Guidelines to Maximizing Paycheck Protection Loan Forgiveness

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I. Introduction

A. The CARES Act

1. The Paycheck Protection Program is a loan designed to provide a direct incentive for small businesses to keep their workers on the payroll.

a. Any small business that employs less than 500 employees is eligible.

b. The program ran out of the initial $349 billion the federal government earmarked for it in just 13 days.

c. A second round of funding provide an additional $310 billion more in funding for the program.

d. The PPP Loan is forgiven if the money is used for payroll, and permitted non-payroll costs

e. The CARES Act calls for a portion of the Paycheck Protection Loans to be forgiven on a tax-free basis.

2. The amount to be forgiven is the sum of the following costs "incurred and payments made" by the borrower during the 8-week period beginning on the date of the loan:

- Payroll costs;
- Any payment of interest on any mortgage obligation (not including any prepayment of or payment of principal on a mortgage obligation) that was incurred before February 15, 2020,
- Any payment of rent under a leasing agreement in force before February 15, 2020,
- Any utility payment, including payment for the distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020.payroll costs (as defined above).

B. How are the Funds to be Used

1. The permissible uses for the funds are as follows:

- Payroll Costs
- Costs related to group health care benefits
- Mortgage interest
- Rental payments
- Utility payments
- Interest payments on other debt obligations incurred before February 15, 2020
- Refinancing SBA EIDL Loans made between 1/31/2020, and 4/3/2020

- Misuse of PPP Loan Funds
- The SBA will direct a borrower to repay PPP loan funds used for an unauthorized purpose.
- Knowingly using the funds for unauthorized purposes will subject the borrower to liability including fraud.
- In the event of misuse by the borrower's shareholders, members, or partners, SBA will have recourse against such shareholders, members, or partners.

2. Treasury Secretary Mnuchin announced that all loans over $2 million will be subjected to audits. A later announcement hinted that all loans under the program would be subject to an audit. Who is going to do that? The SBA? Banks?

C. Limitations on Loan Forgiveness

- The actual amount of forgiveness will be calculated based on:
- The amount Payroll costs, mortgage interest, rent, and utilities paid and incurred during the "Covered Period"
- The 75% Rule
- The Reduction in Work Force Rule
- The Reduction in Wages Paid Rule

II. Defining Payroll and Nonpayroll Costs

A. Payroll Costs Defined

Payroll costs are equal to the sum of:

- Salary, wage, commission, or similar compensation; for a partnership, recent guidance from the SBA explains that payroll costs include not only guaranteed payments to a partner, but also any partner's share of income of the partnership subject to self-employment income. As discussed below, these amounts are subject to a per-employee or per-partner cap of $100,000.
- Payment of cash tip or equivalent.
- Payment for vacation, parental, family, medical, or sick leave.
- Allowance for dismissal or separation.
- Payment required for the provisions of group health care benefits, including insurance premiums.
- Payment of any retirement benefit; or
- Payment of State or local tax assessed on the compensation of employees.

B. Payroll Cost Exclusions

Payroll costs do NOT include:

- The compensation of an individual employee — or the self-employment income of a partner in a partnership – in excess of $100,000, as prorated for the covered period.
- Taxes imposed or withheld under chapters 21, 22, or 24 of the Internal Revenue Code during the covered period.
- Any compensation of an employee whose principal place of residence is outside of the United States.
- Qualified sick leave wages for which a credit is allowed under section 7001 of the Families First Coronavirus Response Act; or
- Qualified family leave wages for which a credit is allowed under section 7003 of that same Act.

C. SBA Clarification

A recent SBA FAQ clarified several points of confusion surrounding the items that are excluded from payroll costs, and this clarification should apply equally when determining the costs eligible for forgiveness.

1. First, the $100,000 per-employee limit applies only to cash compensation, salary or wages.
2. Additional payroll costs allocable to the employee, including employer contributions to defined-benefit or defined-contribution retirement plans, payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums, and payment of state and local taxes assessed on compensation of the employee may be added to the $100,000 of maximum salary in computing payroll costs.
3. For a self-employed taxpayer, recent guidance defines payroll costs in a purely mechanical fashion as the net self-employment income reported on a 2019 Form 1040 Schedule C, Line 31
4. Under the Act, payroll costs are calculated on a gross basis without regard to federal taxes imposed or withheld, such as the employee's and employer's share of Federal Insurance Contributions Act (FICA) and income taxes required to be withheld from employees.
5. Payroll costs are not reduced by 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.

