HOW PPP LOAN FORGIVENESS WILL AFFECT **the 2021 Texas Franchise Tax**

By Remington T. O'Dell, CPA

The Payroll Protection Program (PPP) was created by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) in March of 2020. The program closed on August 8, 2020 after providing billions in potentially forgivable loans for businesses and non-profits to keep workers on the payroll.

Much time and effort has been paid to how the forgiveness of PPP funds will affect federal tax planning; however, not as much attention has been paid regarding the state tax considerations. Only recently have states begun to issue any guidance on whether the forgivable PPP loan proceeds are taxable at the state level.

Depending on the guidance issued, many taxpayers that have never filed a state tax return before may find themselves forced to do so for 2020, including taxpayers subject to the Texas franchise tax.

Federal Tax Treatment

Initially, PPP funds were touted to be excluded from taxability. In accordance with CARES Section 1106(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 ... shall be excluded from gross income."**

While many tax professionals took this language as verification of Congress's intent to exclude the forgiven PPP loan proceeds from being taxed, that was not the interpretation of the IRS. In Rev. Rul. 2020-27, the IRS states that a taxpayer may not deduct eligible business expenses that were paid with PPP loan proceeds, if the taxpayer reasonably expects to receive forgiveness of its PPP loan.

With the passage of the 2021 Omnibus Appropriations Bill by Congress on December 21, 2020, clarification on the tax treatment of PPP forgiveness has finally been provided. The bill makes clear that PPP forgiveness:

- Is not taxable,
- Is excluded from income, and
- Will not reduce any deductions attributable to those funds.

Deductions are allowable for expenses paid with the proceeds of a forgiven PPP loan. In accordance with the provisions of the bill, this change is retroactive to date of enactment of the CARES Act.

Texas Franchise Tax Treatment

Although the 2021 Omnibus Bill brings good news on the federal level, things are quite different on the state level. In accordance with a general information letter (GIL202012080995540) issued by the Tax Policy Division of the Texas Comptroller of Public Accounts on December 11, 2020:

> **"If a Paycheck Protection Program (PPP) loan is forgiven, the debt forgiveness will be considered income for franchise tax reporting unless it qualifies for an exception from being recognized as income under the 2007 Internal Revenue Code."**

While general information letters are not binding on the Comptroller, it appears that this analysis of the Texas Franchise Tax Code by the Comptroller's office is correct and can only be changed by legislative action.

The Texas franchise tax has fixed conformity to the Internal Revenue Code (IRC) as of Jan. 1, 2007. As a result, cancellation of debt (COD) income is governed by IRC 108 as it existed in 2007. This means that subsequent changes to the IRC by CARES Section 1106(i) and the 2021 Omnibus Bill are nonbinding upon the state.

This interpretation of PPP proceeds as COD income will require taxpayers, for Texas franchise tax purposes, to adjust the gross revenue on 2020 tax return using the 2007 IRC rules and use that amount for franchise tax reporting. This is similar to the depreciation adjustments necessary for Cost of Goods Sold (COGS) or Indirect Costs.

Apportionment of COD Income

Another unexpected result for taxpayers is how COD income interacts with the income apportionment rules under the Texas franchise tax code. In accordance with Rule § 3.591(e)(5):

"Debt forgiveness. If a creditor releases any part of a debt, then the amount that the creditor forgives is a gross receipt that is apportioned to the legal domicile of the creditor."

By allocating COD income to the creditor's legal domicile, Rule § 3.591(e)(5) has the unfortunate result of potentially penalizing Texans for using local Texas banks.

Additionally, some local banks were hesitant to offer PPP loans due to the administrative burden they bore and instead turned potential borrowers towards online loan facilitators. Almost $5.7 billion in PPP loans were handled by Lendio alone, which is not a direct lender but facilitates PPP loans as an agent through a network of approved lenders that includes banks, credit unions and non-bank SBA lenders.

Borrowers that went through such online loan facilitators may not be aware of the legal domicile of their creditor, so it is vital that borrowers research such information for state franchise tax planning purposes.

What to Expect

The inclusion of the COD income by the PPP loan borrower could certainly force many taxpayers that have never filed more than a No Tax Due Report over the filing threshold for the first time. This unexpected tax burden could not come at a more unwelcome time as many Texas businesses are barely holding on by a thread during the COVID pandemic.

As of press time, bills have been filed in the 87th Texas legislative session to address this situation. However, until a bill is signed, it is always a good idea "to plan for the worst and hope for the best."

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EDITOR'S NOTE: For more information on this topic, please also see the article "PPP Loans and the Texas Franchise Tax" by Christina Mondrik, CPA-Austin, available on TXCPA's website at www.tx.cpa/resources/news/articles/ppp-loans-and-the-texas-franchise-tax.