

Notice: Treatment of Paycheck Protection Program (PPP) Loans Under the Michigan Income Tax Act

Date: April 19, 2021

This notice outlines the State of Michigan's conformity to the federal income tax treatment of loans issued under the Paycheck Protection Program and provides additional guidance the various income tax issues raised by the federal loan program.

Overview of the Paycheck Protection Program

The Paycheck Protection Program (PPP) was originally created under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, enacted March 27, 2020,[1] to provide cash flow assistance to small businesses impacted by the COVID-19 pandemic. Under the program, eligible borrowers can apply for and receive federally guaranteed loans to be used for the payment of payroll and certain other qualified business expenses. For borrowers that use the loan proceeds to pay those qualified expenses, the borrower is eligible for complete or partial forgiveness of the loan.

As originally enacted, any loan forgiven under the program was specifically excluded from gross income for federal income tax purposes. Section 1105(i) of the CARES Act provided:

- i. Taxability.- Canceled indebtedness under this section shall be excluded from gross income for purposes of the Internal Revenue Code of 1986.[2]

But, while Section 1105(i) held that forgiven PPP loans were excluded from gross income, no similar provision was enacted authorizing a deduction of the business expenses paid for by those forgiven loans. Because the Internal Revenue Code (IRC) generally prohibits a deduction for expenses related to tax-exempt income, the IRS, through Notice 2020-32, held that taxpayers could not deduct otherwise deductible business expenses to the extent that the payment of such expenses resulted in the forgiveness of a PPP loan.[3] Therefore, under the original program implemented under the CARES Act, the forgiveness of the loan was not included in gross income, but otherwise deductible business expenses paid by that loan were no longer deductible on the federal return.

In response, Congress clarified the intended tax treatment of PPP loans by enshrining the exclusion from gross income and the deductibility of all expenses through the Consolidated Appropriations Act (CAA), enacted on December 27, 2020.[4] Section 276 of the CAA provided, in relevant part:

For purposes of the Internal Revenue Code of 1986,

- (1) no amount shall be included in the gross income of an eligible entity . . . by reason of forgiveness of indebtedness described in clause (ii) of such subparagraph,
- (2) no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income provided by paragraph (1).[5]

The CAA therefore clarified that the amount of the forgiven loan must be excluded from gross income of the taxpayer and all expenses required to be paid from the loan proceeds remain fully deductible on the federal return.[6] Section 276(a) was specifically intended to clarify the original intent of the PPP loan program and was applicable to all taxable years ending after the date of the original enactment of the CARES Act, [7] but the provisions of the CAA also apply to all future PPP loans.[8] In other words, all PPP loans will receive the federal tax treatment authorized under the CAA.

I. The Paycheck Protection Program (PPP) and the Michigan Income Tax Act

There are several important tax considerations for individual or corporate borrowers of PPP loans subject to the income tax under the Michigan Income Tax Act. These issues include Michigan's conformity to the exclusion of PPP loan forgiveness and expense deductibility, as well as the general impact of PPP loan forgiveness on the calculation of the sales apportionment factor, the calculation of gross receipts for corporate taxpayers, and the calculation of total household resources.

A. PPP and the Michigan Income Tax Base

The tax imposed on individuals under Part 1 of the Michigan Income Tax Act (i.e., the Individual Income Tax (IIT))[9] and on corporations under Part 2 of the Act (i.e., the Corporate Income Tax (CIT))[10] both begin with amounts that are determined for federal income tax pursuant to federal law. Indeed, for individuals subject to tax under the IIT, the Michigan income tax base begins with federal "adjusted gross income as defined under the internal revenue code," subject to certain other adjustments set forth within the Act.[11] Likewise, for corporations subject to tax under the CIT, the tax base begins with "federal taxable income as defined in section 63 of the internal revenue," subject to certain adjustments prescribed by the Act.[12] The tax base for both individuals and corporations in Michigan therefore incorporates the computation of income that is determined under the relevant provisions of the Internal Revenue Code.

