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Top 10 PPP Loan Issues Needing More Guidance

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Congratulations, you got your Paycheck Protection Program (PPP) loan under the CARES Act! Based on the oversubscribed nature of the program, you are feeling fortunate and downright lucky. Now, all you have to do is spend it all within the next 8 weeks and you will not have to repay anything back, right?

Well... slow your roll there, my friend. There are a number of nuances and issues that need to be considered when determining how, when, and on what the PPP loan funds are spent. However, in addition to the complicated rules and requirements to achieve maximum loan forgiveness, there are a number of open issues the Small Business Administration (SBA) and the U.S. Treasury Department (Treasury) must address in order to get a better (and more complete) picture on how a PPP loan borrower, such as yourself, can get the best use and results from the PPP loan funds.

Below is a summary of current open issues that (I believe) need further SBA and Treasury guidance on PPP loan forgiveness.

1. Impact of Time Periods and Dates with New Funding on April 27, 2020

With the initial lapse in funding as of April 16, 2020 and the increased funding as of Monday April 27, 2020, a number of small businesses that were shut out of the first wave of PPP loans will have another bite at the apple.

However, with the additional funding commencing as of April 27, 2020, there is a potential for problems when calculating the 8-week covered period (commencing as of the date a borrower receives the PPP loan funds) and the June 30, 2020 deadline under the CARES Act associated with the loan forgiveness and reduction calculations. If a borrower receives its PPP loan proceeds after May 5, 2020, then the 8-week covered period will extend beyond the June 30, 2020 deadline.

Section 1102 of the CARES Act provides that PPP loans are only available during the “covered period” of February 15 to June 30, 2020, and during that time, may only be used to pay payroll costs, mortgage interest, rent, utilities, and interest on other debt. However, Section 1106 of the CARES Act provides that only amounts spent during the 8-week “covered period” (which is different than the Section 1102 “covered period”) are eligible for forgiveness.

If a borrower’s 8-week covered period extends beyond June 30, 2020, will payments made after June 30, 2020 be eligible for forgiveness? Moreover, this will have an impact on any borrower who seeks to remedy any reductions in loan forgiveness based on salary reductions or employee headcounts (see below) since those must be done by June 30, 2020? More guidance will be needed.

2. What Does "Costs Incurred and Payments Made" Within 8-Week Period Mean?

This has become a big issue of discussion recently. The CARES Act states that “costs incurred and payments made” within the 8-week covered period will be forgiven, but the use of the word “and” (rather than “or”) creates two possible interpretations – one of which is potentially problematic, and the other much more favorable.

Under the first interpretation, does use of the word “and” require an expense to be BOTH incurred AND paid within the 8-week covered period? Or could the expense be incurred during the 8-week covered period and paid afterwards (or vice versa)?

Consider the timing of these PPP loans under this interpretation: if a borrower received its PPP loan on April 10, 2020, then it could not use the funds to pay any payroll associated with March 2020 (i.e., the costs were not “incurred” during the 8-week period. On the other side, payroll costs “incurred” in May but not paid until June (or at least not paid until after the 8-week period) would also not be included as funds eligible for loan forgiveness based on this interpretation.

Under the second (and more favorable) interpretation, a borrower could argue that the language permits BOTH “costs incurred” AND “payments made” during the 8-week covered period.

Using this interpretation, a borrower receiving the PPP loan funds on April 10 could have May rent forgiven that may not be paid (and is not paid) until June since the cost was incurred prior to the end of the 8-week covered period. Furthermore, taking this very liberal approach, a PPP loan borrower could make payments on costs incurred before and after the 8-week covered period (i.e., past due amounts from January 2020 or prepaid amounts owed in July 2020, etc.), and such payments would be eligible for loan forgiveness because the amounts were paid within the 8-week covered period (even though “incurred” outside the 8-week covered period).

While the first interpretation seems a bit restrictive, the second interpretation seems overly expansive and therefore open to potential abuse by PPP loan borrowers. And since the banks/lenders will be making the decision on loan forgiveness (as noted below), further guidance will be needed from the SBA and/or Treasury to help determine what costs (and payments) may be eligible for loan forgiveness.

Furthermore, in conjunction with such guidance, we trust a definition of “incurred” will be provided as well – because the notion of “incurring” an expense has different contexts for cash basis taxpayers versus accrual basis taxpayers.

