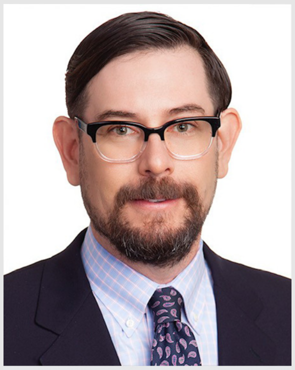
Does the Deductibility of Qualifying PPP Loan Expenses Violate 'Tax 101'?

by Matthew A. Morris



Matthew A. Morris

Matthew A. Morris is a tax partner at Sherin and Lodgen LLP in Boston.

In this article, Morris argues that allowing deductions against government bailout and other relief payments is consistent with federal tax principles, and he suggests ways to avoid controversy and confusion over deductibility in future relief programs.

Taxpayers that received Paycheck Protection Program loan funds in 2020 and paid or incurred qualified expenses are eligible to have all or a portion of those loans forgiven.[1] To prevent taxes being imposed on the forgiven portions of the PPP loans, section 1106(i) of the Coronavirus Aid, Relief, and Economic Security Act specifically provides that the forgiveness of PPP loans is excluded from the recipient's gross income.[2]

But there was a tax aspect of forgiven PPP loans that many taxpayers did not anticipate when qualified expenses were paid or incurred: Notice 2020-32, 2020-21 IRB 837, provided that "no deduction is allowed under the Internal Revenue Code . . . if the payment of the expense results in forgiveness of a covered loan pursuant to section 1106(b)" of the CARES Act. Similarly, Rev. Rul. 2020-27, 2020-50 IRB 1552, provided that any taxpayer that received a PPP loan and that reasonably expects all or a portion of that loan to be forgiven by the end of 2020 could not deduct the expenses on which the forgiven (or soon-to-be-forgiven) portion of the PPP loan is based.[3] In a May 4, 2020, interview on Fox Business, Treasury Secretary Steven Mnuchin expressed support for the IRS's position on disallowing deductions in connection with forgiven PPP loans, stating that "if the money that's coming is not taxable, you can't double dip."[4] Mnuchin further stated that the IRS's position regarding nondeductibility of the expenses "is basically Tax 101."[5]

Despite the IRS's and Mnuchin's characterization of deducting expenses used to qualify PPP loans for forgiveness as a "double dip," some members of Congress and the business

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[1] Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, section 1106(b), 15 U.S.C. section 9005(b) ("An eligible recipient shall be eligible for forgiveness of indebtedness on a covered loan in an amount equal to the sum of the following costs incurred and payments made during the covered period: (1) Payroll costs. (2) Any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation). (3) Any payment on any covered rent obligation. (4) Any covered utility payment."). Section 304(b)(1)(A) of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act — enacted as Title III, division N of the Consolidated Appropriations Act, 2021 (P.L. 116-260) — redesignated section 1106 of the CARES Act to section 7A of the Small Business Act, 15 U.S.C. section 636(a)(36). For the sake of simplicity, however, I refer to the loan forgiveness provision as CARES Act section 1106.

[2] CARES Act section 9005(i) ("For purposes of the Internal Revenue Code of 1986, any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in subsection (b) shall be excluded from gross income.").

[3] *See also* Rev. Proc. 2020-51, 2020-50 IRB 1599 (providing that the only safe harbor for deducting PPP-loan-based expenses is for a taxpayer that has been notified that all or a portion of the PPP loan will not be forgiven or that has decided to withdraw its application for forgiveness of all or a portion of the PPP loan).

[4] Jad Chamseddine, "'Tax 101': Mnuchin Defends Nondeductibility of PPP Expenses," *Tax Notes Today Federal*, May 5, 2020.

[5] *Id.*

community strongly criticized the IRS's disallowance of deductions as contradicting legislative intent to preserve the tax-free character of PPP loans.[6] In response to internal pressure and heavy demand from industry lobbyists, Congress in the COVID-Related Tax Relief Act of 2020 (CRTRA) added language to CARES Act section 1106(i) providing that "no deduction shall be denied or reduced, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by paragraph (1)."[7] Despite his 11th-hour indications that he would not sign the bill,[8] President Trump relented and signed CRTRA into law December 27, 2020. After CRTRA was enacted, the IRS had little choice but to declare that its positions regarding nondeductibility set forth in Notice 2020-32 and Rev. Rul. 2020-27 "are no longer accurate statements of the law."[9]

Although the deductibility of expenses has not garnered as much media attention as other aspects of CRTRA (such as the amount of the stimulus checks and whether Trump would eventually sign), a *New York Times* article discussed the allowance of PPP loan deductions at length.[10] That article framed the dispute regarding deductions of expenses used to qualify PPP loans for relief as a conflict between fundamental tax principles on one side and the richest 1 percent of PPP loan recipients and their "high-paid accountants" on the other.[11] The prevailing theme of this and similar articles is that the country's wealthiest corporations are having their cake and eating it too regarding PPP expenses because there is "no cost on the way in and no cost on the way out."[12]

But a deeper question lies beneath the surface. Specifically, is the concept of deducting an expense used to qualify for forgiveness of a PPP loan truly contrary to fundamental tax principles? A comprehensive review of case law and IRS guidance suggests that allowing for deductions against government bailout and other relief payments is actually consistent with federal tax principles, which have traditionally distinguished reimbursements and similar types of tax-exempt income (against which most deductions are disallowed) from general welfare payments (which are also tax-exempt but against which most deductions are allowed).

This article discusses the background of the controversy over deductibility of expenses used to qualify for PPP loan forgiveness and the history of the federal income tax treatment of general welfare payments. It briefly explores the structure and administration of other recent bailout and emergency relief measures and identifies some of the public policy and other arguments that might explain the reluctance of Congress and the IRS to characterize forgiven government loans as general welfare payments. In conclusion, it suggests a relatively simple solution that could help to avoid future disputes over the tax treatment of bailouts and similar relief payments.

I. Overview of PPP Loan Forgiveness

Before considering an example that illustrates the practical consequences of disallowing the deduction of expenses used to qualify all or a portion of a PPP loan for forgiveness, it is helpful to first identify the time frames relevant to the PPP loan process. They are: (1) the PPP loan application date; (2) the measurement period[13] (2019 calendar year or the one-year period preceding the loan disbursement date) used to calculate the maximum PPP loan amount (equal to 2½ months of average payroll expenses); (3) the loan disbursement date (when the Small Business Administration disburses the PPP loan to the

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[6] See the discussion in notes 25-26, *infra*, and the accompanying text.

[7] CRTRA section 276(a)(1), subtitle B, Title II, division N of the Consolidated Appropriations Act, 2021.

