PAYCHECK PROTECTION PROGRAM: SBA RELEASES FORGIVENESS APPLICATION – SOME QUESTIONS ANSWERED, OTHERS REMAIN

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The concept of a forgivable loan has been the most attractive feature of the Paycheck Protection Program ("PPP") since the first rumors of the program began emanating from Washington. Millions of companies applied for and received PPP loans with the hope (and in many cases, expectation) that the loan would be fully forgiven.

However, borrowers and professional advisors attempting to calculate potential forgiveness on issued PPP loans have been stymied by the forgiveness provisions in Section 1106 of the CARES Act. The Small Business Administration (SBA) is required to issue additional guidance on forgiveness under the CARES Act, and has been promising borrowers this guidance for weeks. While an interim final rule on forgiveness still has not been published, SBA published the loan forgiveness application late on May 15 (the "Application"). While not a complete guide to forgiveness, the Application does provide some helpful guidance.

In the Application, the basic premise of the Section 1106 forgiveness provisions remain intact. To be eligible for forgiveness, PPP borrowers must spend PPP loan proceeds on payroll, rent, utilities and mortgage interest during the 8 weeks after receiving the loan. Headcount and wage reductions can reduce forgiveness eligibility. Thankfully, the Application gives a little more clarity on many of the frequently asked questions that have been puzzling borrowers and professionals alike.

Forgiveness Basic #1 – Calculating your Maximum Forgiveness Amount

According to the Application, borrowers are eligible for PPP loan forgiveness up to the sum of the following costs incurred and payments made during the 8 weeks after the loan funds (more on that 8 week period below):

- "**payroll costs**" (includes salary, wages, leaves, health care, retirement, etc.)
- interest payments under a "**covered mortgage obligation**", which means any indebtedness or debt instrument incurred in the ordinary course of business that (A) is a liability of the borrower; (B) is a mortgage on real or personal property; and (C) was incurred before February 15, 2020

- "**covered rent obligation**", which means rent obligated under a lease agreement for real or personal property in force before February 15, 2020
- "**covered utility payments**", which means payment for a service for the distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020

The best way to maximize forgiveness is, and has always been, to remain at pre-pandemic levels of headcount and compensation during the covered period.

Forgiveness Basic #1 Q&A

Question: When does the 8-week period start?

Answer: The 8-week "**covered period**" generally starts the day the PPP loan is funded. The Application establishes an "**alternative payroll covered period**" that borrowers can elect to use instead, which would start with the 1st day of the 1st pay period following loan funding. The alternative payroll covered period is available only to borrowers with a bi-weekly (or more frequent) payroll schedule. Also note that the alternative 8-week period is only applicable to payroll costs. All other non-payroll costs will use the normal 8-week "covered period" starting on the PPP loan funding date.

Question: What is the maximum forgiveness for each employee?

Answer: The Application clarifies that for each individual employee, "the total amount of cash compensation eligible for forgiveness may not exceed an annual salary of $100,000, as prorated for the covered period." In other words, a maximum of cash compensation of $15,384.61 per employee over the 8 weeks; non-cash compensation (healthcare, retirement, etc.) can be added to that amount.

Question: Would a bonus be an eligible payroll cost for forgiveness purposes? What about an increase to cover the additional $600 per month paid while on unemployment?

Answer: Nothing in the CARES Act, the Application or any guidance issued to date prohibits these payments or makes them ineligible for forgiveness. Nothing specifically authorizes them, either. Countless borrowers and advisors have asked this question, so we would not be surprised if SBA issues guidance on the issue. As a reminder, the maximum amount of forgivable cash compensation (which would include bonuses or other cash boosts) per employee is $15,384.61 over the 8-week period.

Question: Can I get forgiveness for rent payments on personal property leases? How about interest payments on equipment or other personal property financing?

Answer: It appears yes. With respect to leases, the Application expands on the CARES Act definition of "covered rent obligation" and states that lease payments under "lease agreements for real or personal property" are eligible for forgiveness. This expansion on the covered rent obligation definition is consistent with the definition of "covered mortgage obligation", which includes debt secured by a "mortgage on real or personal property." So, while the language is not 100% clear, it appears that the intention is to allow forgiveness for interest and rent payments on personal property financing and leases. How far this would go, particularly on the financing side, is unclear. Would this only apply to interest on purchase money security interest financing? What about formula-based or asset-based lending where the loan amount is tied to the personal property collateral? What about more general revolving facilities or term loans with personal property collateral? These are all good, but unanswered, questions. The reality for most borrowers is that it might not matter because of the 25% limitation on forgiveness for non-payroll costs.

Question: Do I have to have actually paid the payroll costs and other covered amounts during the covered period (or alternative payroll covered period) in order to receive forgiveness?

Answer: No. Eligible costs may be either paid *or* incurred in the applicable period, though they cannot be double counted. In the case of employees, payroll is considered incurred on the day that the employee's pay is earned; amounts incurred during the last pay period of the covered period (or alternative payroll covered period) may be included in the forgiveness calculation, so long those amount are paid on or before the next regular payroll date after the covered period (or alternative payroll covered period). For non-payroll costs, amounts paid *or* incurred are eligible, so long as incurred amounts are paid on or before the next regular billing date, even if the billing date falls after the covered period.

