Deductibility of Expenditures Paid Out of PPP Loan Proceeds; California Conformity with CARES Act

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On April 30, 2020, the Internal Revenue Service issued guidance regarding the deductibility of expenses that are paid from proceeds of a loan that was obtained under the Paycheck Protection Program ("**PPP**").

As discussed in our client alert of April 3, 2020, the Coronavirus Aid, Relief and Economic Security Act (the "**CARES Act**") established the PPP. The PPP allows small businesses to obtain loans 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. Under the program, subject to several limitations, a recipient of a PPP loan may receive forgiveness of all or a portion of the loan amount that was used to pay certain expenses. The CARES Act specified that any portion of the loan amount that is forgiven as part of the PPP program will be excluded from the loan recipient's gross income. However, the CARES Act did not address whether deductions would be allowed for expenses (payroll costs, etc.) paid by the loan recipient/employer with PPP loan proceeds that are ultimately forgiven.

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In Notice 2020-32, the Internal Revenue Service stated that no income tax deduction would be allowed for an expenditure to the extent that the expenditure resulted in a forgiveness of all or a portion of the PPP loan. According to the Notice, allowing a PPP loan recipient to deduct these payments and also not be taxable on the forgiveness of the loan would result in a double tax benefit.

Since the release of this guidance yesterday, members of Congress have expressed disappointment in the Internal Revenue Service's position. Senate Finance Committee Chair Charles Grassley said in a statement that Notice 2020-32 is contrary to the original intent of the CARES Act to "maximize small businesses' ability to maintain liquidity, retain their employees and recover from this health crisis as quickly as possible." It is possible that Congress will attempt to change the position of the Internal Revenue Service through legislation.

The full text of Notice 2020-32 can be found here.

California Provides Preliminary Guidance Regarding Conformity to Federal CARES Act

Also on April 30, 2020, California's Franchise Tax Board circulated its May 2020 Tax News publication, which included preliminary guidance regarding California's conformity to the CARES Act. The publication states that California generally conforms to the pension-related items in the CARES Act, including the changes to the early withdrawal penalties and minimum distribution rule changes. However, California does not have automatic conformity to the changes made with regard to loans from a qualified retirement account.

The publication provides a list of changes made by the CARES Act that California does **not** currently conform to:

- Loan forgiveness related to the PPP
- NOL Carrybacks
- Charitable contributions
- Student loan forgiveness
- Business interest limitations
- Prior year alternative minimum tax liability (for corporations)
- Health-savings accounts changes

According to the publication, the Franchise Tax Board is still in the process of analyzing and considering the impact of the Federal CARES Act on California taxpayers. Additional guidance regarding California's conformity to the CARES Act should be released in the future.

We will keep you updated as we learn more, but please do not hesitate to contact us directly if you have any questions or would like to discuss these issues in more detail.