[8] Several days before the enactment of CRTRA, President Trump referred to the bill as a "disgrace." His main objection was that the stimulus payments were $600 instead of $2,000 per qualifying individual. *See* Benjamin Swasey and Barbara Sprunt, "Trump Signs COVID-19 Relief Deal After His Criticism Threatened to Derail It," NPR, Dec. 27, 2020.

[9] Rev. Rul. 2021-2, 2021-4 IRB 1.

[10] Luke Broadwater, Jesse Drucker, and Rebecca R. Ruiz, "Buried in Pandemic Aid Bill: Billions to Soothe the Richest," *The New York Times*, Dec. 22, 2020.

[11] *Id.*

[12] *Id.*; *see also* Chamseddine, *supra* note 4.

[13] The "measurement period" is a term of art that I use to differentiate the one-year period preceding the loan disbursement date — which is used to calculate the maximum PPP loan amount — from the covered period — which for non-seasonal employers is the eight- or 24-week period starting on the loan disbursement date in which the taxpayer must pay or incur expenses that qualify the loan for forgiveness. *See infra* note 14 (discussing the eight- and 24-week periods).

taxpayer); (4) the covered period (the eight- or 24-week period in which the taxpayer must pay or accrue qualifying expenses[14]); (5) the PPP loan forgiveness application date; and (6) the date on which the SBA reaches a final decision to approve all or a portion of the PPP loan for forgiveness. As I discuss in the example below, the IRS's arguments for disallowing deductions for the expenses are based on a somewhat incongruous relationship among these different time frames.

How exactly could the nondeductibility of PPP-loan-based expenses result in an increased tax burden? Consider X Corp., a corporation that had an average monthly payroll expense of $100,000 for the one-year measurement period preceding the date on which it received a PPP loan.[15] Assume that during the measurement period, X's average monthly receipts were $100,000 and that it had no other gross income and no deductible expenses other than $100,000 in average monthly payroll expenses. On June 1, 2020, X applies for a PPP loan of $250,000 in connection with its qualified payroll expenses. On July 1, 2020, the SBA disburses a $250,000 PPP loan to X. Because it uses the full amount of the loan to pay for qualified expenses such as payroll, rent, and utilities in the 24-week period following the disbursement date (the covered period under section 1106 of the CARES Act[16]), X by the end of 2020 reasonably expects the full amount of that PPP loan to be forgiven.[17]

According to the IRS (if the IRS's position had not been rendered obsolete by CRTRA), the $250,000 in payroll, rent, and utility expenses that qualified the PPP loan for forgiveness is ineligible for a deduction under section 162 because X has a reasonable expectation that by the end of 2020 the SBA will forgive the full amount of the loan.[18] If we think of the forgiven portion of the PPP loan as intending to cover 2½ months of average payroll expenses, X would have $250,000 in gross income during that same 2½-month period but could not use any portion of the $250,000 in forgiven PPP loan proceeds that it spent on payroll, rent, and utilities in the covered period to offset that income. This example illustrates that X's receipt of PPP loan proceeds would not have been a tax-neutral event based on the IRS's position; although there is no recognition of taxable income on X's receipt of the loan proceeds, there would have been a hidden tax cost associated with forgiveness of the loan.

Preventing employers from using otherwise deductible payroll expenses to offset gross receipts not only would have resulted in unanticipated tax costs but also would have failed to give employers an incentive to retain their workforces in place. If X had reduced the number of its employees so that its average payroll expenses during a 2½-month period were $125,000 instead of $250,000, its tax situation would be exactly the same as it would have been had its payroll remained static. The total amount of X's PPP loan in that situation would drop from $250,000 to $125,000, but its payroll expenses would also drop by the same amount. This is not to say that X would have had an incentive to reduce its payroll expenses (at least from a tax perspective), but there also would have been no specific tax incentive for X to retain its full roster of employees.

Also, the fact that X's pre-expense cash flow increases as a result of the PPP loan does not necessarily mean that X received a tax-free windfall. Not only would its tax bill have increased as a result of the nondeductible expenses, but X would also have to anticipate that its cash flow would continue to decline with no guarantee of further SBA loan relief in 2021. Although some businesses in the COVID-19 era

[14] Taxpayers whose disbursement date is before June 5, 2020, have the option of electing an eight-week covered period. *See* 15 U.S.C. section 9005(l). For taxpayers that do not make this election, the covered period begins on the date of the loan and ends on the earlier of December 31, 2020, or 24 weeks. 15 U.S.C. section 9005(a)(3).

[15] *See* CARES Act section 1102(a), 15 U.S.C. section 636(a)(36)(E) (maximum loan amount equal to the average total monthly payroll costs in the one-year period preceding the date of the loan multiplied by 2.5, but not to exceed $10 million); SBA, "Frequently Asked Questions for Lenders and Borrowers Participating in the Paycheck Protection Program (PPP)," A14 at 5 (Dec. 9, 2020) ("In general, borrowers can calculate their aggregate payroll costs using data either from the previous 12 months or from calendar year 2019.").

[16] *See* CARES Act section 1106(a)(3), 15 U.S.C. section 9005(a)(3) (covered period defined as the earlier of (1) the date that is 24 weeks after the loan origination date or (2) December 31, 2020).

[17] *See* 15 U.S.C. section 9005(b) (taxpayer entitled to forgiveness of a PPP loan to the extent that the loan was spent on (1) payroll costs qualifying for a PPP loan under 15 U.S.C. section 636 or (2) qualifying rent, mortgage, and/or utility payments) (quoted *supra* note 1).

[18] *See supra* note 3 and accompanying text.

managed to remain profitable without accounting for the impact of PPP loans, the increase in cash flow for a thin- or zero-margin company like X is more accurately characterized as the cost of staying alive as a going concern than as a tax-free windfall. This is the basic limitation of the cash-in, cash-out analysis informing Mnuchin's "double dip" comment: It fails to acknowledge that the tax consequences of general welfare payments should be treated differently from the tax consequences of bona fide debt relief.

The IRS provided two main arguments in support of its position that PPP loan-based expenses are nondeductible:

1. Section 265 provides that no deduction shall be allowed for "amount[s] otherwise allowable as a deduction which [are] allocable to one or more classes of income other than interest . . . wholly exempt from the taxes imposed by this subtitle."[19] Accordingly, taxpayers cannot deduct any of the expenses used to qualify for PPP loan forgiveness because those expenses are allocable to income that is specifically tax-exempt under section 1106(i).
2. In *Burnett*[20] and *Canelo*,[21] law firms advanced expenses on behalf of their clients with the "expectation" (*Burnett*) or "good hope" (*Canelo*) that the clients would repay the expenses when the firms ultimately achieved a recovery on the claims. These cases establish that otherwise allowable expenses will be disallowed if taxpayers have a reasonable expectation that the expenses will be reimbursed.[22] Because PPP loan recipients that satisfy all the criteria for forgiveness of all or a portion of that loan (that is, by paying qualified expenses during the covered period following the loan disbursement date) have either already applied for relief in 2020 or plan to apply for relief in 2021, those recipients cannot deduct the expenses used to qualify the loan for relief because, by the end of 2020, they have a reasonable expectation that all or a portion of the loan will be forgiven under section 1106(b) of the CARES Act.