Forgiveness Basic #2 – Reduction Based on Salary & Wages

Of course, calculating the maximum forgiveness amount is only the first step. Consistent with the policy of the CARES Act, the forgiveness amount can be reduced on the basis of three different factors, each tied to employment.

The first reduction factor we will examine is the reduction based on salary and wages. The CARES Act states that "loan forgiveness shall be reduced by the amount of any reduction in total salary or wages of any employee during the covered period that is in excess of 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 covered period." There is an exception to the reduction (i) for employees who received, during any single pay period in 2019, wages or salary at an annualized rate of pay in an amount more than $100,000, and (ii) for employees whose pay was reduced from February 15, 2020 through April 26, 2020 if the PPP borrower reinstates wages and salaries not later than June 30, 2020.

PPP borrowers and their advisors have struggled mightily with interpreting the wage and salary reduction provisions of the CARES Act. The Application provides more clarity on how this factor and the applicable exceptions will operate.

Forgiveness Basic #2 Q&A

Question: Do I use total cash compensation or a "rate of pay" calculation to determine salary and wages?

Answer: It appears to be a "rate of pay" calculation. The language in the CARES Act refers to "total salary and wages", which did not make much sense in the context of comparing salary and wages between a quarter (13 weeks) and 8 weeks. The Application, however, uses a more logical approach and calculates this reduction factor based on each employee's "average annual salary or hourly wage."

Question: For purposes of this reduction factor, do salary and wages include overtime, or a bonus?

Answer: As mentioned above, the language of the Application speaks only in terms of "annual salary" and "hourly wage." Additional compensation in excess of that annual salary or hourly wage does not appear to be relevant for this reduction.

Question: What period do I use for the most recent full quarter?

Answer: The Application indicates this is the period from January 1, 2020 through March 31, 2020.

Question: How do I calculate the salary and wage reduction?

Answer: The Application clarifies that the salary and wage reduction is determined on an employee-by-employee basis, not in the aggregate. Each employee whose salary or wages was reduced by more than 25% will cause a reduction in the forgiveness amount. The reduction for each employee, based on the formula in the Application, is an amount equal to 8 weeks' worth of the difference between the average annual salary or hourly wage during the covered period (or the alternative payroll covered period, if selected) and 75% of the average annual salary or hourly wage from January 1, 2020 through March 31, 2020. This is good news for borrowers who were concerned about a more draconian reduction calculation.

Note that employees who received cash compensation from the borrower at an annualized rate of more than $100,000 for any pay period in 2019 are excepted from the salary and wage reduction, and the section of the PPP Schedule A Worksheet in the Application that deals with these employees does not even include a column for this reduction.

Question: How do I qualify for the safe harbor to avoid this reduction?

Answer: A PPP borrower who made a wage cut between February 15, 2020 and April 26, 2020 can avoid a forgiveness reduction based on reduced salary or wages if it restores annual salary or hourly wages by June 30, 2020 to the same level that existed on February 15, 2020. But a borrower who did not cut wages between February 15, 2020 and April 26, 2020, and instead cut wages after April 26, 2020, will not be eligible for the safe harbor even if they restore wages by June 30, 2020. Like the reduction itself, the safe harbor is considered on an employee-by-employee basis. Note that a restoration of wages to 75% of the historical annual salary or hourly wages is not sufficient to qualify for the safe harbor. The restoration needs to be to 100%.

Forgiveness Basic #3 – Reduction Based on FTE Headcount

The second reduction factor is based on full-time equivalent headcount. The CARES Act states that "the amount of loan forgiveness shall be reduced proportionately by the average number of full-time equivalent employees per month during the covered period as compared to either (at the election of the borrower in most circumstances) February 15, 2019 through June 30, 2019, or January 1, 2020 through February 29, 2020." Similar to the reduction for salary and wages, the CARES Act includes a safe harbor for headcount reductions made from February 15, 2020 through April 26, 2020 if the employer restores its headcount by June 30, 2020.

While not quite as perplexing as the reduction based on salary and wages, PPP borrowers and their advisors also have grappled with the headcount reducer, and the Application provides some welcome guidance.

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Forgiveness Basic #3 Q&A

Question: How do I calculate full-time equivalent employees?

Answer: The Application uses a 40-hour per week standard.

Question: How do I determine the FTE headcount?

Answer: The Application calculates the FTE headcount reduction on an employee-by-employee basis, such that each employee will be identified individually in the application. The formula in the application states that "[f]or each employee, enter the average number of hours paid per week, divide by 40, and round the total to the nearest tenth." The result of that formula will be a number that cannot exceed 1.0. This maximum of 1.0 means that overtime cannot boost the consideration for any employee above a 40-hour maximum.

Question: Are there any concessions for employees who resign, are terminated for cause, etc.?

Answer: Yes. There are exceptions to the forgiveness reduction for employees who were laid off but refuse to return to work (for more on that, see FAQ 40), were terminated for cause, voluntarily resigned, or voluntarily requested and received reduction in hours.

