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IRS Disallows Deductions for Forgiven PPP Expenses

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On Friday, May 1, the Internal Revenue Service ("IRS") filled in a gap left by the Coronavirus Aid and Relief Economic Security Act ("CARES Act") by issuing Notice 2020-32 (the "Notice"). The Notice provides that businesses will not be able to claim a deduction for expenses paid with Paycheck Protection Program ("PPP") loan proceeds to the extent that the loan is forgiven.

Section 1106 of the CARES Act provides that a business receiving a PPP loan can have the principal amount of the loan forgiven in an amount equal to the payroll costs, mortgage interest payments, rent and utilities paid within the parameters outlined in the CARES Act and Small Business Administration guidance. Under the CARES Act, the forgiven loan will not trigger taxable income to the business. The CARES Act, however, was silent on the deductibility of the expenses paid with PPP loan proceeds. Generally, such ordinary and necessary expenses incurred in carrying on a trade or business would be deductible under the Internal Revenue Code.

The Notice, however, categorizes the amount of any PPP loan forgiveness as a "class of exempt income" under Internal Revenue Code Section 265 and related regulations. Under this Code Section, because the forgiven loan proceeds will not be included in taxable income, the expenses paid with those proceeds will not be deductible to the business.

The Notice reasons that forbidding the expense deduction avoids a potential double tax benefit to the business receiving the PPP loan forgiveness. While other parts of the CARES Act and the Families First Coronavirus Response Act included explicit language to prevent a double tax benefit with regard to payroll tax credits, the absence of such language in the CARES Act concerning expense deductions left this question open. The Notice fills the gap. As a result, businesses receiving PPP loan proceeds and loan forgiveness will not be allowed to claim expense deductions for the expenses paid with those proceeds. Businesses receiving only partial loan forgiveness will only be denied expense deductions to the extent of the partial forgiveness.

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