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Paycheck Protection Program – Loan Forgiveness

By the Business Practice Group

Borrowers fortunate enough to receive loans under the Paycheck Protection Program ("PPP") are eligible for forgiveness of certain payroll costs, rent payments, utility payments, and mortgage interest payments. But with the good fortune of receiving a loan comes significant questions about how the rules on forgiveness will apply. The SBA has issued its Loan Forgiveness Application ("Application"), clarifying some of the ambiguities in the CARES Act regarding how to calculate a borrower's PPP loan forgiveness. You can access the Application here (your lender may also make this application available electronically). **Borrowers should carefully review the Application as it applies to the borrower's individual circumstances.**

Below is an overview of the current loan forgiveness rules and regulations under the PPP and general steps to determine anticipated loan forgiveness.[1] The steps below are intended to help borrowers understand the current law on loan forgiveness, understand the areas where questions remain, and offer suggestions to help maximize loan forgiveness.

That said, a number of bills are being introduced in Congress to expand the benefits afforded by the PPP and revise key portions of the legislation, including expansion of the current eight-week forgiveness period and extending the re-hiring deadline. We do not know whether any of the proposals will become law and if so, how they may impact the current PPP rules. We encourage borrowers to closely monitor new PPP developments and reach out to us with questions about their individual circumstances.

Loan Forgiveness Steps:

Step 1: Determine the Covered Period and the timing of costs incurred and paid.
Step 2: Determine borrower's eligible expenses.
Step 3: Consider any reductions in the number of employees or employee salary/wages.
Step 4: If a reduction applies, determine eligibility for the forgiveness reduction safe harbors.
Step 5: Apply the 75% payroll cost requirement.
Step 6: Be prepared to apply for forgiveness.

[1] The Small Business Association (SBA) and the U.S. Treasury have issued guidance in the form of interim final rules and Frequently Asked Questions ("FAQs") clarifying or expanding the CARES Act, which are available here: https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses. The FAQs do not carry the force of law but have provided details on how to interpret the CARES Act. In addition, on Friday, May 15, 2020, the SBA published a Loan Forgiveness Application and on Friday, May 22, 2020, the SBA issued an interim final rule containing significant additional guidance on calculating a borrower's loan forgiveness. Like the FAQs, the guidance contained in the Loan Forgiveness Application likely does not carry the force of law.

Step 1: Determine the Covered Period and the timing of costs incurred and paid.

The "Covered Period" is the 8-week period beginning on the day the lender disburses loan proceeds. Certain borrowers may elect an "Alternative Payroll Covered Period" to align with the borrower's payroll schedule. Borrowers with a biweekly (or more frequent) payroll schedule may elect to calculate eligible payroll costs using the eight-week period that begins on the first day of their first pay period following the date of their loan disbursement. Borrowers with a monthly or twice a month payroll period may not use the Alternative Payroll Covered Period.

If opting to use the Alternative Payroll Covered Period, borrowers should apply the Alternative Payroll Covered Period wherever the Application states "the Covered Period or the Alternative Payroll Covered Period". In general, the Alternative Payroll Covered Period only applies when determining eligible payroll costs and any potential reductions in forgiveness on account of reductions in full-time equivalent employees or employees' salaries/wages. All non-payroll costs are calculated based on the Covered Period.

With respect to payroll costs, borrowers may seek forgiveness for payroll costs for the eight weeks beginning on either the day the Covered Period starts or the day the Alternative Payroll Covered Period is deemed to start (i.e., the first day of their first pay period following loan disbursement). Payroll costs are considered paid on the day that paychecks are distributed or the borrower originates an ACH credit transaction. Payroll costs are considered incurred on the day that the employee's pay is earned (i.e., on the day the employee worked). Borrowers may count payroll costs incurred but not paid during the borrower's last pay period of the Covered Period (or Alternative Payroll Covered Period) as eligible for forgiveness if paid on or before the next regular payroll date.