Question: How do I calculate the FTE headcount reduction?

Answer: The Application creates a formula to determine each PPP borrower's "FTE Reduction Quotient." That quotient is determined by dividing the average FTE headcount during the covered period (or alternative payroll covered period, if selected) by the average FTE headcount during the historical period selected by the borrower. This quotient, which cannot exceed 1.0, is then multiplied by the forgiveness amount (more on that below).

Question: How do I qualify for the safe harbor to avoid this reduction?

Answer: To the extent a PPP borrower's loan forgiveness is reduced as a result of having a FTE Reduction Quotient less than 1.0, the borrower may qualify for the safe harbor and eliminate the reduction if both of the following conditions are met: (1) the borrower reduced its FTE headcount in the period from February 15, 2020 to April 26, 2020; and (2) the borrower then restored its FTE headcount by not later than June 30, 2020 to its FTE headcount in the borrower's pay period that included February 15, 2020.

It is important to note that qualifying for this safe harbor (and/or the salary and wages safe harbor) does NOT mean that a PPP borrower's loan will be fully forgiven. The maximum forgiveness amount cannot exceed the amount spent on eligible costs (payroll, etc.) during the relevant 8-week period, and the safe harbors merely eliminate the reductions to forgiveness. Also note that any PPP borrower who is considering how to qualify for one of the safe harbors is likely behind on their payroll spending during that 8-week period.

Forgiveness Basic #4 – Reduction Based on 75/25 Rule

The last reduction factor is the much publicized post-CARES Act guidance stating that no more than 25% of the forgiveness amount be attributable to non-payroll costs. Said another way, at least 75% of forgiveness amount must be spent on payroll.

This 25% maximum has received some criticism since it first started making its way into SBA and Treasury guidance. In fact, a May 8 report from the SBA Inspector General faulted the SBA for adding this requirement, as it was not in the CARES Act and will negatively impact many PPP borrowers.

Forgiveness Basic #4 Q&A

Question: Can I use bonuses or other payroll boosts to make sure that I hit the 75% minimum for payroll costs?

Answer: Same answer as in #1 Q&A above. Nothing in the CARES Act, the Application or any guidance issues to date prohibits these payments or makes them ineligible for forgiveness. Nothing specifically authorizes them, either. As a reminder, the maximum amount of forgivable cash compensation (which would include bonuses or other cash boosts) per employee is $15,384.61 over the 8-week period.

Question: Is the 75/25 rule relevant for loan proceeds that I have not yet spent at the end of the 8 weeks?

Answer: Yes. Interim Final Rule 1 states that, "at least 75 percent of the PPP loan proceeds shall be used for payroll costs." So a borrower's forgiveness amount and eventual use of total loan proceeds must each reflect the 75% requirement.

Forgiveness Basic #5 – Order of Operations

One big mystery has been the order of operations. Each of the reduction factors impacts the forgiveness amount in a different way. The salary/wage factor acts as a dollar-for-dollar offset to the forgiveness amount. The FTE headcount factor reduces the forgiveness amount proportionately. And the 75/25 rule is a required ratio of payroll costs to non-payroll costs. Mathematically, the order of operations in applying the reduction factors matters. Thankfully, the Application provides clarity.

Forgiveness Basic #5 Q&A

Question: What is the order of operations?

Answer: The basic formula is as follows:

Forgiveness Amount = (Payroll costs + Non-payroll costs – Salary/Wage Reduction) x (FTE Reduction Quotient)

There are some positives and negatives for borrowers in this formula. The positive is that the salary/wage reduction is applied before the FTE Reduction Quotient. For borrowers who have both of these reductions, this order will reduce the dollar-for-dollar impact of the salary/wage reduction. The negative is that the non-payroll costs are also subject to the FTE Reduction Quotient, such that those eligible costs will also be reduced by the quotient.

Question: How do I apply the 75/25 rule?

Answer: The Application requires that the PPP borrower divide its total payroll costs during the covered period (or the alternative payroll covered period) by 0.75. If that product is less than the forgiveness amount determined by applying the formula in the preceding question, then the forgiveness amount will be the lesser amount.

Conclusion

While the Application provides some helpful guidance, specific questions remain. A frequent query of borrowers relates to the June 30, 2020 headcount and salary restoration safe harbor – is a business under a specific obligation to retain employees at current compensation levels who are reported as 'restored' by June 30, 2020? The Application does not answer this, or other important questions for PPP borrowers.

The first forgiveness applications are likely to be submitted in June. While the Application gives more certainty to borrowers, we will not be surprised if SBA issues yet more guidance on forgiveness and other issues related to PPP before then. Borrowers should consult with professional advisors carefully before submitting any request for forgiveness under PPP, to ensure they are relying on the most recent rules and guidance.

If you are analyzing your potential PPP forgiveness, considering applying for a PPP loan or would like to better understand SBA guidance, please contact Chris Fattey (716.848.1757) or Valerie Stevens (646.218.7614).

Please check our Coronavirus Resource Center and our CARES Act page to access information related to both of these rapidly evolving topics.

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