

## **Who CARES About Tax Issues for Small Business: A Review of the Tax Forgiveness, Tax Deduction, and Other Tax Issues Associated with the CARES Act’s Paycheck Protection Program (“PPP”)**

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The Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) provides emergency assistance to individuals and businesses affected by the Covid-19 pandemic through a series of measures including the Paycheck Protection Program.<sup>4</sup> The Paycheck Protection Program authorized the SBA to lend up to \$349 billion in forgivable loans to small businesses during the crisis.<sup>5</sup> Congress subsequently passed the Paycheck Protection Program and Health Care Enhancement Act (“PPP Enhancement Act”) after the program exhausted all committed funds. The PPP Enhancement Act appropriated another \$310 billion to the Paycheck Protection Program.<sup>6</sup>

A Paycheck Protection Program loan (“PPP loan”) can be up to \$10 million and made to an eligible recipient if the business was in operation on February 15, 2020 and employs 500 or fewer employees, including individuals employed on a full-time, part-time, or other basis, subject to affiliation and industry rules.<sup>7</sup> If certain requirements are met (involving retaining employees, maintaining wages, and applying the funds toward eligible expenses) then the PPP loan may be forgiven, either partially or in full.<sup>8</sup> Borrowers should only apply for loan forgiveness after the covered period expires and the borrower gathers the required loan

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<sup>4</sup> Pub. L. 116-136, Coronavirus Aid, Relief, and Economic Security Act (March 27, 2020) (hereinafter “CARES Act”); 85 F.R. 20811 (Apr. 15, 2020).

<sup>5</sup> CARES Act.

<sup>6</sup> *Id.*

<sup>7</sup> 15 U.S.C. §§ 636(a)(36) -(E), -(F)(ii), -(D). In certain instances, a business can employ more than 500 employees if it satisfies the affiliation rules and/or does not exceed the SBA size standard for the industry in which it is primarily engaged. See 85 F.R. 20817 (Apr. 15, 2020).

<sup>8</sup> CARES Act §§ 1106 -(b), -(d).

documentation.<sup>9</sup> Following an application for loan forgiveness, the lender has up to 60 days to issue its decision.<sup>10</sup> Loan amounts in excess of \$2 million will be reviewed by the SBA in consultation with the Department of the Treasury.<sup>11</sup>

The number and amount of PPP loans that have been issued since the Paycheck Protection Program began on April 3, 2020 is both unprecedented and staggering. As of May 16, 2020, 4.3 million loans have been issued totaling more than \$513 billion dollars.<sup>12</sup> The program's relative brevity compared to its size has led to an equally immense lack of clarity with regard to how it works, who is eligible, and the tax consequences of receiving a PPP loan. Lenders, borrowers, SBA, the IRS and Congress together are developing the program ad hoc, the consequence of which is a series of tax issues that small businesses should understand in order to more fully benefit from access to low-interest and/or forgivable loans available under the Paycheck Protection Program.

First, during the application process, some small business applicants may have been improperly denied a PPP loan due to having unpaid or delinquent taxes, or a tax lien. These tax-related issues are not disqualifying factors to be considered by the lender and therefore any small business that is otherwise eligible for a PPP loan should not be denied for having them.

Second, during the period when eligible expenses are being made, small businesses may be able to receive loan forgiveness for expenses incurred outside of, but paid during, the covered period, and vice versa.

Third, when small businesses file income tax returns, they may be able to both (i) exclude from gross income canceled indebtedness resulting from a forgiven PPP loan and (ii) deduct ordinary business expenses made with funds from the forgiven PPP loan, despite the current IRS position disallowing such deductions.

#### I. Tax Debt is not a Disqualifying Factor for PPP Loan Eligibility

Some small businesses that are otherwise eligible for a PPP loan have had their applications denied on the basis that they (i) have unpaid or delinquent state and/or federal taxes, or (ii) are subject to a tax lien (collectively "tax debt"). These denials are unjustified and incorrect as the Paycheck Protection Program and existing SBA 7(a) business loan program do not consider tax debt to be a disqualifying factor. Small businesses with tax debt are in fact eligible to receive a PPP loan.