   For example, an employee who earned $4,000 per month in gross wages, from which $500 in federal taxes was withheld, would count as $4,000 in payroll costs.

The employee would receive $3,500, and $500 would be paid to the federal government.

However, the employer-side federal payroll taxes imposed on the $4,000 in wages are excluded from payroll costs under the statute.

D. "Costs Incurred and Payments made"

1. The requirement that only "costs incurred, and payments made" within the 8-week period will be forgiven may seem innocuous, but it has the potential to create a host of problems.

2 There are two possible interpretations of this critical phrase.

a. The first is to focus on the use of "and" rather than "or" in the phrase and assume this requires any expense to be BOTH incurred AND paid within the 8-week period.

(1) This, as you could imagine, would cause some problems.

(2) Say a borrower gets their PPP loan on April 15th – under this interpretation, they wouldn't be able to use the funds to pay payroll attributable to March, because though the costs weren't "incurred" during the 8-week period beginning with the receipt of the proceeds. Or, at the other end of the date range – the same borrower wouldn't be able to prepay June rent at the end of May, before the expiration of the 8-week period, because the rent wasn't incurred until after the period had expired.

b. The other interpretation is more favorable, but perhaps unreasonably so.

(1) Here, we focus on the fact that the language does not require any particular expense to be both paid and incurred, but rather accommodates BOTH "costs incurred" AND "payments made" during the 8-week period.

(2) In this case, the application gets far more expansive. Presumably, an April borrower could have May rent forgiven that wasn't paid until June, because the cost was incurred prior to the end of the 8-week period.

(3) Similarly, the same borrower could pay amounts attributable to costs incurred before and after the period, and both would be eligible for forgiveness because the amounts were paid within the covered period.

(4) And while allowing for prepayment of expenses may appear illogical, remember that the CARES Act specifically bars prepayment of mortgage interest during the covered period, but only mortgage interest.

III. The 75% Rule

A. Overview - The amount to be forgiven is the sum of the payments listed above made by the borrower during the 8-week period beginning on the date of the loan:

1. The amount to be forgiven is the sum of the payments listed above made by the borrower during the 8-week period beginning on the date of the loan:

a. 75% of the loan proceeds must be used for payroll costs

Not more than 25% of the "forgiven amount" may be for non-payroll costs

b. The these are two separate rules which appear to operate independently of each other.

2. Example. X Co. borrowed $100,000 in PPP proceeds on April 10, 2020.

a. <u>25 Percent Rule</u>

Over the next 8 weeks, X Co. spent $50,000 on payroll costs and $40,000 on rent and utilities. X Co.'s loan forgiveness is limited to $66,667, $50,000 of payroll costs and $16,667 of rent and utilities. ($50,000/.75 = $66,667).

b. <u>75 Percent Rule</u>

75% of the loan proceeds must be used for payroll costs.

B. Impact of the 25% Limitation - Unfortunately, this 25% limitation means that unless a business increases its payroll costs over the 8-week covered period relative to its 2019 pace, full forgiveness isn't possible.

Example: Assume X Co. had $3.6 million in payroll costs in 2019. The maximum PPP loan proceeds are $750,000. Assume, X Co. continues its payroll during the covered period at the exact same level as it paid out in 2019. During the 8 weeks, X Co. will pay out $553,000 in payroll costs. It will use the remaining proceeds to pay rent and utilities. All is forgiven, right?

Wrong. Because the SBA is limiting the forgivable portion of non-payroll costs to 25%, the maximum amount of loan forgiveness for X Co. is $738,000 ($553,000/75%). As a result, at a minimum, $12,000 of the loan will not be forgiven.

IV. Reduction in Workforce Rule

A. Overview - The CARES Act provides that the amount of loan forgiveness is reduced by multiplying the amount eligible for forgiveness by the quotient obtained by dividing:

- The average number of Full-Time Equivalent Employees ("FTE") per month employed by the eligible recipient during the eight week "covered period"; by
- The average number of full-time equivalent employees per month employed by the eligible recipient during, at the election of the borrower, the period the ("lookback period'"):
  - (A) Beginning on February 15, 2019 and ending on June 30, 2019; or
  - (B) Beginning on January 1, 2020 and ending on February 29, 2020.

