

## CARES Act Provisions of Related ESOP-Owned Companies

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On March 27, 2020, President Trump signed into law a massive \$2 trillion stimulus bill, the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act or the Act), aimed at shoring up the U.S. economy in light of the disruption caused by the coronavirus pandemic. In addition to the widely discussed individual stimulus payments, the CARES Act contains extensive provisions expanding unemployment insurance, extending tax relief to individuals and employers, adopting healthcare measures, providing economic stabilization funds, and making other emergency appropriations. A number of the Act's provisions are of particular interest to companies owned by employee stock ownership plans (ESOPs).

### Small Business Loans

The Act makes two loan programs available to small ESOP-owned companies for the purpose of providing access to cash to help survive the pandemic's economic disruption.

#### **Paycheck Protection Program**

The CARES Act directs the U.S. Small Business Administration (SBA) to establish a new loan program, known as the Paycheck Protection Program (PPP), to make SBA-guaranteed, forgivable loans of up to \$10 million to qualifying small businesses. The proceeds of PPP loans may be used to cover payroll expenses, costs related to continuing group health care benefits, salaries or commissions, interest payments on mortgage obligations, rents, utilities, and/or debt obligations in existence as of February 15, 2020. Subject to a few exceptions, the PPP program applies to companies, including ESOP-owned companies, with 500 or fewer employees.

PPP loans have looser credit-review standards than other SBA loans: lenders are only required to consider whether the applicant was in operation on February 15, 2020, and whether it paid compensation and withheld payroll taxes for employees or made compensatory payments to independent contractors. Applicants are not required to show that credit is unavailable elsewhere or demonstrate repayment ability, unlike other SBA loans.

The maximum PPP loan is the lesser of (a) \$10 million or (b) 2.5 times the average monthly payroll costs of the business for the year prior to the making of the loan (excluding the prorated portion of any annual compensation above \$100,000 for any person). Note that under the CARES Act, "payroll costs" include vacation, parental, family,

medical, and sick leave; allowances for dismissal or separation; payments for group health care benefits, including insurance premiums; and retirement benefits. Only employees having their principal residence within the United States qualify for payroll costs. Prepayment penalties and the guaranty and annual fees applicable to other SBA loans have been waived.

Further guidance from the Treasury Department and the SBA provides that, other than the principal amount, the terms for all PPP loans will be the same, with an interest rate of 1.0% and a two-year maturity. Payments under PPP loans will be deferred for six months, although interest will accrue during this period. The loans will be nonrecourse to the business owners, except to the extent proceeds are used for an unauthorized purpose.

Perhaps the most favorable feature of PPP loans is that an amount up to the loan's full principal amount and any accrued interest may be forgiven and the forgiven amounts are not subject to Federal income tax. The maximum amount of loan forgiveness is the total amount of the following expenses incurred by the company **during the eight-week period** beginning on the date of the loan: (a) payroll costs, (b) interest payments on mortgage obligations incurred before February 15, 2020, (c) rent payments on leases dated before February 15, 2020, and (d) utility payments under service agreements dated before February 15, 2020 (collectively Covered Costs); provided, however, the Treasury Department and the SBA have stated that due to the expected high program subscription level, they expect to limit the loan forgiveness for non-payroll costs to 25% of those non-payroll costs. The amount of forgiveness may be reduced for a decline in either the number of workers on the company's payroll or the salaries of its employees earning less than \$100,000 during the period between February 15, 2020 and June 30, 2020. However, if a reduction of employees or decrease in compensation between February 15, 2020 and April 26, 2020 is corrected (e.g., through rehiring of employees) by June 30, 2020, the reduction or decrease will not reduce the amount subject to forgiveness. The purpose of these conditions is to encourage employers to keep full-time employees at the same pay level and rehire full-time employees terminated in connection with the pandemic.

The PPP loan applications are open until June 30, 2020.

### **SBA Disaster Loan Program**

A second loan program is available to small ESOP-owned companies. The SBA's Disaster Loan Program (DLP) makes low-interest loans (Disaster Loans) of up to \$2 million available to businesses with 500 or fewer employees. The CARES Act expands the DLP to specifically name ESOPs with 500 or fewer employees as eligible borrowers. Under the DLP, funds are borrowed directly from the Federal government, not through SBA-approved lenders.