The CARES Act modifies SBA's existing 7(a) business loan program to guarantee 100 percent of 7(a) loans issued under the Paycheck Protection Program.<sup>13</sup> The Paycheck Protection

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<sup>9</sup> CARES Act § 1106(f) (providing "no eligible recipient shall receive loan forgiveness \* \* \* without submitting to the lender that is servicing the covered loan the documentation required.").

<sup>10</sup> CARES Act § 1106(g).

<sup>11</sup> SBA, Paycheck Protection Program Loans Frequently Asked Questions (FAQs), # 39 (As of May 19, 2020).

<sup>12</sup> SBA, Paycheck Protection Program (PPP) Report: Approvals through 5/16/2020 (May 16, 2020).

<sup>13</sup> CARES Act § 1102(a)(1); 15 U.S.C. § 636(a)(2)(F).

Program offers 7(a) loans (known as PPP loans) to eligible recipients who apply during the period beginning on February 15, 2020 and ending on June 30, 2020, so long as committed funds are available.<sup>14</sup> An eligible recipient is an individual or entity that is eligible to receive a covered loan.<sup>15</sup> While the Paycheck Protection Program provides increased eligibility for certain businesses and organizations,<sup>16</sup> eligibility is also determined through existing SBA regulations and guidance because PPP loans are part of SBA's 7(a) business loan program rubric.<sup>17</sup>

*a. Eligibility Rules do not Exclude Businesses with Tax Debt*

The eligibility rules outlined in the CARES Act and interim final rules are fairly straightforward and small businesses can readily determine whether they satisfy them. These rules do not consider tax debt. In general, a small business applicant is eligible for a PPP loan if it can substantiate that the small business:

- (i) has 500 or fewer employees whose principal place of residence is in the United States, or is a business that operates in a certain industry and meets the applicable SBA employee-based size standards for that industry;
- (ii) is a small business concern, I.R.C. § 501(c)(3) non-profit organization, I.R.C. § 501(c)(19) veterans organization, Tribal business concern, or any other business; and
- (iii) was in operation on February 15, 2020 and either had employees for whom it paid salaries and payroll taxes or paid independent contractors, as reported on a Form 1099-MISC.<sup>18</sup>

*b. Ineligibility Rules do not Exclude Businesses with Tax Debt*

In addition to the eligibility rules, subsequent SBA interim final rules, federal regulations and SBA's Statement of Procedure provide various ways in which an applicant can be ineligible for a PPP loan. While these rules take into consideration the existence of tax debt, they do so in order to expressly exclude tax debt from the eligibility determination. In other words, the ineligibility rules forbid consideration of tax debt by the lender. In general, a small business applicant is ineligible for a PPP loan if any of the following situations apply:

- (i) The applicant is engaged in any activity that is illegal under Federal, state, or local law;
- (ii) The applicant is a household employer;

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<sup>14</sup> CARES Act § 1102(b).

<sup>15</sup> 15 U.S.C. § 636(a)(36)(A)(iv).

<sup>16</sup> 15 U.S.C. § 636(a)(36)(D).

<sup>17</sup> *Supra* note 1.

<sup>18</sup> 85 F.R. 20811, 20812 § (III)(2)(a) (Apr. 15, 2020).

- (iii) An owner of 20 percent or more of the equity of the applicant is incarcerated, on probation, on parole; presently subject to an indictment, criminal information, arraignment, or other means by which formal criminal charges are brought in any jurisdiction; or has been convicted of a felony within the last five years; or
- (iv) The applicant, or any business owned or controlled by the applicant, has ever obtained a direct or guaranteed loan from SBA or any other Federal agency that is currently delinquent or has defaulted within the last seven years and caused a loss to the government.<sup>19</sup>

