

Information Reporting Requirements for Paycheck Protection Program Loans Forgiven under the CARES Act

Announcement 2020-12

This announcement notifies lenders that they should not file information returns or furnish payee statements under section 6050P of the Internal Revenue Code (Code) to report the amount of qualifying forgiveness with respect to covered loans made under the Paycheck Protection Program (PPP) administered by the Small Business Administration (SBA), in consultation with the Department of the Treasury, under Title I of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (March 27, 2020), as amended by the Paycheck Protection Program Flexibility Act of 2020, Pub. L. No. 116-142, 134 Stat. 641 (June 5, 2020) (collectively, CARES Act).

Section 1102 of the CARES Act established the PPP, which allowed qualifying small businesses (eligible recipients) to obtain loans guaranteed by the SBA under section 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)) (covered loans). Under section 1106 of the CARES Act, an eligible recipient is eligible for forgiveness of indebtedness for all or a portion of the stated principal amount of a covered loan if certain conditions are satisfied (qualifying forgiveness). Under section 1106(i) of the CARES Act, for purposes of the Code, any amount that (but for section 1106(i)) would

be includible in gross income of the eligible recipient by reason of the qualifying forgiveness is excluded from gross income.

Generally, section 6050P of the Code and §§ 1.6050P-1 and 1.6050P-2 of the Income Tax Regulations require an applicable entity (as defined in section 6050P(c)(1) of the Code) that discharges at least \$600 of a borrower's indebtedness to file a Form 1099-C, Cancellation of Debt, with the Internal Revenue Service (IRS), and to furnish a payee statement to the borrower. For purposes of this reporting requirement, § 1.6050P-1(c) provides that "indebtedness" means any amount owed to an applicable entity, including stated principal, fees, stated interest, penalties, administrative costs, and fines.

When all or a portion of the stated principal amount of a covered loan is forgiven because the eligible recipient satisfies the forgiveness requirements under section 1106 of the CARES Act, an applicable entity is not required to, for federal income tax purposes only, and should not, file a Form 1099-C information return with the IRS or provide a payee statement to the eligible recipient under section 6050P of the Code as a result of the qualifying forgiveness. The filing of such information returns with the IRS could result in the issuance of underreporter notices (IRS Letter CP2000) to eligible recipients, and the furnishing of such payee statements to eligible recipients could cause confusion. This announcement is intended to prevent any such confusion.

The principal author of this announcement is Marshall French of the Office of the Associate Chief Counsel (Procedure & Administration). For further information

regarding this announcement, contact Marshall French at (202) 317-5411 (not a toll-free call).

PURPOSE

This notice provides guidance regarding the deductibility for Federal income tax purposes of certain otherwise deductible expenses incurred in a taxpayer's trade or business when the taxpayer receives a loan (covered loan) pursuant to the Paycheck Protection Program under section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)). Specifically, this notice clarifies that no deduction is allowed under the Internal Revenue Code (Code) for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a covered loan pursuant to section 1106(b) of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281, 286-93 (March 27, 2020) and the income associated with the forgiveness is excluded from gross income for purposes of the Code pursuant to section 1106(i) of the CARES Act.

BACKGROUND

I. Paycheck Protection Program

The Paycheck Protection Program was established by section 1102 of the CARES Act. Under the Paycheck Protection Program, a recipient of a covered loan may use the proceeds to pay (1) payroll costs, (2) certain employee benefits relating to healthcare, (3) interest on mortgage obligations, (4) rent, (5) utilities, and (6) interest on any other existing debt obligations. See section 7(a)(36)(F) of the Small Business Act (describing allowable uses of a covered loan). See also Q&A 2.r. in Part III of the

interim final rule, Business Loan Program Temporary Changes; Paycheck Protection Program, Docket No. SBA-2020-0015, 85 Fed. Reg. 20811, 20814 (April 15, 2020).