3. Rental Payment Issue - Related Parties and Equipment Leases

As most are now aware, the SBA has placed a 25% cap on use of the PPP loan funds for so-called non-payroll costs (rent, utilities, mortgage interest, etc.), including those eligible for loan forgiveness. However, many businesses own and lease their own real estate for their businesses in separate legal entities, and thereby pay themselves rent on the property. The operating business and the underlying owner of the real estate are affiliated and related parties.

As of now, the CARES Act permits borrowers to pay rental expenses during the 8-week covered period and have those payments forgiven, and nothing in the CARES Act or SBA guidance (thus far) separates or differentiates such payments when made to a related party entity or to a unrelated party entity. As a result, unless further guidance and clarification is provided, a business owner could increase the rental rate of the property (subject to the 25% cap mentioned above) in order to maximize their PPP loan forgiveness – and pay their related party the increased rent. Since this is a common practice among small businesses and small business owners, it would not be surprising for the SBA to establish certain thresholds or limitations when dealing with related party property owners and rental payments.

It is also important to note that the CARES Act does not distinguish between lease and rental payments for real estate versus those for equipment or personal property. While still subject to the 25% cap, there is no reason to expect that a borrower cannot use lease and rental payments for equipment or personal property toward their loan forgiveness.

4. Are Forgiven Expenses Deductible?

As many know, there is a tax impact on a borrower that receives forgiveness of a debt obligation, and such debt forgiveness is included and taxable in the borrower's gross income. In anticipation of this being a potential issue and hurdle for borrowers under the PPP loans, Section 1106 of the CARES Act states that loan amounts forgiven on a PPP loan "shall be excluded from gross income."

However, this only applies to federal income taxes – it does not apply to state and local income taxes. While the SBA, Internal Revenue Service (IRS) and Treasury cannot necessarily dictate to the states and local governments as to how such loan forgiveness should be treated, it would bear consideration for the IRS to provide guidance to the states and local municipalities as how such loan forgiveness might be treated. Or at the very least, encourage the states and local governments to take similar positions, especially in light of the additional federal funding and payments being made available to state and local governments under the CARES Act.

A related (but important) issue is the aspect of whether expenses that are paid under a PPP loan that are forgiven are deductible by the borrower. As of right now, all indications are that such expenses *would* be deductible by the borrower (even though paid with funds that are forgiven under the PPP loan program).

However, there is an argument (if the IRS wants to take such a position) that Section 265 of the Internal Revenue Code may not permit such deduction since it provides that expenses "allocable to" tax-exempt income are not deductible. Section 265 has been applied to items like interest expense incurred to generate tax-exempt interest income, and it is intended to prevent "double dipping" when a taxpayer would otherwise get both a deduction and tax-exempt income related to the same transaction or investment.

It is possible that Section 265 could be applied to the expenses paid with forgiven PPP loan proceeds. While it may have been intended as such by Congress, a borrower claiming deductions for amounts paid for by a federal government program on a tax-free basis (and, lest we forget, potentially generating a loss that can now be carried back to collect a refund of previously paid taxes) would be an extremely generous outcome for PPP loan borrowers. However, in all likelihood, the IRS will need to weigh in on this and provide some clarity on whether (and/or to what extent) such expenses can be deducted when paid with forgiven PPP loan funds.

5. Is Non-Mortgage Debt Forgivable?

While perhaps intentional in its drafting, the CARES Act has one notable disparity when addressing eligible uses of PPP loan funds and costs paid that are eligible for loan forgiveness.

Section 1102 of the CARES Act states that a borrower may use the PPP loan funds to pay "interest on any other debt obligations that were incurred before the covered period," in addition to payroll costs, mortgage interest, rent, and utilities. However, Section 1106 does not include such non-mortgage debt as an item eligible for loan forgiveness.

Why the change? It appears the federal government will permit a borrower to use the PPP loan funds to pay interest on a non-mortgage debt during the 8-week covered period, BUT such non-mortgage debt payments by the borrower will not be forgiven. This may have been an intentional distinction, but the SBA and Treasury should provide further clarification – and either confirm the distinction under the CARES Act or adjust the interpretation (as they have done in rolling out the PPP loan program at the outset).

6. Who are FTEs?

While one would think this is an easy issue, there is a real question here for loan forgiveness purposes. How should full time equivalent (FTE) employees be counted? Specifically, is the FTE employee count based only on the number of hours worked for a given employee or, for example, are two half-time employees counted as one FTE employee?