Note: For purposes of calculating forgiveness, both "Full-Time Employees" and "Full-Equivalent Employees" are used for these calculations. The CARES Act Section 2301(c)(3), which pertains to the employee retention credits, defines a full-time person by referencing IRC Section 4980H. A full-

time employee is an individual who works an average of at least 30 hours per week. A full-time equivalent employee is determined by adding the hours of part-time employees on a monthly basis and dividing by 120 [IRC Section 4980H(c)(2)(E)].

Until guidance is received otherwise, we suggest using this computation to determine the FTEs for those employees who work fewer than 30 hours per week. Employees working at least 30 hours per week are counted as full-time employees.

B. Reduction in Forgiveness - If a borrower lays people off during the covered period the amount of the loan forgiveness will be reduced by:

$$\frac{\text{Avg. monthly FTEs During Covered Period}}{\text{Avg. monthly FTEs Lookback Period}} \times \text{Total Amount of Loan Forgiveness} = \text{New Loan Forgiveness}$$

Example: Widgets, Inc. wants $1 million in loan forgiveness under the Paycheck Protection Program. During the covered period, Widgets has 25 average monthly full-time employees. During the lookback period, Widgets had 50 average monthly full-time employees. Widgets is eligible for $500,000 in loan forgiveness [(25 / 50) x $1,000,000].

$$\frac{25}{50} \times \$1{,}000{,}000 = \$500{,}000$$

C. Employee Restoration –

1. If a business reduces employees from *February 15 through April 27, 2020*, but eliminates that reduction by June 30, 2020, the reduced forgiveness is restored.

2. <u>Steps</u> - Calculate the "average" FTE during the periods:

   (1) The 8-week covered period beginning with receipt of the loan proceeds.

   (2) February 15 – June 30, 2019 or January 1 – February 29, 2020

   (3) February 15 – April 27, 2020

   (4) February 15, 2020

   (5) Until June 30, 2020.

3. If and employers FTEs in period (1)(the Covered Period), is less than (2)(the Lookback Period (whichever is lower)), an employer has a reduction in loan forgiveness.

4. In order to avoid forgiveness, the employer has until June 30, 2020 to restore any reduction in employees that occurred during period (3) relative to date (4) February 15.

5. Example:

- A business must measure its FTEs for each pay period during the 8-week covered period – assume that number is 20.
- It must then measure its FTEs for the period February 15 – June 30, 2019 or January 1 – February 29, 2020. Assume it is 30 in both cases.

First Step -

FTEs 8 Week Covered Period	20
Look Back Period: Either	
(A) FTEs - February 15 – June 30, 2019	30
(B) FTEs - January 1 – February 29, 2020	30
Loan Forgiveness	$100,000
Forgiveness Ratio	20/30 = .667
New Loan Forgiveness	.667 x $100,000 = $66,667

At this point, if the business were otherwise eligible for $100,000 of forgiveness, that amount would be reduced to $66,667 ($100,000 x 20/30).

Second Step – To what extent did the employer reduce employees

FTEs from February 15 – April 27, 2020	25
FTEs on February 15, 2020	32
Reduction in FTEs	7

Restoration

This 7-person reduction between February 15 and April 27, 2020 will be ignored if no later than June 30, 2020, the business has restored the employee levels to what they were on February 15, 2020 (32).

Query? Why is forgiveness reduced if our staffing drops during the covered period relative to 2019 or the beginning of 2020, but restored if we replace employees lost during the period February 15 to April 27, 2020?

D. Is the Borrower Penalized if Employees Refuse to Come Back to Work

1. What happens if I want to hire back all my employees, but some reject the offer?
2. Short answer: that's okay—it won't affect forgiveness levels.
3. However, the employer must meet certain qualifications:

- You must have made an written offer to rehire in good faith
- You must have offered to rehire for the same salary/wage and number of hours as before they were laid off
- You must have documentation of the employee's rejection of the offer

Note: That employees who reject offers for re-employment may no longer be eligible for continued unemployment benefits.