Under section 1106(b) of the Cares Act, a recipient of a covered loan can receive forgiveness of indebtedness on the loan (covered loan forgiveness) in an amount equal to the sum of payments made for the following expenses during the 8-week “covered period” beginning on the covered loan’s origination date (each, an eligible section 1106 expense): (1) payroll costs, (2) any payment of interest on any covered mortgage obligation, (3) any payment on any covered rent obligation, and (4) any covered utility payment. See section 1106(a) (defining the terms “covered period”, “covered mortgage obligation,” “covered rent obligation,” “covered utility payment,” and “payroll costs”), (b) (regarding eligibility for covered loan forgiveness), and (g) (regarding covered loan forgiveness decisions). However, section 1106(d) of the CARES Act provides that the amount of the covered loan forgiveness is reduced if, during the covered period, (1) the average number of full-time equivalent employees of the recipient is reduced as compared to the number of full-time employees in a specified base period, or (2) the salary or wages of certain employees is reduced by more than 25 percent as compared to the last full quarter before the covered period. In addition, pursuant to an interim final rule issued by the Small Business Administration, no more than 25 percent of the amount forgiven can be attributable to non-payroll costs. See Q&A 2.o. in Part III of the interim final rule, Business Loan Program Temporary Changes; Paycheck Protection Program, Docket No. SBA-2020-0015, 85 Fed. Reg. 20811, 20813-20814 (April 15, 2020).

Section 1106(i) of the CARES Act addresses certain Federal income tax consequences resulting from covered loan forgiveness. Specifically, that subsection provides that, for purposes of the Code, any amount that (but for that subsection) would be includible in gross income of the recipient by reason of forgiveness described in section 1106(b) “shall be excluded from gross income.” Thus, section 1106(i) of the CARES Act operates to exclude from the gross income of a recipient any category of income that may arise from covered loan forgiveness, regardless of whether such income would be (1) properly characterized as income from the discharge of indebtedness under section 61(a)(11) of the Code, or (2) otherwise includible in gross income under section 61 of the Code.

II. Deductibility of Eligible Section 1106 Expenses

Neither section 1106(i) of the CARES Act nor any other provision of the CARES Act addresses whether deductions otherwise allowable under the Code for payments of eligible section 1106 expenses by a recipient of a covered loan are allowed if the covered loan is subsequently forgiven under section 1106(b) of the CARES Act as a result of the payment of those expenses. This Notice addresses the effect of covered loan forgiveness on the deductibility of payments of eligible section 1106 expenses.

III. Summary of Relevant Law

Section 161 of the Code provides that, in computing taxable income under section 63 of the Code, there shall be allowed as deductions the items specified in part VI, subchapter B, chapter 1 of the Code (for example, sections 162 and 163). However, section 161 of the Code provides that the allowance of these deductions is subject to

the exceptions provided in part IX, subchapter B, chapter 1 of the Code. These exceptions include section 265 of the Code. See also section 261.

In general, section 162 of the Code provides for a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Covered rent obligations, covered utility payments, and payroll costs consisting of wages and benefits paid to employees comprise typical trade or business expenses for which a deduction under section 162 of the Code generally is appropriate. Section 163(a) of the Code provides a deduction for certain interest paid or accrued during the taxable year on indebtedness, including interest paid or incurred on a mortgage obligation of a trade or business.

However, section 265(a)(1) of the Code and §1.265-1 of the Income Tax Regulations provide that no deduction is allowed to a taxpayer for any amount otherwise allowable as a deduction to such taxpayer that is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Code. See generally section 265(a)(1); §1.265-1. The term “class of exempt income” means any class of income (whether or not any amount of income of such class is received or accrued) that is either wholly excluded from gross income under any provision of subtitle A of the Code or wholly exempt from the taxes imposed by subtitle A of the Code under the provisions of any other law. See §1.265-1(b)(1). The purpose of section 265 of the Code is to prevent a double tax benefit.

Section 265(a)(1) of the Code applies to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax-exempt income. It also applies where

tax exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose. In such event, it is proper to conclude that some or all of the deductions are allocable to the tax-exempt income. See Christian v. United States, 201 F. Supp. 155 (E.D. La. 1962) (school teacher was denied deductions for expenses incurred for a literary research trip to England because the expenses were allocable to a tax-exempt gift and fellowship grant); Banks v. Commissioner, 17 T.C. 1386 (1952) (certain educational expenses paid by the Veterans' Administration that were exempt from income tax, were not deductible); Heffelfinger v. Commissioner, 5 T.C. 985 (1945), (Canadian income taxes on income exempt from U.S. tax are not deductible in computing U.S. taxable income); and Rev. Rul. 74-140, 1974-1 C.B. 50, (the portion of a state income tax paid by a taxpayer that is allocable to the cost-of-living allowance, a class of income wholly exempt under section 912, is nondeductible under section 265).

