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INSIGHT: Congress Adds 'Flexibility' to Loan Forgiveness and Corresponding Tax Consequences



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The House and Senate recently passed the Paycheck Protection Program Flexibility Act (Flexibility Act) which, if signed into law by the President, would address many of the complaints small businesses have with their Paycheck Protection Program loans (PPP loans), particularly the lack of autonomy over how and when expenses can be made and still qualify for loan forgiveness. The most pressing complaints for many small businesses have been the requirement that at least 75% of eligible expenses be for payroll costs and the relatively short eight-week covered period during which expenses must be paid or incurred to be eligible for loan forgiveness.

Further complicating the original covered period's brevity was confusion over whether, during such period, expenses had to be both paid and incurred to be considered eligible expenses. This confusion was later dispelled after the Small Business Administration (SBA) released an Interim Final Rule confirming a broader reading of the CARES Act's language on May 22, eight weeks after the CARES Act was enacted and well into many businesses' covered periods.

Currently, to receive the full amount of loan forgiveness available at least 75% of eligible expenses have to be for payroll costs and conversely, no more than 25% of eligible expenses can be for non-payroll costs. Under the Flexibility Act, businesses need only allocate 60% of their eligible expenses for payroll costs and could spend up to 40% on mortgage interest and certain rent and utility payments. This business friendly change is very much welcomed as it gives businesses more discretion over how they allocate their PPP loan.

The Flexibility Act addresses the covered period issue by replacing the original eight-week covered period with a period of either 24 weeks or lasting until Dec. 31, 2020, whichever comes first. Given that PPP loans may only be made through June 30, it is safe to say that most, if not all, borrowers would fall under the 24-week covered period absent additional legislative action or SBA guidance extending the June 30 deadline. Businesses that already have a PPP loan as of the date the Flexibility Act becomes law may elect to use the original eight-week covered period instead. However, this choice will impact the loan forgiveness application process as there are multiple tax-related consequences to consider when deciding between keeping the new 24-week covered period or electing to return to the original eight-week covered period.

First, a longer covered period requires businesses to wait longer to apply for loan forgiveness. The amount of loan forgiveness is reduced according to the difference in the number of full-time equivalent employees and the reduction in wages for certain employees. These tests can only be calculated after the covered period ends and therefore a 24-week covered period delays when an application for loan forgiveness can be made. Note that the Flexibility Act gives businesses 10 months after the last day of the covered period to apply for loan forgiveness.

Second, a longer covered period increases the burden to provide the necessary documentation for loan forgiveness. To substantiate eligible expenses, businesses must provide tax forms for the periods that overlap the covered period such as Forms 941, *Employer's Quarterly Federal Tax Return*, and any state quarterly business and individual employee wage reporting and unemployment insurance tax filings, whether or not al-

ready reported. This is significant because a 24-week covered period will increase the substantiation burden by requiring businesses to provide employment tax forms for multiple quarters.

On the other hand, businesses that began their covered periods on or before May 6 and that elect to use the eight-week covered period will have reduced documentation requirements because they will need to provide Form 941 and any relevant state tax filings for the second quarter only. Businesses that began their covered periods on or before May 6, but use the 24-week covered period will need to provide both the second quarter and third quarter Forms 941 and potentially the fourth quarter Form 941, in addition to state filings for those quarters when they apply for loan forgiveness.

The Flexibility Act also eliminates the exclusion found in the CARES Act that prohibits any business receiving loan forgiveness from deferring its payroll

taxes. Therefore, all businesses, including those receiving loan forgiveness, would be able to defer the deposit and payment of the employer's share of Social Security tax and certain railroad retirement taxes that would normally be deposited during the period beginning March 27, 2020, and ending Dec. 31, 2020.

Businesses should be encouraged by the Flexibility Act's proposed changes to the Paycheck Protection Program. These changes are much needed and address many of the most prominent complaints by businesses with PPP loans. If the Flexibility Act is signed into law, businesses would be given more time to make eligible expenses and more control over how much to allocate to non-payroll costs. It is therefore important to consider the effect this could have on loan forgiveness and corresponding tax-related consequences so that the appropriate amount of loan forgiveness is achieved as reflected on Form 1099-C, *Cancellation of Debt*.