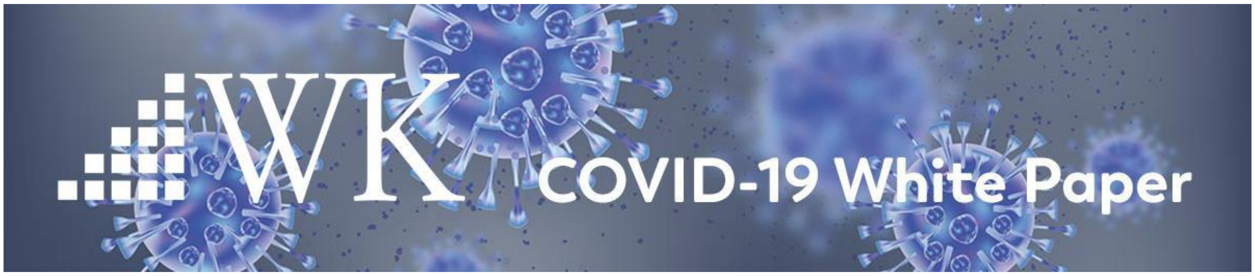

Navigating the Divergent Revenue Reduction Standards of PPP2 and the 2021 ERC

Sammy interviews three accountants and asks only one simple question: “What is one plus one?” Candidate #1 responds, “Two.” Candidate #2 is sure the answer is, “Eleven.” Neither gets the job. Candidate #3 nabs the job by responding with a simple question, “What does it need to be?” It’s an old joke and a favorite among the bean counters, but there is a practical takeaway - one should not seek to measure financial information without knowing its purpose.

Two recently passed COVID-relief provisions require businesses to measure a decline in gross receipts to access federal subsidies. These provisions again give accountants a reason to ask, “What does it need to be?”

- The second round of the Paycheck Protection Program (“PPP”) is available, if and only if a borrower suffered at least a 25 percent reduction in quarterly gross receipts during at least one quarter of 2020 compared to the same quarter in 2019 (note: there are special rules for businesses that did not have a corresponding quarter in 2019); and
- The Employee Retention Credit (“ERC”) is available for businesses that suffered a more-than-50 percent reduction in quarterly gross receipts during 2020 (Q2, Q3 or Q4) or a more-than-20 percent reduction in quarterly gross receipts for 2021 (Q1 or Q2) when compared to the same quarter in 2019 (note: there are special rules for businesses that did not have a corresponding quarter in 2019) .[1]

Because the lines that have been drawn are arbitrary, it is important to consider the metrics of each scenario to ensure your business is not shut out by a narrow margin.

Revenue measurements for PPP 25 percent reduction

PPP Round 2 is limited to businesses with a 25 percent reduction in gross receipts for any quarter in 2020. The measurement period is finished, but many businesses are trying to understand what happened and what it means.

[1] The 2020 ERC is also available for businesses without a significant gross receipts reduction for the period the business was partially or fully closed pursuant to a government closure order.

First, consider what the test means with a few examples.

- Company A's gross receipts were down 30 percent for the entire year. Do they need to measure each quarter? No; if gross receipts are down at least 25% for the year, then at least one quarter was down 25 percent. Company A qualifies.
- Company B's gross receipts for the year were up 40 percent. Receipts were down 30 percent in Q1 but rebounded and were up 50 percent in each of the next three quarters. Do they meet the revenue reduction threshold even though they had a pretty good year and the reduction was largely pre-COVID? Yes, Company B qualifies.
- Company C was down 19 percent each and every quarter. Do they really get shut out of PPP Round 2? Unfortunately, PPP Round 2 is not for them. Company C does NOT qualify even though it likely suffered more than Company B.

So that brings us to the question of how a business should measure its gross receipts. This is where things get messy. For simplicity, we will assume a business has no affiliated businesses.

Of course, Congress left the definition of "gross receipts" undefined for PPP Round 2, so the Small Business Administration (SBA) was left to fill it in. Most SBA rules about gross receipts are based on an annual accounting period, and the SBA has found information presented on a borrower's tax return to be a reliable source of revenue information. Thus, the SBA has extended an existing regulation from 13 C.F.R. 121.104 to PPP Round 2.

Under the existing regulation, the business would first look to figures reported on its income tax return. If the income tax return shows an annual gross income decline of at least 25 percent, the business clearly qualifies. However, what if the income tax return is not finished, or it will show a less-than-25 percent decline? The business still has hope.

The existing regulation also says that a business that has not filed a federal income tax return for the relevant period can calculate its annual receipts for the year using "any other available information." The rule goes on to provide the following examples: the business's normal books of account, audited financial statements or information contained in an affidavit by a person with personal knowledge of the facts. This broad of a rule invites the question, "What is one plus one?"

The PPP Round 2 reduction requirement is met if any *quarter* is down the requisite amount, so a business cannot demonstrate a quarterly gross receipt reduction on its income tax return. The SBA has generally defined gross receipts in relation to a business's "accounting method," and most references are to its accounting method for federal income tax purposes. The instructions to the Round 2 application form provides this guidance.

> Gross receipts include 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. Generally, receipts are considered "total income" (or in the case of a sole proprietorship "gross income") plus "cost of goods sold" and excludes net capital gains or losses as these terms are defined and reported on IRS tax return forms.

