



## **IRS Notice 2020-32**

### **IRS Says No Federal Income Tax Deductions Allowed for Costs and Expenses Paid with Forgiven Paycheck Protection Program Loans**

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The Internal Revenue Service (“IRS”) [published Notice 2020-32](#) on May 1, 2020 affecting the federal income tax deduction of expenses by taxpayers who have received coronavirus pandemic relief through a loan (“covered loan”) pursuant to the [Paycheck Protection Program](#) established under the Coronavirus Aid, Relief, and Economic Security Act (“[CARES Act](#)”).

In Notice 2020-32 the IRS interprets the provisions of the CARES Act and section 265 of Internal Revenue Code (“Code”) and concludes that payroll costs and other expenses a business pays with amounts it receives from a covered loan that qualify it for loan forgiveness (“covered loan forgiveness”) are not deductible by the business for federal income tax purposes.

This IRS interpretation appears significant in terms of potential tax and financial effects for a business that receives a covered loan and covered loan forgiveness pursuant to the Paycheck Protection Program.

#### **Notice 2020-32 IRS Provided Guidance**

Notice 2020-32 states that it is to provide 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 covered loan pursuant to the Paycheck Protection Program established by section 1102 of the CARES Act.

Notice 2020-32 states that it is intended to clarify that no federal income tax deduction is allowed under the Code for an expense that is otherwise deductible if the payment of the expense by a taxpayer results in covered loan forgiveness pursuant to section 1106(b) of the CARES Act, and the income associated with the covered loan forgiveness is excluded from gross income of the taxpayer for federal income tax purposes pursuant to section 1106(i) of the CARES Act.

The IRS notice seems to indicate that covered loan forgiveness excluded from gross income for federal income tax purposes by a business that received a covered loan should also eliminate and take away federal income tax deductions by the business for expenses that it paid or incurred (e.g. employees’ wages and salaries during the covered period) with the covered loan proceeds. The IRS appears to be taking a position that for tax purposes, the

federal government will have indirectly but effectively paid the covered loan recipient's costs and expenses that result in the covered loan forgiveness.

### **IRS Explanation of Paycheck Protection Program Covered Loans and Forgiveness**

The IRS refers to the provisions the Paycheck Protection Program, under which a business taxpayer that has applied for and receives 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.

Also, under section 1106(b) of the Cares Act, a business that is a recipient of a covered loan can receive covered loan forgiveness of indebtedness on the loan in an amount equal to the sum of payments made for specified expenses ("eligible section 1106 expenses") during the 8-week "covered period" beginning on the covered loan's origination date.

The eligible section 1106 expenses of a business that has received a covered loan indicated are (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.

The IRS notice indicates a covered loan forgiveness can be reduced if the covered loan is not used for eligible section 1106 expenses. It states section 1106(d) of the CARES Act provides that the amount of the covered loan forgiveness that a business can receive is reduced if, during the covered period, (1) the average number of full-time equivalent employees of the covered loan 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% 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% of the amount forgiven can be attributable to non-payroll costs.

### **IRS Explanation of Federal Income Tax Exemption of Covered Loan Forgiveness**

The IRS confirms in Notice 2020-32 that section 1106(i) of the CARES Act provides that any amount that (but for that subsection) would be includible in gross income of a business that is a covered loan recipient by reason of covered loan forgiveness shall be excluded from the business' gross income for federal income tax purposes.

The IRS interprets the CARES Act to exclude from the gross income of a business that is a covered loan recipient any category of income that may arise from covered loan forgiveness, regardless of whether such income would be properly characterized as income from the discharge of indebtedness under the Code.

## **IRS Interpretation and Conclusion Disallowing Deduction of Expenses Allocable to Covered Loan Forgiveness**

IRS Notice 2020-32 states that the terms of the CARES Act do not address whether federal income tax deductions, otherwise allowable for payments of eligible section 1106 expenses by a business that is 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; and that Notice 2020-32 is published to address the effect of covered loan forgiveness on the deductibility of payments of eligible section 1106 expenses.

### **Code Section 265 Disallowance of Deductions Allocable to Tax Exempt Income**

Notice 2020-32 then summarizes general rules on allowance of federal income tax deductions for business expenses, including deduction of business expenses under section 162, and interest under section 163 of the Code. It then states an explanation of Code section 265, the IRS' interpretation of it, and states the effect of Code section 265 with respect to businesses that receive a covered loan and covered loan forgiveness under the Paycheck Protection Program.

