Paycheck Protection Program (PPP) Tax Treatment
for Federal & State Taxes

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Federal

On January 6, 2021, the IRS released Revenue Ruling 2021-02 that declares its previous Notice 2020-32 superseded. Notice 2020-32 stated expenses paid with PPP loan proceeds expected to be forgiven were not deductible. However, the Consolidated Appropriations Act "CAA 2021" clarified Congress' original intent and codified the deductibility of expenses paid with PPP loan proceeds expected to be forgiven in addition to the CARES Act provision that forgiven PPP loan proceeds are excluded from taxable income. This applies to all borrowers, old and new, regardless of the status of their forgiveness applications.

Before this change in the law, borrowers believed they were being penalized for applying for forgiveness because the non-deductibility of forgiven expenses would inflate their income and increase their tax liabilities due.

The recent stimulus legislation updated the Cares Act passed in March to "say that no deduction is denied, no tax attribute is reduced, and no basis increase is denied by reason of the exclusion from gross income of the forgiveness of an eligible recipient's covered loan," the IRS said in a statement.

The change is widely regarded as a victory for small businesses, which can use tax-free money to generate more breaks, something that's typically prohibited under the tax code. Lawmakers said allowing the deductions was necessary to keep small businesses afloat amid waves of restrictions and weakened consumer spending resulting from the coronavirus pandemic.

State

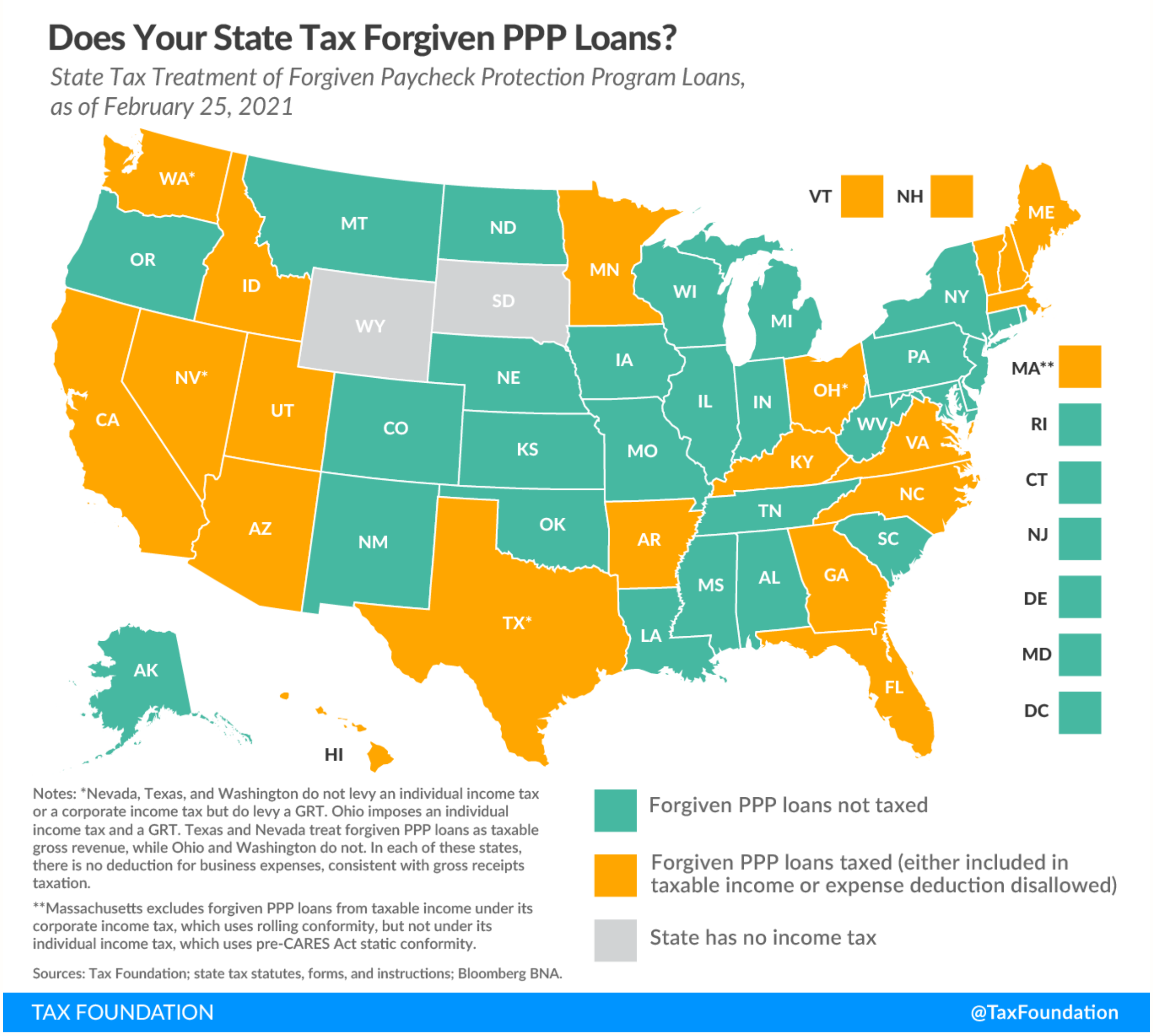
The taxability of the forgiveness proceeds has been addressed by several states, but the deductibility of expenses paid with PPP funds is relatively new and not yet fully addressed in many jurisdictions.

