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Steve Leimberg's Business Entities Email Newsletter - Archive Message #186

Date: 27-Apr-20
From: Steve Leimberg's Business Entities Newsletter
Subject: Alan Gassman, Brandon Ketron & John Beck: PPP Loans Must Be Necessary to Avoid Fines and/or Imprisonment, but What Does Necessary Mean

□ The recent □ pronouncements □ about this issue are causing many borrowers to conclude that it is safer to lay off workers than to risk penalties or even criminal prosecution, especially when the business can □ now afford □ to keep workers, but would lose money and reduce its chances of survival in so doing. □

Alan S. Gassman, Brandon L. Ketron and John N. Beck provide members with commentary on an important PPP issue that was also discussed in today's LISI Webinar titled *What To Do After The Paycheck Protection Program and Health Care Enhancement Act; PPP and EIDL Loans for Small Businesses, Sole Proprietors and Others and Special Loan Relief Opportunities for Medical Practitioners*, and is available for replay at this link: [Alan/Brandon](#). This issue was also discussed in **Marty Shenkman and Bob Keebler**'s LISI Webinar on Friday, April 24th that can be viewed at this link: [Marty/Bob](#).

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Here is their commentary:

EXECUTIVE SUMMARY:

Shots fired across the bow of publicly traded companies and hedge funds that have applied for and received Payroll Protection Program (□ PPP □) funds warn that the language requiring that a loan must be □ necessary to support the ongoing operations of the business □ is a serious requirement that could cause taxpayers to be fined up to \$1,000,000 and/or result in a prison term of up to thirty years. The above quoted language, which comes directly from the language of the CARES Act, and recent SBA pronouncements that publicly held companies and hedge funds will not meet this

requirement because they have the ability to raise capital provides little, if any, comfort and significant confusion and uncertainty for small businesses and professional practices that have been successful for many years and managed conservatively in order to be able to survive a crisis like this one.

It is clear that PPP loan recipients and applicants need to be aware of this issue, and to consider what is their best planning strategy and action. The recent "pronouncements" about this issue are causing many borrowers to conclude that it is safer to lay off workers than to risk penalties or even criminal prosecution, especially when the business can "now afford" to keep workers, but would lose money and reduce its chances of survival in so doing.

FACTS:

On March 27, 2020 the CARES Act became law for a primary purpose of allocating hundreds of billions of dollars to go to small businesses and professional entities to save jobs under the Payroll Protection Program ("PPP"). Many small businesses have applied and some have received funding.

The great majority of U.S. businesses and entrepreneurs have experienced significant losses and face tremendous risks as a result of the COVID-19 crisis, including significant reductions in revenue, increased expenses, and a continual state of worry for what will happen in the future.

Even though some U.S. states appear to be re-opening to some extent, the COVID-19 pandemic does not seem to be anywhere near under control. Bill Gates, a well-qualified and respected individual with extensive knowledge and experience with infectious diseases and business management, has expressed hopes that a vaccine will become available within the year. The uncertainty surrounding the timeline for a vaccine is indicative of the uncertainty surrounding businesses reopening. Even if a vaccine is released within a year, many businesses will be terribly affected by the effects of COVID-19 for much longer, and businesses not yet profoundly affected may be much like dominoes in a long line, waiting for the chain reaction that might blow their business into kingdom come. What makes this worse is the question as to whether lenders will reduce or call in credit that has been available to borrowers, and even shut down businesses that cannot satisfy loan ratio requirements, or when an "insecure lender" clause exists that permits the lender to call in loans when they feel that there is not sufficient capital to allow the loan to be as safe as it was when credit was extended.

The purpose of the PPP is allow small businesses to have moneys and encouragement to keep their payrolls in place by covering the essential day-to-day operational expenses for a period of 8 weeks after a loan is procured. The forgiveness of such loan, in whole or in part, also allows the business to increase its operating capital, if it is profitable during that period of time, in order to provide balance sheet assets that may be sorely needed in the many months to come. The program requires that the moneys advanced be used solely to cover employee payroll, utilities, rent, interest, health insurance, and pensions, with no allowance to pay for legal and accounting fees that will be needed to help sort out how to comply with this complicated law.

