K&L GATES

MEMO

TO:

FROM: Elizabeth H. Evans

DATE: January 25, 2021

RE: Paycheck Protection Program

BACKGROUND

The Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act (Pub. L. 116-260) ("Economic Aid Act") passed Congress with strong bipartisan support and was signed into law by President Trump on December 27, 2020. It contained provisions to renew access to the Paycheck Protection Program for small businesses (such renewed program, "PPP2"). On January 6, 2021, the Small Business Administration ("SBA") released two separate Interim Federal Regulations (IFR) to implement PPP2[1]. On January 8, 2021, the SBA gave formal notification as to when the portal for PPP2 applications will open.[2] The last date to submit an application for PPP2 is March 31, 2021.

ELIGIBILITY

The rules for eligibility have changed since the first round of Paycheck Protection Programs loans ("PPP1"). Each Borrower applying must have less than 300 employees. The same affiliation rules that came into effect during the PPP1 program apply to the PPP2 program.

Publicly listed companies are excluded from PPP2. Also excluded are companies that have affiliates in the People's Republic in China ("PRC") or the Special Administrative Region of Hong Kong ("HK") or that have a PRC and HK national on the board of the Borrower. Borrowers are not eligible if they are required to register as a foreign agent or if the Borrower's primary purpose

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[1] The full text of the regulations may be found at the following links: **IFR on Second Draw Loans** and **Consolidated PPP IFR**

[2] https://home.treasury.gov/news/press-releases/sm1230

is political lobbying activity. Borrowers who receive a "shuttered venue operations grant" under the Economic Aid Act and Borrowers who are the subject of bankruptcy proceedings are also not eligible for PPP2, as SBA is committed to preserving the availability of Second Draw PPP Loan funds for businesses still in operation.[3] Finally, a Borrower who is deemed to be an "Unresolved Borrower" is not eligible to borrow under PPP2. An "Unresolved Borrower" includes any borrower whose first PPP loan is being reviewed by the SBA. Lenders will be notified by the SBA if the applicant is an "Unresolved Borrower," which is important because the IFR indicates that the borrower may be deemed "unresolved" if "information in the SBA's possession indicates that the borrower may have been ineligible to have received its first PPP loan." However, the IFR also contains the requirement that the SBA work expeditiously to resolve any issues in respect of "Unresolved Borrowers" and is setting aside funds for those "Unresolved Borrowers" that are eventually cleared.

APPLICATION PROCESS

Although a Borrower may apply for a PPP2 loan, even if it still has unused amounts under their PPP1 loan, it is clear that the PPP2 loan will not be disbursed until the initial PPP1 funds are fully utilized. In order to apply for a PPP2 loan, Borrowers need to: (a) demonstrate a revenue decline of greater than 25% in any quarter of 2020 over the corresponding 2019 quarter or (b) submit FY 2020 tax returns showing a 25% decline over FY 2019. Revenue is defined to mean "Gross Receipts" in accordance with current SBA regulations[4]; provided, however, that proceeds from PPP1 that were subsequently forgiven by Treasury are specifically *excluded* from the definition of "Gross Receipts."

There are also special rules for Borrowers who have engaged in merger and acquisition activity during 2019 and 2020 in order to ensure that Gross Receipts fairly reflect this activity when comparing years. Entities acquired during 2020 are required to submit evidence as if they had been owned by the purchaser during the entire period of measurement, including the look back to relevant quarters of 2019. The converse of this is that entities that were sold are completely excluded from the period of measurement (as they should not be double counted since the purchaser may use those receipts). An exception to this is where a "segregated division" is sold. In this case, the "Gross Receipts" are counted by the seller until the date of sale.

[3] Preserving funds for such businesses is necessary because only businesses that are still in operation will retain employees, which is a primary purpose of the PPP.

[4] The SBA regulations define "Gross Receipts" to include: (1) all revenue in whatever form received or accrued (in accordance with the entity's accounting method) from whatever source, including from the sales of products or services, interest, dividends, rents, royalties, fees, or commissions, reduced by returns and allowances, and (2) cost of goods sold (provided that subcontractor costs, reimbursements for purchases a contractor makes at a customer's request, investment income, and employee-based costs such as payroll taxes are not deductible) and to exclude: (1) net capital gains or losses as these terms are defined and reported on IRS tax return forms, (2) taxes collected for and remitted to a taxing authority if included in gross or total income, (3) proceeds from related transactions between a concern and its domestic or foreign affiliates; and (4) amounts collected for another by a travel agent, real estate agent, advertising agent, conference management service provider, freight forwarder or customs broker.

AMOUNT AND USES OF PPP2 FUNDS

Borrower are eligible to borrow up to the lesser of (1) two and a half monthly payroll costs or (2) $2,000,000, unless they are borrowers with a North American Industry Classification System ("NAICS") code of 72 on their most recent tax return (in which case they can borrow up to three and a half times monthly payroll costs). Payrolls costs can be calculated off of either the 2019 and 2020 calendar year or the actual twelve months prior to disbursement. Since the PPP2 loans are all to be made within this first quarter of 2021, the SBA believes it is easier for most PPP2 Borrowers to use the 2020 calendar year. Businesses that are part of a single corporate group may not receive more than $4,000,000 of Second Draw PPP Loans in the aggregate. This is a significant downsizing from the corporate limit of $20,000,000 with respect to PPP1.