V. Reduction in Wages Rule

A. Overview

1. There is also a provision, however, that reduces the salary or wages paid to an employee who had earned less than $100,000 in annualized salary by more than 25% during the covered period.

2. If a borrower cuts its employees' wages during the covered period, the amount of loan forgiveness will be reduced by:

- The amount of any salary or wage reduction of any "covered employee" whose annualized rate of pay during any pay period in 2019 was less than $100,000; and
- Whose salary or wage reduction was in excess of 25% of the total salary or wages they received during the most recent full quarter before the covered period.

3. A "covered employee" is any employee who did not receive, during any single pay period during 2019, wages or salary at an annualized rate of pay in an amount more than $100,000.

Example: X is paid on a by monthly basis. Her basic annual compensation is $75,000, or $3,125 each pay period. X is covered employee

However, if X received a $5,000 annual bonus in the final pay period of the year – she is no longer considered a covered employee – annualized compensation for that pay period would exceed $100,000 [($3,125 + $5,000) x 24 = $195,000]

4. The reduction in forgiveness amount is required if the reduction in wages over the 8-week period is in excess of 25% of the total salary or wages of the employee during the most recent full quarter during which the employee was employed before the covered period.

Example: Widgets, Inc. wants $100,000 in loan forgiveness under the Paycheck Protection Program. One change during the "covered period", Widgets cuts Y's wages from $12,308 to $4,000. The reduction in wages ($12,308 – 4000 =$8,308) in excess of 25 percent of the total salary or wages of the employee during the most recent full quarter ($5,000) is $3,308 ($8,308 – 5,000)

Widgets would only be eligible for $96,692 of loan forgiveness ($100,000 – $3,308 = $96,692).

B. Avoidance of Reduction

1. This reduction can be avoided, however, if the employer increases the employee's pay before June 30, 2020.

2. To avoid forgiveness, the employer has until June 30, 2020 to eliminate the reduction in the salary or wages

a. During the period beginning on February 15, 2020 and ending April 27, 2020, there is a reduction, as compared to February 15, 2020, in the salary or wages of 1 or more employees of the eligible recipient; and

b. Not later than June 30, 2020, the eligible employer has eliminated the reduction in the salary or wages of such employees.

3. Example - Employee X made $80,000 a year on February 15, 2020 Beginning on that date his wages were reduced by 50%. During the period February 15, 2020 he would have made $15,780, he did make $7,890. The employer would have to eliminate the $7,890 salary reduction by June 30, 2020 to avoid a reduction in forgiveness

VI. Obtaining Loan Forgiveness

A. Overview

1. To seek forgiveness, a borrower must submit to the lender an application that includes documentation verifying the number of employees and pay rates, and cancelled checks showing mortgage, rent, or utility payments.

2. All lenders have 60 days to decide on the loan forgiveness, and any portion that is not forgiven must be repaid within two years.

3. Any forgiven loans will be excluded from gross income for tax purposes.

Example. Continuing the previous example with Rob's Car Wash, in the first 8 weeks after the business borrows the $250,000, the business pays $200,000 in payroll costs, mortgage interest, and utility payments. Rob's Car Wash is eligible to have $200,000 of the $250,000 loan forgiven. The forgiveness will not create taxable income. In addition, because of the deferment rules in the CARES Act, any payments due on the remaining $50,000 will not be due for six months.

B. Expected Requirements and Documentation

1. In order to meet the forgiveness obligations, it is anticipated that companies will be required to submit evidence clearly demonstrating the payment of payroll, rent, utility and interest from the borrowed funds during the covered period, including the following:

- Documentation verifying the number of full-time equivalent employees on payroll and pay rates for the periods Covered Period and the Look Back Period including—
- Payroll tax filings reported to the Internal Revenue Service; and
- State income, payroll, and unemployment insurance filings.
- Documentation, including cancelled checks, payment receipts, transcripts of accounts, or other documents verifying payments on covered mortgage obligations, payments on covered lease obligations, and covered utility payments
- A certification from a representative of the eligible recipient authorized to make such certifications that—
  - The documentation presented is true and correct; and
  - The amount for which forgiveness is requested was used to retain employees, make interest payments on a covered mortgage obligation, make payments on a covered rent obligation, or make covered utility payments; and
  - Any other documentation the Administrator determines necessary.

