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Every Business That Received a Payroll Protection Program Loan (PPP Loan) CARES About Forgiveness

COVID-19 Resource

Expansion of the payroll protection program (PPP) loans has emerged as a key form of relief provided by the CARES Act, but amid the euphoria and confusion of rolling out a brand new program in the midst of a crisis, some large questions linger, not the least of which is — once you get the funds how the forgiveness will rules apply. As lenders start to disburse funds, and more money may be on the way from Congress, the forgiveness rules are still a work in progress that require careful navigation with only a limited map to help.

Background

Overall, PPP loans provide relief in the form of the federal government paying for certain costs (**Covered Costs**) of a small business over an eight-week period (the **Eight-Week Period**). The PPP program starts when an applicant secures a government guaranteed PPP loan from a lender in an amount equal to 2.5 times its average monthly *Payroll costs* (the PPP loan). The PPP loan is forgiven to the extent that the business uses the loan for *Covered Costs* over the Eight-Week Period after the bank makes the first disbursement of loan proceeds. Reductions in employee headcount or salary also may reduce forgiveness of the PPP loan. Lane Powell's [COVID-19 Resource Center](#) includes several articles summarizing

PPP loans (as enacted and as revised by the SBA), as well as a [spreadsheet](#) for computing the amount and forgiveness components of PPP loans.

Applications First

After the March 27 enactment of the CARES Act, PPP loan application issues took front and center. The Small Business Association (SBA) and the U.S. Treasury issued several types of guidance, including a [summary](#) on the SBA website, a [sample application form](#), an [interim final rule](#) (the IFR) and [FAQ guidance](#) (the FAQs) — we published an [article](#) about the highlights of the FAQs. Despite remaining questions, ambiguities and implementation challenges that are bound to occur in a program this large that was created so quickly, it generally appears that the PPP loan process is well underway — businesses have applied for PPP loans and many already have been approved. In addition, Congress is discussing increasing the original \$349 billion allocated for PPP loans by as much as \$250 billion.

Disbursements Next

FAQ 20 requires that “[t]he lender must make the first disbursement of the loan no later than ten calendar days from the date of loan approval.” FAQ 20 also provides that the Eight-Week Period “begins on the date the lender makes the first disbursement of the PPP loan to the borrower.” Some have already received their PPP loan and many others have been told the current equivalent of *the check is in the mail*. Disbursement of loan proceeds starts the Eight-Week Period when borrowers need to focus on maximizing the amount of loan they will have forgiven.

Unfortunately, there is as much ambiguity and uncertainty concerning PPP loan forgiveness as there was with obtaining a PPP loan (at least before the SBA and the U.S. Treasury provided some clarity). We anticipate that the SBA will provide guidance on forgiveness. In the meantime, this article discusses forgiveness of a PPP loan, based on the statute and limited guidance published to date.

Covered Costs

Forgiveness applies to “costs incurred and payments made” for the four items listed below.(CARES Act § 1106(b).)

- The phrase “costs incurred and payments made” suggests that forgiveness is available for costs incurred during the Eight-Week Period, even if paid after, and also for payments made during the Eight-Week Period, even though incurred before. However, this accrual for costs incurred but not paid during the Eight-Week Period may be limited to payroll costs because the statute refers to “payments” for the other three costs.
- Additional guidance is needed to better understand how to properly compute “costs incurred and payments made” when determining the amount of PPP loan that can be forgiven, including whether costs should be computed based on the accrual or cash basis, and whether the answer depends on the borrower’s normal method of accounting for tax or book purposes.