The fourth situation appears to describe two scenarios wherein a small business applicant with tax debt could be determined to be ineligible: by having Delinquent Federal Debt or causing a Prior Loss to the Government. However, neither Delinquent Federal Debt nor Prior Loss to the Government apply to tax debt, as discussed in the ineligible businesses identified “in 13 CFR 120.110 and described further in Standard Operating Procedure (SOP) 50 10, Subpart B, Chapter 2 \* \* \*.”<sup>20</sup> 13 C.F.R. 120.110 provides a list of businesses that are ineligible for SBA business loans, including subsection (q) which describes a Prior Loss to the Government as involving a Federal loan or Federally assisted financing:

“Unless waived by SBA for good cause, businesses that have previously defaulted on a Federal loan or Federally assisted financing, resulting in the Federal government or any of its agencies or Departments sustaining a loss in any of its programs, and businesses owned or controlled by an applicant or any of its Associates which previously owned, operated, or controlled a business which defaulted on a Federal loan (or guaranteed a loan which was defaulted) and caused the Federal government or any of its agencies or Departments to sustain a loss in any of its programs. For purposes of this section, a compromise agreement shall also be considered a loss \* \* \* .”<sup>21</sup>

Because tax debt does not involve a Federal loan or Federally assisted financing, Prior Loss to the Government does not apply.

Delinquent Federal Debt is described in Standard Operating Procedure 50 10 5(k) (“SOP”) which expressly excludes unpaid/delinquent taxes from debt that can be considered delinquent. According to the SOP, “[a] debt is considered ‘delinquent’ when any Federal loan or federally assisted financing has not been paid within 90 days of the payment due date. Federal loan or federally assisted financing does not include unpaid/delinquent taxes.”<sup>22</sup> This exclusion of tax-related debt from Delinquent Federal Debt is confirmed in the regulation that SOP cites to for Delinquent Federal Debt, 31 C.F.R. 285.13, the scope of which includes “any person owing

<sup>19</sup> 85 F.R. 20811, 20812 § (III)(2)(b) (Apr. 15, 2020).

<sup>20</sup> 85 F.R. 20811, 20812 § (III)(2)(c) (Apr. 15, 2020) (referencing 13 C.F.R. § 120.110, What businesses are ineligible for SBA business loans?).

<sup>21</sup> 13 C.F.R. § 120.110(q).

<sup>22</sup> SOP 50 10(K) Subpart B, Ch. 2, § (III)(A)(16)(b)(i) and –(b)(iii).

delinquent nontax debt \* \* \*,”<sup>23</sup> with “[n]ontax debt mean[ing] any debt other than a debt under the Internal Revenue Code of 1986 (26 USC 1 et seq.).”<sup>24</sup>

When presented with this line of reasoning, the SBA 7(a) Loan Guaranty Processing Center appeared to agree that tax debt is not a disqualifying factor for a PPP loan, stating “[t]here is no reference in the Interim Final Rule or the Federal Regulations at 13 CFR 120.110 to outstanding state and federal tax issues as a disqualifying factor under the PPP.”<sup>25</sup> Lenders should therefore be prohibited from using the existence of (i) unpaid or delinquent state and/or federal taxes, or (ii) tax liens in their determination of a small business’s eligibility for a PPP loan.

## II. Expenses Incurred or Paid Outside the Covered Period can Still Qualify as Eligible Expenses

The CARES Act provides that a borrower is eligible for loan forgiveness equal to certain costs incurred and payments made during the covered period.<sup>26</sup> It is unclear, based on this language, whether payroll costs incurred before the covered period start date but paid during the covered period are eligible expenses. The answer to this issue is important for many small businesses because payroll typically does not cover prospective work, but rather is based on prior work already performed. Small businesses that received their PPP loan disbursement in the middle of a payroll period necessarily have a portion of each employee’s work being incurred before and after the covered period start date. If payroll costs must be both incurred and paid during the covered period to be eligible for loan forgiveness, then the portion of each employee’s work incurred before the covered period start date is not eligible and the administrative burden to account for this is increased.