For more information on the SBA's definitions, see its Q&A [here.]

Consider for a moment Company C, which had a 19 percent reduction in its income. Allow us to add some additional facts:

- The 19 percent reduction was reflected on Company C's GAAP-basis (accrual-basis) financial statements each quarter of 2020, relative to the prior year.
- Company C files its tax returns using cash-basis accounting.
- Company C had a Q2 2020 reduction in cash-basis gross receipts of 30 percent.

Does Company C qualify? Clearly, yes. In accordance with Company C's normal accounting method (as used for federal income tax purposes), Company C had a reduction in cash receipts that was large enough to qualify.

What if we tweak the facts slightly, and Company C files its income tax returns using accrual-basis income statements? Now, we have a problem. Under its normal accounting methods—both for internal reporting and for tax reporting—Company C was only down 19 percent. However, the SBA rules allowing other evidence of gross receipts might just save the day.

Of course, the SBA's guidelines allow a business to submit its income tax filings to demonstrate an annual reduction or quarterly financial statements (using its normal accounting method) to demonstrate a quarterly reduction, but the SBA also says the company could provide quarterly or monthly annotated bank statements demonstrating which items represent gross receipts. Accordingly, it appears Company C could qualify if either (a) the accrual-basis gross receipts fell at least 25 percent; or (b) the cash receipts fell at least 25 percent.

Notably, the previously referenced SBA Q&A providing guidance on "gross receipts" does not mention the "affidavit" approach referenced in the existing regulation.

Here are the key takeaways:

- Businesses that suffered an annual reduction can use various sources to demonstrate a 25 percent reduction, including its calendar-year tax return (if available).
- Many businesses that had good years in 2020 might still qualify for PPP Round 2.
- Businesses should evaluate gross receipts reductions on BOTH a cash- and accrual-basis.

Revenue measurements for ERC 20 percent reduction

While the ERC is available for many businesses on a retroactive (2020) basis now, we will focus our attention on its application to the 2021 year. Congress authorized businesses with a more-than-20 percent reduction in Q1 or Q2 gross receipts in 2021, compared to the comparable periods in 2019, to receive a credit of up to $7,000 per employee for each of the first two quarters of the year. Businesses with no more than 500 full-time equivalent employees in 2019 get the benefit of this credit even if the employees are working at full capacity.

Again, consider what the test means with a few examples.

- Company D's gross receipts were flat in Q1 2021 and down 42 percent in Q2 2021, compared to the same quarters in 2019. Company D has met the ERC revenue test for Q2. However, it likely does not qualify for the ERC for Q1.

- Note: Company D could qualify for Q1 under a special election if its Q4 2020 gross receipts were down more than 20 percent, but we will assume it did not qualify under this special election.
- Company E's gross receipts were the same as Company D's, except that Company E was down 21 percent in each of Q1 and Q2. Company E gets double the benefit as Company D.
- Company F's gross receipts were up 10 percent in Q1 and up 15 percent in Q2. Of course, Company F does not qualify for either quarter.

It is important to note the ERC statute imposes no requirement for the reduction in gross receipts to be in any way linked to COVID-19.

So, how do we measure the revenue decline? The ERC uses a different definition than the PPP used. We will consider the definitions applicable to for-profit businesses (other definitions apply for non-profit organizations).

The ERC cross-references Sec. 448(c) of the Internal Revenue Code, which defines a for-profit business's "gross receipts" for purposes of determining whether a number of simplifying tax accounting methods can apply. Under Sec. 448(c), there is a temporary regulation, which makes clear that the term "gross receipts" should be determined under the taxpayer's federal-income-tax accounting method. This creates a significant opportunity for cash-basis taxpayers, as we'll see in a moment.

Consider our examples involving Companies D and E, above. While each likely suffered a roughly 40 percent decline in gross receipts over Q1 and Q2, Company E received double the ERC benefit. But what if Company D's picture had been slightly different? Imagine Company D is a cash-basis taxpayer and generally collects from customers within 30 days. Company D holds enough of its Feb and Mar 2021 invoices to make sure it exceeds the 20% reduction in cash receipts in Q1. It now qualifies for the ERC in Q1 2021, and—if it threads the needle just right—it might be able to do something similar in Q2 to defer income into Q3.

What about Company F? They are having a very good year, but is there anything preventing a cash-basis Company F from deferring income out of Q1 and Q2 to reduce its tax-basis gross receipts below the 80 percent threshold? The business' cash flow needs are one constraint, but the tax law makes this strategy possible.

The income deferral considered by Company F certainly falls outside Congress's intended subsidy when it expanded the 2021 ERC. Perhaps the income deferral considered by Company D would as well. However, because Congress linked the ERC to the taxpayer's normal income-tax method of accounting, because cash-basis taxpayers have significant control over the timing of income recognition through their invoicing practices, and because the ERC provides a significant subsidy on an all-or-nothing basis, Congress has invited taxpayers to consider Sammy's question, "What do my gross receipts need to be?"

Here are the key takeaways.

- Businesses who are close to the thresholds will be shut out of what can be a significant subsidy, so they may be made worse off by selling more.
- Businesses using the cash-basis method of accounting for income tax purposes may be able to qualify for the ERC in 2021 with planning.
- The cash-basis strategies might allow a business to shift income between periods to allow the business to demonstrate the requisite reduction in gross receipts.