Also, many businesses utilize the SBA rule that a full-time employee is an individual that works more than 30 hours per week, but others still utilize the "standard" approach of 37-40 hours per week. In other words, my full-time employees may not be the same as your full-time employees – but the hope is that the use of a FTE employee formula may balance the equation.

However, when all payroll costs were included for calculation of a borrower's loan amount under the PPP, the borrower included all temporary, per diem, half-time, part-time, full-time and salaried employees (subject to the $100,000 compensation and related limitations). If PPP loan forgiveness is based on FTE, then there is a possibility that the full payroll costs that were included in the loan amount would not be forgiven even if entirely paid to those same borrower employees.

As the SBA notes in Question 36 of the PPP FAQs (as updated on April 25, 2020), the SBA stated that, for purposes of loan eligibility, the CARES Act defines the term *employee* to include "individuals employed on a full-time, part-time, or other basis." To this end, the SBA states that a "borrower must therefore calculate the total number of employees, including part-time employees, when determining their employee headcount for purposes of the eligibility threshold." The SBA even uses an example whereby a borrower with 200 full-time employees and 50 part-time employees (each working 10 hours per week) has a total of 250 employees.

However, as noted in the SBA's answer to Question 36 in the FAQs, for purposes of loan forgiveness, the CARES Act uses the standard of "full-time equivalent employees" to determine the extent to which the loan forgiveness amount will be reduced in the event of workforce reductions. Unfortunately, the SBA stops there and does not provide any guidance on what or who a FTE is for purposes of PPP loan forgiveness. Thus, more clarity and guidance are needed at this point.

7. Issues With Employee Headcounts for Reduction/Reinstatement

We all know there is a complicated formula for calculation of PPP loan forgiveness (see our previous article Maximize Your PPP Loan Forgiveness) which creates a lot of chaos when contemplating reductions in the loan forgiveness based on reduced employee headcounts, as well as how reinstatements of such employee headcounts can mitigate such reductions of forgiveness.

In addition to the determination of what (or who) constitutes a FTE for loan forgiveness purposes, the CARES Act and the SBA need to address employees who have quit, retired, or been terminated, laid off or furloughed by the borrower – as well as the timing of each. Neither the CARES Act nor any current guidance is clear on whether "ex" employees are taken into account in calculating the forgiveness reduction on account of (a) the reduction calculated on the basis of FTE employee count, (b) the reduction calculated on the basis of compensation reduction, or (c) both.

Moreover, we assume that the rehiring of employees does not necessarily mean the exact same individual person – or does it? The CARES Act alludes to a notion of "rehiring" employees, so there is a question as to whether or not the headcount calculation needs to contemplate the same employee individuals that were laid off being rehired. Can a borrower rehire employees for a completely different position? For example, can a retailer that fired 15 sales people during the applicable covered period hire 15 painters or remolding workers to renovate the business or offices? Could a business owner hire their spouse and/or children to bump up their payroll costs and headcounts by June 30, 2020 in order to avoid the reduction in loan forgiveness? It is unlikely that such avenues are intended by the CARES Act, but it would be helpful to have that clarified by the SBA.

Also, when calculating the reduction in loan forgiveness and the elimination of such reduction based on the employee headcounts, it is unclear whether it is an "all-or-nothing" proposition. In other words, if a borrower lost 6 employees between the applicable period of February 15 and April 26, 2020, but replaced 2 before June 30, 2020, is there a pro-rata restoration of the reduced loan forgiveness? Or must the borrower restore all 6

employees before June 30, 2020 in order to maximize the loan forgiveness and avoid the reduction?

As of right now and using the foregoing example, there would be no restoration to the reduction of the PPP loan forgiveness at all since the entire reduction was not restored before June 30, 2020. This seems a bit drastic in light of the intended benefits of the PPP loan program, and hopefully the SBA and Treasury will utilize the provisions of Section 1106(d)(6) of the CARES Act whereby they "may prescribe regulations granting de minimis exemptions from the requirements" under the PPP loan forgiveness parameters.

Finally, the following general question remains: how soon and for how long do rehired (or newly hired) employees need to work in order for the PPP loan borrower to have eliminated any reduction in FTE employee made during the applicable period (February 15, 2020 to April 26, 2020) count by June 30, 2020? Also, as will be discussed below, is there any requirement to maintain a certain level of employee headcount *after* June 30, 2020?

8. Issues with Salary Reductions for Reduction/Reinstatement

In addition to the reduction by employee headcounts, the amount of PPP loan forgiveness will be reduced by the amount of any reduction in total wages and salary of any employee earning an annualized salary of less than $100,000 during the 8-week covered period in excess of 25% as compared to the total wages and salary of that employee during the last full quarter in which the employee was employed immediately prior to the date of the first disbursement of the PPP loan.