Form 3508, *Paycheck Protection Program Loan Forgiveness Application*, partially addresses this by creating an Alternative Payroll Covered Period, wherein small businesses with a biweekly (every other week) or more frequent payroll schedule can elect to start their eight-week covered period, for purposes of payroll, on the first day of the first pay period after the PPP loan was disbursed.<sup>27</sup> This may prove beneficial for small businesses with more frequent payroll by easing the administrative burden of having to identify and substantiate eligible payroll expenses contained within a partial payroll period. For example, if a small business using a biweekly payroll schedule pays its employees every other Thursday and its PPP loan is disbursed on a Monday, by electing to use the alternative covered period, the small business can wait to start the eight-week period, for purposes of calculating eligible payroll expenses, until Friday, the first day of its next pay period. On the other hand, if no election is made, the small business will continue to use the normal covered period, which starts on the first day the loan was disbursed, in this case the Monday that is part of a prior payroll period. However, the Alternative Payroll

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<sup>23</sup> 31 C.F.R. § 285.13(b)(5).

<sup>24</sup> 31 C.F.R. § 285.13(a).

<sup>25</sup> Email correspondence with SBA’s 7(a) Loan Guaranty Processing Center (May 15, 2020).

<sup>26</sup> CARES Act § 1106(b).

<sup>27</sup> SBA Form 3508, *Paycheck Protection Program Loan Forgiveness Application*; See also Juan F. Vasquez, Jr., Jaime Vasquez, and Victor J. Viser, *INSIGHT: Tax Issues Associated with Paycheck Protection Program Loan Forgiveness*, Bloomberg Tax (May 21, 2020).

Covered Period is not available to all small businesses and also results in different covered periods for payroll and non-payroll expenses.

With regard to eligible payroll expenses, Form 3508 broadly interprets the CARES Act language (costs incurred and payments made during the covered period) to allow loan forgiveness for “payroll costs paid and payroll costs incurred” during the covered period.<sup>28</sup> While this language still contains some ambiguity that will hopefully be resolved by additional SBA guidance, it leaves open the possibility that payroll costs that were incurred before the covered period are eligible for loan forgiveness if they are paid during the eight-week covered period. Form 3508 does confirm payroll costs that are incurred during the last pay period of the covered period are eligible for loan forgiveness if they are paid on or before the next regular payroll date following the end of the covered period.<sup>29</sup>

With regard to non-payroll costs (such as mortgage interest, rent, or utilities with service beginning before February 15, 2020), Form 3508 provides that such costs are eligible for loan forgiveness if they are paid during the covered period or incurred during the covered period, so long as they are paid before the next billing date, even if the billing date is after the covered period.<sup>30</sup> This language is not as ambiguous and makes clear that non-payroll costs can be incurred or paid outside the covered period and still be eligible for loan forgiveness.

### III. Deduction Issue

While the CARES Act allows small businesses to exclude from gross income expenses that are forgiven under a PPP loan, the IRS intends to offset this benefit, having taken the position that ordinary business expenses that were forgiven as part of a PPP loan are not deductible. This position appears contrary to congressional intent and may be subject to court challenge, and/or it may change going forward, especially in light of recent filed legislation that would ensure deductibility of certain PPP loan amounts received and paid for covered expenses.<sup>31</sup>

Section 1106(b) of the CARES Act provides that small businesses are eligible for forgiveness of indebtedness on a covered loan in an amount equal to the sum of payroll costs, mortgage interest, rent, and utility payments made or incurred during the covered period, subject to limits based on reductions in the number of employees and reductions to wages of certain employees.<sup>32</sup> Forgiven amounts are considered “canceled indebtedness” by the lender.<sup>33</sup> Section

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<sup>28</sup> SBA Form 3508, Paycheck Protection Program Loan Forgiveness Application (May 2020).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> Juan F. Vasquez, Jr. and Peter A. Lowy, *Challenging Temporary Treasury Regulations: An Analysis of the Administrative Procedure Act, Legislative Reenactment Doctrine, Deference, and Invalidity*, III Hous. Bus. Tax L. J. 248 (2003) (Showing that when the IRS issues guidance that is inconsistent with congressional intent, such item may be challenged and invalidated. “In the tax arena, wide arrays of regulations (without regard to the level of deference) have been declared invalid. This array includes legislative regulations, interpretive regulations, and temporary questions.”).