More specifically, for the states, there is not an automatic adaptation of this provision depending on how that state has chosen to adopt the Internal Revenue Code ("IRC"). To fully conform with the nontaxable PPP Loan Forgiveness, a state must adopt the most current IRC as well as conform to the CARES Act provisions.

Recognizing that many of us are not tax experts, let's move forward to a convenient "state by state" link to provide you with the most recent information/guidance.

The not-for-profit Tax Foundation offers a current (updated daily) map and table that show states' tax treatment of forgiven PPP loans.

As of February 25, 2021, the update is as follows:



State Tax Treatment of Forgiven PPP Loans (as of February 25, 2021)

State	Excludes from Taxable Income	Allows Expense Deduction
Alabama	✔	✔
Alaska	✔	✔
Arizona		✔
Arkansas		✔
California	✔	
Colorado	✔	✔
Connecticut	✔	✔
Delaware	✔	✔
Florida		✔
Georgia	✔	
Hawaii	✔	
Idaho		✔
Illinois	✔	✔
Indiana	✔	✔
Iowa	✔	✔
Kansas	✔	✔
Kentucky	✔	
Louisiana	✔	✔
Maine		✔
Maryland	✔	✔
Massachusetts**		✔
Michigan	✔	✔
Minnesota		✔
Mississippi	✔	✔
Missouri	✔	✔
Montana	✔	✔
Nebraska	✔	✔
Nevada*		
New Hampshire		✔
New Jersey	✔	✔
New Mexico	✔	✔
New York	✔	✔
North Carolina	✔	
North Dakota	✔	✔
Ohio*	✔	
Oklahoma	✔	✔

State	Excludes from Taxable Income	Allows Expense Deduction
Oregon	✔	✔
Pennsylvania	✔	✔
Rhode Island	✔	✔
South Carolina	✔	✔
South Dakota	No Individual or Corporate Income Tax	
Tennessee	✔	✔
Texas*		
Utah		✔
Vermont		✔
Virginia		✔
Washington*	✔	
West Virginia	✔	✔
Wisconsin	✔	✔
Wyoming	No Individual or Corporate Income Tax	
District of Columbia	✔	✔

Notes: *Nevada, Texas, and Washington do not levy an individual income tax or a corporate income tax but do levy a GRT. Ohio imposes an individual income tax and a GRT. Texas and Nevada treat forgiven PPP loans as taxable gross revenue, while Ohio and Washington do not. In each of these states, there is no deduction for business expenses, consistent with gross receipts taxation.

**Massachusetts excludes forgiven PPP loans from taxable income under its corporate income tax, which uses rolling conformity, but not under its individual income tax, which uses pre-CARES Act static conformity.

Sources: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

Why do states have such different practices when it comes to the taxation of PPP loans? It all has to do with how states conform to the federal tax code.

All states use the Internal Revenue Code (IRC) as the starting point for their own tax code, but every state has the authority to make its own adjustments. States that use rolling conformity automatically adopt federal tax changes as they occur, which is the simplest approach and provides the most certainty to taxpayers. States that use static conformity link to the federal tax code as it stood on a certain date and must proactively adopt legislation to accept more recent changes.

