

MEMORANDUM

From: [Gordon Russell](#)
[Arthur Nathan](#)
[Drew Robertson](#)

Date: April 15, 2020

Subject: PPP Loan Forgiveness Standards and Requirements as of the Interim Final Rule

The CARES Act provides that all PPP loans are *eligible* for forgiveness but not *automatically* forgiven. Instead, borrowers must apply for forgiveness with their lender, and the amount to be forgiven may be limited. Borrowers should, therefore, take important steps preceding and during the 8-weeks following the date of the PPP loan to maximize the amount forgiven.

This memorandum sets out what we currently know from both the CARES Act enacted on March 27, 2020 and the Interim Final Rule published by the SBA on April 3, 2020 about how forgiveness of PPP loans will work. Please note that we are in the Comment Period. The CARES Act has given the SBA until April 26, 2020 to finalize administrative rules for the PPP program, including guidance for loan forgiveness, and the SBA has advised that further guidance will be released. The contents of this memorandum are therefore dated, and certain parts of our analysis may become inaccurate or incomplete in the next two weeks.

EXECUTIVE SUMMARY

1. Repayment of CARES Act loans may be forgiven up to 100% if the borrower timely spends the loan proceeds on covered payroll and other permitted expenses.
2. Forgiveness requires approval of the lender based upon rigorous recordkeeping. We suggest you keep the PPP borrowed funds in a segregated account, prepare a budget on the front end to be sure the money is used for purposes that may result in forgiveness, and that you

monitor the use of loan proceeds against the budget during the 8-weeks following receipt of the loan proceeds.

3. The amount of a PPP Loan subject to forgiveness can be reduced by a headcount limitation and a wage limitation. Do the math before you spend the money.
4. Principal amounts not forgiven bear interest at 1% and are payable over a 2-year period. The first payment is due in 6 months after the date of the loan.
5. Bottom line to ensure maximum forgiveness: don't reduce your employee headcount and don't reduce wages by more than 25% for employees who make less than \$100,000 per year.

ANALYSIS

I. What The CARES Act Tells Us About Forgiveness of PPP Loans.

A. What costs qualify for forgiveness.

Loan forgiveness is discussed in Section 1106 of the CARES Act ("Section 1106"). Section 1106 provides that "[a]n eligible recipient shall be eligible for forgiveness of indebtedness on a covered loan in an amount equal to the sum of the following costs incurred and payments made during the covered period:

- (1) Payroll costs;
- (2) Any payment of interest on any covered mortgage obligation (**which shall not include any prepayment of or payment of principal on a covered mortgage obligation**);
- (3) Any payment on any covered rent obligation; and
- (4) Any covered utility payment." (emphasis added).

In plain English, this means that the amount the borrower spends on each of these four “forgivable” categories of costs is the starting amount for determining eligibility for forgiveness.

For purposes of Section 1106, the “covered period” means the 8-week period following the date of the PPP loan. Again, in plain English: NO HOARDING IF YOU WANT "FREE MONEY." COVID-19 is the rainy day. The money received as loan proceeds must be disbursed within the first eight (8) weeks following the date of the loan to obtain forgiveness from repayment. This is a 56-day period. Please recall that the borrowing cap limitation was 2.5 times covered payroll which equates to approximately 10 weeks or 70 days.

“Payroll costs” is a defined term under the CARES Act that includes several specifically enumerated categories of expenses. It is broader than salary and wages. However, it does not include (i) compensation to employees whose principal place of business is outside the US, (ii) qualified sick and family leave wages for which a credit is allowed under the Families First Coronavirus Response Act, (iii) federal employment taxes imposed or withheld between 2/15/20 and 6/30/20, including the employee’s and employer’s share of FICA and Railroad Retirement Act taxes, or (iv) income taxes required to be withheld from employees. Compensation is capped at \$100,000 on an annualized basis per employee, so any compensation over \$100,000 for a particular employee is not counted as covered payroll for purposes of forgiveness and other purposes under the CARES Act.