The four Covered Costs are:

1. **Payroll costs.** (CARES Act § 1106(b)(1).) Payroll costs have the same meaning as the term did for PPP loan application purposes. (CARES Act § 1106(a)(8).) The SBA has clarified that the term includes costs for employee vacation, parental, family, medical and sick leave. See FAQ 8. (However, the CARES Act excludes qualified sick and family leave wages for which a credit is allowed under sections 7001 and 7003 of the Families First Coronavirus Response Act (Section 7(a)(36)(A)(viii)(II)(dd), (ee) of the Small Business Act (15 USC 636(a) as amended by CARES Act § 1102(a).) Accordingly, the significant SBA guidance already released for payroll costs generally should apply equally for purposes of computing forgiveness.
- Most significantly that means (notwithstanding statutory language suggesting otherwise) payroll costs are not reduced by federal income tax withholding or the employee portion of FICA. See FAQ 16.
 - It also means that the \$100,000 cap applies only to salary and other cash compensation and not to amounts paid by the borrower for benefits (e.g. health care and retirement plan contributions). See FAQ 7. Some employers have suspended (or are considering suspending) profit sharing or other retirement plan contributions on behalf of employees. It might make sense to delay any such decisions until after the Eight-Week Period.

- The treatment of commissions and bonuses made on an accrual basis remains unclear. Although the legal commitment to pay such bonuses (for employees making less than the \$100,000/year cap) may be sufficient to include a pro-rated amount in payroll costs, actually paying that portion during the Eight-Week Period would be safer absent SBA clarification.

2. **Mortgage Interest.** (CARES Act § 1106(b)(2).) This generally includes any interest on indebtedness incurred in the ordinary course of business before February 15 that is a mortgage on real or personal property. (CARES Act § 1106(a)(2).) Principal payments or prepayments are excluded. (CARES Act § 1106(b)(2).)

- Because interest generally accrues ratably, it will generally be hard to prepay interest, at least not more than the amount economically accrued during the Eight-Week Period. But it is unclear if the CARES Act prohibits forgiveness for late payments of interest.

- The term *mortgage* is generally understood as a loan secured by specifically identified collateral. The collateral is often real property but can also be personal property and even intangible property.

- Hopefully the SBA will not attempt to limit the definition of a mortgage to real property as there is no such suggested limitation in the CARES Act. Ships and planes are regularly subject to security interests generally referred to mortgages. Similarly, secured loans against other rolling stock, including construction equipment, trucks and automobiles are often documented with the lender on the title to secure the collateral.

3. **Rent.** (CARES Act § 1106(b)(3).) This generally includes rent under a lease agreement in force before February 15. (CARES Act § 1106(a)(4).)

- Nothing in the CARES Act appears to disqualify rent paid to a related person, provided that the lease for the property was in force before February 15.

- It is unclear how the SBA will treat late payment of past-due rent or prepayments of future rent.

4. **Utilities.** (CARES Act § 1106(b)(4).) The CARES Act limits utilities to electricity, gas, water, transportation, telephone or internet access for which service began before February 15.

Some Costs Covered Better Than Others

- **75-25 Split Between Payroll Costs and Other Forgivable Costs.** Nothing in the CARES Act favors any one of the four Covered Costs when computing forgiveness. As a practical matter, because the amount of the PPP loan is based on 2.5 times monthly payroll costs and the Eight-Week Period covers about two months, a business generally can be expected to spend around 75 percent of a PPP loan on forgivable payroll costs, assuming no changes to payroll.
- **Comment:** The SBA's calculation in the IFR to support the 75 percent requirement indicates that employers keeping headcount and salary the same will be below 75 percent. The SBA describes the PPP loan as providing a loan amount "equivalent to eight weeks of payroll (eight weeks / 2.5 months = 56 days / 76 days = 74 percent rounded up to 75 percent)." However, 56 divided by 76 equals about 73.68 percent. **Accordingly, employers must increase payroll costs above the amounts used for obtaining the loan to get to the 75 percent threshold needed for full PPP loan forgiveness.**
- However, the SBA added a requirement that no more than 25 percent of the forgiveness amount of any PPP loan can be attributable to non-payroll costs. (IFR 2(o).) Accordingly, amounts spent on the other forgivable costs (rent, interest and utilities) in excess of 25 percent of the PPP loan will not be forgiven — at least until some borrowers test the SBA's rule in court as an unauthorized limitation on the statutory scheme.