Although CRTRA specifically allows for deductions in connection with forgiven PPP loan funds, each of the IRS's arguments helps us frame the essential question addressed in this article: Does a deduction of expenses used to qualify all or a portion of a PPP loan for forgiveness truly violate fundamental tax principles?

As detailed in Section II of this article, the problem with IRS argument 1 is that the expenses for payroll, mortgage, rent, and utilities paid or incurred during the covered period are not "allocable to" tax-exempt income as that term is used in section 265(a)(1). Merriam-Webster Dictionary defines allocable as "capable of being allocated" and defines the verb "allocate"as "to apportion for a specific purpose or to particular persons or things" or "to set apart or earmark." The expenses qualifying for PPP loan forgiveness are not apportioned, set apart, or earmarked for any purpose other than the taxpayer's normal business operations — the taxpayer would have to pay these expenses to keep the business alive as a going concern regardless of their potential effect on the PPP loan. The expenses are used to qualify all or a portion of the PPP loan for forgiveness, but that does not mean that the expenses are allocable to the forgiven loan proceeds.

For companies that remained profitable without accounting for the impact of PPP loan proceeds, the forgiven proceeds are not "allocable to" qualifying expenses because those companies are not required to trace the receipt of the proceeds to payment of those expenses. They could have used the proceeds to pay for nonqualifying expenses, or paid the qualifying expenses from preexisting cash reserves, and still qualify for forgiveness. For companies with a demonstrated financial need for PPP loan

[19] Section 265(a)(1); *see also* Notice 2020-32 at 6 (concluding that section 265 "prevents a double tax benefit"); and Rev. Rul. 2020-27 at 6-7 (citing section 265 as secondary support for its position that PPP-loan-related expenses are nondeductible).

[20] *Burnett v. Commissioner*, 356 F.2d 755, 759 (5th Cir. 1966) ("We find that the record amply supports the Tax Court's conclusion that petitioner's expenditures constituted advances to his clients which were virtually certain to be repaid and, consequently, were not deductible as business expenses."); *see also Hillsboro National Bank v. Commissioner*, 460 U.S. 370 (1983) (applying the tax benefit rule to deny the taxpayer a deduction for taxes imposed on shareholders but paid by the corporation).

[21] *Canelo v. Commissioner*, 53 T.C. 217, 223-227 (1969).

[22] *See* Rev. Rul. 2020-27 at 4-6 (discussing cases — primarily *Burnett*, *Canelo*, and *Hillsboro National Bank*, cited in notes 20-21, *supra* — that support the position that expenses for which there is a reasonable expectation of repayment are nondeductible).

forgiveness, the forgiven proceeds are not "allocable to" qualifying expenses because the proceeds are not specifically set aside for that purpose. These companies could have paid the qualifying expenses from other sources (for example, additional drawdowns on lines of credit), or used the proceeds to pay for nonqualifying expenses, and still qualify for forgiveness.

The problem with IRS argument 2 is that the reasonable expectation of expense repayment in *Burnett* and *Canelo* is only loosely analogous to a reasonable expectation of PPP loan forgiveness. The law firms in *Burnett* and *Canelo* pre-screened clients to determine which particular cases would likely result in a recovery. On the basis of that process, the firms decided which clients were eligible for litigation expense advancements. Unlike those law firms, most taxpayers applying to the SBA for loan forgiveness did not selectively determine which expenses they would pay on the basis of which expenses were likely to be reimbursed — they simply paid the nondiscretionary expenses required to keep their businesses alive and then used those expenses as the basis for relief.

Although several tax practitioners argued that the IRS's nondeductibility arguments were incorrect,[23] taxpayers that contemplated deducting expenses used to qualify for PPP loan forgiveness still had to be prepared to (1) provide a detailed explanation of their position on a Form 8275, "Disclosure Statement," to protect against accuracy-related penalties,[24] and (2) defend their position before IRS Examination, IRS Appeals, and (potentially) the Tax Court. Fortunately for those taxpayers considering taking a relatively aggressive position that these expenses should be deductible, Congress intervened just before the end of the 2020 calendar year.

The adverse tax implications and inconsistencies of the IRS's position were not lost on Congress and the business community. In a December 3, 2020, letter to Congress, a coalition of several hundred trade and professional associations argued that the IRS's position undermines Congress's clear intent in the CARES Act to provide tax-free treatment for forgiven PPP loan proceeds. The coalition stated that the disallowance of deductions transforms "*tax-free* loan forgiveness into *taxable income*."[25] (Emphasis in original.)

Further, the Democratic and Republican leaders of the House Ways and Means and Senate Finance committees publicly expressed disapproval of the IRS's position on the nondeductibility of PPP loan-funded expenses in a May 5, 2020, letter to Mnuchin.[26] Finance Committee Chair Chuck Grassley, R-Iowa, and ranking member Ron Wyden, D-Ore.; and Ways and Means Committee Chair Richard E. Neal, D-Mass., argued that "the deduction is not allocable to the exempt income resulting from the forgiven loan. The deductions for expenses that make a borrower eligible for loan forgiveness are attributable to the conduct of its business." That argument highlights one of the main weaknesses in the IRS's position: Many companies that received PPP loans had to pay qualifying expenses to stay alive as a going concern regardless of the expenses' later impact on loan forgiveness. The argument also highlights one of the fundamental injustices associated with the PPP loan program: There is no tracing process to determine how taxpayers are actually using the PPP loan proceeds, nor does the SBA ask any

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[23]I would like to acknowledge my colleagues in the tax practitioner community who raised well-reasoned challenges to the nondeductibility of PPP-loan-based expenses before the IRS officially reversed its position. *See, e.g.*, John Anthony Castro, "Expenses Paid With a Forgiven PPP Loan Are Deductible, IRS Is Wrong," Castro & Co. (May 7, 2020); and Deborah Walker and Barry M. Weins, "Expenses Used for PPP Loan Forgiveness: Deductible or Not?" *J. Acct.* (Dec. 3, 2020).

[24]*See* section 6662(d)(1)(A) (there is a "substantial understatement" if the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000); and section 6662(d)(2)(B) (reducing the understatement penalty by the portion attributable to the tax treatment of an item (1) for which there is substantial authority, or (2) that is adequately disclosed in the return or in a statement attached to the return and for which there is a reasonable basis for the tax treatment of that item).

[25]The letter refers to this unanticipated tax consequence as a "surprise tax increase of up to 37 percent on small businesses when they file their taxes for 2020." The coalition's basic premise is that the denial of deductions for payroll and other expenses that qualify the loan for forgiveness amounts to a "surtax on [the] workforce," which unfairly penalizes employers that retained employees "even when there was little to no work to perform."