<sup>32</sup> CARES Act §§ 1106(b), -(d)(2)-(3).

<sup>33</sup> CARES Act § 1106(c)(1).

1106(i) of the CARES Act excludes this canceled indebtedness from gross income, providing “any amount which (but for this subsection) would be includible in gross income of the eligible recipient by reason of forgiveness described in [1106(b)] shall be excluded from gross income.”<sup>34</sup>

In general, small businesses are able to deduct ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.<sup>35</sup> Rent, utility payments, and payroll costs comprise typical trade or business expenses for which a deduction under section 162 of the Code generally is appropriate.<sup>36</sup> If these costs were also excluded from gross income because they were eligible expenses as part of a PPP loan, then small businesses may receive a double tax benefit, by both excluding and deducting the expense from gross income.

IRS Notice 2020-32 clarifies that this double tax benefit will not be permitted, providing “no deduction is allowed under the Internal Revenue Code for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a covered loan pursuant to section 1106(b) of the CARES Act and the income associated with the forgiveness is excluded from gross income for purposes of the Code pursuant to section 1106(i) of the CARES Act.<sup>37</sup> The Notice cites in support to section 265(a)(1) of the Code, which provides that no deduction is allowed for any amount otherwise allowable as a deduction [that is allocable] to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by subtitle A of the Code.<sup>38</sup>

Under the IRS position, small businesses would only be able to exclude the expense from gross income, and would then be required to include it. This position was subject to immediate criticism by Congress as going against congressional intent and legislation has been introduced clarifying the intent to maintain the double tax benefit.

#### a. *Congressional Intent*

Following IRS Notice 2020-32, multiple senators made their opposition to the notice known as the intent of the CARES Act was to provide emergency assistance and health care response for individuals, families, and businesses affected by the Covid-19 pandemic.<sup>39</sup> Senate Finance Committee Chairman Chuck Grassley stated, “When we developed and passed the Paycheck Protection Program, our intent was clearly to make sure small businesses had the liquidity and the help they needed to get through [the Covid-19 pandemic]. Unfortunately, Treasury and the IRS interpreted the law in a way that’s preventing businesses from deducting expenses associated with PPP loans. That’s just the opposite of what we intended and should be fixed.”<sup>40</sup>

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<sup>34</sup> CARES Act § 1106(i).

<sup>35</sup> I.R.C. § 162.

<sup>36</sup> IRS Notice 2020-32 (2020).

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*; I.R.C. § 265(a)(1); Treas. Reg. § 1.265-1(b)(1).

<sup>39</sup> 85 F.R. 20811 (Apr. 15, 2020).

<sup>40</sup> Chuck Grassley, *Bipartisan Senators Introduce Bill to Clarify Small Business Expense Deductions Under PPP* (May 6, 2020).

The Small Business Expense Protection Act of 2020 was introduced in the Senate on May 5, 2020 by a bipartisan group of Senators including Chuck Grassley (R-Iowa), John Cornyn (R-Texas), Ron Wyden (D-Ore.), Marco Rubio (R-Fla.), and Tom Carper (D-Del.).<sup>41</sup> The Act clarifies the treatment of business expenses forgiven under section 1106(i) of the CARES Act by amending that section to read:

For purposes of the Internal Revenue Code of 1986— (1) any amount which (but for this subsection) 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, and (2) 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).<sup>42</sup>

In support, Senator Cornyn stated, “The Paycheck Protection Program has been a lifeline to small businesses in Texas during the coronavirus pandemic. This legislation would erase any confusion by clarifying that expenses paid with a forgiven PPP loan can still be deducted from small businesses’ taxes.”<sup>43</sup>

b. *Exclusion vs. Exemption*

A plain reading of section 265(a)(1) of the Code does not support the IRS’s position. This section applies to prevent deductions only for a class of income which is:

- (i) wholly excluded from gross income under any provision of Subtitle A, or
- (ii) wholly exempt from the taxes imposed by subtitle A under the provisions of any other law.