For any mortgage interest obligation, rent obligation, or utility to be “covered” (such that it is a use of loan proceeds that is eligible for forgiveness) the underlying obligation must have existed before February 15, 2020. Moreover, a covered mortgage interest obligation specifically must be both: (a) a liability **of the borrower**; and (b) a mortgage on real or personal property on a security interest in personal property. Utility payments include payments for the service of electricity, gas, water, transportation, telephone, and internet access.

It bears repeating: only loan proceeds spent during the 8-week period following the date of the PPP loan for covered payroll costs and those other eligible expenses in the categories described above will be eligible for forgiveness from the duty of repayment. Accordingly, thoughtful diligent

accounting and financial management practices are needed from receipt of the loan proceeds to track exactly how and when PPP loan proceeds are spent.

B. Reductions of the Forgiveness Amount.

While the amount spent on the approved categories above is the starting place for determining how much of a PPP loan is forgivable, the final amount of loan forgiveness that a borrower may receive is subject to reduction based upon two different formulas. For simplicity, these are referred to below as the “employee limitation” and the “wage limitation.” (These terms do not come from the CARES Act or the Interim Final Rule). Under the CARES Act and the Interim Final Rule, these limitations appear to be cumulative. We expect that there will be further guidance on these limitations when the Final Rule is published by the SBA.

1. “Employee Limitation.”

First, the employee limitation states that forgiveness is reduced, but not increased, by multiplying the amount the borrower spent on the above forgivable categories of expenses by the quotient obtained by dividing the average number of full-time equivalent employees (“FTEs”) per month employed by the borrower during the 8-week period following the funding of the PPP loan by either (a) the average number of FTEs per month employed by the borrower during the period beginning on February 15, 2019 and ending on June 30, 2019; or (b) the average number of FTEs per month employed by the eligible recipient during the period beginning on January 1, 2020 and ending on February 29, 2020. The borrower may choose whether to use the average number in (a) or in (b) (whichever is most advantageous to the borrower), except for seasonal employers who must use the number in (a). The average number of FTEs is determined by calculating the average number of FTEs for each pay period falling within a calendar month. Neither the CARES Act nor the Interim Final Rule defines a FTE for the purpose of PPP loan forgiveness. In the event that the Final Rule does not provide a specific definition, we will publish additional material examining this issue in detail.

This sounds more complicated than it really is. Stated more simply: the employee limitation test means we look at two (2) time periods. One is a look forward period and the other is a historical (look back) period of time.

Time Period A is a forward looking period of time. It is the average number of FTEs employed in the 8-week period following the date of the borrower's PPP loan.

Time Period B is either:

(i) the average number of FTEs employed by the borrower beginning 2/15/2019 and ending 6/30/2019; or

(ii) the average number of FTEs employed by the borrower beginning 1/1/20 and ending 2/29/20.

Generally, Employers elect whether to use option (i) or (ii) for Time Period B and may elect whichever is most advantageous to them (except that seasonal employers must elect the first option).

If the average number of FTEs in Time Period A is equal to or greater than the average number of FTEs in Time Period B, then the amount forgiven will not be reduced by the employee limitation. (This only makes sense: the number of employees was not reduced and therefore loan forgiveness is not reduced.)

If the average number of FTEs in Time Period A is less than the average number of FTEs in Time Period B, then the amount to be forgiven will be reduced in proportion with any reduction in the number of FTEs employed during the 8-week period after receipt of the loan compared to the average number of FTEs in Time Period B(i) or B(ii).

It may help to see this further broken down in chart form, which we have done on the next page.

Time Period A =	Time Period B =	If A is equal to or greater than B	If A is less than B
the average number of full-time equivalent employees in the 8-week period <u>following</u> the date of the PPP loan	Either: (i) the average number of full-time employees employed by the borrower beginning 2/15/2019 and ending 6/30/2019; or (ii) the average number of full-time employees employed by the borrower beginning 1/1/20 and ending 2/29/20.	Amount forgiven will not be reduced by the employee limitation test.	Amount forgiven will be reduced in the proportion of any reduction in the number of employees employed during the 8-week period after receipt of the loan compared to the time periods in (i) or (ii).