At least sixty percent (60%) of the PPP2 funds must be used for Payroll Costs for the PPP2 loans to be eligible for forgiveness. Payroll costs, however, have been expanded to include group insurance benefits payments. Other expenses that can be covered by PPP2 funds include: operation expenditures, property damage costs, supplier costs and worker protections costs. Borrowers can now choose a covered period for the PPP loan of any duration from eight to twenty-four weeks. Also, Economic Injury Disaster Loans that were previously refinanced with PPP1 loan proceeds are now forgiven and are not refinanced (or netted off) the amount which may be borrowed under the PPP2 program.

DEDUCTIBILITY

In addition to the IFRs released by the SBA, on January 6, 2021, the IRS issued a formal revenue ruling[5] that clearly overrode previous guidance and stated that expenses paid with forgiven PPP loan proceeds are still deductible. This is consistent with the language under the Economic Aid Act.

EMPLOYEE RETENTION CREDIT

The enactment of the Consolidated Appropriations Act, 2021, also extended and expanded the opportunity for small businesses to claim the Employee Retention Credit ("ERC"). Under the amendments to the original provisions of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), eligible employers have until ***June 30, 2021*** to claim tax credit on wages paid to those employees that they retained through the coronavirus health crisis.

a. ERC Now Available to Employers that Borrowed under PPP1

Although the ERC was (under the CARES Act) unavailable to those employers who participated in the PPP1 program, the amendments now permit those businesses who borrowed under PPP1 to take advantage of the ERC. This portion of the new law is retroactive to the effective date of the CARES Act and applies to all "qualifying wages" paid after March 12, 2020. It is important to note, however, that the ERC may only be utilized against wages that are not

[5] Revenue Ruling 2021-02

forgiven or expected to be forgiven under the PPP regulations. Wages that are forgiven or expected to be forgiven are *not* qualifying wages for purposes of the ERC.

The CARES Act provided that businesses qualified for the ERC if their business operations were either: (1) fully or partially suspended by a lockdown order or (2) if, for any quarter in 2020, gross receipts were less than 50% of gross receipts for the same quarter in 2019. Therefore, under the second test, the employers would have to demonstrate a 50% reduction in gross receipts. The CARES Act also limited what constituted qualifying wages for purposes of applying the 2020 ERC. Employers with 100 full-time employees or less (after applying the affiliate aggregation rules) could apply the ERC to all wages paid. Employers with more than 100 full-time employees could only utilize the ERC for qualifying wages paid to employees *not* working or *not* providing services. Finally, wages that were increased during an eligible quarter (an "ERC Quarter") did *not* qualify for the ERC because Section 2301(c)(3)(B) of the CARES Act capped qualifying wages at what the employee would have been paid for working an equivalent duration during the 30-day period immediately preceding such ERC Quarter. These limits on eligibility and what constitutes qualifying wages for purposes of the applying the ERC to 2020 have not been changed retroactively.

Accordingly, employers who would otherwise qualify under the CARES Act (now expanded to include borrowers under PPP1), may use the ERC to be claimed against 50% of qualifying wages paid up to $10,000 per employee annually for wages paid between March 13, 2020 and December 31, 2020. This effectively capped the credit at $5,000 per employee (the credit for $10,000 in qualified wages x 50% tax credit rate). As a result, employers who paid qualified wages (as described above) in excess of the amount of the forgiven (or to be forgiven) PPP loan, should now be able to file amended employment tax returns to claim the ERC.

b. 2021 Employee Retention Credit

The new statute expands the applicability and size of the ERC as of January 1, 2021. Qualifying employers now includes businesses with 500 or fewer employers (after applying the affiliate aggregation laws) and does not distinguish between working and non-working employees below the 500 full-time employee threshold. The new law also lowers the bar with respect to the reduction in gross receipts required to qualify for the 2021 ERC. Effective January 1, 2021, an employer qualifies for the ERC is such employer's business operations are either fully or partially suspended by a lockdown order or if, for any quarter in 2021, gross receipts are less than 80% of gross receipts for the same quarter in 2019. To claim the ERC in 2021, employers must only show a 20% reduction in gross receipts when compared to 2019. Additionally, Section 2301 (c)(3)(B) of the CARES Act has been deleted by the new statute, and this means that increased wages during any ERC Quarter (*e.g.* hazard pay or bonuses) are now eligible (up to the $10,000 per employee cap). Qualifying employers (including those who borrow under PPP2) may now claim the ERC against 70% of qualifying wages of up to $10,000 per employee paid during the first two quarters of 2021. This expands the aggregate maximum per employee credit to $14,000 (($10,000 in qualified wages x 70% tax credit rate) x 2 = $14,000).

The new statute also adds the ability for employers to receive the ERC (which is usually taken by reducing required payroll tax deposits) in advance. If an employer has fewer than 500 full-time employees, it may elect for any calendar quarter to receive an advance payment of the credit for that quarter in an amount not to exceed 70% of the average quarterly wages paid by the employer in 2019. Of course, this will be eventually reconciled with the actual ERC. If the advance payments end up exceeding the actual ERC, the employer's pay roll tax will be increased for that calendar quarter by the excess.