[26]The lawmakers state: "Providing assistance to small businesses, only to disallow their business deductions as provided in Notice 2020-32, reverses the benefit that Congress specifically granted by exempting PPP loan forgiveness from income. This interpretation means that whatever income a small business is able to produce will be taxed on a gross basis to the extent of the loan forgiveness, leaving substantially less after-tax capital for the swift economic recovery we hope is on the horizon."

questions regarding financial need before determining whether to forgive the loan.[27]

To address the adverse tax consequences that would have resulted from the IRS's disallowance of deductions for expenses used to qualify PPP loans for forgiveness, Congress in CRTRA included the following amendment to CARES Act section 1106(i): "No deduction shall be denied or reduced, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by paragraph (1)."[28] In response to CRTRA's amendment of CARES Act section 1106(i), the IRS declared Notice 2020-32 and Rev. Rul. 2020-27 obsolete as of the effective date of the amendment.[29]

II. General Deductibility Principles

In examining the double-dip controversy surrounding expenses used to qualify for PPP loan forgiveness, it is helpful to review the federal income tax treatment of (1) expenses allocable to specific items of tax-exempt income (which are generally nondeductible) and (2) expenses allocable to general welfare payments (which are generally deductible).

A. Specific Items of Tax-Exempt Income

As discussed in Section I, the IRS based its disallowance of a deduction for PPP loan expenses in part on section 265(a)(1), which provides that no deduction shall be allowed for amounts "otherwise allowable as a deduction which is allocable to one or more classes of income other than interest . . . wholly exempt from the taxes imposed by this subtitle."[30] The nondeductibility of expenses allocable to specific items of tax-exempt income derives generally from the concept expressed by the Supreme Court in *Skelly Oil* that "the Code should not be interpreted to allow [taxpayers] the practical equivalent of a double deduction, absent a clear declaration by Congress."[31]

The Court based its double-deduction analysis in *Skelly Oil* — in which it denied deductions for amounts that the company was required to refund to customers because of overcharges in prior years — on the "well settled" principle from *Arrowsmith* that the character of income when received in a prior tax year may be examined to determine the proper tax treatment of a deduction claimed in a subsequent tax year.[32] Federal courts have generally applied *Arrowsmith* to relate back events from a subsequent tax year to a prior tax year to determine whether the capital or ordinary nature of the income and deductions should be harmonized (often referred to as the relation back and matching principles).[33] *Skelly Oil*, therefore, is often interpreted as an extension of the relation back and matching principles of *Arrowsmith* to a situation in which a taxpayer claims deductions against income that was never subject to tax.

The IRS does not cite *Skelly Oil* as a direct authority for its arguments in Notice 2020-32 or Rev. Rul. 2020-27, but the Tax Court has referred to the "underlying rationale" of *Skelly Oil* that taxpayers should not be entitled to a double deduction for expenses related to tax-exempt income.[34] Even though the IRS does not address it explicitly, the double-deduction concept is the bedrock of the IRS's position for disallowing expenses used to qualify PPP loans for forgiveness.

[27] Although it might be impractical for Congress to require the SBA to trace PPP loan proceeds to payment of qualifying expenses, Congress could require PPP loan applicants to prove financial need as one of the requirements for a conditional grant-in-aid (discussed in Section V, *infra*).

[28] CRTRA section 278(a)(2) (titled "Clarification of Treatment of Business Expenses").

[29] Rev. Rul. 2021-2 (Notice 2020-32 and Rev. Rul. 2020-27 are obsolete for tax years ending after March 27, 2020, which is the effective date of the amendment to CARES Act section 1106(i)).

[30] Section 265(a)(1); *see also* Notice 2020-32 at 6 (concluding that section 265 "prevents a double tax benefit"); and Rev. Rul. 2020-27 at 6-7 (citing section 265 as secondary support for its position that PPP-loan-related expenses are nondeductible).

[31] *United States v. Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (citations and internal quotations omitted); *see also* LTR 200518014 (discussing the evolution of the *Skelly Oil* and *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), line of cases).

[32] *Skelly Oil*, 394 U.S. at 684-685 (citing *Arrowsmith*, 344 U.S. 6).

[33] *See, e.g.*, *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974) (applying the matching principle of *Arrowsmith* to conclude that a "payment made by a taxpayer in satisfaction of a liability arising from an earlier transaction, on which that taxpayer reported capital gain, must be treated as a capital loss at least to the amount of the capital gain, regardless of the taxpayer's motivation for making the payment").

[34] *See, e.g.*, *Mohler v. Commissioner*, T.C. Memo. 1983-618 (applying the "double deduction" rationale from *Skelly Oil* to disallow a deduction for the full amount of a flight training course when the Veterans Administration reimbursed the taxpayer for a portion of the training cost and the reimbursement was tax-exempt under 38 U.S.C. section 3101(a)).

In consideration of the general relation back and matching principles from *Skelly Oil* and *Arrowsmith*, it is tempting to conclude that deductions are permitted only if the underlying income has been subject to tax. However, that conclusion oversimplifies the relevant case law. As the IRS itself points out in LTR 200518014, *Skelly Oil* "often is cited for the broad proposition that a taxpayer should not get a deduction for items not included in the taxpayer's income," but "the specific holding of the case is that a taxpayer may not receive a deduction for a *refund or repayment* of an item that was not included in income." (Emphasis in original.) After considering the relatively narrow holding of *Skelly Oil*, we can start to question whether it is even appropriate to apply the relation back or matching principles to cases in which taxpayers claim expenses that bear some connection to tax-exempt income.

Further, the IRS's broad interpretation of the term "allocable to" in section 265(a)(1) is inconsistent with the narrow interpretation of the term by the IRS Office of Chief Counsel (OCC) and disregards the OCC's process of closely analyzing the relationship between the tax-exempt income and the claimed deductions. The IRS maintains that section 265(a)(1) "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 section 1106 expense to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven) because such payment is *allocable to* tax-exempt income,"[35] but the OCC has historically adopted a narrow interpretation of "allocable to" in section 265. (Emphasis added.) The OCC has consistently maintained that corporations that receive payments excluded from gross income under subtitle A, chapter 1, subchapter B, Part III of the code (sections 101 to 140) are entitled to claim deductions under section 162 if those deductions are not *specifically* (rather than generally) allocable to the tax-exempt income.

In ILM 200947035, the OCC concluded that an employer is not precluded from taking a section 162 deduction for compensation paid to an employee because the employer was receiving insurance payments on account of the employee's injury that are specifically excluded from gross income under section 104(a)(3). As support for this conclusion, the OCC found that the term "allocable" in section 265(a)(1) "implies a close connection between the tax exempt income and the deductible expense." The OCC determined that the compensation payment in that case "is not the reason for the insurance payment. The insurance payment is received on account of Employee's disability not on account of Employer's contractual obligation to pay Employee's salary." The OCC also concluded that the deductions should be allowed because a disallowance would "frustrat[e] the effect of the exclusion from gross income provided by section 104(a)(3)."

