

## **PPP Loans and the Texas Franchise Tax**

One of the many new terms introduced in 2020 was the Paycheck Protection Program (PPP). Established by the Coronavirus Aid, Relief, and Economic Security (CARES) Act (Pub.L. 116–136) and administered by the Small Business Administration (SBA), with the support of the United State Treasury, the PPP provides small businesses funds to pay up to eight weeks of payroll costs, including benefits, and allows for funds to be used to pay interest on mortgages, rent, and utilities. In January 8, 2021, legislation was enacted to expand the PPP to include a second draw loan for certain taxpayers and to expand the scope of eligibility for PPP funds.

One of the interesting and controversial aspects of the PPP is the loan forgiveness element. Originally, the IRS declared that business expenses incurred and paid for using forgiven PPP loans would be nondeductible, but revised its position in Rev. Rul. 2021-2, after the legislature in the Consolidated Appropriations Act of 2021 (Pub. L. No. 116-260) (CCA) specified that the forgiven loans would not be includible in income and ordinary, reasonable, necessary, business expenses associated therewith would not be disallowed. For Texans, this might create Texas franchise tax issues.

### **I. Introduction**

The Texas Franchise Tax, based on a margin calculation, was originally made effective for 2008 franchise tax reports based on business conducted in 2007 and reported on the subject businesses' 2007 federal income tax returns, as set forth in Texas Tax Code § 171.1011. The margin calculation is based on a formula that subtracts cost of goods sold (“COGS”), compensation, or a standard / minimum deduction from the entity's revenues. The margin is then apportioned based upon a gross receipts formula, comparing gross receipts from business done in Texas to gross receipts from its entire business.

The franchise tax statute incorporates the Internal Revenue Code (IRC) as of January 1, 2007 without adjustments made after that date, so taxpayers may still need to make adjustments to their federal tax amounts in reporting Texas franchise tax.<sup>1</sup>

Both the CARES Act and the CAA state that the forgiveness of the PPP debt is not taxable income for federal tax purposes. However, both laws were enacted after January 1, 2007. Forgiveness of debt was generally taxable under the Internal Revenue Code effective January 1, 2007, as cancellation of indebtedness income. Therefore, unless an exception applied as of that date, forgiven PPP loans are likely to be includible in calculating both Texas franchise tax revenues and gross receipts.

As a general rule, when a debt is forgiven, or cancelled, a debtor's gross income includes an amount equal to the difference between what was due on the obligation and the amount the debtor has paid to date. The taxpayer realizes and recognizes a benefit equal to the value of the reduction of the liability. Since the debt was not included in income previously, a reduction of the debt becomes income when it's forgiven because it's a decrease in an existing obligation.

### **II. Revenues**

The margin computation begins with a taxable entity's revenues. The franchise tax computation of revenue, which is used in calculating taxable margin, compiles amounts reported on specific lines of the applicable federal income tax forms for the various types of reporting entities.

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<sup>1</sup> See Texas Tax Code § 171.0001(9).

Referencing specific lines on federal income tax forms allows Texas to incorporate, by reference, the entire body of federal tax law that determines the amounts reportable on the forms.

For PPP loan purposes, forgiven loans would need to be added back to the items reported on the federal income tax return in calculating Texas franchise tax revenues, unless the taxpayer identifies an exception from the inclusion that would have applied under the IRC in effect on January 1, 2007.

Unless there is some provision or reason forgiven loan receipts would not be treated as receipts for income tax purposes the Comptroller's office will require them to be receipts for franchise tax purposes.

### **III. Calculating Margin**

How will the associated expenses fit into the equation? Taxpayers calculate margin by subtracting items from revenues. Margin is generally measured by revenues, less either COGS sold or compensation. COGS is calculated in accordance with instructions set forth in Texas Tax Code § 171.1012 as interpreted in Comptroller Rule 3.558. Compensation is calculated in accordance with instructions set forth in Texas Tax Code § 171.1013 as interpreted in Comptroller Rule 3.589. The other ways to compute margin aren't affected by the expenses deducted on the federal income tax return.