The PPP loan calculation provides borrowers with a maximum of 2.5 times the average monthly amount of their payroll, health insurance, and pension expenses, with the average monthly expense calculated over twelve months. Individual employee salaries are only includable in the calculation based upon \$100,000 in wages/salary plus additional amounts paid for health insurance and retirement plan contributions.

PPP loans will be forgiven if the amounts spent during the eight weeks following the date of receiving the loans satisfies these requirements:

- (1) At least 75% of the funds are spent on payroll, including medical insurance and retirement plan contributions; and
- (2) Other moneys are spent on rent, interest, and utilities based upon obligations in place before February 15, 2020.

COMMENT:

The subject of great concern that was brought to the forefront in the past few days is the question as to what the requirement that the loan be "necessary to support the on-going operations of the applicant" actually means. Every PPP borrower must attest to the fact that this requirement is met in their PPP loan application. The Small Business Administration ("SBA") will be auditing recipients of the PPP loans. False claims that are made intentionally with respect to this can result in criminal fines of up to \$1,000,000, and imprisonment for up to thirty years.

The U.S. Treasury Department and SBA have released updated guidelines in a FAQ issued on April 23, 2020 stating that "it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith, and such a company should be prepared to demonstrate to SBA, upon request, the basis for its certification." The SBA has stated that if a business has taken a loan that the business did not need, the business may return the loan by May 7, 2020, and face no criminal consequences.

Great pressure has therefore been placed on businesses to be sure of their eligibility, because they will face potential criminal sanctions if the loan they received was not "necessary". Unfortunately, and as discussed below, without a clear meaning of what "necessary" means, the statute containing the PPP eligibility requirements seems somewhat vague and ambiguous.

The SBA, Treasury Department, and lawmakers alike have all been issuing clarifications to the unprecedented program, its eligibility requirements, and its oversight, especially as it relates to criminal liability and the necessity requirement. These constant updates make one thing abundantly clear notwithstanding the confusion: the statute and its requirements are not straight forward as presently drafted, and reasonable players on all sides of the system are understandably interpreting the requirements somewhat differently and inconsistently. One series of articles on this situation can be found in [Paycheck Protection Loan Backlash: How To Defend Your Business Reputation And Avoid Getting Shake Shaked](#), which is on the Forbes blog of LISI Commentator **Bruch Brumberg**.

Some larger businesses and hedge funds applied for PPP loans and were approved by the SBA after a review of their application. If these businesses are not qualified because the loans are not "necessary," then the definition of "necessary" is not clear, because many of these applicants must have objectively interpreted the requirements in a reasonable manner that ended in their concluding that they were eligible. Returning the money now may be more motivated by a fear of "public shaming" as opposed to concluding that the necessary standard may not have been met.

Some applicants applied for and received funding before many guidelines and clarifications were even issued. If those applicants applied for and received funds relying on an objectively reasonable interpretation of an unclear statute, without any notice from government institutions or lawmakers to the contrary, the statute might possibly be found to be unconstitutionally vague. While the authors are not experts in the area, we found the following in legal literature and feel that it is appropriate to share our understanding of this.

In 1926, the U.S. Supreme Court issued its opinion in *Connally v. General Construction Co.*, which greatly expanded what is known as the "vagueness doctrine." In this case, the vagueness doctrine was explained to apply to "a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application."

More recently, in 2015, the U.S. Supreme Court addressed the vagueness doctrine again in *Johnson v. United States*, stating that the government violates due process when it takes "away someone's life, liberty, or property under a criminal law so vague that it fails to give ordinary people fair notice of the conduct it punishes, or so standard-less that it invites arbitrary enforcement."

Here, where property, or at the very least a property interest, is being denied to businesses by concluding that they are not qualified for a PPP loan due to a murky or overzealous "necessary" requirement, when objectively reasonable interpretations of the term have seemingly varied based upon each individual application for the loan, it may be that the vagueness of the term "necessary" prevents criminal enforcement of this statute. This is made more convincing by the fact that the CARES Act does not give the SBA or any other entity the right to promulgate legislative regulations or guidance, and does not provide that hedge funds or publicly traded entities cannot qualify for PPP loans. .