In Manocchio v. Commissioner, 78 T.C. 989 (1982), a taxpayer attended a flight-training course that maintained and improved skills required in the taxpayer's trade or business. As a veteran, the taxpayer was entitled to an educational assistance allowance from the Veterans' Administration pursuant to 38 U.S.C. section 1677 (1976) equal to 90 percent of the costs incurred. Because the payments received were exempt from taxation under 38 U.S.C. section 310(a) (1976), the taxpayer did not report them as income. The taxpayer did, however, deduct the entire cost of the flight training course, including the portion that had been reimbursed by the Veterans' Administration. In a reviewed opinion, the court held that the reimbursed flight-training expenses were nondeductible under section 265(a)(1) of the Code.

NON-DEDUCTIBILITY OF PAYMENTS TO THE EXTENT INCOME RESULTING
FROM LOAN FORGIVENESS IS EXCLUDED UNDER SECTION 1106(i) OF THE
CARES ACT

To the extent that section 1106(i) of the CARES Act operates to exclude from gross income the amount of a covered loan forgiven under section 1106(b) of the CARES Act, the application of section 1106(i) results in a “class of exempt income” under §1.265-1(b)(1) of the Regulations. Accordingly, section 265(a)(1) of the Code disallows any otherwise allowable deduction under any provision of the Code, including sections 162 and 163, for the amount of any payment of an eligible section 1106 expense to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven) because such payment is allocable to tax-exempt income. Consistent with the purpose of section 265, this treatment prevents a double tax benefit.

This conclusion is consistent with prior guidance of the IRS that addresses the application of section 265(a) to otherwise deductible payments. In particular, Rev. Rul. 83-3, 1983-1 C.B. 72, provides that, where tax exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, section 265(a) applies because such deductions are allocable to the tax-exempt income. In accordance with the analysis set forth in Rev. Rul. 83-3, the direct link between (1) the amount of tax exempt covered loan forgiveness that a recipient receives pursuant to section 1106 of the CARES Act, and (2) an equivalent amount of the otherwise deductible payments made by a recipient for eligible section 1106 expenses, constitutes a sufficient connection for section 265(a) to apply to disallow deductions for such payments under any provision of the Code, including sections 162 and 163, to the

extent of the income excluded under section 1106(i) of the CARES Act.

The deductibility of payments of eligible section 1106 expenses that result in loan forgiveness under section 1106(b) of the CARES Act is also subject to disallowance under case law and published rulings that deny deductions for otherwise deductible payments for which the taxpayer receives reimbursement. See, e.g., Burnett v. Commissioner, 356 F.2d 755, 759-60 (5th Cir. 1966); Wolfers v. Commissioner, 69 T.C. 975 (1978); Charles Baloian Co. v. Commissioner, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 31; Rev. Rul. 80-173, 1980-2 C.B. 60.

CONTACT INFORMATION

The principal authors of this notice are Sarah Daya and Patrick Clinton of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding the application of sections 161, 162, 163, and 261 please contact Ms. Daya at (202) 317-4891 (not a toll-free call); for further information regarding the application of section 265, please contact Mr. Clinton at (202) 317-7005 (not a toll-free call).

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor allowing a taxpayer to claim a deduction in the taxpayer's taxable year beginning or ending in 2020 (2020 taxable year) for certain otherwise deductible eligible expenses, as defined in section 2.03 of this revenue procedure, if (1) the eligible expenses are paid or incurred during the taxpayer's 2020 taxable year, (2) the taxpayer receives a loan (covered loan) guaranteed under the Paycheck Protection Program (PPP) authorized under section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)), which at the end of the taxpayer's 2020 taxable year the taxpayer expects to be forgiven in a taxable year after the 2020 taxable year (subsequent taxable year), and (3) in a subsequent taxable year, the taxpayer's request for forgiveness of the covered loan is denied, in whole or in part, or the taxpayer decides never to request forgiveness of the covered loan, as described in section 3 of this revenue procedure. A taxpayer described in section 3.01 or 3.02 of this revenue procedure may be able to deduct some or all of the eligible expenses on (1) the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the 2020 taxable year; (2) an amended return or an administrative adjustment request (AAR) under section 6227 of the Internal Revenue Code (Code) for the 2020 taxable year, as applicable; or (3) the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the subsequent taxable year.

