back door. In other words, you get the benefit of the money, but you can't deduct payments for expenses such as payroll, rent, interest on covered mortgage obligations and any covered utility payments. That effectively increases your net business income.

As this stance stirred up controversy, some legislators proposed new rules that would make the expenses deductible. By simplifying these rules and proposing additional legislation that may forgive loans under $150k, law makers sought to simplify forgiveness for the vast majority of borrowers. (Some 4.5 million of the 5.2 million loans were under $150k.)

But here we are at the end of the year, and the vast majority of borrowers haven't even applied for forgiveness. A change in government administrations is weeks away, and many small businesses desperately want to get these loans off of their balance sheets.

**The latest guidance**

Fast forward to yesterday evening when we received both a Revenue Ruling (Rev. Rul.) and a Revenue Procedure (Rev. Proc.). A Rev. Rul. is an official interpretation by the IRS of the Internal Revenue Code, related statutes, tax, treaties and regulations. A Rev. Proc. is an official statement of a procedure that affects the rights or duties of taxpayers or other members of the public. Simply put, a revenue ruling states the IRS' position and the revenue procedure states instructions on how to implement the IRS' position. These both differ from a Notice, which is a public pronouncement guiding interpretations of the tax code and other provisions of the law.

Let's start with the Rev. Rul., which again, is the IRS's official position on the issue of deductibility. Not much has changed since the May notice. Expenses paid with PPP loan funds are not deductible. However, the big difference is that the Notice said "no deduction is allowed for an eligible expense that is otherwise deductible if the payment of the eligible expense **results in forgiveness of the covered loan**" (emphasis mine). The phrasing "results in forgiveness" implies that the forgiveness needed to happen before this rule would kick in. That created a lot of angst because most borrowers wouldn't have applied for forgiveness before the end of the year and thus weren't sure whether to deduct the expense paid with the loan on their 2020 tax return.

However, the Rev. Rul. states that even if a borrower has "a reasonable expectation of reimbursement" the deduction is inappropriate. In short, even if forgiveness hasn't happened, borrowers can't deduct expenses paid for with PPP funds if they reasonably believe the loan will be forgiven.

The Ruling gives two examples. In one, the taxpayer (designated as B) hasn't applied for forgiveness by the end of 2020 (which will be the case for many of you out there) but has satisfied all of the requirements under the Coronavirus Aid, Relief and Economic Security Act (CARES Act) and expects to apply for forgiveness in 2021. The rule states "at the end of 2020 B both knew the amount of eligible expenses that qualified for reimbursement in the form of covered loan forgiveness and has a reasonable expectation of reimbursement." Because that reimbursement of the loan was "foreseeable," B may not deduct her eligible expenses.

The Rev. Proc. provides a safe harbor which allows taxpayers to claim a deduction in 2020 if:

1. The eligible expenses are paid or incurred during the taxpayer's 2020 taxable year
2. The taxpayer received a PPP loan and at the end of the year the taxpayer expects the loan forgiven in a taxable year after 2020, and
3. In that subsequent taxable year, the taxpayer's request for forgiveness is denied or the taxpayer never requests forgiveness.

Under the above scenario, the taxpayer is allowed to deduct expenses originally thought to be non-deductible on a timely filed return or can amend the return in the taxable year.

The Rev. Proc. seems a little redundant given the fact that if the situation occurs and the taxpayer is denied forgiveness (whether in 2020 or beyond) or decides not to apply for forgiveness at all, she would likely deduct the expenses anyway before she files her return or amend the return if she realizes she should have deducted expenses that they didn't originally deduct.

Still, section 4 of the Rev Proc explains the procedures and statement that needs to be submitted in order for the safe harbor to apply.

**Problems to come**

Like most PPP guidance, the new clarification creates more questions. What do business owners with no employee payroll do (e.g., Schedule C filers with no employees)? These business owners do not take deductions for owner compensation, which is the payroll expense that qualifies them for forgiveness. Are they in the clear? Or does this money get added to their income (which specifically contradicts the CARES Act that established the program).

If Sole Proprietor filers do get the entire amount forgiven, but business owners with employees don't, is that fair? It creates a dynamic where similarly situated taxpayers are treated differently. I imagine that will be the basis for many a tax court case.

The new Rev. Rul. and Rev. Proc. reduce the incentive for taxpayers to apply for forgiveness before the new Biden administration and the new Congress take power in January. I know this has become frustrating for almost everyone involved (borrowers, lenders, tax professionals, etc). The good news is we are all in this together, and we'll figure it out. It just may take some patience and time before that happens.