When we apply the rationale of ILM 200947035 to forgiven PPP loans, we start to see the problems with the IRS's broad interpretation of "allocable" in section 265(a)(1). If the forgiven portion of the SBA loan is treated as the payment in this case — which is the simplest and clearest parallel because both the insurance payment and the forgiven portion of loan are nontaxable under specific statutory provisions — it is clear that there is no proximate relationship between the loan and the qualifying expenses paid in the covered period. The loan amount is based on 2½ months of average payroll expenses and is unrelated to the expenses that the taxpayer used to qualify all or a portion of the PPP loan for forgiveness. There is arguably a closer relationship between the qualifying expenses and the forgiven portion of the PPP loan than that between the expenses and the underlying loan proceeds (that is, the amount that the taxpayer initially receives, regardless of any potential forgiveness), but the relationship is still attenuated because the taxpayer has to pay the qualifying expenses regardless of their potential impact on PPP loan forgiveness. Further, the OCC's second rationale for allowing the deduction of expenses in ILM 200947035 also applies here because the IRS's position on nondeductibility would have undermined congressional intent to preserve the nontaxable character of the forgiven proceeds.

[35] Notice 2020-32 at 6.

B. General Welfare Payments

In addressing whether particular deductions should be allowed against nontaxable government payments, the IRS and the Tax Court have historically distinguished payments that are intended to reimburse the taxpayer for a specific economic loss (in which case a deduction in connection with the payment is typically disallowed) from payments that are intended to provide a general economic benefit to the taxpayer (in which case a deduction in connection with the payment is typically allowed).

In GCM 18780 (Mar. 17, 1977), the IRS Office of General Counsel distinguished moving expense relocation payments under 42 U.S.C. section 4622 — which it considered reimbursements that rendered the underlying moving expenses nondeductible — from replacement housing payments under 42 U.S.C. section 4623 — which it considered to be "in the nature of general welfare payments because they were intended, pursuant to the general welfare goal of providing decent, safe and sanitary housing, to bestow an added economic benefit on the displaced person."[36] Without referring to it as such, the memorandum's discussion of general welfare payments refers to the general welfare doctrine, which is a long-standing IRS administrative practice of excluding needs-based payments from the recipient's gross income and permitting the recipient to claim deductions for expenses paid with the excluded income.[37] Because the government payments at issue were reimbursements for specific moving expenses, the tax benefit rule required the taxpayer to include the amount of the previously deducted expenses in income when the government reimbursed the taxpayer for those expenses under 42 U.S.C. section 4622. Although it is one of the few items of administrative guidance in which IRS counsel refers to the application of the general welfare doctrine in the context of section 162 deductions, GCM 18780 indicates that such an application is at least theoretically possible given the right set of facts.

In *Bailey*,[38] an individual real estate investor, James Bailey, purchased a property from the local urban redevelopment authority (URA). Bailey and the URA entered into a contract whereby the URA agreed to provide a facade grant to renovate the property's exterior and Bailey agreed to renovate the interior. Although Bailey had to submit financial statements to qualify for participation in a low-interest loan program to help pay for the interior renovations, "there was no requirement that the recipient of a facade grant be an underprivileged individual or have a low income."[39] The URA contracted directly with contractors to perform the exterior renovations, and Bailey granted the URA a right-to-enter easement so that it could perform the renovations. Because the facade grant program was "awarded without regard to any need of the recipients," the Tax Court concluded that the grants were not excludable under the general welfare doctrine.[40] Although the IRS and federal courts cite *Bailey* in support of the general proposition that "payments to businesses generally do not qualify under the general welfare exclusion because the payments are not based on individual or family needs,"[41] the Tax Court in *Bailey* leaves the door open for an application of the general welfare doctrine in the context of section 162 business expenses if the underlying government payment is more closely related to the general economic needs of the recipient than to a substitute for lost income.[42]

If Congress had not intervened by specifically allowing for deductions of expenses paid or incurred in connection with forgiven PPP loan funds, taxpayers could have tried to apply the general welfare doctrine to claim the expenses. The general welfare doctrine argument could have focused on the fact that PPP loan proceeds

[36] GCM 37293, at 3 (Oct. 13, 1977) (discussing and providing block quotations from GCM 18780).

[37] *See, e.g.*, Rev. Rul. 76-395, 1976-2 C.B. 16 ("The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for promotion of general welfare are not includible in an individual's gross income.").

[38] *Bailey v. Commissioner*, 88 T.C. 1293 (1987).

[39] *Id.* at 1298.

[40] *Id.* at 1301. The Tax Court nevertheless held that the grants were excludable because Bailey never had dominion and control over the facade grant funds. *See id.*

[41] LTR 200651003 (citing *Bailey*, 88 T.C. at 1300-1301).

[42] *See also Graff v. Commissioner*, 673 F.2d 784 (5th Cir. 1982) (distinguishing nontaxable general welfare payments under section 235 from taxable "substitutes for rental" payments under section 236).

were intended to bestow a general economic benefit on businesses adversely affected by COVID-19 so that they would have an incentive to retain their employees, rather than to specifically compensate for lost profits or to provide reimbursement for specific expenses.[43] Because of the weaknesses in the IRS's section 265 argument and the special tax treatment afforded to general welfare payments by the IRS and the Tax Court, taxpayers and practitioners should consider whether a deduction of expenses used to qualify for PPP loan forgiveness is — as maintained by Mnuchin — truly contrary to the principles of Tax 101.

III. Tax Treatment of Recent Bailouts

Almost all of the confusion related to the tax treatment of government bailouts and other emergency relief payments is attributable to Congress's characterization of the relief as loans or equity investments rather than general welfare payments. A summary of the structure and administration of those recent relief measures may help us to understand how Congress and the Treasury can collaborate to avoid tax disputes regarding future bailouts.