Although businesses will want to run the numbers for (i) and (ii) when determining which option to use for Time Period B, as a **general rule**, Time Period B (i) should benefit businesses that added headcount in the second half of 2019, and Time Period B (ii) should benefit businesses that reduced headcount during 2019. See **Examples 1-4** in the attached Appendix for some hypothetical calculations using this formula.

2. “Wage Limitation.”

Second, the wage limitation is more straightforward. It states that forgiveness is reduced dollar for dollar by any reduction in total salary or wages of any employee that 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 8-week period immediately preceding the date of the PPP loan. For the purpose of this wage limitation, an employee is any employee who did not receive, during any single pay period during 2019, wages or salary at an annualized rate of more than \$100,000. In other words, employees making more

than \$100,000 per year do **NOT count as part of the wage limitation calculation**. See **Example 5** in the attached Appendix for a hypothetical calculation using this formula.

The goal of the CARES Act is simple: no reduction of payroll greater than 25% should occur for those employees making less than \$100,000 annualized and, if it does, then the amount of forgiveness is reduced.

It is important to note that this employee limitation and wage limitation appear to be cumulative of each other, or at least there is nothing in the CARES Act or the Interim Final Rule stating that they are mutually exclusive. Therefore, a borrower that is subject to reductions (a) based on the employee limitation formula of X and (b) based on the wage limitation formula of Y would have a total reduction in forgiveness eligibility of “X + Y.”

3. Exception to Limitations on Forgiveness.

There is an exception, however, that allows a business to **avoid** both of these limitations on forgiveness eligibility. If the borrower's reduction in employees and/or wages occurs between February 15, 2020 and April 26, 2020, then the borrower can “eliminate” either or both reductions up until June 30, 2020 and the borrower will not suffer from the applicable reductions in forgiveness eligibility.

This test means the SBA compares the number of FTEs on April 26, 2020 to the number of FTEs on June 30, 2020 and if the reduction in the number of FTEs is eliminated by June 30th, the employee limitation should not apply. In addition, if an employee's wages or salary were reduced between February 15, 2020 and April 26, 2020, and if the employer restores the wages or salary by June 30, 2020, the loan forgiveness reduction from the wage limitation should not apply. Note that this exception does not address the 25% pay reduction ceiling. We expect that the Final Rule may address this issue.

For example, if a borrower laid off 50% of its workforce in early March 2020 as a result of a downturn in business caused by COVID-19, that borrower can use the PPP loan funds to bring those employees back to work by June 30, 2020 and they will not be penalized for the March layoffs. The same is true for a reduction in salary or other wages. Only *uncorrected* reductions in employee

numbers or salary/wages (or new reductions occurring after April 26, 2020) will cause forgiveness eligibility to be reduced.

Also note that the consideration of whether a prior reduction has been eliminated does not appear to be variable. It appears to be all or nothing in that either the borrower satisfies the exception and the reduction formulas do not apply or the exception is not met and the reduction formulas do apply.

C. Application for forgiveness and required documentation.

The borrower's application for forgiveness goes to the lender servicing its PPP loan. The application must include the following:

- (1) Documentation verifying the number of FTEs on payroll and pay rates for the periods described in the calculation formulas above, including:
 - a. Payroll tax filings reported to the Internal Revenue Service; and
 - b. State income, payroll, and unemployment insurance filings;
- (2) 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;
- (3) A certification from a representative of the eligible recipient authorized to make such certifications that
 - a. the documentation presented is true and correct; and
 - b. 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
- (4) Any other documentation the SBA determines to be necessary.