Forgiveness Has Its Limits

Forgiveness Capped at PPP Loan Amount. The amount forgiven cannot exceed the principal amount of the PPP loan. (CARES Act § 1106(d)(1).)

- This likely means that every borrower must pay at least two months of interest (computed at 1 percent per annum) even if the loan is forgiven immediately after the Eight-Week Period, even though the interest is deferred for the first six months of the loan.
- It also avoids questions that could arise when the forgivable amount exceeds the principal amount of the loan.

Reduction in Forgiveness for Reduction in Number of Employees. The forgivable amount generally is reduced if there is a reduction in the number of employees. (CARES Act § 1106(d)(2).) The reduced forgivable amount equals the result of multiplying the sum of the Covered Costs by the ratio of (1) the average number of full-time equivalent employees during the Eight-Week Period to (2) at borrower's election (a) the average number of full-time equivalent employees from February 15, 2019 to June 30, 2019 or (b) the average number of full-time equivalent employees from January 1, 2020 to February 29, 2020. Special rules apply to seasonal employers.

- The CARES Act appears to apply this reduction to the sum of all Covered Costs, before taking into account the absolute cap (i.e., the PPP loan amount). It thus appears possible that this reduction would not impact a business with sufficient Covered Costs.
- It is unclear how this reduction applies with respect to the 75-25 split required by the SBA.

Reduction in Forgiveness for Reduction in Salary. The forgivable amount generally is reduced by an amount related to a reduction in salary (the **Salary Reduction Amount**). (CARES Act § 1106(d)(3).) The CARES Act requires businesses to calculate the Salary Reduction Amount, if any, for each employee who received, during any single pay period in 2019, wages or salary of \$100,000 or less on an annualized basis. (CARES Act § 1106(d)(3)(B).)

- Yes, this literally means that reductions in wages or salaries for those who make more than \$100,000 have no detrimental impact on the forgiveness computation.
- It also means that there is no reduction related to employees who did not work for the business in 2019.

The Salary Reduction Amount equals the excess, if any, of the reduction during the Eight-Week Period over 25 percent of the total salary or wages of the employee during the most recent full quarter during which the employee was employed before the Eight-Week Period — the first quarter of 2020 for PPP loans received in the second quarter of 2020. (CARES Act § 1106(d)(2)(A).)

- Accordingly, we estimate that a business potentially could reduce wages by about 40 percent without having a Salary Reduction Amount.
- For example, an employee earning a salary of \$52,000 per year would have received \$13,000 in the first quarter of 2020. That employee also normally would have received \$8,000 during the Eight-Week Period. The employer would have a Salary Reduction Amount only to the extent that the reduction during the Eight-Week Period exceeded \$3,250 (25 percent of \$13,000). Therefore, the employer could avoid reduction in forgiveness so long as the employer doesn't reduce the employee's salary below \$4,750 (\$8,000-\$3,250), or \$593.75 per week. Such salary reduction represents a decrease of a little over 40 percent, without triggering any Salary Reduction Amount.
- Of course reducing salaries could make it difficult to achieve complete loan forgiveness given the 75-25 split required by the SBA.
- We also would not be surprised if the SBA interprets the CARES Act in a manner that does not allow such large salary reductions.

Impact of Rehiring. The forgiveness amount is “determined without regard” to reductions in forgiveness resulting from a reduction in the number of employees or a reduction in salary, as applicable, during the Eight-Week Period, if the employer eliminates the headcount/salary reduction by June 30. (CARES Act § 1106(d)(5).)

- Technically, this rule would allow an employer that fires all employees to avoid a reduction in forgiveness if the employer hires everyone back at original pay for only one day (June 30).
- We anticipate that the SBA may provide rules to prevent such planning.

How Much Forgiveness Can I Expect?

The [spreadsheet](#) on our website includes calculations for forgiveness. This allows businesses to play out different scenarios based on current information available about forgiveness. We plan to update the spreadsheet as additional guidance is released.