Non-payroll costs are generally eligible for forgiveness if they are either paid during the Covered Period or incurred during the Covered Period and paid on or before the next regular billing date, even if the billing date is after the Covered Period. For example, a borrower with a Covered Period that began on June 1 and ended on July 26 that paid its May and June utility bill in June may seek loan forgiveness for both bills, because they were paid during the Covered Period. In addition, the borrower may seek forgiveness for the portion of the July utility bill through July 26 (the date the Covered Period ends) even if the July utility bill is paid after the end of the Covered Period (so long as paid on the next regular billing date).

Step 2: Determine borrower's eligible expenses.

The maximum forgiveness amount can equal up to the full principal amount of the loan and accrued interest if a borrower's eligible payroll costs during the Covered Period (or Alternative Payroll Covered Period) equals or exceeds 75% of the loan amount. Not more than 25% of the loan forgiveness amount may be attributed to non-payroll costs.

Payroll Costs Include:

"Payroll costs" has the same meaning as it did for the PPP application, and includes the following:

- Salary, wage, commission, cash tip, or similar compensation up to $15,384 per employee during the Covered Period ($100,000 annualized).
- Payment for vacation, parental, family, medical, or sick leave.
- Severance payments.
- Payment required for group health care benefits, insurance premiums, and retirement benefits.
- Payment of state or local tax assessed on the compensation of employees.

Note: The $15,384 per employee cap only applies to cash compensation, and not to non-cash benefits. The last two bullet points above are non-cash benefits not subject to the per employee cap.

Owner-employees are accounted for separately on the Application. The maximum payroll costs allowable for forgiveness is the lesser of (1) $15,385 (the eight-week equivalent of $100,000 per year), or (2) the eight-week equivalent of their 2019 cash compensation. No additional forgiveness is provided for retirement or health insurance contributions for general partners.

Payroll Cost DO NOT Include:

- Payments made to independent contractors or sole proprietors.
- Compensation paid to non-U.S. residents.
- Employer's share of federal taxes.[1]
- Paid leave for which a credit is allowed under the Families First Coronavirus Response Act.

Non-Payroll Costs (limited to not more than 25% of the loan forgiveness amount):

- Payments of interest on any business mortgage obligation for real or personal property incurred in the ordinary course of business prior to February 15, 2020. This does not include principal payments or prepayments.
- Payments for business rent or lease payments pursuant to lease agreements for real or personal property in force before February 15, 2020.
- Payments for utilities—electricity, gas, water, transportation, telephone, or internet access—for which service began before February 15, 2020.

Step 3: Consider any reductions in the number of employees or employee salary/wages.

Reductions in full-time equivalent employees or employee wages/salaries may reduce the amount eligible for forgiveness. The first step is to determine baseline full-time equivalency ("FTE") and wages/salaries, as further described below. A borrower will need to complete detailed worksheets contained in the Application to calculate potential adjustments to the forgiveness amount. Below is a high-level overview of the adjustments based on reductions in FTE or reductions in employee salaries/wages. To ensure that borrowers are not doubly penalized, the salary/wage reduction applies only to the portion of the decline in employee salary and wages that is not attributable to the FTE reduction.

Employee Reductions

The eligible amount of loan forgiveness may be reduced if there is a reduction in the average weekly FTE employees during the Covered Period[2] measured against one of two prior baseline periods.[3]

The FTE for each employee is determined by the average number of hours paid per week, divided by 40, and rounded to the nearest tenth. The maximum FTE for each employee is capped at 1.0. In the alternative, borrowers can opt for the "simplified method" by assigning a 1.0 for employees who work 40 or more hours per week and .5 for all employees who work fewer hours.

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[1] Although the CARES Act suggested otherwise, FAQ # 16 explicitly provides that payroll costs are not reduced by federal taxes imposed on an employee and required to be withheld by the employer, but payroll costs do *not* include the employer's share of payroll tax.
[2] For purposes of Step 3, Covered Period refers to either the Covered Period or Alternative Payroll Covered Period.
[3] Special rules apply to seasonal employers.