A. TARP — October 2008

The Troubled Asset Relief Program (TARP)[44] was enacted by President George W. Bush on October 3, 2008. The purpose of TARP was to enable Treasury to purchase or insure troubled assets, which essentially consisted of "toxic" collateralized debt obligations and mortgage-backed securities.[45] TARP authorized Treasury to purchase up to $700 billion of these toxic assets, but the Dodd-Frank Act reduced the authorization to $475 billion.[46]

Treasury's infusions of cash into the troubled banking and auto industries were treated for federal income tax purposes as preferred equity investments.[47] Although some tax practitioners questioned whether the cash infusions should be treated as debt rather than equity (which would have enabled these industries to claim interest deductions on payments to Treasury),[48] other tax practitioners and public policy experts questioned whether any type of bailout is ever appropriate, regardless of its form. Philosophy professor Michael Huemer has cited moral hazard, misallocation of resources to bad actors, the inherent unreliability of macroeconomic risk predictions, and corruption of the political system as just some of the reasons that bailouts should be avoided in most circumstances as a matter of public policy.[49]

Law professor Cheryl D. Block has defined bailout as "a form of government assistance or intervention specifically designed or intended to assist enterprises facing financial distress and to prevent enterprise failure."[50] She has applied the same definition to TARP.[51] In contrast to the "official protestations of 'no more bailout' in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010," Block recognizes that "future government interventions are inevitable, should economic circumstances become sufficiently dire."[52] She not only addresses the

[43] *See* preamble to S. 3548, 116th Cong. (2020) (Senate bill for the CARES Act) ("To provide emergency assistance and health care response for individuals, families, and businesses affected by the 2020 coronavirus pandemic.").

[44] P.L. 110-343, 12 U.S.C. section 5311 et seq.

[45] TARP section 3(9), 12 U.S.C. section 5202(9), defines troubled assets as "(A) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008, the purchase of which the Secretary determines promotes financial market stability; and (B) any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability." Commentators often use the less diplomatic but more accurate term "toxic assets" in lieu of the statutory terminology.

[46] Dodd-Frank Wall Street Reform and Consumer Protection Act section 1302 (2010).

[47] *See* Baird Webel, "Troubled Asset Relief Program (TARP): Implementation and Status," Congressional Research Service, at 2-4 (updated Aug. 21, 2014) (discussing the bank support programs, credit market programs, other investment programs, and housing programs, all of which are components of the TARP Capital Purchase Program).

[48] *See, e.g.*, Jonathan Prokup and Dustin Covello, "Rethinking the Tax Treatment of Government Assistance to Financial Institutions in Light of Treasury's 2008 Capital Purchase Program," 25 *J. Tax. & Reg. Fin. Inst.* 5 (Jan./Feb. 2012)

[49] *See* Huemer, "The True Costs of Government Bailouts," 11 *Geo. J.L. Pub. Pol.* 335 (2013).

[50] Block, "Overt and Covert Bailouts: Developing a Public Bailout Policy," 67 *Ind. L.J.* 951, 960 (Fall 1992).

[51] *See* Block, "Measuring the True Cost of Government Bailout," 88 *Wash. U.L. Rev.* 149, 156 (2010) (defining the term "bailout" as "a form of government assistance or intervention specifically designed or intended to assist enterprises facing financial distress and to prevent enterprise failure") (citing definition from Block, "Overt and Covert Bailouts," *supra* note 50).

[52] *Id.* at 149.

complexity associated with measuring the total costs directly associated with bailout programs (which she refers to as "programmatic expenses"), but also discusses the indirect costs such as tax expenditures associated with "covert" or "hidden bailouts."[53]

One of the main takeaways from Block's extensive research is that what the public broadly refers to as a bailout actually encompasses many different forms of government assistance. This spectrum ranges from profitable bailouts — such as the Chrysler bailout in the late 1980s, which resulted in a profit to the government — to general revenue bailouts — which are the most controversial because the "costs are broadly spread among the general taxpaying public."[54] Block's careful analysis of the myriad bailout types and the challenges associated with streamlining the process of properly accounting for the costs of those programs highlights the importance of clarity and precision in any government relief initiative. Not all bailouts are created equal, and Congress has broad discretion to structure a relief program that is specifically tailored to the immediate needs of specific companies, industries, or the national economy as a whole while preserving the government's interest in recouping at least a portion of its expenditures.

Although TARP's preferred equity structure was successful in securing repayment of at least a portion of the program's cost,[55] this structure was irreconcilable with the government's interest in ensuring that the companies spent the relief payments properly. For example, TARP never imposed specific conditions on the companies that received TARP funds. Alan B. White, who was chair of PlainsCapital Bank of Dallas, captured the sentiment of many bank executives when he referred to TARP money as "opportunity capital."[56] When federal regulators invited PlainsCapital and other banks to apply for TARP dollars, there were no conditions attached[57] — the government cash was treated just the same as cash from any other investor. Accordingly, banks used the cash from TARP investments for purposes other than lending[58] — such as acquisitions of competitors — that many considered to be inconsistent with the underlying purpose of TARP to increase "the flow of financing available to small businesses and consumers."[59]

B. Airline Bailouts — 2001 and 2020

The 2001 airline bailout, which was enacted by President George W. Bush on September 23, 2001, was structured as a $15 billion total relief package for airlines whose survival was jeopardized by the dramatic decrease in air traffic as a result of the September 11 terrorist attacks.[60] The relief package authorized the distribution of up to $5 billion in direct payments, and up to $10 billion in loans and loan guarantees, to affected airlines.[61] The structure of the 2001 airline bailout bears some basic similarities to the PPP provisions of the CARES Act by creating a bifurcated system of direct payments (with no expectation of repayment) and loans (which are federal credit instruments that require repayment). Unlike the administration of PPP loans, however, the administration of the 2001 airline bailout was criticized for the complexity of the loan application process and the overly rigorous scrutiny of loan applicants.[62] The 2001 airline

[53] Block discusses relaxed net operating loss rules under section 172 and relaxed loss limitation rules following corporate ownership changes under section 382 as prominent examples of bailout relief in the form of tax expenditures. *Id.* at 206-210.

[54] *Id.* at 163-169.

[55] *See id.* at 164 (although the Treasury Office of Financial Stability reported "that it had spent less TARP money than anticipated and received a return higher than expected from its TARP investments . . . aggregate TARP bailout actions are expected to contribute $116.8 billion to the federal deficit.").

[56] Mike McIntire, "Bailout Is a Windfall to Banks, if Not to Borrowers," *The New York Times*, Jan. 17, 2009.

[57] *Id.*

[58] *See id.* ("A review of investor presentations and conference calls by executives of some two dozen banks around the country found that few cited lending as a priority. An overwhelming majority saw the bailout program as a no-strings-attached windfall that could be used to pay down debt, acquire other businesses or invest for the future.").

[59] Treasury release, "Treasury Provides Funding to Bolster Healthy, Local Banks: Capital Purchase Program Funds 23 Banks to Help Meet Lending Needs of Local Consumers, Businesses" (Jan. 27, 2009).

[60] Air Transportation Safety and System Stabilization Act (2001).

[61] *Id.* at section 101(a)(1)-(2).

[62] *See, e.g.*, Micheline Maynard, "New Scrutiny for Airline Bailout Plan Three Years After Sept. 11," *The New York Times*, Sept. 15, 2004 ("In the end, the loan guarantees did little to help the biggest airlines recover, either because they did not seek them, their bids were turned down, or they were unable to use the aid to their advantage.").

bailout illustrates that the overarching goals of any government relief program must be consistent with its administration. If the goal of a particular bailout is to provide broad-based relief to the airline industry, the application process should not be so rigid as to effectively exclude all but a handful of smaller businesses from participation.