Section 1106(i) of the CARES Act “excludes” cancelled indebtedness due to loan forgiveness from gross income; it does not exempt such amounts. Were the CARES Act to have amended language similar to what was done in section 1102(a), then (i) may have applied. This is not the case. Similarly were section 1106(i) to “exempt” from gross income cancelled indebtedness due to loan forgiveness, then (ii) may have applied. This is also not the case.

The following excerpt is a helpful description of the important difference between an exemption and an exclusion:

[A] tax exemption is a provision that exempts from tax a transaction that would, in the absence of the exemption, otherwise be subject to tax. That is, there has

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<sup>41</sup> S. 3612 – 116th Cong. (May 5, 2020).

<sup>42</sup> *Id.*

<sup>43</sup> Richard Rubin, *Tax Deductions Tied to Forgiven Small Business Loans Draw Support*, Wall Street Journal (May 5, 2020).

been a statutory decision not to tax a certain transaction that is clearly within the ambit and authority of the taxing statutes to tax. ... An exclusion, on the other hand, relates to a transaction that is not taxable because it falls outside the scope of the statute giving rise to the tax, ab initio. Transactions excluded from the tax are those which, by the language of the statutes, are defined as beyond the reach of the tax.<sup>44</sup>

If the Small Business Expense Protection Act of 2020 or similar legislation is not passed, the IRS position laid out in IRS Notice 2020-32 will be subject to Court challenge as being inconsistent with congressional intent, and may ultimately be entitled to little or no deference.<sup>45</sup> Further, there will be an added element of confusion to an already interesting 2020 filing season. Consider, for example, a CPA tax preparer taking a return position that PPP loan amounts forgiven were also deductible business expenses. Technically that position would be inconsistent with IRS guidance. Would the CPA need to report the position on a Form 8275 Disclosure Statement? Should the CPA request an opinion of counsel that the position more likely than not comports with legislative intent?

Furthermore, there will be unintended disadvantages for certain flow-through entities. For example, in the case of certain S corporations the owner-shareholder may receive a Form W-2 that includes as income some portion of the forgiven loan while also receiving a Form K-1 reporting income that is grossed up for the forgiven portion (because no deduction was allowed). Contrast that with a partnership return where the partner just receives a K-1 with the applicable grossed up portion. If Congress does not fix this unintended disadvantage for S corporations Treasury should.

## **Conclusion**

While the Paycheck Protection Program has been a measured success, having issued 4.3 million forgivable loans totaling more than \$513 billion, it has been marked by a continual lack of guidance that has resulted in many issues of concern to small businesses, three of which were discussed herein:

First, during the application process, some small business applicants may have been improperly denied a PPP loan due to having unpaid or delinquent taxes, or a tax lien. These tax-related issues are not disqualifying factors to be considered by the lender and therefore any small business that is otherwise eligible for a PPP loan should not be denied for having them.

Second, during the period when eligible expenses are being made, small businesses may be able to receive loan forgiveness for expenses incurred outside of, but paid during, the covered period, and vice versa.

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<sup>44</sup> Jaye Calhoun and William J. Kolarik, II, Kean Miller, *Sales and Use Tax Laws – Differentiating Between Exemptions and Exclusions Under Louisiana Law*, American Bar Association, citing *Bridges v. Nelson Indus. Steam. Co.*, 190 So.3d 276, 280 (2016) (citing Bruce J. Oreck, Louisiana Sales & Use Taxation § 3.1 (2d ed. 1996)).

<sup>45</sup> Juan F. Vasquez, Jr., *Judicial Deference for Revenue Rulings in a Post-Mead World*, J. Tax Practice & Proc. (Aug/Sep 2004). See also, *supra* note 31.

Finally, when small businesses file income tax returns, they may be able to both (i) exclude from gross income canceled indebtedness resulting from a forgiven PPP loan and (ii) deduct ordinary business expenses made with funds from the forgiven PPP loan, despite the current IRS position disallowing such deductions.