SECTION 2. BACKGROUND

.01 Sections 1102 and 1106 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281, 286-93 (March 27, 2020), established the PPP as a new loan program administered by the U.S. Small Business Administration (SBA) as part of its section 7(a) Loan Program (15 U.S.C. 636(a)) that was designed to assist small businesses nationwide adversely impacted by the COVID-19 emergency to pay payroll costs and other eligible expenses. See Business Loan Program Temporary Changes; Paycheck Protection Program, 85 FR 20811 (April 15, 2020). Under the PPP, the SBA is permitted to guarantee the full principal amount of a covered loan, defined by section 1102(a)(2) of the CARES Act as a loan made under the PPP during the covered period; a covered loan may be forgiven under section 1106 of the CARES Act.

.02 The covered period for making covered loans refers to the period beginning on February 15, 2020, and ending on December 31, 2020 (covered period). The covered period initially was to end on June 30, 2020. See section 1102(a)(2) of the CARES Act. The Paycheck Protection Program Flexibility Act of 2020, Public Law 116-142, 134 Stat. 641 (June 5, 2020), extended the end date of the covered period to December 31, 2020.

.03 An individual or entity that is eligible to receive a covered loan (eligible recipient) can receive forgiveness of the full principal amount of the covered loan up to an amount equal to the following costs incurred and payments made during the covered period: (1) payroll costs, (2) interest on a covered mortgage obligation, (3) any covered rent obligation payment, and (4) any covered utility payment (eligible expenses). See section 1106(b) of the CARES Act.

.04 Under section 1106(i) of the CARES Act, for purposes of the Code, “any amount which (but for [section 1106(i)]) would be includible in gross income of the eligible recipient by reason of forgiveness described in [section 1106](b) shall be excluded from gross income.” Section 1106(i) of the CARES Act excludes the amount from gross income regardless of whether the amount would be (1) income from the discharge of indebtedness under section 61(a)(11) of the Code, or (2) otherwise includible in gross income under section 61.

.05 Section 161 of the Code provides that, in computing taxable income under section 63 of the Code, certain deductions are allowed.

.06 Revenue Ruling 2020-27, 2020-50 IRB ____ (Dec. 7, 2020), holds that a taxpayer computing taxable income on the basis of a calendar taxable year may not deduct eligible expenses in its 2020 taxable year if, at the end of the 2020 taxable year, the taxpayer has a reasonable expectation of reimbursement in the form of covered loan forgiveness on the basis of the eligible expenses it paid or accrued during the covered period (citing *Burnett v. Commissioner*, 356 F. 2d 755 (5th Cir. 1966) cert. denied 385 U.S. 832 (1966); *Canelo v. Commissioner*, 53 T.C. 217, 225-226 (1969), aff’d. 447 F.2d 484 (9th Cir.1971); *Herrick v. Commissioner*, 63 T.C. 562 (1975); *Silverton v. Commissioner*, T.C. Memo. 1977-198 (1977)). Revenue Ruling 2020-27 alternatively relies on section 265(a)(1) of the Code and §1.265-1 of the Income Tax Regulations, which provide that no deduction is allowed for any amount otherwise allowable as a deduction to the extent the amount is allocable to one or more classes of income other than interest wholly exempt from the taxes imposed by subtitle A of the Code. See generally section 265(a)(1); §1.265-1. This rule applies “whether or not any amount of

income of that class or classes is received or accrued.” Id.

SECTION 3. TAXPAYERS ELIGIBLE FOR SAFE HARBOR

Taxpayers who meet the requirements of section 3.01 or 3.02 of this revenue procedure and comply with the requirements of section 4 of this revenue procedure are eligible for the safe harbor procedures provided in sections 4.01 or 4.02 of this revenue procedure, as applicable.