Since lawmakers and several government institutions have been issuing updated official and unofficial guidance on what "necessary" means in the context of PPP loans, ability to claim that there is sufficient vagueness to make the statute inapplicable in a given situation is dependent on being able to show that an applicant for PPP loans was provided "fair notice" of their ineligibility, which would disqualify them from claiming that the statute was unconstitutionally vague, because they were aware of the general parameters that made them ineligible from updated guidelines after applying. Arguing vagueness would be more appropriate for a business that applied for and received a loan prior to the new guidelines being issued, but what court will require that applicants look for FAQ's and tweets from a Senator, as mentioned below, before signing their application under the present stressful and scattered circumstances that business owners find themselves in.

Who "Needs" a PPP Loan?

Almost every business owner and manager involved with the finances of a business are clearly aware that there are significant capital needs, which include the obvious need for monies to keep a business like a bar, restaurant or private school afloat, but also capital needs that are "necessary" to assure that the business or professional practice can survive negative future contingencies, which are much more likely now than they had been before this crisis.

For example, a professional practice that has expenses of \$100,000 a month and \$200,000 in the bank, may not "need" to spend PPP loan proceeds for three or even six months if revenues may continue to allow the present cash in the business to last that long, but what happens if the key professional or manager of the business gets sick with the COVID-19 virus, and the business interruption insurance that the company has or would now be willing to buy is not available because the policies do not cover a global pandemic, or what happens if a major group of customers or suppliers turn out to be dominoes in the long string of black and what tiles that eventually fall on the business and cause it to be shut down or require it to operate at a loss for several months in order to survive?

Every borrower has a different situation, and many borrowers are receiving the same amount of revenue as they were before, and may have only slightly increased expenses, but a very uncertain future.

One example that comes to mind is critical care doctors, who have medical groups that primarily service emergency rooms and intensive care units.

One would generally not expect that their revenues have been reduced, but one would expect that they have a significant risk of losing key personnel for a long period of time, and also a fear that medical systems will break down and not provide them with compensation, or even the ability to work.

It is certainly arguable that the loan is not "necessary" for this group, but standing in their shoes, I would certainly feel the need for additional capital, especially given the fact that a good many critical care professionals have contracted COVID-19, leaving their practices without a doctor or doctors and other professionals when they are terribly needed

As a practical matter, many critical care pulmonologist have office practices are now suffering because patients with underlying health conditions should be deferring any contact with a medical office to the extent possible. For example, patients who may have sleep apnea and need sleep studies or consultations are probably better off deferring these until it is safe to walk into a medical doctor's office.

What Is the Meaning of the Word "Necessary"

To further this discussion, it is necessary to consider the word "necessary," and to what extent a court or jury would find that a business or professional practice did not have sufficient need for a PPP loan because it was not "necessary." Guidance may be found from past and current interpretations of the word "necessary," and more pointed updates have been provided recently relating to this issue.

Courts' Interpretations of "Necessary"

Starting in the past, in 1819 the fourth—and perhaps most famous—Chief Justice of the U.S. Supreme Court, John Marshall, issued a monumental constitution based decision defining the word necessary as it appears in the Necessary and Proper clause of the United States Constitution. In *McCulloch v. State* the Supreme Court considered whether the word necessary must "always import an absolute physical necessity, so strong, that one thing to which another may be termed necessary, cannot exist without that other." The Court concluded that it does not, and explained the word necessary "frequently imports no more than that one thing is convenient, or useful, or essential to another."

Notably, Black's Law Dictionary uses the same definition of "necessary" as Chief Justice Marshall did in his opinion in *McCulloch*.

In 1933, the meaning of "necessary" was analyzed by the Supreme Court again in *Welch v. Helvering*, where a taxpayer attempted to take a deduction on expenses that he claimed fell within the test now found at Internal Revenue Code (IRC) Section 162 as being "ordinary and necessary" business expenses. Here, the Court determined that the expenses in the case were necessary because "they were appropriate and helpful," but they were not ordinary.