The 2020 airline bailout was introduced in CARES Act section 3102, which authorizes the Treasury secretary to make or guarantee loans to eligible businesses in an amount not to exceed $25 billion for passenger air carriers, $4 billion for cargo air carriers, and $17 billion for businesses "critical to maintaining national security."[63] CARES Act section 3102 also authorizes the use of up to $454 billion (plus any amounts not used for loans to the specific businesses described earlier) for programs established by the board of governors of the Federal Reserve System "for the purpose of providing liquidity to the financial system that supports lending to eligible businesses, States, or municipalities."[64] Eligible businesses include air carriers or any U.S. business that has incurred losses as a direct result of COVID-19 that has "not otherwise applied for or received economic relief in the form of loans or loan guarantees" provided under any other provision of the CARES Act.[65]

Although the 2020 airline bailout is ostensibly structured as a loan program under the CARES Act, 70 percent of the amounts paid to airlines that meet specified conditions is in the form of a grant that need not be repaid, and the remaining 30 percent is in the form of low-interest loans.[66] The conditions that Treasury requires for grant eligibility include limits on some types of executive compensation, and special qualification and certification requirements for businesses, states, and municipalities participating in the $454 billion liquidity lending program.[67] Based on Treasury's announcement regarding the closing of loans to seven major airlines,[68] it appears likely that the 2020 airline bailout package will have a greater overall impact on the airline industry than the 2001 package. The basic themes of the 2020 package are that (1) PPP loans are not the only aspects of the CARES Act that provide conditional grants-in-aid in the guise of loan forgiveness, and (2) Congress has the discretion to delegate to Treasury the determination of exactly how much of a particular bailout payment should be treated as a conditional grant and how much should be treated as a low-interest loan.

IV. Public Policy Considerations

The following discusses some of the public policy and other explanations for the IRS's reluctance to characterize forgiven government loans as general welfare payments. Although it took place over a decade ago, the following transcript of an exchange between White House press secretary Robert Gibbs and CBS News correspondent Chip Reid on June 10, 2009 — which addresses the broader implications of Dodd-Frank on private industry — identifies how public perception can influence the national debate on private sector relief such as PPP loan forgiveness:

> Q (CHIP REID): So isn't this a pretty extraordinary departure from the way American capitalism has — I know these are extraordinary circumstances, but, still,

[63] CARES Act section 4003(b), 15 U.S.C. section 9042(b).

[64] *Id.*

[65] CARES Act section 4002(4), 15 U.S.C. section 9041(4).

[66] *See* David Shepardson and Tracy Rucinski, "Exclusive: Treasury Wants Warrants, Repayment From Major U.S. Airlines on 30% of Grant Money," Reuters, Apr. 10, 2020 ("Mnuchin spoke with the chief executives of major airlines in separate calls on Friday and told them the department was offering 70 percent of the aid in grants that would not need to be repaid, and 30 percent in low-interest loans for which the airlines would be required to offer warrants, the sources said.").

[67] Businesses participating in the liquidity lending program must not engage in stock repurchases in the 12-month period after the disbursement date unless they are under a preexisting contractual obligation, and they must not issue capital gain or dividend distributions on common stock. CARES Act section 4003(c)(3)(A)(ii). Further, CARES Act section 4003(c)(3)(D)(i) requires that eligible applicants make several good-faith certifications, including that (1) the funds are required to support the applicant's ongoing business operations; (2) the applicant will retain at least 90 percent of its workforce as of March 24, 2020, until September 30, 2020; (3) the applicant will restore at least 90 percent of its workforce as of February 1, 2020, not later than four months after the termination of the public health emergency; (4) the applicant is created or organized in the United States or under U.S. law and has significant operations and employees based in the United States; and (5) the applicant is not a debtor in bankruptcy.

[68] Treasury release, "Treasury Concludes Loans to Seven Major Airlines, Supports Additional Relief for Aviation Industry Workers" (Sept. 29, 2020) (listing Alaska Airlines, American Airlines, Frontier Airlines, JetBlue Airways, Hawaiian Airlines, SkyWest Airlines, and United Airlines as the seven loan recipients).

> to have a government employee setting the salaries for hundreds of private-sector employees —
>
> MR. GIBBS: Well, again, Chip, these are private-sector employees that, in many ways, have their job based on the extraordinary assistance that has been provided by taxpayers to ensure that they can continue to have their job.
>
> Q: — all companies have taxpayer assistance in one way or another.
>
> MR. GIBBS: How so?
>
> Q: Well, I mean, there are all different forms of so-called corporate welfare all through the tax code.
>
> MR. GIBBS: Well, I think that — I'm not entirely sure what you're getting at, but —
>
> Q: I'm getting at if any company that gets any kind of government assistance can have their salary set by the federal government, where does that stop?
>
> MR. GIBBS: Chip, that was the appropriate question if what I had outlined met that criteria. Again, I denoted there are seven companies that have received extraordinary taxpayer assistance, anywhere from — I don't know the rankings of how much they've made, but obviously these seven companies have received extraordinary assistance. Congress passed the Dodd amendment that relates to any company that receives funding or money directly through the TARP program. But again, this is not an effort to set the salaries, as you said, to the penny of every publicly owned or traded company in this country. This is a proposal that protects the taxpayer.
>
> Q: But there are many in the business community who think once you've set this precedent, where does it stop?
>
> MR. GIBBS: Well, Chip, you guys have asked me any number of times about the role that the government has to play in the event that it's providing, as I've said, the exceptional or extraordinary assistance that has been provided by the taxpayers. The President believes and Congress believed that that was something that was important to do to protect the taxpayers, to ensure that compensation, either through salary or bonuses, was done in a way that was consistent with sound and appropriate practices and that limited risk for taxpayers. *I think that's what's important here, is that these are investments that have been made through the TARP program by taxpayers through taxpayer money.* This is an effort both congressionally mandated and through the Treasury Department to ensure that that investment is protected in order not to rationalize an irrationally risky compensation package.[69] [Emphasis added.]

The debate implicit in this exchange is the extent to which the federal government should be able to condition the receipt of extraordinary assistance on the basis of specified criteria that are intended to protect the government's investment in troubled companies using taxpayer money. The concept of the government investing in troubled companies is a recurring analogy in bailouts and other relief measures,[70] but the comparison is deeply problematic for several reasons. First, the analogy is flawed because it erroneously suggests that Congress has a duty to account to taxpayers just as officers or directors of a corporation have a duty to account to their shareholders. Second, there is a fundamental difference between a bailout or other relief payment — which is solely intended to promote the general welfare of a particular company or industry — and an investment — which is solely intended to produce a return of capital.