.01 A taxpayer meets the requirements of this section 3.01 if:

(1) The taxpayer paid or incurred eligible expenses in the 2020 taxable year for which no deduction is permitted because at the end of the 2020 taxable year the taxpayer reasonably expects to receive forgiveness of the covered loan based on those eligible expenses (non-deducted eligible expenses);

(2) The taxpayer submitted before the end of the 2020 taxable year, or as of the end of the 2020 taxable year intends to submit in a subsequent taxable year, an application for covered loan forgiveness to the lender; and

(3) In a subsequent taxable year, the lender notifies the taxpayer that forgiveness of all or part of the covered loan is denied.

.02 A taxpayer meets the requirements of this section 3.02 if:

(1) The taxpayer meets the requirements of section 3.01(1) and (2) of this revenue procedure; and

(2) In a subsequent taxable year, the taxpayer irrevocably decides not to seek forgiveness for some or all of the covered loan. For example, a taxpayer that determines that it will not qualify for covered loan forgiveness and withdraws the application submitted to the lender as described in section 3.01.

SECTION 4. SAFE HARBOR PROCEDURES

A taxpayer described in section 3.01 or 3.02 of this revenue procedure may use the safe harbor procedures provided in section 4.01 or 4.02 of this revenue procedure.

.01 Safe harbor for deductions to be claimed in 2020 taxable year. A taxpayer described in section 3.01 or 3.02 of this revenue procedure who satisfies the requirements of section 4.03 and 4.04 of this revenue procedure may deduct non-deducted eligible expenses on the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the 2020 taxable year, or amended return or AAR under section 6227 of the Code for the 2020 taxable year, as applicable.

.02 Safe harbor for deductions to be claimed in subsequent taxable year. A taxpayer described in section 3.01 or 3.02 of this revenue procedure who satisfies the requirements of section 4.03 and 4.04 of this revenue procedure, may deduct non-deducted eligible expenses on the taxpayer's timely filed, including extensions, original income tax return or information return, as applicable, for the subsequent taxable year referenced in section 3.01 or 3.02 of this revenue procedure. Taxpayers described in section 3.01 of this revenue procedure may, but do not need to, use this safe harbor to deduct non-deducted eligible expenses in a subsequent taxable year because those taxpayers may deduct the non-deducted eligible expenses in the year that the loan forgiveness is denied under general tax principles, assuming that the taxpayer does not elect to use the safe harbor in section 4.01 of this revenue procedure.

.03 Limitation on amount of deduction for eligible expenses. A taxpayer applying section 4.01 or 4.02 of this revenue procedure may not deduct an amount of non-

deducted eligible expenses in excess of the principal amount of the taxpayer's covered loan for which forgiveness was denied or will no longer be sought.

.04 Statement. A taxpayer may not apply the safe harbor procedures in section 4.01 or 4.02 of this revenue procedure to deduct any amount of non-deducted eligible expenses unless the taxpayer attaches the statement described in this section 4.04 to the return on which the taxpayer deducts non-deducted eligible expenses. The statement must be titled "Revenue Procedure 2020-51 Statement," and must include:

- (1) The taxpayer's name, address, and social security number or employer identification number;
- (2) A statement specifying whether the taxpayer is an eligible taxpayer under either section 3.01 or section 3.02 of Revenue Procedure 2020-51;
- (3) A statement that the taxpayer is applying section 4.01 or section 4.02 of Revenue Procedure 2020-51;
- (4) The amount and date of disbursement of the taxpayer's covered loan;
- (5) The total amount of covered loan forgiveness that the taxpayer was denied or decided to no longer seek;
- (6) The date the taxpayer was denied or decided to no longer seek covered loan forgiveness; and
- (7) The total amount of eligible expenses and non-deducted eligible expenses that are reported on the return.

.05 Additional limitations. Nothing in this revenue procedure precludes the IRS from examining other issues relating to the claimed deductions for non-deducted eligible expenses, including the amount of the deduction and whether the taxpayer has

substantiated the deduction claim. It also does not preclude the IRS from requesting additional information or documentation verifying any amounts described in the statement described in section 4.04 of this revenue procedure.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning or ending in 2020.