The IRS interpretation starts with stating that Code section 265(a)(1) and applicable IRS regulations under it (see text of regulations in the Appendix below) 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, wholly exempt from the federal income tax.

The IRS explanation states that the purpose of Code section 265 is to prevent a double tax benefit. In other words, amounts of expenses that are directly allocable to tax exempt income are not deductible.

Code section 265(a)(1) reads:

“§ 265 Expenses and interest relating to tax-exempt income.

(a) General rule. - No deduction shall be allowed for—

(1) Expenses. - Any amount otherwise allowable as a deduction which 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 this subtitle, or any amount otherwise allowable under section 212 (relating to expenses for production of income) which is allocable to interest (whether or not any amount of such interest is received or accrued) wholly exempt from the taxes imposed by this subtitle.”

The IRS explanation in Notice 2020-32 states that Code section 265(a)(1) applies to otherwise deductible expenses incurred for the purpose of earning or otherwise producing tax-exempt income; that it also applies where tax exempt income is earmarked for a specific purpose and deductions are incurred in carrying out that purpose; and in such event, it is

proper to conclude that some or all of the deductions are allocable to the tax-exempt income. The IRS then cites certain court decisions it indicates have interpreted and applied Code section 265(a)(1) this way.

The IRS states in Notice 2020-32 that to the extent 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 IRS regulations.

The IRS then concludes that 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 deduction 1106 expense (e.g. employees’ wages, salaries) to the extent of the resulting covered loan forgiveness because such payment is *allocable to tax-exempt income*. The IRS states that is consistent with the purpose of Code section 265, and this treatment prevents a double tax benefit.

Notice 2020-32 states that this conclusion of the IRS is consistent with prior guidance of the IRS that addresses the application of Code section 265(a) to otherwise deductible payments. It cites Rev. Rul. 83-3, 1983-1 C.B. 72, which provides that, where tax exempt income is earmarked for a specific purpose, and deductions are incurred in carrying out that purpose, Code section 265(a) applies because such deductions are allocable to the tax-exempt income.

It states further that 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 business receives pursuant to section 1106 of the CARES Act, and (2) an equivalent amount of the otherwise deductible payments made by a business for eligible section 1106 expenses, constitutes a sufficient connection for Code 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 from gross income of the business that is recipient of the covered loan under section 1106(i) of the CARES Act.

Notice 2020-32 states that deductibility of payments of eligible section 1106 expenses that result in a covered 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*, citing certain court decisions and IRS revenue rulings.

As an example for purposes of discussion (note: this example is not in Notice 2020-32), assume hypothetically the Code was amended to provide that the federal government would pay \$10,000 directly to a certain type of business, and the amount received by the business would be excluded from its the gross income and not subject to federal income tax if the business, in turn, paid the full \$10,000 to its employees as salaries and wages. In such a case, according to the IRS’ interpretation of Code section 265 indicated in Notice 2020-32, the business’ payment of the amount to its employees as salaries and wages would not be deductible by the business for federal income tax purposes, even though ordinarily such payment would be deductible under the Code.

A covered loan to a business followed by non-taxable forgiveness of the loan pursuant to the Paycheck Protection Program is apparently considered by the IRS to have essentially the same effect as the above example, and to therefore be subject to the same tax treatment. Meaning that because the covered loan recipient is not taxed on the covered loan forgiveness, it is also not allowed a federal income tax deduction for amounts it paid with the covered loan proceeds if such payment entitles the loan recipient the nontaxable covered loan forgiveness.

The interpretation of the CARES Act and Paycheck Protection Program taken together with Code section 265 stated in Notice 2020-32 indicates expansive application of the Code section 265 by the IRS. It implicitly and indirectly connects related but separate factors of receipt of a covered loan, payment of payroll and other business expenses with the covered loan proceeds, and any forgiveness of the loan to the extent it is not included in gross income, with denial of deductions for the expenses under Code section 265.