Disaster Loans have pros and cons when compared to the PPP loan program. Disaster Loan proceeds are not restricted and can be used for any purposes. ESOP Trusts are, for example, able to utilize the proceeds for repayments under exempt loans, and make distributions and diversification payments. Repayment of Disaster Loans is delayed for one year. Disaster Loans are not forgivable, however, like the PPP loan programs.

Under the DLP, the ESOP Trust must be the borrower, rather than the company. Thus far neither the Internal Revenue Service ("IRS") nor the Department of Labor have provided any guidance with respect to the ESOP Trust's borrowing under this program. Since the decision to take on a DLP is a fiduciary decision, an ESOP Trustee must proceed cautiously when considering whether a DLP loan is in the best interest of the ESOP and its participants and beneficiaries.

## **Plan Provisions**

The CARES Act also made a number of changes to retirement plan rules to expand access to account balances for participants affected by the COVID-19 crisis. Most of these rules are optional or of limited application for ESOPs, but may apply to a 401(k) plan that the company may also sponsor.

### **Penalty-Free Coronavirus-Related Distributions in 2020**

The CARES Act allows participants in eligible retirement plans to take distributions during 2020 of up to \$100,000 from their plan benefits (including distributions of 401(k) deferrals) without incurring the 10% early distribution tax that

would otherwise generally apply to payments made prior to age 59-1/2. The distribution must qualify as a “coronavirus-related distribution,” which can only be made to a “qualified individual.” A “qualified individual” includes (i) a participant who has experienced adverse financial consequences resulting from a reduction in work hours, been laid off, quarantined, furloughed, or is unable to work due to lack of childcare on account of the disease; and (ii) a participant, spouse, or dependent who has been diagnosed with the virus.

ESOPs do not have to make these coronavirus-related distributions available because the IRS has indicated that the distributions are permitted, but not required, for any retirement plan. To the extent the special distributions are offered, they must be made in calendar year 2020.

A coronavirus-related distribution under the Act will be included in the qualified individual’s taxable income ratably over a three-year period, unless the individual elects to have it taxed in the year of distribution. A qualified individual who takes a coronavirus-related distribution may repay to an eligible retirement plan all or a portion of the amount distributed within three years of when it was taken. If repaid, the repayment will be treated as a rollover contribution, such that the distributed amount is not subject to taxation. The distribution will not be treated as eligible rollover distributions, so mandatory 20% withholding will not apply, although the 10% withholding will apply unless waived by the participant.

### **Plan Loan Dollar Limits and Loan Due Date Changes**

The CARES Act increases the current \$50,000 or 50% of account balance loan limits for qualified individuals. Qualified individuals may borrow up to the greater of \$100,000 or 100% of their account balance. The Act also provides a one-year extension of time to repay a plan loan if the due date occurs between March 27, 2020 and December 31, 2020. It appears that remaining payments, plus applicable interest, may be re-amortized over the extended period, and that these extension rules are mandatory.

These changes have limited applicability to ESOPs since most do not offer participant loans.

### **Required Minimum Distributions**

Plan participants age 70-1/2 and older have complained that they are faced with receiving required minimum distributions (RMDs) in 2020 from defined contribution plans that are based on the value of their accounts at the end of 2019, but which would be distributed from balances decimated by recent market declines. To address this situation, the CARES Act offers participants the right **not to take** RMDs in 2020. This suspension also applies to participants who turned age 70-1/2 in 2019 and had not yet received their 2019 distribution, although many RMD distributions due April 1, 2020 were made. Amounts distributed in 2020 that would have been RMDs but for the CARES Act will not be treated as eligible rollover distributions for purposes of 20% withholding, and will not require employers to provide the special tax notice under 402(f) of the *Internal Revenue Code* applicable to eligible rollover distributions. However, such amounts are eligible for rollover by the participant to an eligible retirement plan. The suspension of RMDs under the CARES Act is similar to the suspension that applied in 2009 after the financial crisis of 2008.

### **Plan Amendments**

Plans must be amended to reflect these new rules by the last day of the plan year beginning on or after January 1, 2022 (*i.e.*, for calendar year plan years, by December 31, 2022).

Please contact a member of the Winston & Strawn Employee Benefits and Executive Compensation Practice Group for further information.

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