SECTION 6. PAPERWORK REDUCTION ACT

.01 This revenue procedure provides procedures by which taxpayers described in section 3.01 or 3.02 of this revenue procedure are eligible for the safe harbor provided in section 4 of this revenue procedure. Taxpayers taking advantage of this revenue procedure must file a statement as described in section 4.04 of this revenue procedure with their income tax return or information return. The collection of information will be associated with the income tax returns or information statements to which the statement will be attached. That collection of information has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–0123 for business filers (<https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd>) and 1545-074 for individual filers (https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031).

.02 This information is required to be collected and retained for compliance purposes, namely, to determine whether the taxpayer has made a decision to use the safe harbor, to determine that the amount claimed on the return is correct, and to ensure that any future action that is inconsistent with the decision to use the safe harbor

is handled correctly, potentially by application of equitable estoppel and/or the doctrine of consistency.

.03 The Treasury Department and the IRS estimate that the maximum number of respondents would be 5,212,128. This number was determined by examining the PPP data for the total number of approved covered loans. See https://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program?utm_medium=email&utm_source=govdelivery#section-header-11. This data is currently correct through August 8, 2020. Because some taxpayers will not decide to use the safe harbor in this revenue procedure, the number of estimated respondents is on the high end of the estimate.

.04 The maximum estimated number of respondents is 5,212,128. The estimated annual burden per respondent/recordkeeper varies from 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes. The estimated total annual reporting and/or recordkeeping burden is 1,303,032 hours (5,212,128 respondents * 15 minutes). The estimated annual cost burden to respondents is \$95 per hour. Accordingly, we expect the total annual cost burden for the statements to be \$123,788,040 (5,212,128 * 0.25 * \$95). The estimated annual frequency of responses is once because the statement only has to be filed once.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Sarah Daya and Charles Gorham of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Ms. Daya at (202) 317-4891 (not a toll-free call).

Rev. Rul. 2020-27

ISSUE

May a taxpayer that received a loan guaranteed under the Paycheck Protection Program (PPP) authorized under section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)) (covered loan), and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, 134 Stat. 281 (March 27, 2020) deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan based on the otherwise deductible expenses?

FACTS

In each of the following situations, the taxpayer computes taxable income on the basis of the calendar year for federal income tax purposes and received a covered loan from a private lender in 2020.

Situation 1. During the period beginning on February 15, 2020, and ending on December 31, 2020 (covered period), Taxpayer A (A) paid expenses that are described in section 161 of the Internal Revenue Code (Code) and section 1106(a) of the CARES Act (eligible expenses). These expenses include payroll costs that qualify under section 1106(a)(8) of the CARES Act, interest on a mortgage that qualifies as interest on a covered mortgage obligation under section 1106(a)(2) of the CARES Act, utility payments that qualify as covered utility payments under section 1106(a)(5) of the CARES Act, and rent that qualifies as payment on a covered rent obligation under

section 1106(a)(4) of the CARES Act. In November 2020, pursuant to the terms of section 1106 of the CARES Act, A applied to the lender for forgiveness of the covered loan on the basis of the eligible expenses it paid during the covered period. At that time, and based on A's payment of the eligible expenses, A satisfied all requirements under section 1106 of the CARES Act for forgiveness of the covered loan. The lender does not inform A whether the loan will be forgiven before the end of 2020.

Situation 2. During the covered period, Taxpayer B (B) paid the same types of eligible expenses that A paid in Situation 1. B, unlike A, did not apply for forgiveness of the covered loan before the end of 2020, although, taking into account B's payment of the eligible expenses during the covered period, B satisfied all other requirements under section 1106 of the CARES Act for forgiveness of the covered loan. B expects to apply to the lender for forgiveness of the covered loan in 2021.

LAW

Section 1102 and 1106 of the CARES Act, established the PPP as a new loan program administered by the U.S. Small Business Administration (SBA) as part of its section 7(a) Loan Program (15 U.S.C. 636(a)) that was designed to assist small businesses nationwide adversely impacted by the COVID-19 emergency to pay payroll costs and other covered expenses. See Business Loan Program Temporary Changes; Paycheck Protection Program, 85 FR 20811 (April 15, 2020). Under the PPP, the SBA is permitted to guarantee the full principal amount of a covered loan. Under section 1102(a)(2) of the CARES Act, a covered loan is a loan made under the PPP during the covered period. A covered loan may be forgiven under section 1106 of the CARES Act, based on certain eligible expenses being paid or incurred during the covered period.

