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VIA EMAIL

July 30, 2020

Senator Sherrod Brown
503 Hart Senate Office Bldg.
Washington, DC 20510

Senator Rob Portman
448 Russell Senate Office Building
Washington, DC 20510

Re: Reversing IRS Notice 2020-32

Dear Senators Brown and Portman:

Thank you for the swiftness with which you and your colleagues acted in passing the CARES Act and the Paycheck Protection Program Flexibility Act. The Paycheck Protection Program (PPP) has been a lifeline for many of our clients. We write today to ask you to take measures to help these businesses once again because the IRS has taken action that significantly reduces the benefits of the PPP.

On April 30, 2020, the IRS released Notice 2020-32 (the “**Notice**”). The Notice provided that businesses whose PPP Loans are forgiven cannot take a deduction for business expenses that the PPP funds are used for. This will have a tremendous negative impact on all small businesses that are trying to survive in the post-COVID economic landscape and runs directly counter to Congress’s intent in creating the PPP. Indeed, the Notice renders Section 1106(i) of the CARES Act meaningless.

Fortunately, legislation has already been introduced by Sen. John Cornyn to address this issue. The Small Business Expense Protection Act of 2020 (S.3612 and H.R. 6821) has bipartisan support, with 25 co-sponsors from both parties in the Senate and 29 in the House.¹ We urge you to support the Act and pass this critical legislation during the current session or incorporate it into the HEALS Act.

The Impact of the Notice

As Senators Grassley and Wyden and Congressman Neal rightly noted in their [May 5 letter](#) to Secretary Mnuchin, the result of the Notice is effectively that businesses are being taxed on their PPP loans, which, as discussed below, was not the intent of Congress when creating the program.

The chart below uses sample data to demonstrate the impact of the Notice on business owners. A business with \$5,000,000 of income and a \$750,000 PPP loan that was used in full on forgivable expenses will pay \$180,000 **more** in taxes as a result of the IRS Notice. That is the same amount of tax that it would have paid had Congress not excluded the amounts forgiven from income.

¹ The HEROES Act also includes a provision that would reverse the Notice.

	<i>Tax Burden without Notice 2020-32 (expenses are deductible)</i>	<i>Tax Burden with Notice 2020-32 (expenses not deductible)</i>	<i>Tax Burden with Forgiveness Taxed as Income</i>
Revenue	\$5,000,000	\$5,000,000	\$5,000,000
Forgiven PPP Loan Amount	\$750,000	\$750,000	\$750,000
Deductible Expenses	\$4,000,000	\$3,250,000	\$4,000,000
Income Subject to Taxation	\$1,000,000	\$1,750,000	\$1,750,000
Total Tax Burden*	\$240,000	\$420,000	\$420,000

*For simplification of the calculation, an effective tax rate of 24% is assumed

This outcome is patently unfair to businesses and is contrary to Congress’s intent. Many businesses only retained workers because of the PPP Loan and the promise that it was tax free. Unfortunately, many of these already struggling businesses won’t have the cash to pay such taxes. Businesses should not be penalized for taking the relief that Congress offered in these unprecedented times. If they are, businesses will have substantially less after-tax capital to assist with the economic recovery or to survive these economically tumultuous times. Businesses facing a loss due to COVID-19 are also negatively impacted: any Net Operating Loss Carryback will be reduced by the amount of the non-deductible expenses, resulting in a reduction in cash even in a loss situation.

The Notice Is Clearly Counter to Congressional Intent

The PPP was designed to minimize disruption to American businesses and provide relief to those that are experiencing unprecedented economic disruption. Congress specifically provided for favorable tax treatment of the forgiveness of the loan by including Section 1106(i) in the CARES Act, which excluded the forgiven loan proceeds from income. This provision was critically important to the structure of the program: PPP loans were designed to effectively provide businesses that maintained their payrolls a tax-free grant.

As shown above, disallowing business deductions as provided in Notice 2020-32 reverses the benefit that Congress specifically granted by exempting PPP loan forgiveness from income. Had Congress intended for there to be tax consequences of the PPP or for there to be neutral tax treatment for loan forgiveness, Section 1106(i) would not have been included.

The Notice Misapplies the Law

The Notice relies on Section 265(a)(1), which states that deductions are not allowed when they are allocable to a class of income that is “wholly exempt from the taxes imposed by this subtitle [of the Internal Revenue Code].” The IRS misapplies the law in two ways:

The Forgiven PPP Loan Is “Excluded,” Not “Exempt,” From Income

The clear language of Section 265 provides that it applies to deductions allocable to income “wholly exempt from the taxes imposed by this subtitle.” (emphasis added). Based on the plain

language of the CARES Act, Section 265 does not apply because the CARES Act excluded PPP Loan forgiveness from income; it did not exempt it.

No regulatory interpretations support the IRS's interpretation of Section 265, either. Treas. Reg. § 1.265-1(b)(1) clarifies that exempt income is any class of income "wholly excluded from gross income under any provision of Subtitle A, or wholly exempt from the taxes imposed by Subtitle A under the provisions of any other law."² PPP Loan forgiveness was not excluded from gross income under any provision of Subtitle A – it was excluded in the CARES Act itself and the CARES Act does not amend Subtitle A. Therefore, the first clause of Treas. Reg. § 1.265-1(b)(1) is inapplicable. The second clause is also inapplicable because, as described above, the CARES Act specifically excludes loan forgiveness from income; it does not exempt it.

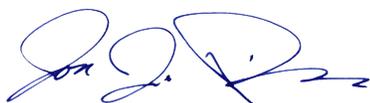
The Deduction Is Not Allocable to Exempt Income

Even assuming *arguendo*, that the forgiven loan is "wholly exempt" from income, the expenses are not allocable to the income from the forgiven loan. The deductions for the forgivable expenses (payroll, rent, utilities and mortgage interest) are attributable to the conduct of its business, not to the PPP loan. In fact, at the time the expenses were incurred, the loan may or may not be forgiven, and the amount of the forgiveness can be limited by a number of factors. Therefore, the deductions are properly allocable to the income produced by the business, not to the PPP loan forgiveness.

Conclusion

We urge you to assist Ohio's small business owners by taking swift action to reverse the IRS Notice. We are available at any time to discuss these issues in more detail and to provide more information or analysis.

Sincerely,



JON J. PINNEY
Managing Partner



KEVIN T. O'CONNOR
Partner, Chair Tax Practice

² In this case, the reference to Subtitle A is to the portions of the Internal Revenue Code dealing with income taxes.