To determine any possible reductions, first calculate the baseline average weekly FTE employees during (i) February 15, 2019, to June 30, 2019, and (ii) January 1, 2020, to February 29, 2020. Borrowers should use whichever period is more favorable (i.e., the period that has the lowest number of FTE employees). Then, determine the average number of weekly FTE employees anticipated to be employed during the Covered Period.

A reduction in average weekly FTE employees during the Covered Period in comparison to the chosen baseline period will reduce the potential loan forgiveness amount. If there is a reduction in FTE employees, the amount to be reduced equals the result of multiplying the sum of eligible expenses by —

- Average weekly FTE employees during the Covered Period; over
- Average weekly FTE employees during either 2/15/19 to 6/30/19 or 1/1/20 to 2/29/20 (whichever is lower).

In other words, a 20% decrease in average weekly FTE employees during the Covered Period as compared to the baseline period results in a 20% decrease in loan amounts eligible for forgiveness.

Wage and Salary Reductions

Additionally, the eligible amount of loan forgiveness will be reduced for certain reductions in employee salary or wages.

Borrowers will need to complete the Schedule A Worksheet included in the Application to determine whether the forgiveness amount will be adjusted as a result of salary and wage reductions. This applies to all employees (i) who were employed during the Covered Period, (ii) who either received compensation at an annualized rate of less than or equal to $100,000 for all pay periods during 2019 or who were not employed by borrower during 2019, and (iii) whose principal place of residence is the U.S.

Borrowers will compare wages/salaries paid to covered employees during the Covered Period with wages/salaries paid during the most recent full quarter the employee was paid (the first quarter of 2020 for PPP loans received in the second quarter). A decrease in wages/salaries paid for any covered employee during the Covered Period in excess of 25% of what was paid in the first quarter of 2020 will reduce the amount eligible for forgiveness.

Step 4: If a reduction applies, determine eligibility for the forgiveness reduction exceptions and safe harbors.

Employee Rehire and Salary/Wage Restoration Safe Harbor

If a borrower restores FTE employees or salary/wage levels, the borrower may be eligible for elimination of the reduction amount. Borrowers generally have until June 30, 2020 to eliminate the reduction in FTE employees or reduction in wages/salaries. However, to fully take advantage of the forgiveness rules, it is best to re-hire or restore wages/salaries as soon as possible. Additionally, borrowers are not required to rehire the same employees employed prior to the start of the Covered Period.

Forgiveness Reduction Exceptions

Borrowers whose employees (i) rejected offers of employment, (ii) were fired for cause, (iii) voluntarily resigned, or (iv) voluntarily requested and received a reduction of their hours, may be able to avoid the reduction in forgiveness on account of a reduction in FTE employees. Borrowers must maintain documentation related to these events to be eligible for the exceptions.

For employees who refuse reemployment the SBA requires that:

1. Borrower made a good faith written offer to rehire their employee(s);
2. The offer was for the same hours and salary/wages as before;
3. The employee(s) rejected the offer;
4. The employee's rejection is documented; and
5. The borrower informed the applicable state unemployment insurance office of such employee's rejected offer of reemployment within 30 days of the rejection.

Any FTE reductions on account of the above exceptions will be excluded from the loan forgiveness reduction calculation.

Step 5: Apply the 75% payroll cost requirement.

In addition to the reduction in the loan forgiveness amount for reductions in FTE employees and wages/salaries, a borrower's total forgiveness will be reduced if at least 75% of the potential forgiveness amount was not used for payroll costs. The total loan amount eligible for forgiveness is equal to the lesser of:

- The amount of the PPP loan.
- The amount of forgiveness taking into account FTE employee and salary/wage reductions.
- Payroll costs divided by 75%.

No more than 25% of the forgiveness amount may be spent on non-payroll costs.

Step 6: Be ready to apply for forgiveness.

