# Double Tax Benefits in the CARES Act

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In this article, the authors explain why employers' deductions for expenses paid should be unaffected by the CARES Act, regardless of whether they were funded with SBA loans that were later forgiven without the recognition of income.



Typically, under federal tax law a taxpayer recognizes income upon the receipt of cash or property absent a specific exclusion, and when an exclusion from gross income applies, the federal tax law denies a deduction for related expenses (or the property acquired with the cash has a zero basis).[1] The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) reminds us that we live in atypical times.

While the CARES Act explicitly denies a double benefit for taxpayers regarding some new tax incentives,[2] and the IRS has clarified that some overlapping benefits in the Families First Coronavirus Response Act (P.L. 116-227) ("Families First Act") and the CARES Act are mutually exclusive,[3] the CARES Act is silent about whether an employer can deduct expenses essentially funded by the government tax free.[4]

The CARES Act expands SBA loan availability for businesses employing no more than the greater of 500 employees or, if applicable, the size standard in number of employees established by the SBA for the industry in which the business operates. Recipients of these new SBA loans are eligible for loan forgiveness equal to the recipient's payroll costs, mortgage interest

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[1] *See, e.g.*, sections 108, 118, and 265; *see also Old Colony Trust v. Commissioner*, 279 U.S. 716 (1929) (holding that an employer's payment of an employee's income taxes constituted taxable income to the employee).

[2] CARES Act sections 2301 (providing that rules similar to section 280C(a) shall apply to employer retention credits), 2301(h)(2) (denying a section 45S credit for family or medical leave on wages creditable for the employee retention credit for COVID-19-affected businesses), and 2206(d) (denying a deduction for interest on employer payments of qualified education loans excluded from income).

[3] *See* IRS, "COVID-19-Related Tax Credits for Required Paid Leave Provided by Small and Midsize Businesses FAQs" ("IRS FAQs"), at 18 and 19 (clarifying, for example, that if an employer qualifies for both qualified leave credits under the Families First Act and the employee retention credit under the CARES Act, the credits cannot be applied to the same wage payments).

[4] At least one other commentator has suggested that silence means that these expenses are not deductible. *See* Eric Yauch, "Congress Asked to Clarify Tax Deductibility of PPP Loan Proceeds," *Tax Notes Federal*, Apr. 13, 2020, p. 323 (describing an April 8, 2020, letter by Cornell University law professor Richard L. Reinhold arguing that further legislative action would be needed to afford a deduction for amounts funded with SBA loans).

payments, rent, and utilities incurred or paid by a recipient during the eight-week period beginning on the date of the loan's origination.[5]

Section 1106(i) of the CARES Act excludes from income any forgiven loan amount which would, but for section 1106(i),[6] be includable in the gross income of the recipient. No rule denies a deduction for the associated expenses funded with the forgiven loan. Interestingly, the "but for" language in CARES Act section 1106(i) also appears in section 108(a), which already excludes from income some debt forgiveness that would be includable "but for" that subsection.[7]

More guidance is available under the Families First Act, which preceded the CARES Act by just nine days. Under the Families First Act, employer payroll tax credits are available to employers who are required to provide paid sick or family leave.[8] The Families First Act expressly increases the employer's gross income by the amount of the payroll tax credit allowed.[9] IRS guidance reaffirms this treatment of the credit in a recently published FAQ.[10] Because the creditable wages are included in income, it stands to reason that the wages paid, although funded by the government through tax credits, are deductible by the employer.[11]

Unlike the Families First Act, the CARES Act excludes the government funding mechanism from income.[12] Under general income tax principles, one would normally expect no deduction for the amounts that were not taxed when received.[13]

Section 108, for example, excludes from gross income amounts that would otherwise be includable as cancellation of debt income under some circumstances.[14] Section 108(b) then reduces a number of tax attributes, including net operating losses and the taxpayer's basis in its assets, generally dollar for dollar.[15] This reduction does not, however, apply to all tax attributes a taxpayer may have. In particular, section 108 does not reduce ordinary deductions, such as those for wages paid. Also, if the taxpayer has no attributes to reduce, the taxpayer, having excluded the loan forgiveness from income, suffers no offset.[16]

The CARES Act includes no similar provision denying deductions or reducing tax attributes. Absent this type of provision, expenses paid by the SBA loan are arguably deductible.[17] The government may seek to draw on general tax law

[5] CARES Act section 1106(b).

