Not COVID Friendly – Kentucky Disallowing Deductions for Expenses Covered by PPP Loans

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When the federal government released its Paycheck Protection Program (PPP) in March 2020 as a part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, thus providing a variety of COVID-19 relief initiatives, it was clear that the program would deliver short-term cash flow relief to select businesses. However, the long-term effects of accepting and utilizing PPP loan funds on the overall financial success of businesses were largely unknown. In particular, the CARES Act failed to specify whether businesses using forgivable PPP loans to pay the covered business expenses could later deduct these expenses from their taxable income.

While the U.S. Treasury Department and the IRS took the position that allowing these deductions would be "double dipping," as was said by then-Treasury Secretary Steven Mnuchin, Congress provided that this interpretation was contrary to its intent for enacting the CARES Act. Many tax practitioners and businesses also identified the hypocrisy of extending forgivable loans to struggling businesses only to later force them to pay for these expenses in a non-deductible manner when filing their taxes. Congress addressed these concerns in its most recent COVID-19 relief legislation.

On December 21, 2020, Congress passed the Consolidated Appropriations Act (CAA) and included therein explicit clarification on the federal tax aspects of PPP loan forgiveness. The CAA provides that businesses that used PPP loan funds to cover the allowable ordinary and necessary business expenses can still deduct these expenses on their 2020 federal income tax returns.

While the issue has now been settled for federal income tax purposes, states have taken varying positions as to whether they will follow federal lead on allowing these deductions for state income tax purposes. In particular, the Kentucky Department of Revenue recently released a Q&A on its website providing that it will ***not*** allow businesses to deduct expenses paid for by PPP loans for

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Kentucky income tax purposes.

Along with instructing that these federal deductible expenses must be added back for Kentucky income tax purposes, the Department also provided a litany of other contrary positions to allowances provided in the CARES Act. These include that the Department will not recognize the net operating loss (NOL) carrybacks allowed for up to five (5) years under the CARES Act, the suspension of the 80% limitation on NOLs, the charitable contribution limitation increase, the increase to the net business interest expense limitation, the "above the line" charitable contribution deduction amendment, and the IRC Section 461 business loss limitation amendment. Its reasoning for not adopting federal procedures regarding these issues is that these changes would require the Kentucky General Assembly to amend the state's existing statutes governing Kentucky income tax and the conformity date of the IRC therein. However, the Department did provide that it will follow the federal income tax position for the core treatment of loan forgiveness under the PPP.

While some states such as New York and Illinois have rolling conformity with federal changes, Kentucky is not alone in states that have not adopted the federal position on business expense deductions. The North Carolina Department of Revenue, for example, has also issued explicit guidance that it will not allow business expense deductions for expenses covered by PPP loans.

However, a short 2021 Legislative Session is currently underway in Kentucky. Thus, many believe the General Assembly may quickly nip this issue in the bud along with finalizing the 2021-2022 budget. We will continue to monitor the development of this issue. For more information on PPP loan forgiveness and tax implications of same, visit Frost Brown Todd's Tax Law Defined Blog.

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