Experts Want States to Clarify Tax Treatment of Forgiven PPP Loans

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By Paul Jones

As businesses receive hundreds of billions of dollars in Paycheck Protection Program (PPP) loans, tax experts want states to indicate whether they, like the federal government, will treat the forgiven loan debt as tax exempt.

"It would be helpful for states to clarify this," said Jared Walczak of the Tax Foundation.

The PPP is designed to keep workers employed and their employers afloat during the pandemic. Its roughly $350 billion allocation — approved through the Coronavirus Aid, Relief, and Economic Security (CARES) Act — has been completely exhausted, and as of press time, businesses were waiting on Congress for additional funding. The loans, which are capped at the lesser of 2½ times a business's average monthly payroll or $10 million, are intended for small- to medium-size businesses. The debt can be forgiven in whole or in part if the business meets specific requirements, including spending the money on approved expenses — mainly payroll as well as utilities, rent, and mortgage interest — and maintaining existing employment and compensation levels. While forgiven debt is often treated as taxable income under federal law, the CARES Act treats the forgiven portion of the loans as exempt from federal taxation.

Whether states will treat it as tax exempt, however, isn't entirely clear yet. Walczak said it's possible a state with static or selective IRC conformity could determine that because it doesn't conform to the latest version of the IRC, it also doesn't conform to the CARES Act's tax treatment of forgiven PPP loans.

"If a state is using an older version of the revenue code," it could determine that it "isn't bringing in any changes [in] the CARES Act" and "would follow the default of taxing the discharge of debt," Walczak said.

According to Walczak, even states with rolling IRC conformity could interpret their tax code as not automatically adopting the federal treatment of forgiven PPP loan debt, because the CARES Act doesn't make changes to section 108. Instead, it includes the exclusion for forgiven PPP loan debt in its statutory language, separate from the IRC.

Rolling conformity states could thus decide that they don't conform to the provision because the CARES Act doesn't amend the code, Walczak said.

States whose tax calculations begin with adjusted gross income or taxable income that decide their tax codes don't adopt the CARES Act's exclusion of forgiven PPP loan debt would likely have to issue guidance requiring taxpayers to add the forgiven loan amount into their income.

However, Walczak said, states could also take the opposite position. For example, it could be argued that because a state uses federal AGI or taxable income as a starting point for state tax calculations, “a change to how the federal government calculates those” — including the CARES Act provision excluding forgiven PPP loan debt — “would be carried into the state tax code.”

Chris Allanach of the Oregon Legislative Revenue Office told *Tax Notes* that he believes Oregon’s use of federal taxable income as a starting point for calculating state taxable income could mean it automatically adopts the CARES Act's exclusion of forgiven PPP loans.

“I would think . . . that if the feds would say that [forgiven PPP loans] were not taxable income, then we would not tax” them, Allanach said.

Tax experts want states to clarify their positions on the issue. “We will probably need some guidance from the [revenue departments] on this,” Nikki Dobay of the Council On State Taxation told *Tax Notes*.

Walczak said he hopes states “will do what they can to clarify this, especially if it’s not their intent to tax this loan forgiveness.” For now, “revenue departments have been relatively quiet on this, perhaps because they’re still clarifying these matters internally,” he added.

Mark Mullin and Dashiell Shapiro of Shartsis Friese LLP said they’re planning to advise taxpayers to be careful and not assume that forgiven PPP loan debt is exempt until the state makes its position clear.

“It would be very nice to have upfront guidance from states so we didn’t have to assume the worst” as businesses try to anticipate their liability, and “the sooner the better,” Shapiro said. He argued that even if there isn't a high risk that many states will issue guidance applying taxes to forgiven PPP loan debt, that risk is will be a big problem for planning until taxpayers know the position states will take.

Mullin said it would be helpful for taxpayers if states all took a similar position, such as “a sort of universal indication that they’re all going to follow the [federal] government’s lead.”

States may address the issue through guidance or conformity legislation that outlines the aspects of the CARES Act they’re proactively adopting.

But Charlotte Crane, a tax law professor at Northwestern University Pritzker School of Law, said businesses with forgiven PPP loans could still face state tax liability even if states conform to the CARES Act provision treating forgiven debt as untaxable. She said state revenue departments might decide to scrutinize whether the businesses actually met the conditions of the program.

State revenue departments “may be the only people auditing the taxpayers because they’re the only stakeholders who have enough stake in it, and enough time, to do that audit,” Crane said. “Banks aren’t supposed to be forgiving these loans unless the conditions are met,” she said, so even if the federal government doesn’t scrutinize the forgiveness of a business's loan through the program, if a state auditor is made aware of a taxpayer’s forgiven PPP loan, the auditor could decide to take a look and say “wait a minute, this shouldn’t have been forgiven,” deciding that a taxpayer can't get the forgiveness of indebtedness excluded from their state taxes.

Another question about the PPP is whether typically deductible expenditures that are funded through PPP loans will still be deductible because the forgiven loan is excluded from taxation. There's confusion on the matter, and tax experts are waiting for the federal government to provide clarity. If the federal government determines that not only are forgiven PPP loans excluded from taxation, but that the expenditures they funded can be used to reduce a taxpayer's liability, states might resist following that treatment to protect their revenue.

"Following the feds on this will cause states to be financing, indirectly, these loans," Mullin said. "They might not want to do that, especially if their budgets are hurting."