It is common for states to conform to certain parts of the federal tax code but decouple from others. States that use rolling conformity sometimes adopt legislation to decouple from certain federal changes after they occur. Most states that use static conformity update their conformity dates routinely, but sometimes indecision about whether to accept new federal tax changes results in states remaining conformed to an outdated version of the IRC for many years. When static conformity states do update their conformity dates, they sometimes decouple from specific changes on an ad hoc basis. Even beyond the question of conformity dates, there has been a great deal of uncertainty surrounding the state tax treatment of forgiven PPP loans due to the way the federal government provided for the nontaxability of forgiven PPP loans.

When the CARES Act was enacted on March 27, 2020, Congress' intent was that forgiven PPP loans be tax-free at the federal level, which is a departure from usual practice. Normally, when federal debt is forgiven for various reasons, the amount forgiven is considered taxable income by the federal government and by states that follow that treatment. In normal circumstances, this is a reasonable practice. However, Congress specifically designed PPP loans as a tax-free emergency lifeline for small businesses struggling to stay open amid the pandemic, so the CARES Act excluded PPP loans from taxable income (although not by amending the IRC directly). Congress also seems to have intended that expenses paid for using PPP loans be deductible—the Joint Committee on Taxation scored the original provision as such—but did not include language to do so directly in statute. In the months following the CARES Act's enactment, the Treasury Department ruled that expenses paid for with PPP loans were not deductible under the law as it stood at the time, citing section 265 of the IRC, which generally prohibits firms from deducting expenses associated with tax-free income. This interpretation came as a surprise to many lawmakers, since excluding the forgiven loans from taxation, but then denying the deduction, essentially cancels out the benefit Congress provided. Therefore, on December 27, 2020, when the Consolidated Appropriations Act for 2021 was signed into law, the law was amended to specify that expenses paid for using forgiven PPP loans would indeed be deductible.

As a result, most states now find they are in one of three positions. States that conform to a pre-CARES Act version of the IRC generally treat forgiven federal loans as taxable income and related business expenses (like payroll, rent, and utilities) as deductible. States that conform to a post-CARES Act but pre-Consolidated Appropriations Act version of the IRC are generally on track to exclude forgiven PPP loans from taxable income but deny the deduction for related expenses. States that use rolling conformity or that have otherwise updated their conformity statutes to a post-Consolidated Appropriations Act version of the IRC both exclude forgiven PPP loans from income and allow related expenses to be deducted. In some instances, however, states have adopted specific provisions on PPP loan income that supersedes their general conformity approach.

State policymakers are now in the position to help ensure PPP recipients receive the full emergency benefit Congress intended by refraining from taxing these federal lifelines at the state level. Denying the deduction for expenses covered by forgiven PPP loans has a tax effect very similar to treating forgiven PPP loans as taxable income: both methods of taxation increase taxable income beyond what it would have been had the business not taken out a PPP loan in the first place. In many states that currently tax forgiven PPP loans, including Arizona, Arkansas, Hawaii, Maine, Minnesota, New Hampshire, and Virginia, bills have been introduced to prevent such taxation, and Wisconsin recently acted to do the same. This situation is one in which baselines matter: from a baseline of the taxation of the forgiven loans (or the denial of the deduction), conforming to federal treatment represents a revenue loss. If, however, the baseline scenario is one in which forgiven PPP loans did not exist—the status quo ex ante—then following federal guidance is revenue neutral. This was not revenue that states counted on or expected to be able to generate.

If policymakers wish to avoid imposing taxes on these small business lifelines, however, they need to act quickly, as tax deadlines are fast approaching.

We recognize there is much uncertainty and some confusion. For instance, Alabama and South Carolina have indicated they will provide the same two tax benefits regarding PPP loans as the IRS. But North Carolina and California will only adopt one of them — treating the forgiven loan as tax free.

Or, in some states such as Massachusetts and Pennsylvania, whether a small business can enjoy either of the PPP-related tax breaks will depend on whether its state taxes are filed under the corporate tax code or the individual tax code.

Our advice to small business owners: Before filing, talk with a tax adviser familiar with your state's tax laws.

And, if you can afford to wait for a state and local tax refund you may be owed, file for an extension on your state taxes. In several months you're likely to have a clearer picture on how your state intends to treat your forgiven PPP loan and the deductibility of your business expenses not just for tax year 2020 but also tax year 2021. That will be relevant since neither the pandemic nor the PPP program are over.

VGM Government Relations will monitor these issues and offer timely updates as they occur. Questions or concerns? Please contact me at mark.higley@vgm.com or cell/text 319.504.9515.