2. The law requires that eligible recipient shall not receive forgiveness under this section without submitting to the lender that is servicing the covered loan the documentation required

3. With this in mind, companies should consider the following:

a. <u>Keep PPP Funds Separate</u>

(1) Deposit all PPP proceeds in a separate bank account and ensure that PPP loan proceeds are used only for expenditures that are eligible for forgiveness. Keep all related support to corroborate disbursement of such funds.

(2) For payroll funding, only payroll for amounts within the forgiveness parameters should be funded from the PPP segregated account. Ideally, employees making more than the threshold would receive two separate checks.

(3) Where circumstances do not permit this or where it is too impractical (e.g., if payroll must be funded into a single account), only funding within the forgiveness parameters should come from the PPP account, with the excess funded from non-PPP sources. It is key to understand that the $100,000 annual salary limit per employee is on gross compensation, so associated applicable withholding taxes should be paid from these funds.

b. <u>PPP Loan Recordkeeping</u>

Good recordkeeping will be critical for loan forgiveness. Over the eight-week period, keep track of eligible expenses and their accompanying supporting documentation. Lenders will likely require these documents in digital format, so take the time to scan any paper documents and keep backups of the digital records. The documentation should include:

- Payroll registers or ledgers
- Health insurance invoices and payments
- Payments for retirement amounts
- Support for rent expense (lease and cancelled checks/Automatic Clearing House (ACH) or wire transfer evidence)
- Support for interest paid on debt obligations
- Evidence of utilities paid including invoices
- State and local payroll tax payments (e.g., for New York State, the MCTMT and State unemployment insurance) supported by tax returns, vouchers, or other documentary evidence.

c. Accounting for Payroll Costs

Question: How should a borrower account for federal taxes when determining its payroll costs for purposes of the maximum loan amount, allowable uses of a PPP loan, and the amount of a loan that may be forgiven?

Answer: Under the Act, payroll costs are calculated on a gross basis without regard to (i.e., not including subtractions or additions based on) federal taxes imposed or withheld, such as the employee's and employer's share of Federal Insurance Contributions Act (FICA) and income taxes required to be withheld from employees. As a result, payroll costs are not reduced by 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.

For example, an employee who earned $4,000 per month in gross wages, from which $500 in federal taxes was withheld, would count as $4,000 in payroll costs. The employee would receive $3,500, and $500 would be paid to the federal government. However, the employer-side federal payroll taxes imposed on the $4,000 in wages are excluded from payroll costs under the statute.

d. Maintain Employee Data

(1) Maintain a headcount of all full and part-time employees on payroll. In many cases your payroll processing company will be able to provide this information.

(2) The company will need to account for the average number of full-time equivalent employees per month during:

(a) The eight-week period beginning with the receipt of loan proceeds (numerator)

(b) The period covering February 15, 2019 and June 30, 2019, or

(3) The period covering January 1, 2020 to February 29, 2020

(4) The period February 15, 2020 to April 27, 2020

(3) Additionally, the company will need to carefully track payroll during both the eight-week period and first quarter of 2019 for all employees who earn $100,000 or less annually (see .

(4) The Act also permits companies to avoid any reduction in the potential forgiveness in connection with reductions to headcount or salary levels by (i) rehiring by June 30, 2020 any staff that were terminated between February 15 and April 26 and (ii) restoring their pay to required levels by June 30. However, these cures do not impact the requirement that the funds be properly spent in the 8-week period following loan funding.

VII. Tax Treatment of Forgiven Costs

A. If a PPP loan is forgiven the expenses funded with the proceeds of the loan will not be deductible for federal income tax purposes?

B. The IRS, in Notice 20-32, applied general principles of existing tax law in finding that expenses funded with the proceeds of a PPP loan are not deductible by the taxpayer up to the amount of the PPP loan that is forgiven. Section 265 of the Internal Revenue Code disallows an otherwise allowable deduction that is allocable to tax-exempt income. The IRS reasoned that PPP loan forgiveness constitutes a category of tax-exempt income because of the application of Section 1106(i) of the CARES Act and thus expenses funded by PPP loan proceeds are not deductible to the extent of loan forgiveness.