[6] It is unclear whether the income exclusion under CARES Act section 1106(i) applies to interest paid by the SBA under section 1106(c)(3) of the act (which requires the SBA to remit to lenders the amount of the forgiven loan "plus any interest accrued through the date of payment"), or if the SBA loans described in the CARES Act are indebtedness in the first place, because critical indicia of indebtedness for income tax purposes include whether there is an unconditional obligation to pay and a reasonable expectation of repayment. *See, e.g.*, *Wood Preserving Corp. v. United States*, 347 F.2d 117, 119 (4th Cir. 1965); *Gilbert v. Commissioner*, 248 F.2d 399, 407 (2d Cir. 1957). These issues are beyond the scope of this article.

[7] Absent further guidance or a correction, it is technically unclear whether one should apply section 108 before CARES Act section 1106(i) or vice versa. Taxpayers will likely apply the CARES Act first to avoid the tax attribute reduction rules in section 108.

[8] Families First Act sections 7001 and 7003.

[9] Families First Act sections 7001(e)(1) (also denying a section 45S credit for family or medical leave on applicable wages), 7703(e)(1) (same). Interestingly, the Families First Act includes no gross income rule for self-employment credits allowed to self-employed individuals. *See* Families First Act sections 7002(d)(3) and 7004(d)(3).

[10] *See* IRS FAQs at 49.

[11] IRS FAQs at 50, 51. Employers that are otherwise required to capitalize the wages that they pay (for example, under section 263A), however, should consider whether capitalization might be required.

[12] CARES Act section 1106(i).

[13] *See, e.g.*, section 165(a) (permitting a deduction for a loss that is "not compensated for by insurance or otherwise"); section 265(a) (disallowing deductions allocable to tax exempt income); section 1017(a) (providing that when cancellation of indebtedness income is excluded from income under specific provisions of section 108, other attributes are reduced); 2 U.S.C. section 6102 (denying deductions for specified expenses paid or incurred by designated congressional officials to the extent they receive reimbursement).

[14] Section 108(a) (including (A) bankruptcy, (B) insolvency, (C) qualified farm indebtedness, (D) noncorporate qualified real property business indebtedness, or (E) qualified principal residence indebtedness discharged before January 1, 2021).

[15] Section 108(b)(3). The general business credit, minimum tax credit, passive activity credit carryover, and foreign tax credit carryovers, however, are only reduced by 33⅓ cents on the dollar. Section 108(b)(3)(B). However, these attributes are only reduced as of the beginning of the tax year following the year in which the excluded cancellation of debt income arose. Sections 108(b)(4)(A) and 108(b)(5)(B).

[16] *See* reg. section 1.108-7(e), examples 1 and 2 (when there is $100,000 discharge of indebtedness, NOLs are reduced by $50,000 and nothing says that this causes any of the discharged indebtedness to be treated as income).

[17] Other IRC provisions and IRS guidance adopt a similar position — allowing both a deduction and exclusion from income — for policy reasons. For example, under the parsonage exemption, a pastor can purchase a house with a mortgage and pay deductible mortgage interest, while exempting from tax the salary income used to pay the mortgage interest. Sections 107, 265(a)(6)(B). Similarly, although gifts are excluded from income under section 102(a), no deduction is denied for the expenses funded using the proceeds of a gift.

principles in an attempt to deny the deduction of those expenses,[18] but we do not believe this would be a strong argument because the CARES Act provides for a specific exemption for income attributable to the forgiveness of SBA loans, but does not specifically deny a deduction for expenses funded using the proceeds of those loans.

The government might also try to invoke section 265, which disallows some deductions "allocable to" a "class of income" that is "wholly exempt from" tax (including interest payments on indebtedness used to purchase tax-exempt bonds) to assert that the expenses funded with the SBA loan proceeds are nondeductible. These expenses, however, are being funded as an initial matter out of loan proceeds, which are not inherently exempt from tax, calling into question whether the expenses are even "allocable" to exempt income within the meaning of section 265.[19] Section 108 and the related attribute reduction rules imply that an otherwise generally applicable rule like section 265 should not affect the deductibility of payments funded by SBA loans under the CARES Act.