No forgiveness will be granted without this documentation. To avoid potential problems down the road, it is important to be creating this documentation and keeping good records from the moment that PPP loan proceeds are received.

The lender must issue a decision on the application for forgiveness not later than 60 days after receiving it from the borrower.

D. Forgiven amount is not taxable.

Any amounts that are forgiven are considered cancelled indebtedness by the lender and are not considered part of borrower's gross income for tax purposes. The amount of loan forgiveness “shall not exceed the principal amount of the financing made available under the applicable covered loan.”

E. Important information for lenders about pre-purchase.

A lender has the option to report an expected forgiveness amount on a covered loan or a pool of covered loans up to 100 percent of the principal on the covered loan or loans. In this case, the Administrator of the SBA shall purchase the expected forgiveness amount from the lender as if the amount were the principal amount of a loan guaranteed under 7(a).

II. What The SBA’s Interim Final Rule Tells Us.

The SBA published the Interim Final Rule on April 3, 2020 (the “Interim Final Rule”). The Interim Final Rule states that “[t]he amount of loan forgiveness **can be up to the full principal amount of the loan and any accrued interest**. That is, the borrower will not be responsible for any loan payment if the borrower uses all of the loan proceeds for forgivable purposes described below and employee and compensation levels (sic) are maintained.” (emphasis added). It is not clear how this statement on the forgiveness of “**any accrued interest**” aligns with CARES’s express statement that forgiveness is capped at the amount of the *principal*. We would also note that the Interim Final Rule appears to contain an internal contradiction by earlier stating on Page 3 (consistent with CARES) that Section 1106 “provides for forgiveness **of up to the full principal amount** of qualifying loans[.]” (emphasis added). We expect that the reference to accrued interest may be a mistake and that the SBA Final

Rule is likely to clarify this going forward. Borrowers should assume that interest may not be forgiven, though interest on all PPP loans is capped.

The Interim Final Rule clarifies that, while mortgage interest payments, rent payments, and utility payments are all forgivable uses (as described above) not more than 25% of the loan forgiveness amount may be attributable to non-payroll costs. This is consistent with the SBA's administrative decision to require that at least 75% of all PPP loan proceeds be allocated for "payroll costs" to the exclusion of other allowable, or even other forgivable, uses.

Note that "payroll costs" are not the same as compensation, salary, or wages. There are certain defined exclusions from payroll costs, such as Federal employment and withholding taxes, and payroll costs will also have certain additions, such as benefits. This is discussed in part above and defined in greater detail in the CARES Act itself.

The Interim Final Rule further clarifies that independent contractors do not count as employees for the purposes of PPP loan forgiveness.

III. Further Guidance and the "Final Rule."

The Interim Final Rule promises that the "SBA will issue additional guidance on loan forgiveness." The CARES Act gives the SBA 30 days to issue regulations on the forgiveness portion of the PPP loan program, so such regulations are expected to be published on or before April 26, 2020. Other guidance may also be issued prior to that date.

Please be in touch with comments or questions.

APPENDIX

Employee Limitation Examples

Consider the following examples. For purposes of each of these examples, we will assume that “Company” averaged 100 FTEs between February 15, 2019 and June 30, 2019 and received a \$1,000,000 PPP loan in April 2020.

EXAMPLE 1: First, let’s say that Company had grown so that it had an average of 120 FTEs between January 1, 2020 and February 29, 2020, but reduced its FTEs down to an average of 80 during the 8-week period after receiving its PPP loan. Let’s also say that Company spent 100% of its PPP loan on forgivable uses (payroll costs, covered mortgage payments, covered rent payments, and covered utility payments). In this scenario, the calculation for Time Period B(i) would be 0.8 (80/100) and the calculation for Time Period B(ii) would be 0.67 (80/120). Company would elect to go with B(i) as the more favorable number and would multiply \$1,000,000 by 0.8 to get a forgivable amount of \$800,000.

