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Lewis M. Horowitz
horowitzl@lanepowell.com

Eric J. Kodesch
kodesche@lanepowell.com

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Headcount and Compensation Reductions Have a Lesser Impact in PPP Loan Forgiveness With New Tripling of 'Covered Period'

COVID-19 Resource

Now that the Paycheck Protection Program Flexibility Act (PPPFA) has been signed into law, which we summarized in this article, one of the key changes to the Paycheck Protection Program (PPP) created by the CARES Act is the tripling of the "covered period" for paying or incurring forgivable costs (payroll costs, mortgage interest, rent and utilities). Under the PPPFA the original eight-week covered period has been increased to 24 weeks (or the period from origination to December 31, if shorter). Businesses can elect to retain the original, eight-week covered period if they so choose, though just about all businesses will find the longer 24-week period more beneficial because there is a much greater likelihood they will have sufficient payroll costs and other forgivable non-payroll costs to obtain full loan forgiveness.

In a prior article we discussed two benefits from the PPPFA, potentially unintended, to businesses: (1) minimizing the impact of the $100,000 annualized cap and (2) effectively overturning the SBA-created caps for employee-owners and the self-employed. Intentional or not, the extension of the time period for paying or incurring forgivable costs limits

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the statutory reductions in forgiveness when there has been a greater than 25 percent reduction in compensation or a reduction in full-time equivalents (FTEs). Here's how it works.

Background: Statutory Reductions in Forgiveness

The CARES Act potentially reduces the PPP loan amount forgiven when the business (1) reduced compensation of any one individual by more than 25 percent (but only if the individual was earning less than an annualized $100,000) or (2) reduced its FTEs. In a prior article, we discussed how the Small Business Administration (SBA), in its PPP loan forgiveness application, adopted a clear and favorable interpretation for calculating these reductions, pursuant to which a business:[1]

1. Starts with the sum of forgivable costs paid or incurred during the "covered period."

2. Subtracts the amount related to a reduction in compensation. Under the CARES Act, there is no reduction in forgiveness for a reduction in the salary of someone who made over $100,000. Further, the SBA has determined that there is no reduction in forgiveness for hourly workers if the business does not reduce the hourly rate, but pays for fewer hours.

3. Multiplies the resulting amount by the ratio of average monthly full-time equivalents (FTEs) during the "covered period" to the average monthly FTEs in either of two reference periods (February 15, 2019 – June 30, 2019, or January 1, 2020 – February 29, 2020), as selected by the business.

The PPPFA changes the meaning of the term "covered period" from eight weeks to 24 weeks (or the number of weeks from loan origination to December 31, if shorter). Importantly, the PPPFA does not amend the text of the CARES Act provisions providing for compensation or FTE reductions (CARES Act Joint Statement by Treasury Secretary Steven T. Mnuchin and SBA Administrator Jovita Carranza Regarding Enactment of the Paycheck Protection Program Flexibility Act[2]

Impact of PPPFA – Minimizes the Impact of the Statutory Reductions

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By extending the covered period, the PPPFA substantially increases (possibly triples) the total potential forgivable amount and thus minimizes the impact on reductions to forgiveness attributable to reductions in compensation or FTEs. Indeed, in most cases, the increase in forgivable costs will effectively eviscerate the impact of statutory reductions in compensation or a reduction in the FTE ratio. This is so even though the PPPFA also extends the time in which the business can have reductions in compensation and FTEs that reduce forgiveness. (Any borrower for whom that is not true will simply elect the original eight weeks as its covered period.)

For example, assume that a business receives a PPP loan of $1 million based on average 2019 payroll costs of $400,000 per month. Assume further that, using the original eight-week period, it has forgivable costs totaling $1 million, no reduction in forgiveness for a reduction in compensation, but an FTE ratio of 90 percent. The cap on forgiveness based on the statutory reductions in forgiveness is $900,000 (90 percent of $1 million). Assume that over a 24 week period the business has $2.5 million of forgivable costs – a reasonable assumption because the covered period tripled. Now the business could, for example, have reductions in compensation that reduce the $2.5 million forgivable amount by $500,000 and have an FTE ratio that drops to 50 percent but still qualify for forgiveness for the entire $1 million PPP loan.

Results will differ for each business, but for many businesses the increase in the starting point for calculating the statutory reductions in forgiveness likely will moot or minimize the impact of these compensation/FTE reductions. Those negatively impacted by the statutory reductions can still take advantage of the restoration safe harbor. Note, however, that the PPPFA changes the restoration date from June 30 to December 31, with no ability to elect to use the original June 30 date.

Planning Steps

Businesses can elect to use the original eight-week covered period. We need to see the SBA process for making the election, as well as the amended PPP loan forgiveness application, but it appears that businesses can:

1. Prepare a PPP loan forgiveness application based on an eight-week covered period. If this results in full PPP loan forgiveness, submit the

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application and be done. Otherwise, undertake steps 2 and 3.

2. Prepare a PPP loan forgiveness application based on the 24-week covered period.

3. Submit the PPP loan forgiveness application with the greater forgiveness, electing out of the extended covered period, if necessary.

The Takeaway

The changes made by the PPPFA will likely result in most businesses receiving complete (or increased) forgiveness of their PPP loan. Initially, businesses were attempting to use loan proceeds equal to 2.5 months of payroll costs to cover payroll, mortgage interest, rent and utilities over an eight-week period. Extending the covered period to 24 weeks significantly increases the likelihood businesses will have sufficient payroll costs (which are now divided by 60 percent) and other forgivable non-payroll costs to obtain full loan forgiveness.

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1 We previously speculated that the SBA provided business-friendly interpretations of the statutory reductions because of the SBA-created cap of payroll costs during the "covered period" divided by 75 percent. The PPPFA minimizes the impact of this cap by (1) increasing the length of the "covered period" and (2) decreasing the divisor to 60 percent.

2 In the press release, the Treasury stated that June 30 is now the last date on which a PPP loan application can be approved. This conflicts with a revision to the CARES Act effected by the PPPFA and makes a covered period ending on December 31 an impossibility. We do not know whether the Treasury will revise their administratively-imposed deadline.

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