The covered period for making loans was initially the period beginning on February 15, 2020 and ending on June 30, 2020. See section 1102(a)(2) of the CARES Act. The Paycheck Protection Program Flexibility Act of 2020, Pub. L. No. 116-142, 134 Stat. 641 (June 5, 2020), extended the end date of the covered period for making loans from June 30, 2020 to December 31, 2020.

An individual or entity that is eligible to receive a covered loan (eligible recipient) can receive forgiveness of the full principal amount of the covered loan up to an amount equal to the following eligible expenses that are paid or incurred during the covered period: (1) payroll costs, (2) interest on a covered mortgage obligation, (3) any covered rent obligation payment, and (4) any covered utility payment. See section 1106(b) of the CARES Act.

Under section 1106(i) of the CARES Act, for purposes of the Code “any amount which (but for [section 1106(i)]) would be includible in gross income of the eligible recipient by reason of forgiveness described in [section 1106](b) shall be excluded from gross income.” Section 1106(i) of the CARES Act excludes the forgiven amounts from gross income regardless of whether the income would be (1) income from the discharge of indebtedness under section 61(a)(11) of the Code, or (2) otherwise includible in gross income under section 61 of the Code.

On May 2, 2020, the Department of the Treasury and the Internal Revenue Service (IRS) released Notice 2020-32, 2020-21 IRB 837 (May 18, 2020), which clarifies that no deduction is allowed for an eligible expense that is otherwise deductible if the payment of the eligible expense results in forgiveness of a covered loan. Notice 2020-32 relied on section 265(a)(1) of the Code and §1.265-1 of the Income Tax Regulations, which

provide that no deduction is allowed for any amount otherwise allowable as a deduction to the extent the amount is allocable to one or more classes of income other than interest wholly exempt from the taxes imposed by subtitle A of the Code. See generally section 265(a)(1); §1.265-1. This rule applies “whether or not any amount of income of that class or classes is received or accrued.” Id. The term “class of exempt income” means any class of income that is either wholly excluded from gross income under any provision of subtitle A of the Code or wholly exempt from the taxes imposed by subtitle A of the Code under the provisions of any other law. See §1.265-1(b)(1).

Notice 2020-32 also relied on authorities holding that deductions for otherwise deductible expenses are disallowed if the taxpayer receives reimbursement for such expenses. Authorities addressing reimbursement further hold that an otherwise allowable deduction is disallowed if there is a reasonable expectation of reimbursement. See *Burnett v. Commissioner*, 356 F. 2d 755 (5th Cir. 1966) cert. denied 385 U.S. 832 (1966); *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), aff’d 447 F.2d 484 (9th Cir.1971); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977); Rev. Rul. 80-348, 1980-2 C.B. 60; Rev. Rul. 79-263, 1979-2 C.B. 82.

In *Burnett*, a lawyer advanced expenses to clients that the clients were obligated to repay only to the extent the lawyer was successful in obtaining recovery on the client’s claim. The taxpayer argued that the advances were deductible trade or business expenses under section 162 of the Code because there was no unconditional obligation on the part of the clients to repay the advances. The court noted that the taxpayer provided assistance only to clients with claims that were likely to be successful and that the advances were “made to clients with the expectation, substantially realized, that

they would be recovered.” 356 F.2d at 758. On that basis, the court affirmed the Tax Court’s holding that the advances were not deductible. Similarly, in *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), aff’d 447 F.2d 484 (9th Cir.1971), a personal injury law firm advanced litigation costs on behalf of its clients, and the clients had no obligation to repay the costs unless their case was successful. The law firm deducted the litigation costs in the year paid and included the reimbursed costs in income in the year of reimbursement. The law firm screened clients to reduce the risk that the advanced costs would not be repaid and took cases when there was a “good hope” of recovery. The court determined that the law firm’s advances operated as loans to its clients for which the law firm had an expectation of reimbursement. Therefore, deductions for the advances under section 162 were not allowed. See also *Herrick v. Commissioner*, 63 T.C. 562 (1975) (similar effect); *Silverton v. Commissioner*, T.C. Memo. 1977-198 (1977) (similar effect).