"Appropriate and helpful" is certainly a lower standard than "essential." Since *Welch*, a number of cases have found that items that many would consider to be "luxury" items and services have qualified as "reasonable and necessary" business expenses, including the cost of paying for limousines to take key executives to work, taking spouses on

business trips to make a good impression, and paying large salaries to key executives whose work could be performed by competent replacements for much less.

The language and application of the Accumulated Earnings Tax may provide valuable guidance. This part of the Internal Revenue Code imposes a tax on corporations (other than S corporations) that are found to have a net worth exceeding "the reasonable needs of the business."

The regulations under IRC Section 537 makes clear that the "reasonable needs of the business" can include "product liability loss reserves," and include moneys set aside for possible future expenses that are set aside and would be "directly connected with the needs of the corporation" and are "for bona fide business purposes."

The above quoted language comes from the following portion of IRC Section 537, and the regulations under Section 537, include discussion that confirms that it is necessary to have capital for the "reasonable future needs" of the business based upon what "a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business." It certainly seem that this is analogous to what is necessary to support the operations of the business. □

Below is an excerpt from Treasury Regulation Section 1.537-1:

§ 1.537-1 Reasonable needs of the business.

(a) In general. The term *reasonable needs of the business* includes (1) the reasonably anticipated needs of the business (including product liability loss reserves, as defined in paragraph (f) of this section), (2) the section 303 redemption needs of the business, as defined in paragraph (c) of this section, and (3) the excess business holdings redemption needs of the business as described in paragraph (d) of this section. See paragraph (e) of this section for additional rules relating to the section 303 redemption needs and the excess business holdings redemption needs of the business. An accumulation of the earnings and profits (including the undistributed earnings and profits of prior years) is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes. ,,,. See § 1.537-3 for a discussion of what constitutes the business of the corporation □ See § 1.537-2, relating to grounds for accumulation of earnings and profits.

(b) Reasonable anticipated needs.

(1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings or profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

(f) Product liability loss reserves.

(1) The term *product liability loss reserve* means, with respect to taxable years beginning after September 30, 1979, reasonable amounts accumulated for the payment of reasonably anticipated product liability losses, as defined in section 172(j) and § 1.172-13(b)(1).

(2) For purposes of this paragraph, whether an accumulation for anticipated product liability losses is reasonable in amount and whether such anticipated product liability losses are likely to occur shall be determined in light of all facts and circumstances of the taxpayer making such accumulation. Some of the factors to be considered in determining the reasonableness of the accumulation include the taxpayer's previous product liability experience, the extent of the taxpayer's coverage by commercial product liability insurance, the income tax consequences of the taxpayer's ability to deduct product liability losses and related expenses, and the taxpayer's potential future liability due to defective products in light of the taxpayer's plans to expand the production of products currently being manufactured, provided such plans are specific, definite and feasible. Additionally, a factor to be considered in determining whether the accumulation is reasonable in amount is whether the taxpayer, in accounting for its potential future liability, took into account the reasonably estimated present value of the potential future liability.

(3) Only those accumulations made with respect to products that have been manufactured, leased, or sold shall be considered as accumulations made under this paragraph. Thus, for example, accumulations with respect to a product which has not progressed beyond the development stage are not reasonable accumulations under this paragraph.

It is difficult to read the above and not come to the conclusion that most U.S. businesses and professional practices have a need for PPP loans that are necessary to support the ongoing operations of the business, just like product liability loss reserves are well respected for those businesses that have exposure to product liability losses.

A conventional and well accepted analysis of what would be necessary to borrow to be reasonably capitalized in a way similar to the Accumulated Earnings Tax analysis is the concept of the "fairness opinion" that is often issued by for companies raising capital or engaging in transactions whereby an independent opinion is provided as evidence that a business meets the required good faith certification of being "necessary to support the ongoing operations of the Applicant." This scenario is similar to the use of fairness opinions that evolved from the landmark opinion of *Smith v. Van Gorkham* which was decided by the Delaware Supreme Court in 1985. Fairness opinions are obtained from financial professionals to provide evidence that prudent business judgment was exercised in a corporate transaction, thus providing corporate boards with some level of liability protection. It is unclear whether opinions to support PPP good faith certification would be recognized because of the lack of current guidance but it certainly would not hurt. The authors thank valuation experts Timothy Bronza, CPA, ASA, and Elitsa Healy, CFA, for their input with respect to this.

