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SMALL BUSINESS

Multibillion-Dollar Tax Muddle Hovers Behind Small-Business Loan Program

Tax experts say Congress should clarify whether expenses tied to loan forgiveness are deductible

People lining up late last month at the Arkansas Workforce Center in Fayetteville, Ark.

PHOTO: JT WAMPLER/ASSOCIATED PRESS

By Richard Rubin

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WASHINGTON—A tax ambiguity that could amount to tens of billions of dollars or more is lurking in the small-business loan forgiveness program the government is using to combat the economic impact of the coronavirus pandemic.

The relief law passed by Congress last month created the $350 billion Paycheck Protection Program, designed to fill small businesses' revenue holes during the crisis and encourage them to keep workers on their payrolls. The loans can be forgiven if companies use the money for payroll, rent and other expenses. Though the money is just starting to go out to businesses now, the crucial tax consequences at the end of the loan forgiveness are murky.

"We have yet another source of confusion for beleaguered employers who are trying to figure out what to do," said Marty Sullivan, chief economist at Tax Analysts, the nonprofit publisher of Tax Notes.

The new law clearly states—contrary to typical tax law—that forgiven debt won't be counted as taxable income. But the law says nothing about whether those ordinary expenses for salaries and other costs still trigger deductions like they normally do.

If they don't yield deductions, then the program is basically a wash from a tax perspective, which limits the potential value of the program. Tax-free income comes in, nondeductible expenses go out, and businesses pay taxes only on the revenues and expenses outside the loan forgiveness program. The forgiveness would still give a significant boost to struggling firms and help them survive.

But if businesses can deduct those expenses, then the program contains a benefit much more powerful than the loan forgiveness alone. Tax-free income comes in and deductible expenses go out. Those deductions could offset other income from the business or other income generated by the business owners. Even if that leads to businesses reporting tax losses now, they can use other provisions of the new law to use those losses against prior years' profits and claim refunds.

In this case, someone who gets $50,000 of loan forgiveness to cover $50,000 of deductible expenses would have no income and $50,000 of deductions. At a 22% tax rate, that is worth $11,000.

"The bottom line is they're going to have to clarify this and clarify it very quickly," said Tony Nitti, an accountant at RubinBrown LLP. "People need to know that information now that are borrowing."

The Senate Finance Committee is aware of the questions about deductibility, committee spokesman Michael Zona said, adding that the goal of the law is to provide as much liquidity to businesses as possible. He said the Finance Committee, which handles tax policy, is working with the Senate Small Business and Entrepreneurship Committee, the Small Business Administration and the Treasury Department on this and other implementation issues.

The result isn't a small, technical tax matter.

On a $350 billion program—one lawmakers are considering expanding to about $600 billion—the value of deductions is the size of the loan forgiveness multiplied by the tax rate of the business owners. If the program expands, that could easily top $100 billion.

It isn't precisely clear what Congress intended. On one hand, lawmakers explicitly made the loan forgiveness tax-free, suggesting they were trying to confer a benefit on small-business borrowers.

But Congress didn't turn off Section 265 of the tax code, which generally disallows deductions associated with tax-free income. Richard Reinhold, who teaches tax law at Cornell University, brought this issue to the administration's attention earlier this week, according to Tax Notes.

In other cases, Congress has encouraged such a double benefit; religious leaders who receive tax-free housing allowances can still deduct their mortgage interest and property taxes under an exception to the normal rules.

The Treasury Department and the Internal Revenue Service could try to write administrative rules that would offer guidance on the deductions but it would be easiest if Congress addresses this in future rounds of legislation, said Tom West, a former Treasury Department official now at KPMG LLP.

"It would be very helpful to have a clear uniform treatment for this forgiveness," he said.

Making the loan forgiveness tax-free without allowing the deductions almost defeats its purpose, because it yields the same basic result as making the loan forgiveness taxable and allowing the deductions. That suggests that Congress may have intended to allow deductions against tax-free income, but tax experts say they can't be sure without further clarification from the government.

"They couldn't have intended what they wrote but they wrote what they wrote," said Monte Jackel, a Maryland tax lawyer and former IRS official who said he expects the deductions to be allowed eventually. "There's no way out of the box other than to get a legislative fix."

Spokespersons for Treasury and the IRS didn't comment.

In the meantime, Robert Kihm, an accountant in Centennial, Colo., isn't sure what to do. First, he told his small-business clients they could get loan forgiveness and the tax deductions. Now, he isn't so certain.

"They've thrown this out there without any regulations or any advice or anything we can use," he said. "It's maddening to us tax preparers trying to do the right thing for our clients."

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