

## Expenses Associated with the Use and Forgiveness of the Paycheck Protection Program Loans – Deductible or Non-Deductible?

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In response to the Coronavirus outbreak in early 2020, Congress moved quickly – not necessarily wisely – to provide relief to individuals and businesses hurt by the so-called pandemic. The primary response was to provide economic impact payments – Stimulus checks – to individuals and then, among other payroll tax credits, to provide forgivable loans to businesses that used them for narrowly-defined business purposes.

We will be addressing the issues surrounding the forgivable loans, also known as the Paycheck Protection Program ("PPP") loans.

The PPP was created by the Coronavirus Aid, Relief, and Economic Security Act ("Cares Act") on March 25, 2020. In particular, Sec 1102 of that Act created the program, under the auspices of the Small Business Administration.

Sec 1102 spelled out the amount and use of the loans by the businesses that applied. Specifically, the loans were forgivable and could only be used for the following:

- Payroll costs, which were restrictively defined
- Rent
- Utilities
- Mortgage interest and certain other interest on pre-existing debt

All these costs were further restricted as to the timeframe in which they were expended, starting out as an 8-week period and ultimately expanding to a 24-week period.

Further, and most importantly, under Sec 1106 of the Act, these loans were expected to be forgiven by the SBA when used for their designated purpose over the designated time period beginning on the date of funding of the loan.

The first question of most tax professionals pertained to the potential taxability of these loans in light of their promised forgiveness. Alas, however, Congress beat us to the punch and declared that "any amount which ... would be includible in gross income .. by reason of forgiveness ... shall be excluded from gross income." CARES Act Sec 1106(i)

What a great deal!!

But the tax forgiveness euphoria created by the CARES Act itself was short-lived. The Internal Revenue Service dampened the hopes of many struggling businesses impacted by coronavirus with its declaration that none of the expenses paid for with forgiven loan proceeds are deductible toward the determination of taxable income.

Even though Congress has voiced its opinion that this was not their intent, without legislation to that effect, the IRS position rules the day ... or does it?

So what has IRS said regarding these expenses?

On May 2, 2020, IRS released Notice 2020-32 stating that no deduction is allowed for an eligible expense that is otherwise deductible if the payment of the eligible expense results in forgiveness of a covered loan. Notice 2020-32 relied on IRC Sec 265(a)(1) of the Code and Sec 1.265-1 of the Income Tax Regulations which provide that no deduction is allowed for any amount otherwise allowable as a deduction to the extent the amount is allocable to one or more classes of income wholly exempt from taxes imposed by Subtitle A of the Code.

After exploring several scenarios, IRS concluded that the expenses otherwise deductible, listed in Sec 1106(b) of the CARES Act may not be deductible in the year in which those expenses were paid or accrued if the taxpayer reasonably expects to receive forgiveness of the covered loan on the basis of those same expenses being paid or accrued during the covered period.

That is quite an onerous conclusion by IRS that essentially nullifies the Congressional intent of the CARES Act implementation.

But is IRS correct?

Are there precedents where amounts excludible from gross income can also be used to pay deductible expenses for which a deduction results?

I believe there is.

There are a number of exclusions from gross income where there are no restrictions placed on the use of the excluded income. For instance,

- Life insurance proceeds and death benefits
- Gifts and inheritances
- Compensation for injuries and/or sickness
- Scholarships and fellowships
- Combat zone compensation, to name a few.

However, let's explore an excludible item from gross income where the use of the funds actually contribute to their exclusion ... the parsonage allowance.

IRC Sec 107(2) specifically states that gross income does not include —

the rental allowance paid to [a minister of the gospel] as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.

So what is included in "providing a home" for the minister? If the cost of furnishings and utilities are included, pursuant to Sec 107, certainly mortgage interest and property tax is also included. In fact, according to IRS Publication 517, mortgage interest and real estate property tax are an exception to the disallowance of a deduction for expenses

paid with the tax free income received from a housing or parsonage allowance – an exception to the so-called "Deason rule".

Tax professionals who prepare tax returns for ministers are painfully aware of the requirement to tabulate all the minister's housing expenses, including repairs, maintenance, insurance and even mortgage principal payments and insurance, because they are all included in determining the "fair rental value" of the minister's home. Any excess of the housing allowance over those housing expenses is included in income.

Therefore, the "parsonage allowance" under IRC Sec 107 is excluded from gross income yet some, if not most, of the tax-free funds are used to pay deductible expenses such as mortgage interest and real estate property tax. How is this different from the expenses paid with excludible PPP loan forgiveness funds? It's not.

Therefore, it is my professional opinion that the covered expenses paid for with PPP loan proceeds which are ultimately forgiven, making them excludible from gross income, **are deductible** under the same tax principle as the deductibility of mortgage interest and real estate property tax paid with funds designated as a minister's parsonage or housing allowance.

If you concur, this position should be disclosed on Form 8275-R Regulation Disclosure Statement with the tax return in order to avoid the accuracy-related penalties if a position contrary to Treasury Regulations is adequately disclosed with at least a reasonable basis.