Businesses may use PPP loan funds to pay payroll costs, benefits, interest on mortgages, rent, and utilities. These costs may qualify for inclusion in computing COGS or compensation. To the extent they qualify under the Texas Tax Code and the Comptroller's Rules, it is anticipated the Comptroller's office will allow taxpayers to include offsetting expenses in COGS and compensation.

### **IV. Apportionment**

The next question is how to apportion the gross receipts arising as cancellation of indebtedness income under the IRC of 2007.

In general, net gains or losses on sales of intangibles held as capital assets or investments are apportioned to the location of the payor. Examples include: stocks, bonds, commodities, futures contracts, patents, copyrights, licenses, trademarks, franchises, goodwill and general receivable rights.<sup>2</sup> It is anticipated that the apportionment of receipts from forgiven loans would be apportioned based upon the location of payor rule and based upon the location of entity that is forgiving the loan.

Dividends and interest that are received from a national bank are apportioned to Texas if the bank's principal place of business is located in Texas. Dividends and interest that are received from a bank that is organized under the Texas Banking Code are apportioned to Texas. Therefore, loan forgiveness from national banks not headquartered in Texas may not be Texas gross receipts and may not be apportionable to Texas.

### **V. Potential Challenges**

If a taxpayer can identify a particular IRC provision, Treasury Regulation, or other IRS guidance that loan forgiveness would not have been includible in income under the IRC of 2007, the taxpayer may have a valid challenge to inclusion of gross receipts in income.

Even though cancellation of indebtedness income is generally required to be reported on Form 1099-C if the proper conditions are met, the income is not necessarily required to be included in the recipient's income if the recipient meets certain exclusions. These exclusions might be considered as options for

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<sup>2</sup> Tax Policy News, June 2010.

challenging inclusion in franchise tax gross receipts. For example, if a discharge of indebtedness occurs when the taxpayer is insolvent IRC §108(a)(1)(B) excludes it from gross income. IRC §108(a)(1)(A) excludes from gross income debt discharged in a “title 11 case” in a bankruptcy proceeding under title 11 of the United States Code (i.e., the Bankruptcy Code). To qualify, a taxpayer must be under the bankruptcy court’s jurisdiction and the court must grant the discharge of indebtedness directly or pursuant to a plan approved by the court. IRC § 108(d)(2). The bankruptcy exclusion applies to all proceedings under title 11, including both chapter 7 liquidations and chapter 11 reorganizations. If a discharge of indebtedness occurs when the taxpayer is insolvent IRC §108(a)(1)(B) excludes it from gross income. Whether a taxpayer is insolvent is determined immediately before the discharge. Taxpayers can qualify to exclude cancelled debt from taxable income if (1) they incur debt directly in operating a farm, (2) more than half their income from the prior three years was from farming, and (3) the loan was owed to a person or agency regularly engaged in lending. There are other exceptions as well that might be considered; however, these may not all apply to PPP loan forgiveness, so taxpayers and practitioners should take caution in researching potential arguments against inclusion in franchise tax gross receipts.

The Texas Legislature convened for its 87th Regular Session on January 12, 2021. It could require a legislative change to make the corresponding adjustment to remove forgiven PPP loan proceeds from revenues and gross receipts and still allow the associated expenses to be included in COGS or compensation.

## **VI. Conclusion**

Given the restrictions of the COVID-19 pandemic and the changed procedures applying to the legislative session, it is uncertain whether a legislative change would be prioritized. However, since it would benefit small businesses with forgiven PPP loans, it could be just the type of legislation Texas might want to pass during a pandemic. In the meantime, businesses and their advisors should plan for the potential inclusion of forgiven PPP in revenues and gross receipts, and ascertain whether the associated costs would be allowed for inclusion in COGS or compensation. Rep. Geren and Sen. Hancock have filed bills to exclude PPP loan forgiveness from franchise tax revenue calculations. *See* S.B. No. 372 and H.B. 1195. These will be ongoing issues as new batches of PPP loans are administered by the SBA in 2021.



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