Under the related “tax benefit rule,” if a taxpayer takes a proper deduction and, in a later tax year, an event occurs that is fundamentally inconsistent with the premise on which the previous deduction was based (for example, an unforeseen refund of deducted expenses), the taxpayer must take the deducted amount into income. See section 111 of the Code (providing that gross income does not include income attributable to the recovery during a taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by chapter 1 of the Code). The Supreme Court applied the tax benefit rule in *Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983). In that case, the Court observed that “[t]he basic purpose of the tax benefit rule is to achieve rough transactional parity in

tax ... and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule.” Id. at 383.

ANALYSIS

In both Situation 1 and Situation 2, A and B each have a reasonable expectation of reimbursement. At the end of 2020, the reimbursement of A’s and B’s eligible expenses, in the form of covered loan forgiveness, is reasonably expected to occur – rather than being unforeseeable – such that a deduction is inappropriate. Compare *Canelo*, 53 TC at 225-226 with *Hillsboro*, 460 U.S. at 383. Section 1106(b), (d), and (g) of the CARES Act, and the supporting loan forgiveness application procedures published by the SBA, provide covered loan recipients like A and B with clear and readily accessible guidance to apply for and receive covered loan forgiveness. See www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program. Under these procedures, each taxpayer calculates the amount of its covered loan forgiveness on the basis of the eligible expenses paid or accrued in the covered period and submits a completed form and supporting documentation to their covered loan lender. See PPP Loan Forgiveness Application Form 3508. Within 60 days of receipt of an application for forgiveness, their covered loan lenders must issue a decision regarding A and B’s applications. See section 1106(g) of the CARES Act. Accordingly, A’s and B’s eligible expenses are not deductible because there is a reasonable expectation of reimbursement.

Section 265(a)(1) of the Code also disallows any amount of A’s and B’s eligible

expenses otherwise allowable as a deduction under the Code, including section 161, to the extent the payment of such eligible expenses is allocable to tax-exempt income in the form of the reasonably expected covered loan forgiveness. The fact that the tax-exempt income may not have been accrued or received by the end of the taxable year does not change this result because the disallowance applies whether or not any amount of tax-exempt income in the form of covered loan forgiveness and to which the eligible expenses are allocable is received or accrued. See section 265(a)(1); §1.265-1(b)(1).

Situation 1.

Based on the foregoing, when A completed its application for covered loan forgiveness, A knew the amount of its eligible expenses that qualified for reimbursement, in the form of covered loan forgiveness, and had a reasonable expectation of reimbursement. The reimbursement, in the form of covered loan forgiveness, was foreseeable. Therefore, pursuant to the foregoing authorities, A may not deduct A's eligible expenses.

In the alternative, section 265(a)(1) disallows a deduction of A's otherwise deductible eligible expenses because the expenses are allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness.

Situation 2.

Although B did not complete an application for covered loan forgiveness in 2020, at the end of 2020, B satisfied all other requirements under section 1106 of the CARES Act for forgiveness of the covered loan and at the end of 2020 expected to apply to the lender for covered loan forgiveness of the covered loan in 2021. Thus, at the end of

2020 B both knew the amount of its eligible expenses that qualified for reimbursement, in the form of covered loan forgiveness, and had a reasonable expectation of reimbursement. The reimbursement in the form of covered loan forgiveness was foreseeable. Therefore, pursuant to the foregoing authorities, B may not deduct B's eligible expenses.

In the alternative, section 265(a)(1) disallows a deduction of B's otherwise deductible eligible expenses because the expenses are allocable to tax-exempt income in the form of reasonably expected covered loan forgiveness.

HOLDING

A taxpayer that received a covered loan guaranteed under the PPP and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of the CARES Act may not deduct those expenses in the taxable year in which the expenses were paid or incurred if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of the expenses it paid or accrued during the covered period, even if the taxpayer has not submitted an application for forgiveness of the covered loan by the end of such taxable year.

EFFECT ON OTHER DOCUMENTS

This revenue ruling amplifies Notice 2020-32, 2020-21 IRB 837 (May 18, 2020).

DRAFTING INFORMATION

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