The IRS has previously stated that section 265 is "intended to reach only those situations in which all the income of a particular type or from a particular source is exempt from tax."[20] For these reasons, the government would face hurdles in trying to successfully establish that section 265(a) denies deductions for expenses funded from the proceeds of an SBA loan.

Similarly, legislation enacted in response to an earlier economic downturn (the savings and loans crisis of the late 1980s and early 1990s) permitted a deduction giving rise to a double benefit.[21] During the savings and loan crisis, to incentivize healthy financial institutions to take over distressed savings and loan institutions (whose liabilities exceeded their assets), the government agreed to provide what were effectively make-whole payments to healthy financial institutions that acquired troubled institutions. The relevant statutory regime made clear that the make-whole payments were nontaxable, but did not make clear whether the healthy financial institutions should be able to claim loss deductions when they disposed of or wrote down the assets for which the make-whole payments were received. The government took the position in litigation that the losses claimed by the healthy financial institutions should be disallowed as a result of the make-whole payments, citing general tax law principles.[22] Ultimately, however, citing the specific statutory scheme that clearly made the governmental assistance payments nontaxable without denying a deduction, the court held that the healthy financial institutions were entitled to claim what appeared to be a double benefit[23] (that is, both an exclusion of specified make-whole payments from income and a deduction for the losses for which those make-whole payments provided compensation).[24]

This precedent-interpreting legislation enacted during an earlier financial crisis supports the argument that the CARES Act should be

[18] *See*, *e.g.*, *Manocchio v. Commissioner*, 710 F.2d 1400 (9th Cir. 1983) (denying a deduction for an expense when the taxpayer had received a nontaxable reimbursement payment); Rev. Rul. 76-144, 1976-1 C.B. 17 (denying deductions for expenses or losses paid or incurred by a taxpayer that were reimbursed in accordance with a disaster relief act). *See also* sections 362(c) (when non-shareholder contributions to capital are used to acquire property, the corporation's basis in the acquired property is reduced by the amount contributed); 118(a) (exempting from a corporation's gross income contributions to capital of the corporation); 163(e)(3)(A) (denying a deduction for original issue discount when the original issue discount is not taxable to a foreign holder).

[19] Rev. Rul. 83-3, 1983-1 C.B. 72 (when the IRS ruled that section 265 applied to deny various types of deductions), on the other hand, involved several scenarios when expenses (*e.g.*, educational expenses) were funded out of grants or allowances (*e.g.*, veterans benefits) that were absolutely exempt from U.S. federal income taxation. Rev. Rul. 83-3 (modified by Rev. Rul. 85-96, 1985-2 C.B. 87, and Rev. Rul. 87-32, 1987-1 C.B. 131).

[20] GCM 38658 (stating that a taxpayer may both exclude some dividends and interest from income under section 116 while also deducting penalties forfeited on a premature withdrawal of funds from a savings account under section 165(c) because interest in excess of the threshold is not tax exempt).

[21] *See*, *e.g.*, *Centex Corp. v. United States*, 395 F.3d 1283 (Fed. Cir. 2005).

[22] *Id.*

[23] The posture of the *Centex* case was somewhat unique, in that it involved a breach of contract claim by Centex, asserting that the government had breached its agreement with Centex by enacting legislation that retroactively eliminated tax benefits (namely, the "double benefit" of income exclusion coupled with loss deduction) that Centex had expected to receive (under the guise of being clarifying legislation). In addressing this claim's merit, the court needed to determine whether, under the law in effect before this clarifying legislation, Centex was in fact entitled to a double benefit. The court concluded that it was.

[24] Similarly, there are other circumstances in the tax law when what arguably is a double benefit is permitted. *See*, *e.g.*, section 50(c)(3) (providing an exception to the general rule that the tax basis of an asset is reduced by the amount of the investment tax credit for the energy property, instead providing that the tax basis of an eligible asset is reduced only by 50 percent of the credit).

similarly construed as leaving unaffected deductions for expenses paid, regardless of whether they were funded with SBA loans that were later forgiven without the recognition of income. ■