

## OBSERVATIONS

### CARES Act – Business Tax Provisions 4

March 31, 2020

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As referenced in our prior Blogs, the CARES Act was signed by the President on Friday and is now law. The Act has numerous provisions, one of which is the Paycheck Protection Program (PPP). PPP will provide loans to businesses for payroll and certain other costs. One of the most significant provisions of these loans is that some or all of it can be forgiven in the future, essentially converting a loan into a government grant.

The amount of loan that can be provided is based solely on payroll and is the subject of our previous blog #3.

The use of the funds can go beyond payroll costs to include rent, utilities and some loan items and is the subject of our previous blog #2.

The following is our reading of the Bill specifically as it relates to the repayment process and forgiveness provisions. Please be aware that the Bill and our interpretation are subject to any administrative interpretation issued by the Small Business Administration.

#### Loan Deferral?

The loans will provide complete payment deferment for borrowers for a period of not less than six (6) months and not more than twelve (12), including amounts for principal, interest and fees.<sup>1</sup>

During this time, the SBA/Administrator will make payments of principal and interest to the lender for the covered loan. The interest will be added to the principal of the covered loan which is subject to forgiveness.

#### What is the interest rate?

A covered loan shall bear an interest rate not to exceed four (4) percent.<sup>2</sup>

<sup>1</sup> Act Section 1102; Page 26 adds 15 U.S.C. 14A 636 (a) (36) (M), herein, SBA

<sup>2</sup> Ibid– Page 25

## Loan Forgiveness

An eligible recipient shall be eligible for forgiveness of indebtedness on a covered loan in an amount equal to the sum of the following costs incurred and payments made during the “covered period” (defined below):

- (1) Payroll costs (this includes various items including self-employment income, see blog #2)
- (2) Any payment of interest on any covered mortgage obligation (which shall not include any prepayment of or payment of principal on a covered mortgage obligation).
- (3) Any payment on any covered rent obligation.
- (4) Any covered utility payment.<sup>3</sup>

The term “covered period” means the 8-week period beginning on the date of the origination of a covered loan.<sup>4</sup>

Any amount not forgiven would remain in place as a regular SBA loan that has amortization at a “maximum maturity of 10 years”<sup>5</sup>. We presume the length of the loan/amortization period will be established at time the loan is created and presumably most if not all will be set for ten (10) years from the original date of the loan.

### Could the forgiveness amount be limited even if the loan is used for eligible expenses?

Yes, there are various provisions in the bill that reduce the amount that can be forgiven:

1. The amount of loan forgiveness shall not exceed the principal amount of the financing made available under the applicable covered loan.<sup>6</sup>
2. Forgiveness amounts may be reduced if there is a reduction in Employees or Wages.
  - a. Reduction in employee levels<sup>7</sup>
    - i. Employee levels means the number of average full time equivalent employees per month (thus an employer with part time and seasonal employees will require a separate calculation to determine full time equivalent employees).
    - ii. If employee levels during the covered period are less than a comparison period, then there is a calculation to determine the reduction of the amount forgiven.
    - iii. The comparison period is either of the following and is at the election of the loan recipient;
      1. February 15, 2019 and ending on June 30, 2019, or
      2. January 1, 2020 and ending on February 29, 2020.
    - iv. The calculation is done by multiplying the total loan amount by (the covered period employee levels divided by the optional measurement period employee levels).

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<sup>3</sup> Act Section 1106, Page 41

<sup>4</sup> Ibid Page 41

<sup>5</sup> Ibid Page 25

<sup>6</sup> Ibid Page 45

<sup>7</sup> Ibid Page 45

- v. Example: assume there were 10 employees during the comparison period of February 15, 2019 through June 30, 2019 and only 8 employees during the covered period; the calculation is 8 divided by 10 is 80%, so only 80% of the loan would be forgiven and 20% would be required to be repaid.
  - vi. Adjustments are available for seasonal employees.
- b. Reduction in employee wages<sup>8</sup>
- i. If wages of an employee were reduced in the covered period by more than 25% from the prior quarter, then any amount over the 25% reduction will not be forgiven.<sup>9</sup>
  - ii. This refers to employees who did not have compensation during 2019 of \$100,000 or more.<sup>10</sup>

#### What if I rehire staff that have been let go prior to the loan?

Essentially, if you replenish staff and/or wages to amounts in place at February 15, 2020, then the reduction of forgiveness referenced above is reduced. The criteria for this are as follows;

1. It applies to employees let go or wages reduced between February 15, 2020 and 30 days after enactment of the Act (presumably April 26<sup>th</sup>, 30 days after the President signed the Bill).
2. If employee levels and/or wage levels are restored to their February 15<sup>th</sup> 2020 amounts prior to June 30, 2020, then the debt forgiveness reduction associated with reductions in employees and/or wages do not include these amounts.<sup>11</sup>
3. There is also an allowance for tipped workers.<sup>12</sup>

#### How is the forgiveness taxed?

Amounts which have been forgiven shall be considered canceled indebtedness by a lender authorized under section 7(a) of the Small Business Act (15 U.S.C.636(a)).<sup>13</sup>

However, 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 described in subsection (b) shall be excluded from gross income.<sup>14</sup> So on the face of it, it implies that the income forgiveness is not taxable at all, but potentially the expenses paid with the loan proceeds that were forgiven are still deductible. We expect to see further guidance if this is indeed the case.

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<sup>8</sup> Ibid page 47

<sup>9</sup> Ibid Page 47

<sup>10</sup> Ibid Page 47

<sup>11</sup> Ibid Page 47-48

<sup>12</sup> Ibid Page 47

<sup>13</sup> Ibid Page 41

<sup>14</sup> Ibid Page 52

Considerations:

1. Loan application requirements are still being clarified including documentation required.
  - a. However, at a minimum we expect banks will require payroll records and organizational records to prove when the entity came into being.
  - b. There are also certifications that are required by the applicant: see Blog #3.
2. Forgiveness requirements are VERY strict about documentation. Failure to provide required documentation will result in amounts NOT being forgiven and having to be paid back.
3. We suggest to our clients they consider doing the following;
  - a. Have the loan proceeds put into a separate bank account in which only loan proceeds are deposited into this account.
  - b. Disbursements would come from this bank account and would include only those eligible for forgiveness.
  - c. Keep receipts and records of every disbursement including;
    - i. Payroll recordings including payroll ledgers, federal and state payroll returns
    - ii. Copies of checks
    - iii. If electronic payments are made, be sure the bank statement shows whom the payment was made to or keep some form of electronic record of the payment
  - d. Do not increase salaries to staff from prior periods, particularly the officers or owners, during the covered period including amounts for retirement or profit sharing.
  - e. If rent payments are made to a related party, do not increase rent costs.

Given the complexity of the requirements and the importance and value that can be achieved by having procedures in place for compliance, we encourage clients to contact us to assist them with the application process and with establishing procedures for proper documentation to allow for forgiveness.

Again, there may be additional information and interpretations which may alter our current understanding, but we will be providing further blogs as information becomes available.

**MALONEY & KENNEDY, PLLC**