



PAYCHECK PROTECTION PROGRAM

Forgiveness of Paycheck Protection Program (“PPP”) Loans: More Questions than Answers

By: Juan Zaragoza-Gómez

Now that the first round of the Small Business Administration’s (“SBA”) PPP Loans is already closed, and the second round is close to the end, it’s time to start thinking about the best part of these loans, their forgiveness. Before getting into the details, let us give some local perspective of the impact of this program.

In Puerto Rico, small and medium size companies provide 80% of the private sector employment (i.e. 80% of a total of approximately 687,000 employees). The PYMES (the Spanish acronym for small and medium size companies) Group, comprised of businesses with 500 employees or less, represent as a group the single largest employer in the Island. So far, over 23,000 PYMES in Puerto Rico have benefited from this program, receiving a total aggregate loan amount of over \$1.5 billion.

FORGIVENESS RULES

Needless to say, the forgiveness potential of the PPP loans is its biggest attribute. Now that so many loans have been disbursed and the “eight-week covered period” (which began the day of the deposit of the proceeds and herein also referred to as the “covered period”) is running for these recipients, it’s imperative to get a clear understanding of the rules that control the forgiveness amount and the ones restricting the use of the funds. We expect

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the SBA or the U.S. Treasury to issue in the next few days substantial guidance on these rules.

ALLOWABLE USES OF PPP LOAN PROCEEDS

The Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) provides that borrowers may use the PPP loan proceeds to pay “payroll costs” and certain qualified business expenses. The CARES Act itself does not require any specific allocation of proceeds among these expenses. However, the SBA’s Interim Rules (and all subsequent SBA guidance) require borrowers to spend at least 75% of the loan forgiveness amount on “payroll costs” as defined below. The borrower is responsible for documenting the use of proceeds for payroll costs to determine the amount of forgiveness.

If a borrower uses loan proceeds for unauthorized purposes, the borrower will be required to repay those amounts and could be subject to additional charges from the SBA. The qualified expenses are the following:

1. Payroll costs, defined as including all the following components (which are the same ones used to determine the amount of the loan):
 - a. salaries and wages (capped at \$100,000 on an annualized basis for each employee);
 - b. payments for vacation, parental, family, medical or sick leave;
 - c. severance payments;
 - d. payments required for the provision of group health care benefits, including insurance premiums;
 - e. retirement benefits; and
 - f. State Unemployment Tax (“SUTA”), Disability Insurance (“SINOT” for its Spanish acronym), State Insurance Fund premiums (“Fondo del Seguro” in Spanish) and Chauffeur’s Insurance (“Seguro Choferil” in Spanish).

2. Interest (but not principal) on any debt or mortgage obligations that existed prior to February 15, 2020.
3. Rent arising under a lease agreement in force before February 15, 2020.
4. Utility payments (including electricity, gas, water, transportation, telephone, or internet access) for which service began before February 15, 2020.

ADJUSTMENTS TO LOAN FORGIVENESS AMOUNT

Assuming that all PPP loan proceeds are used on qualified expenses during the eight-week covered period following the loan funding, the loan forgiveness amount may be reduced for the following three reasons:

1. Less than 75% of the qualified expenses used on payroll

If less than 75% of the qualified expenses are to be used on payroll, the forgiveness is reduced by the amount under the 75%.

2. Decrease Based Upon Reduction in Full-Time Equivalent Employees (“FTEs”)

This reduction in loan forgiveness (if any) is calculated by multiplying the amount of loan forgiveness by a fraction, the numerator of which is the borrower’s average number of FTEs during the eight-week covered period, and the denominator is the lower of (at the borrower’s election):

- a. the borrower’s average number of FTEs between February 15, 2019 and June 20, 2019 or
- b. the borrower’s average number of FTEs between January 1, 2020 and February 29, 2020.

