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Rev. Rul. 2020-27, 2020-50 IRB -- IRC Sec(s). 265, 11/19/2020

## Revenue Rulings

### Rev. Rul. 2020-27, 2020-50 IRB, 11/19/2020, IRC Sec(s). 265

#### **Expenses and interest relating to tax-exempt income-forgiveness of covered loan; Paycheck Protection Program-class of exempt income.**

#### **Headnote:**

Taxpayer that received covered loan guaranteed under Paycheck Protection Program and paid or incurred certain otherwise deductible expenses listed in section 1106(b) of CARES Act (P.L. 116-136; 3/27/2020) may not deduct those expenses in tax year in which expenses were paid or incurred if, at end of such taxable year, taxpayer reasonably expects to receive forgiveness of covered loan on basis of expenses it paid or accrued during covered period, even if taxpayer hasn't submitted application for forgiveness of covered loan by end of such taxable year. **Code Sec. 265(a)(1)**; disallows deduction of otherwise deductible eligible expenses because expenses are allocable to tax-exempt income in form of reasonably expected covered loan forgiveness. **Notice 2020-32, 2020-21 IRB 837** is amplified.

**Reference(s):** ¶ **2655.03(5)**; **Code Sec. 265**;

#### **Full Text:**

#### **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 [17 AFTR 2d 358] (5<sup>th</sup> Cir.

1966) cert. denied 385 U.S. 832 (1966); *Canelo v. Commissioner*, 53 TC 217, 225-226 (1969), aff'd 447 F.2d 484 [28 AFTR 2d 71-5543] (9<sup>th</sup> 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 [28 AFTR 2d 71-5543] (9<sup>th</sup> 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 [1977,198 PH Memo TC] (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 [51 AFTR 2d 83-874] (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](http://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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