The cases and rulings cited and discussed in Notice 2020-32 as supportive of this interpretation do not involve facts and circumstances that are similar to those involved for a taxpayer that receives a covered loan and covered loan forgiveness pursuant to the Paycheck Protection Program. The cases and rulings mentioned do not involve an exclusion from gross income of a cancelled or discharged indebtedness, or loan forgiveness, or hold that it is a reason for a denial of deductions under Code section 265.

As indicated above, IRS Notice 2020-32 states and acknowledges that the CARES Act provisions establishing the Paycheck Protection Program and providing for covered loans and covered loan forgiveness do not state whether a covered loan recipient that pays the loan proceeds for payroll costs (and other items required to be entitled to forgiveness of the covered loan) may deduct the amounts it pays for federal income tax purposes.

On April 22, 2020, the Joint Committee on Taxation [published](#) a lengthy Description of the Tax Provisions of Public Law 116-36, The Coronavirus Aid, Relief, and Economic Security Act (“CARES”) Act. This description includes an explanation of the covered loan forgiveness provisions in section 1106 of the CARES Act. It states the “Federal tax consequences” of covered loan forgiveness are that for federal income tax purposes, any amount which (but for the provision (section 1106)) would be includible in gross income of the recipient of a covered loan by reason of forgiveness pursuant to the provision is excluded from gross income. The explanation does not mention or discuss Code section 265, or its application and effect in relation to a covered loan or covered loan forgiveness pursuant to the Paycheck Protection Program and CARES Act.

The IRS interpretation in Notice 2020-32 appears to be that all costs and expenses incurred by a taxpayer with covered loan proceeds that result in forgiveness of the loan are entirely allocable to the exclusion from gross income of the taxpayer of the loan forgiveness allowed by section 1106(i) of the CARES Act, and therefore nondeductible. Treas. Reg. 1.265-1(c), is not mentioned in Notice 2020-32. It provides for allocation of expenses to any class or classes of income, and in part states if an expense or amount otherwise allowable as a deduction is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

IRS Notice 2020-32, is written published guidance of the IRS, which is generally given deference and weight with respect to interpretation and application of provisions of the Code. However, IRS revenue rulings and notices have been held by courts to have less weight than the literal provisions of the Code and IRS published regulations.

## **Conclusion**

The IRS interpretation and conclusion stated in Notice 2020-32 is important for any business that receives a covered loan and covered loan forgiveness under the Paycheck Protection Program and CARES Act. The IRS interpretation and its apparent intended effect may not have been anticipated or previously considered by some businesses that have applied for and received a covered loan or expect to apply for and receive a covered loan forgiveness.

The IRS interpretation in Notice 2020-32 disallowing federal income tax deduction of expenses allocable to a covered loan and covered loan forgiveness should be considered carefully by a business that has applied for (or in the future applies for and receives) a covered loan and/or covered loan forgiveness under the Paycheck Protection Program.

If you have questions about the effect of this IRS guidance in Notice 2020-32 on disallowance of federal income tax deductions, or any other tax matters related to the Paycheck Protection Program and CARES Act, please contact any attorney at GableGotwals you know or those who work in that practice area named below.

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## Appendix

Treas. Reg. § 1.265-1. Expenses relating to tax-exempt income.

(a) Nondeductibility of expenses allocable to exempt income.

- 1) No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.
- 2) No amount shall be allowed as a deduction under section 212 (relating to expenses for production of income) for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt interest income.

(b) Exempt income and nonexempt income.

- (1) As used in this section, 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) wholly exempt from the taxes imposed by subtitle A of the Code. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is

(i) Wholly excluded from gross income under any provision of subtitle A, or

(ii) Wholly exempt from the taxes imposed by subtitle A under the provisions of any other law.

- (2) As used in this section the term “nonexempt income” means any income which is required to be included in gross income.

(c) Allocation of expenses to a class or classes of exempt income. Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(d) Statement of classes of exempt income; records.

- (1) A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (i) the amount of each class of exempt income, and (ii) the amount of expenses and amounts otherwise allowable allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (c) of this section. If an item is apportioned between a class of exempt income and a class of nonexempt income, the statement shall show the basis of the apportionment. Such statement shall also recite that each deduction claimed in the return is not in any way attributable to a class of exempt income.
- (2) The taxpayer shall keep such records as will enable him to make the allocations required by this section. See section 6001 and the regulations thereunder

T.D. 6313, 9/16/58.