For this purpose, "Internal Revenue Code" is defined under both Parts to mean "the United States internal revenue code of 1986 in effect on January 1, 2018 or, at the option of the taxpayer, in effect for the tax year." [13] Importantly, the reference to the Internal Revenue Code is not limited only to the specific provisions codified within Title 26 of the United States Code,[14] as it also includes "other provisions of the laws of the United States relating to federal income taxes." [15] As such, it is generally the intent that income subject to the state income tax in Michigan "be computed in like manner and be the same as provided in the internal revenue code." [16]

In this context, the PPP program was originally created under the CARES Act and later clarified by the CAA, as Section 276 of the CAA excluded forgiven loans from gross income and authorized the deduction of certain business expenses required to be paid through the PPP loan.[17] Although Section 276 of the CAA is not a specific provision within the IRC, it nonetheless constitutes a provision of "the laws of the United States relating to federal incomes taxes." [18] Consequently, forgiven PPP loans that are excluded from the computation of federal income tax are similarly excluded from the computation of the tax base under both the IIT and CIT. Likewise, business expenses paid for by PPP loans that are deductible at the federal level remain deductible in computing the Michigan tax base under the IIT and CIT. In other words, the Michigan tax base for both individuals and corporations using the IRC in effect for the tax year fully conforms to the federal income tax treatment of PPP loans.[19]

B. PPP and Sales Factor Apportionment

Both individual and corporate taxpayers apportion income using a single sales factor apportionment formula that is determined under the respective provisions of Part 1 or Part 2 of the Act. Although the technical rules for the determination and sourcing of sales differ under each Part, the overall formula is identical insofar as the sales factor is determined from a fraction that compares Michigan sales (i.e., the numerator) to total sales everywhere (i.e., the denominator).

Under the IIT, the allocation or apportionment of business income is performed under Chapter 3 of the Act.[20] For purposes of that chapter, "sales" is defined, in pertinent part, to mean "all gross receipts of the taxpayer." [21] To compute the sales factor, each sale must be sourced to a location either within or outside of Michigan. In applying the sourcing rules to transactions that do not involve tangible personal property, the sale is generally sourced to the location of the income-producing activity.[22] Here, to the extent that a PPP loan is forgiven, it is a gross receipt that must be included in the sales factor calculation. In sourcing that sale, the forgiven PPP loan should be sourced to the commercial domicile of the entity.[23] The forgiven amount of a PPP loan is therefore included in the denominator of the sales factor calculation for all taxpayers and included in the numerator only for those borrowers with commercial domicile in Michigan.

Under the CIT, the allocation or apportionment of income is performed in accordance with Chapter 14 of the Act.[24] For purposes of computing the sales factor under the CIT, "sales" is generally limited to amounts received by the taxpayer as consideration received for the transfer of property that can be characterized as stock in trade, for the performance of certain services, or for the rental, lease, licensing, and use of tangible and intangible property.[25] Defined as such, neither the borrowing of a loan nor the subsequent forgiveness of that loan is a "sale." PPP loans, including the forgiven amount of any such loan, are therefore not included in either the numerator or the denominator of the sales factor computation for corporations subject to the CIT.

C. PPP and "gross receipts"

Under the CIT, gross receipts are measured for several different contexts, including the threshold for determining whether a taxpayer is required to file a return and pay the tax[26] and the determination of whether the taxpayer qualifies for the small business alternative credit.[27] The term "gross receipts" is defined, in relevant part, to mean "the entire amount received by the taxpayer from any activity whether in intrastate, interstate, or foreign commerce carried

on for direct or indirect gain, benefit, or advantage to the taxpayer or to others," and subject to various statutory exceptions.[28] Loan amounts required to be repaid are generally excluded in gross receipts of a corporate taxpayer.[29] Thus, a PPP loan is included in gross receipts under the CIT only to the extent that the loan is forgiven.

D. PPP and Total Household Resources

Total Household Resources (THR) is measured to determine eligibility for various individual income tax credits under the IIT. THR is defined as "all income received by all persons of a household in a tax year while members of a household,"[30] where "income" is defined to mean "federal adjusted gross income plus all income specifically excluded or exempt from the computation of federal adjusted gross income." [31] Because THR is based on federal AGI, its calculation will include PPP expenses deductible at the federal level. But, because forgiven PPP loans are specifically exempt from the computation of federal adjusted gross income,[32] the amount of the forgiven loan must be added to THR. Any portion of a PPP loan that is not forgiven is treated similar to other loans and therefore excluded from THR.