Although it may still be unclear what "necessary" means for PPP loans, the SBA's Economic Injury Disaster Loan (EIDL) has a need requirement that requires that there be a "substantial economic injury" that is a direct result of a disaster. COVID-19 qualifies as a disaster, but the "substantial economic injury" requirements are more in-depth and similar to the "necessary" requirement for PPP loans. Substantial economic injury will most often consist of a decrease in revenue or significant increase in expenses with the result being that the business is unable to meet its obligations and pay ordinary and necessary operating expenses in the normal course of business.

"Necessary" for PPP loans could mean something very similar to "substantial economic injury," especially given the below referenced recent pronouncements. Some clarification on what "necessary" may mean under the PPP law has been provided by individual lawmakers. Legally, this may be of some significance because the legislative intent behind the PPP is the closest concrete guidance to date in absence of the SBA providing specific guidelines on the term.

In wake of the news that hedge funds and other large entities with presumably sufficient cash reserves were receiving PPP loans, U.S. Senator Marco Rubio (R-FL) became vocal on Twitter and in media appearances about Congress's intentions behind the PPP and the term "necessary." Senator Rubio is the U.S. Senate Chairman of the Committee on Small Business and Entrepreneurship and was apparently very involved with the subject legislation. Senator Rubio recently reiterated that PPP loans must be "necessary to support the on-going operations of the business" and also indicated as follows:

1. The Small Business Committee will use subpoena power to identify anyone who gave a false certification for a PPP loan.
2. Businesses applying for a PPP loan must certify that they have been harmed by the crisis and need the PPP loan to operate.
3. Any company with revenue to cover its operations is ineligible.

While there is no doubt that Senator Rubio's comments were well intentioned and may have an overall positive impact, these statements likely have little to no precedential effect, and we know of no support for the proposition that any company with revenue to cover its operations is ineligible.

If Senator Rubio's comments had been included in Committee Reports or in initial SBA regulations, such statements might have some precedential effect and might reduce the level of confusion we are experiencing surrounding the interpretation of the word "necessary," but these instead have been issued informally and without authority or authorization from the Statute or any governing body.

Based upon concerns voiced by advisors and businesses, it appears that these "pronouncements" will reduce both the number of loans taken, and the number of jobs that would have been saved by legitimate and concerned business owners and professionals.

How About an Opinion Letter?

Many legal advisors will recommend that an opinion letter be issued, in order to help prove that proper conditions exist to qualify for a PPP or EIDL loan, and that the borrowers have no intent to break any law in applying for and receiving such a loan. This will add to the cost, and delay in obtaining loans, but may be the most prudent action, especially for independent officers and directors who have not much to gain but much to lose by voting to take PPP or EIDL's for a for profit or not for profit agency. Associated questions include where there is officer and director liability insurance that will cover possible claims, including criminal defense costs, and whether such coverage can be put into place or increased before a loan is taken.

Conclusion

Advisors and borrowers must be very careful to closely examine their situation, and the conservative needs for cash and capital, which we believe can include recognition of the risks inherent in having a "stay-at-home" economy, which may have to endure the present challenges for a year or longer.

Given that many applicants did not receive loans because of the lack of funds or infrastructure to provide them, and that political winds may blow unpredictably, one would think that erring on the side of making sure that a business can survive the present crisis would be the most prudent course of action, especially where employees, contractors, suppliers, and customers rely on the business for their livelihood, products, and services.

Advisors must do their best to educate present and would be PPP borrowers by sharing and educating on the law and what uncertainties exist so that the benefit of taking the loans, and possible forgiveness, can be weighed against the uncertainty of possible penalties, repayment of amounts expected to be forgiven, or even criminal prosecution.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

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