EXAMPLE 2: Second, let’s use the same facts as Example 1, but this time assume that Company was able to achieve an average of 90 FTEs during the 8-week period after receiving its PPP loan. In this case, B(i) is still the more favorable calculation and Company A would multiply its \$1,000,000 by 0.9 (90/100) to get a forgivable amount of \$900,000. This illustrates the importance of getting the average number of FTEs for Time Period A and Time Period B as close to even as possible (in other words, achieving the CARES Act’s goal of keeping employees employed).

EXAMPLE 3: Third, let’s assume that, instead of growing in early 2020, Company was shrinking such that it went from an average of 100 FTEs between February 15, 2019 and June 30, 2019 down to an average of 80 FTEs between January 1, 2020 and February 29, 2020. Let’s further assume that it had only 60 FTEs in the 8-week period after receiving its PPP loan. In this scenario, it is more favorable for Company to use Time Period B(ii) ($60/80 = 0.75$) than it is to use Time Period B(i) ($60/100 = 0.6$). Therefore, Company would

multiply its \$1,000,000 loan (spent on forgivable uses) by 0.75 to determine that \$750,000 of the loan is forgivable.

EXAMPLE 4: Finally, let's assume the same facts as Example 3, except that Company only spent the required \$750,000 of its PPP loan on payroll costs and spent the remaining \$250,000 on a use that is *permitted* under the CARES Act, but does not qualify for forgiveness (such as servicing of prior debt obligations). In this scenario, the \$250,000 would automatically be excluded from forgiveness eligibility, and the resulting employee limitation calculation would therefore be made by multiplying only \$750,000 by 0.75 to get a forgivable amount of just \$562,500. This illustrates the importance of spending PPP loan proceeds on the proper categories in order to maximize forgiveness eligibility.

Wage Limitation Example

EXAMPLE 5: Assume that Company obtains a \$1,000,000 PPP loan. Company has six (6) employees with the following salaries or wages **in the most recent full quarter** (not annualized): \$30,000 for Emp. #1; \$22,500 for Emp. #2; \$20,000 for Emp. #3; \$17,500 for Emp. #4; \$17,500 for Emp. #5; and \$15,000 for Emp. #6. Also assume that Emp. #1 (making \$120,000 per annum) also made over \$100,000 in 2019. The reduction is calculated for each employee as follows:

1. Emp. #1 made over \$100,000 in 2019, so she is excluded from any wage limitation reduction (regardless of how much she made in the most recent full quarter and regardless of how much her pay was reduced during the 8-week period).
2. Emp. #2 (\$22,500) had a 30% pay reduction of \$6,750 during the 8-week period of the PPP loan. The portion of this reduction that is in excess of 25% is just 5% (30% - 25% = 5%) or **\$1,125**.
3. Emp. #3 (\$20,000) also had a 30% pay reduction of \$6,000 during the 8-week period of the PPP loan. The portion of this reduction that is in excess of 25% is also 5%, or **\$1,000**.

4. Emps. #4 and #5 (\$17,500 each) had 27% reductions of \$4,750 each during the 8-week period. The portion of their reductions above 25% is just 2%, or **\$350 each**.
5. Finally, Emp. #6 (\$15,00) had a reduction of 25%, or \$3,750 during the 8-week period. Because none of this reduction is in excess of 25%, there is no calculation to be made for purposes of the wage limitation.

Now we aggregate **each employee's** (except Emp. #1 who is excluded) reduction that is in excess of 25% compared to the most recent full quarter to get a total of **\$2,825** (\$1,125 + \$1,000 + \$350 + \$350). This amount is reduced dollar-for-dollar from the amount of the PPP loan eligible for forgiveness, thereby reducing maximum possible forgiveness to \$997,175. As you can see, the amount of the reduction increases for each employee whose salary or wages is reduced in excess of that 25% threshold.

This is our best current understanding of how this limitation will work based on the language of the CARES Act and assumes that we are talking about a calendar-year taxpayer. We expect that the SBA may provide further guidance in the Final Rule.