

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).