This is not to say that the corporation-shareholder analogy is entirely without merit. The federal government is committing a significant amount of capital to a particular company or industry and should be able to impose restrictions to ensure that this capital is properly spent. But the purpose of an investment

[69] White House, "Press Briefing by Press Secretary Robert Gibbs and Secretary of Commerce Gary Locke" (June 10, 2009).

[70] *See, e.g.*, Mitchell Hartman, "What Did America Buy With the Auto Bailout, and Was It Worth It?" Marketplace.org, Nov. 13, 2018.

in the open market (to maximize profits) and that of a relief payment in a bailout or other relief setting (to prevent financial catastrophe for a particular industry and, by extension, the national economy) are so different as to render the analogy untenable.

If TARP is an illustration of the limitations in the corporation-shareholder approach, and PPP is an illustration of the limitations in the creditor-borrower approach, what is the proper analogy to apply when considering how to frame the relationship between the federal government and troubled companies? The answer might be to dispense with analogies altogether and focus instead on the true nature of the relationship between the federal government and its corporate citizens in need of federal assistance. Without misleading comparisons, we are left with the much simpler task of determining how Congress may condition the receipt of federal aid in a manner that is consistent with the spending clause of the Constitution.[71] The debate regarding the proper scope of the spending clause is older than the Constitution itself,[72] but few would assert that Congress exceeds its authority under the spending clause if it issues grants to troubled businesses in the midst of a pandemic or other national crisis when those grants are specifically conditioned on the payment of qualified expenses.

Although the Supreme Court requires specific conditions to be met for Congress's exercise of the spending clause to be valid, Congress has substantial latitude to condition the receipt of federal funds if those conditions are unambiguous, related to the "federal interest in particular national projects or programs," and consistent with other constitutional provisions.[73] Despite this broad latitude, the potential for constitutional challenges under the spending clause and the potential for abuse and non-accountability in a general welfare-based system could explain why Congress has traditionally used debt and equity arrangements over conditional grants-in-aid and other relief structures.

V. Recommendations

Although the business and practitioner community breathed a collective sigh of relief when the deductibility provision in CARES Act section 1106(i) was enacted, we should take some time to reflect on the source of the dispute and how it might be avoided in the future. Specifically, we should ask ourselves (1) why PPP, TARP, and other government relief programs result in so many areas of controversy and confusion from a federal tax perspective and (2) whether these areas of controversy and confusion might be resolved by characterizing specific amounts under these relief programs as general welfare payments or conditional grants-in-aid instead of tax-free forgiven loan proceeds (PPP) or equity investments in troubled companies (TARP).

This is not to say that all relief payments should be characterized as general welfare payments. For amounts that companies choose to apply to purposes other than the specific expenses that qualify for PPP loan forgiveness (that is, expenses other than payroll, mortgage, rent, and utilities), the government should have the flexibility to structure these payments as bona fide loans because they are amounts that Congress never intended to forgive. But by creating a system in which the SBA disbursed loans first and asked questions later regarding eligibility for forgiveness, the PPP was almost certain to result in confusion and inefficiency from a federal tax perspective.

Congress could avoid this confusion and inefficiency in future relief programs by bifurcating relief payments into (1) nontaxable general welfare grants-in-aid (based on specific conditions, such as the types of expenses that can

[71] *See* U.S. Const. Art. I, section 8, cl. 1 ("Congress shall have the Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States.").

[72] *Compare The Federalist No. 30* (Alexander Hamilton) ("Congress, by the articles which compose that compact . . . are authorized to ascertain and call for any sums of money necessary, in their judgment, to the service of the United States; and their requisitions, if conformable to the rule of apportionment, are in every constitutional sense obligatory upon the States."), *with The Federalist No. 41* (James Madison) ("It has been urged and echoed, that the power 'to lay and collect taxes, duties, imposts, and excises, to pay the debts, and provide for the common defense and general welfare of the United States,' amounts to an unlimited commission to exercise every power which may be alleged to be necessary for the common defense or general welfare. No stronger proof could be given of the distress under which these writers labor for objections, than their stooping to such a misconstruction.").

[73] *See South Dakota v. Dole*, 483 U.S. 203, 207-208 (1987).

be paid with the funds) and (2) nontaxable loan proceeds (structured like bona fide debt instruments with no conditions for forgiveness). That bifurcated structure would streamline the administration of future relief programs by creating separate categories of grant and loan applicants and removing applicants that meet the grant qualifications from the pool of loan applicants. It is likely that businesses would want to apply both for grants for the qualified expenses and loans for the nonqualified expenses, but keeping the expense categories separate would help to create a more transparent tax structure.

Recipients of the general welfare grants-in-aid and government loans would be entitled to deduct expenses paid with those relief payments, and neither category of recipients would be required to report the relief payments in gross income. As much as critics might object to the concept of a double dip by recipients of the conditional grants-in-aid, taxpayers have a long history of IRS administrative guidance and case law to rely on in support of those deductions. Congress could (and should) address the deductibility issue proactively in future relief programs by including language similar to that included in CRTRA section 266(a)(1).[74]

Moreover, the solution to the double-dip controversy from a public policy perspective might be to add "demonstrated financial need" as one of the conditions required for a federal grant. This type of condition would require the SBA to remove profitable businesses (that is, those that are profitable without accounting for the impact of the relief payment) from the pool of grant applicants, which would address at least some of the actual or perceived injustices of the PPP loan program.

VI. Conclusion

There are several reasons that the federal government structures bailouts and other relief measures as loans or equity investments. One of the most significant reasons is the public's perception of the government's role as that of a fiduciary charged with protecting taxpayers' investments in or loans to troubled companies. As revealed by the double-dip controversy regarding the deductibility of PPP loan expenses and the no-strings-attached controversy regarding TARP's preferred equity investments, framing government relief in the guise of loans or equity is bound to yield controversy. The government's loan terms rarely measure up to those found in bona fide instruments, and the notion of the federal government as a fiduciary or guardian of an investment using taxpayer funds is incompatible with the analogy of an equity investment in the open market.

The solution for future relief programs might be for Congress to avoid the typical debt and equity analogies and to clarify that the forgiven proceeds are in the nature of general welfare payments or a conditional grants-in-aid for companies with demonstrated financial need rather than bona fide loan forgiveness. In response to the inevitable public critique of this form of corporate welfare, Congress could focus on the specific conditions required for these companies to receive relief and on the fact that a grant-in-aid provides greater flexibility for imposing restrictions on the relief payments than that allowed in traditional debt or equity structures. Once Congress strips these relief payments of the guise of debt or equity, the public should have a clearer understanding of the relationship between the federal government and troubled companies in the private sector. ■

[74] *See* CRTRA section 276(a)(1), amending CARES Act section 1106(i) ("No deduction shall be denied or reduced, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by paragraph (1).").