Borrowers must submit applications for loan forgiveness to their lenders together with documentation of payroll cost, employee headcounts, and expenditures during the Covered Period. Forgiveness is not automatic. Once submitted, the lender is required to provide a response within 60 days. If a lender issues a decision to the SBA denying loan forgiveness in any amount, the lender must provide written notice of the decision to the borrower. Within 30-days of a lender's notice, a borrower may request the SBA review the lender's decision.

We recommend carefully documenting all expenses during the Covered Period so that borrowers are prepared to promptly request forgiveness. Be prepared to justify all expenses and to show how all PPP funds were used.

Borrowers are instructed to submit the following documents with its Application:

Payroll:

- Documentation verifying the eligible cash compensation and non-cash benefit payments from the Covered Period or the Alternative Payroll Covered Period consisting of each of the following:
    - Bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees.
    - Tax forms (or equivalent third-party payroll service provider reports) for the periods that overlap with the Covered Period or the Alternative Payroll Covered Period:

        - Payroll tax filings reported, or that will be reported, to the IRS (typically, Form 941); and
        - State quarterly business and individual employee wage reporting and unemployment insurance tax filings reported, or that will be reported, to the relevant state.
    - Payment receipts, cancelled checks, or account statements documenting the amount of any employer contributions to employee health insurance and retirement plans that the borrower included in the forgiveness amount (PPP Schedule A, lines (6) and (7)).

FTE:

- Documentation showing (at the election of borrower):
    - the average number of FTE employees on payroll per month employed by the Borrower between February 15, 2019 and June 30, 2019;
    - the average number of FTE employees on payroll per month employed by the Borrower between January 1, 2020 and February 29, 2020; or
    - in the case of a seasonal employer, the average number of FTE employees on payroll per month employed by the Borrower between February 15, 2019 and June 30, 2019; between January 1, 2020 and February 29, 2020; or any consecutive twelve-week period between May 1, 2019 and September 15, 2019.
- The selected time period must be the same time period selected for purposes of completing PPP Schedule A, line 11. Documents may include payroll tax filings reported, or that will be reported, to the IRS (typically, Form 941) and state quarterly business and individual employee wage reporting and unemployment insurance tax filings reported, or that will be reported, to the relevant state. Documents submitted may cover periods longer than the specific time period.

Nonpayroll:

- Documentation verifying existence of the obligations/services prior to February 15, 2020, and eligible payments from the Covered Period.
- Business mortgage interest payments: Copy of lender amortization schedule and receipts or cancelled checks verifying eligible payments from the Covered Period; or lender account statements from February 2020 and the months of the Covered Period through one month after the end of the Covered Period verifying interest amounts and eligible payments.
- Business rent or lease payments: Copy of current lease agreement and receipts or cancelled checks verifying eligible payments from the Covered Period; or lessor account statements from February 2020 and from the Covered Period through one month after the end of the Covered Period verifying eligible payments.
- Business utility payments: Copy of invoices from February 2020 and those paid during the Covered Period and receipts, cancelled checks, or account statements verifying those eligible payments.

In addition, borrowers must maintain additional documentation including the Schedule A Worksheet and its supporting documents.

The SBA has indicated it may review PPP loan and forgiveness applications to confirm: (i) borrower eligibility for loan amounts, (ii) appropriate use of loan proceeds, and (iii) borrower eligibility for forgiveness amounts. Such review may occur at any time in the SBA's discretion. Borrowers must retain all PPP loan documentation for <u>six years</u> from the date of loan forgiveness or repayment in full.

Conclusion

The overall takeaway is that forgiveness is not guaranteed and significant questions regarding the CARES Act remain. **Borrowers should carefully review the Application in detail as it applies to the borrower's individual circumstances.**

The information above reflects PFG's current understanding of the CARES Act, SBA guidance, and the Loan Forgiveness Application, and is provided for general education and knowledge. It should not be relied on as legal advice. Moreover, the laws related to the PPP are constantly changing. Each borrower's circumstances will be different, and we encourage you to reach out to our Business Practice Group to discuss your individual situation.