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Run It Back — Maximizing PPP Loan Forgiveness

COVID-19 Resource

For businesses fortunate enough to obtain a Paycheck Protection Program (PPP) loan, one of the biggest questions is how the forgiveness part of the program will work. We previously provided some guidance on loan forgiveness, in this Legal Update, noting the many open issues that require Small Business Administration (SBA) policy decisions and published guidance. The SBA was to issue guidance on this issue by April 26, but that day has come and gone without any new policy decisions on the subject. In the absence of that guidance, we can provide some thoughtful predictions, subject to change if SBA issues further guidance, about maximizing loan forgiveness.

Statutory Framework

Section 1106 of CARES provides the statutory framework for PPP loan forgiveness. Section 1106(b) provides loan forgiveness equal to the sum of the following items during the "covered period":

- Payroll costs, including benefits;
- Interest on covered mortgage obligations (incurred before February 15) — which has been interpreted to include secured loans on personal property such as ships and rolling stock;
- Rent (agreement beginning before February 15); and
- Utility costs (service beginning before February 15).

Payroll costs include salaries, commissions, wages and tips paid to employees. Payroll costs also include certain employee benefits and state and local taxes, including unemployment insurance premiums imposed on employee compensation. They also include costs related to the continuation of group health care benefits during periods of paid sick, medical or family leave. Payroll costs are subject to a $100,000 per employee limit for cash compensation. Payroll costs do *not* include compensation paid to employees with a principal residence outside of the U.S., cash compensation in excess of $100,000, the employer portion of FICA taxes, or any wages paid pursuant to the paid sick or qualified family leave provisions of the Families First Coronavirus Response Act (FFCRA).

The *covered period* is defined as the eight-week period beginning on the date of loan origination.

Section 1106(d) of CARES provides limitations on the amount of loan forgiveness. First, the forgiveness amount may not exceed the principal amount of the loan. Second, the amount of forgiveness is subject to haircut provisions if the employer (1) reduces the number of employees during the covered period, or (2) reduces salary or wages paid to employees.

Businesses must "apply" for loan forgiveness. The application process involves submitting documentation to the lender that verifies or certifies the following:

- Employees and payroll;
- Payments on covered mortgages, leases and utilities; and
- Representation that information provided is true and correct;
- Representation that loan proceeds were used for qualifying purposes; and
- Any other documentation determined necessary.

Interim Final Rules

The Small Business Association (SBA) issued interim final rules (IFR) regarding the PPP loan program on April 3, published in the Federal Register (and thus officially effective) on April 15. These rules limit PPP loan forgiveness. Non-payroll costs eligible for forgives may not exceed 25 percent of the aggregate forgiven balance. Stated differently, payroll costs during the eight-week forgiveness period must be at least 75 percent of the aggregate forgiven balance, or, the total forgivable amount equals the amount derived by dividing payroll costs during the covered period by 75 percent.

The IFR also requires that "at least 75% of the PPP loan proceeds shall be used for payroll cost purposes." We interpret this "use of proceeds" provision to mean the borrower must have payroll costs of at least 75 percent of their loan amount during the two-year period the loan is outstanding. In other words, if a borrower spends all of the PPP loan proceeds on forgivable costs, but with 70 percent for payroll costs and 30 percent to other forgivable costs, a portion of the PPP loan will not be forgiven. The borrower will need to have additional payroll costs between the end of the covered period and the maturity date of the loan to satisfy this 75 percent requirement.

Maximizing Forgiveness

PPP loan recipients should carefully consider their options for maximizing loan forgiveness. The most obvious pathway to maximizing loan forgiveness in the PPP is to maintain payroll and headcount. The PPP loan program has been subject to political and public pressures. It's difficult to say what new or clarifying rules may be issued as we transition to the forgiveness phase of PPP lending. Regardless, borrowers should still be asking: what else should I be doing to maximize PPP loan forgiveness?

PC Load Letter – Costs Incurred and Payments Made

CARES Act and the current PPP loan rules do not define what is meant by the phrase "costs incurred and payments made." This phrase is used in the statute to define what items give rise to loan forgiveness. The term *costs incurred* suggests an accrual or otherwise becoming liable to make a payment. The term *payments made* suggests a cash basis approach. The word "and" in the statute could mean that businesses must both accrue the costs and spend the cash during the covered period. However, statute using the word "payment" for each of the forgivable costs other than payroll costs may suggest a disjunctive use with respect to payroll costs. For example, if a clothing catalog describes a T-shirt as available in green and blue, people would understand that they could purchase a blue shirt or a green shirt. This ambiguity drives most of the loan forgiveness strategy, but beware as all of these proposals may prove ineffective when the SBA finally issues the required guidance.

Short Payroll Period

Employers typically run payroll on a monthly, semi-monthly or bi-weekly basis. An employer's payroll generally will not align with the beginning or ending of the *covered period*. The first paycheck issued in the covered period, a "payment made," generally will include amounts for work done before the covered period began. Hopefully, the SBA will give credit for the full paycheck. After all, because eight weeks is less than 75 percent of two-and-a-half months, this credit for pre-covered period compensation may be the best way to ensure that employers that maintained headcount and salary achieve the 75 percent level mandated by the SBA.

Similarly, the closing period likely will end before the end of a pay period. Businesses may opt to make an additional payroll on the last day of the covered period. This would effectively ensure that there is no payroll in the forgiveness calculation due to payroll costs incurred but not paid until after the covered period. However, this seems like a massive undertaking and an unreasonable trap for the unwary for a program specifically geared towards small businesses. We are hoping the SBA will provide guidance on this critical issue.

Increasing Benefits

Employers should consider making or accelerating payments to employee's health savings accounts and making optional contributions to employee retirement programs. Because non-ordinary course payments could ultimately be prohibited, we recommend delaying such action until we see the SBA's guidance.

Stuffing Headcount and In-Sourcing

Employers should consider adding headcount during the covered period. This option is probably most attractive to businesses with available work and those most affected by employees taking advantage of sick or family medical leave (*i.e.,* substituting workers not working but being paid under FFCRA provisions).

Employers typically review their core functions and may outsource non-essential functions to third parties (*e.g.*, accounting, legal, IT, etc.). Employers that have previously outsourced these functions may benefit from loan forgiveness if they bring these functions back in-house.

Many independent contractors can be converted to W-2 employees, but that status cannot be toggled off and on without creating other issues. So, this approach works best for independent contractors who should probably have been treated as employees. Increased forgiveness might take some of the sting out of coming into compliance.

Raising Wages

Employers that have made the difficult decisions to terminate employees may find it difficult to retain the remaining workers as economic conditions improve. Potential approaches to minimize employee turnover in the coming months would be raise wages, provide hazard pay for those employees most exposed to the virus, accelerate bonuses, or pay a bonus during the covered period instead of providing a 2021 raise. For purposes of maximizing forgiveness, this strategy only works best for employees making less than the $100,000 per year limit (*i.e.*, less than $15,384 of cash compensation during the covered period).