3. Decrease Based Upon Salary Reduction

The amount of loan forgiveness will also be reduced if employees who made less than \$100,000 in annualized wages in 2019 receive a reduction in pay of more than 25% during the covered period. The SBA will be issuing additional guidance on the loan forgiveness element of the PPP, and specific guidance on this provision is warranted to determine how this dollar-for-dollar calculation will work in practice (i.e. either on an aggregate

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From November 2014 to December 2016 Juan served as Secretary of the Treasury for the Government of Puerto Rico. During such period he also served as a member in several government boards such as the Government Development Bank, Teachers Retirement System, Puerto Rico Industrial Development Company, among others.

Among other professional experiences Juan adds to his resume being Partner in Charge of Arthur Andersen’s San Juan Tax Practice, President of the Puerto Rico Certified Public Accountants Society and Assistant Secretary for Internal Revenue at the Puerto Rico Treasury Department. Over the years he has also participated in several advisory municipal and state committees regarding Tax Reforms, Sales and Use Tax and Municipal Revenue Collection among other tax topics.

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basis or on a per employee basis). Reductions in FTEs or salary reductions that occur between February 15, 2020 and April 26, 2020 can be cured, to the extent the employer eliminates the reductions by June 30, 2020. From a practical standpoint, it is interesting to note the June 30, 2020 deadline will fall in most cases beyond the “eight-week covered period.”

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As part of recently issued guidance dated May 3, 2020, the SBA clarified that if a terminated employee rejects a rehire offer from the employer at the same salary and work hours, the loan forgiveness will not be reduced as a result of such rejection. From a practical standpoint, considering the substantial amount of Unemployment Benefits available in Puerto Rico, which in a lot of cases exceed the employee's compensation, it is expected that this type of situation will become very common.

ATBA Comments:

As of the date of this newsletter no significant guidance regarding the above rules have been issued either by the SBA or the U.S. Treasury. The following are some of the most significant issues that remain open:

- Accrual or cash basis?

The CARES Act provides that a borrower is eligible for forgiveness of its PPP loan in an amount equal to the sum of permissible **“costs incurred, and payments made”** during the eight-week covered period. The phrase “costs incurred and payments made” could be subject to at least 2 interpretations: (a) that a cost must be **both incurred and paid** during the covered period; or (b) that a cost must **either be incurred or paid during the covered period (i.e. cash basis)**.

- What is the meaning of the term **“full time equivalent employees”**?

The CARES Act nor the existing limited guidance provide any rules clarifying the definition of such term. Keep in mind that for purposes of determining qualification with the “not more than 500 employee threshold” for applying for the loan, all employees either full time, part time or temporary were considered equal. Under certain SBA rules, not applicable (yet) to the PPP loan, the term “full time equivalent employee” is determined by considering as a one full time equivalent employee, any combination of one or more employees that work at least 30 hours per week or 130 hours per month.

- Will salaries increases, bonuses or similar payments be considered as qualifying payroll costs?

In the ordinary course of business, employers may pay bonuses, raise salaries, provide additional fringes not previously granted such as life insurance or even increase temporarily the employer's matching under a 401k Plan. It is currently not clear if any of the above compensation adjustments, particularly to the extent non-recurring, will be considered as valid payroll costs for loan cancellation purposes. It should be noted however that the loan forgiveness potential of some of these items (i.e. those considered as salary) is limited due to the \$100,000 annualized cap.

- Will the debt cancellation income be considered as taxable income for Puerto Rico income tax purposes.?

As a rule, such type of income is considered taxable income. The CARES Act provides that such income will be considered exempt for federal tax purposes, but no exemption is provided at the State's level. Local legislation is required to grant such exemption, and to the extent granted, also address the deductibility of the related expenses.

We will keep you posted with any other communication or guidance issued by the SBA, U.S. Congress, or the Puerto Rico Treasury Department. At ATBA we have experienced personnel which can assist you in the computation of the potential PPP loan forgiveness and other tax related matters.

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