II. PPP and Taxpayer Recordkeeping Obligations

The treatment of PPP loans in Michigan will generally be accorded the same treatment as provided on the federal return filed for that period. Because in these cases any income included or excluded from the Michigan return will match that of the federal return, additional documentation substantiating the PPP loan is not required for Michigan return filing purposes. Taxpayers therefore do not need to include any specific loan documentation, including proof of forgiveness or proof of expenses, with the filing of the Michigan individual or corporate income tax return.

However, even if PPP loan documentation is not required to be submitted with an original Michigan income tax return, all taxpayers are nonetheless required to keep accurate and complete records necessary for an accurate determination of their tax liability.[33] Borrowers of PPP loans should therefore retain sufficient documentation of their participation in the PPP loan program. Sufficient documentation can be provided in various forms, but should generally include proof of the taxpayer's application and subsequent receipt of the PPP loan, the amount of the loan subsequently forgiven, and the business expenses paid through loan proceeds. Examples of sufficient documentation in this context may include, but is not limited to:

- Documentation regarding approval and subsequent receipt of the PPP loan
- Lender documentation regarding receipt of PPP loan proceeds and subsequent expense payments
- Submitted loan forgiveness application
- Communications from either the lender or the SBA regarding the status or amount of loan forgiveness
- Any applicable loan documentation identifying the extent of loan forgiveness.

[1] PL 116-136.

[2] PL 116-136, Section 1105(i).

[3] IRS Notice 2020-32.

[4] PL 116-260.

[5] PL 116-260, Section 276(a)-(b).

[6] *Id.* at Section 276(a)(1)(i)(1)(2)

[7] PL 116-260, Section 276(a).

[8] PL 116-260, Section 276(b).

[9] MCL 206.1 *et seq.* The tax base on a resident estate or trust under Part 1 is based on "federal taxable income as defined in the internal revenue code." MCL 206.36.

[10] MCL 206.601 *et seq.*

[11] MCL 206.30(1).

[12] MCL 206.607(1)

[13] MCL 206.12(3); MCL 206.607(6).

[14] 26 USC § 1 *et seq.*

[15] MCL 206.2(2); MCL 206.601.

[16] MCL 206.51(9); see MCL 206.601.

[17] PL 116-260, Section 276(a)-(b).

[18] MCL 206.2(2); MCL 206.601. Other tax provisions included within the CARES Act may be subject to same general analysis. For example, Section 2301(e) of the Act provides that the rules of IRC 280C(a) will apply for recipients of the Employee Retention Credit (ERC), effectively resulting in the disallowance of certain business expenses ordinarily deductible by ERC recipients. Because Section 2301(e) is a provision relating to federal income tax laws, it is treated as incorporated as part of the IRC, even if not included as a technical amendment to IRC 280C(a). Consequently, expenses disallowed for recipients of the ERC remain disallowed on the Michigan return and no adjustment to the Michigan return is permitted.

[19] The analysis differs in the rare cases where a taxpayer that elects to use the IRC in effect on January 1, 2018. MCL 206.12(3); MCL 206.607(6). The CAA provision - enacted March 27, 2020 - excluding forgiven PPP loans from gross income was neither within the IRC on January 1, 2018 nor given retroactive impact; therefore, a taxpayer electing to use this version of the IRC must include forgiven loan amounts in gross income, but may deduct all business expenses paid for by loan proceeds.

[20] MCL 206.110 *et seq.*

[21] MCL 206.20(1).

[22] MCL 206.123.

[23] The state where an entity is directed or managed is generally its commercial domicile. MCL 206.6(1).

[24] MCL 206.661 *et seq.*

[25] MCL 206.665.

[26] MCL 206.621(1).

[27] MCL 206.671.

[28] MCL 206.607(4).

[29] MCL 206.607(4)(g)(ii).

[30] MCL 206.508(4).

[31] MCL 206.510.

[32] PL 116-260, Section 276(a)-(b).

[33] MCL 205.28(3).