Thus, if the total salary and wages of one or more employees during the applicable period of February 15, 2020 to April 26, 2020 as compared to the total salary and wages for each such employee on February 15, 2020 and, on or before June 30, 2020, the borrower restores such employees' total wages and salary to 100% of the wages and salaries prior to the reduction, then the PPP loan forgiveness reduction that would otherwise have applied to the compensation reduction during the applicable period is (presumably) eliminated. But again, depending on the circumstances, this may or may not fully eliminate the reduction in the forgiveness amount.

To begin with and much like the employee headcount reduction, is this an "all-or-nothing" test? It is not clear whether the forgiveness amount will be reduced by 100% of the compensation-based reduction discussed above, or if it will be reduced only by the amount that is in excess of 25%.

Also, again like the employee headcount calculations, we need clarification on the application of these provisions in circumstances where an employee is terminated, quits, retires, is terminated, laid off or furloughed by the borrower during the applicable period of February 15, 2020 to April 26, 2020 and that borrower hires a *new* employee at the same total salary and wages on or before June 30, 2020. Will that new hire (of a different employee) eliminate the potential forgiveness reduction that would otherwise have occurred?

Moreover, the CARES Act speaks only in terms of "the most recent full quarter during which the employee was employed" prior to the start of the 8-week covered period, thereby leaving open the question of whether the correct baseline period for measurement is (a) the three full months before the 8-week covered period, (b) the last full calendar quarter of the borrower, or (c) the last full fiscal quarter of the borrower (for those borrowers with non-calendar quarter fiscal years). To this end, since the CARES Act utilizes a comparison to the prior "quarter," it is not currently clear if a reduction in pay for a person hired during the 8-week covered period would be included in the calculation of the compensation-based reduction in the forgiveness amount.

Finally, two additional points of concern and/or confusion:

- The compensation-based reduction requires a comparison of (i) total salary and wages for a given employee during the 8-week covered period to (ii) the total salary and wages of that employee during the most recent full quarter (i.e., 12 weeks), which raises a significant issue on the calculation of this reduction. A calendar/fiscal quarter is either 12 or 13 weeks, depending on your accounting, and an 8-week covered period is, naturally, 8 weeks. Thus, without further guidance, it appears that if during the 8-week covered period an employee gets paid less than 75% of what the employee did during the

previous quarter prior to the 8-week covered period, then the loan forgiveness amount is reduced – even though 8 is only 67% of 12. For example purposes and to keep it simple, if Employee X earned $12,000 for twelve weeks in the previous calendar quarter and $8,000 during the 8-week covered period, then the business appears to be required to reduce its forgivable amount by $1,000 – which is the excess of the reduction ($4,000) over 25% of the $12,000 salary ($3,000).

- The CARES Act also says the forgiveness reduction is not required if it relates to any employee who, during any single pay period in 2019, has an annualized salary in excess of $100,000. If we take this to an extreme, then any employee who got a bonus during one pay period in 2019 that, when annualized, exceeds $100,000 in total pay would be excluded from this calculation, right? Again, I do not think this is the intention of the provision, but we (and the banks/lenders) need further clarification from the SBA and Treasury.

9. Post-June 30th Tactics/Issues

As noted above several times, the timing and dates associated with the PPP loans and forgiveness calculations are somewhat chaotic and burdensome. However, it still seems relatively clear that the "deadline" of the PPP loan program (and the forgiveness calculations) is June 30, 2020. This begs the question: **what happens (or what could happen) after June 30, 2020?**

Let's play this out – can a borrower rehire its employees at their "customary" wages and salaries prior to June 30, 2020, maximize its loan forgiveness and avoid reductions based on the employee headcount and compensation, and then terminate or lay off employees and/or reduce salaries on Friday July 3, 2020? Or perhaps the borrower decides to pay all of its employees their holiday bonuses early during the 8-week covered period (in order to maximize the payroll costs expended during the 8-week period), but contracts with the employees that they will not receive the bonus at year-end? Or perhaps instead of an early holiday bonus, the borrower simply bonuses all the employees during the 8-week covered period, but then (contractually) reduces their wages and salaries after June 30, 2020 on a pro-rata basis to "pay back" the borrower for the bonus? To dovetail with an item referenced above, can a borrower hire their spouse and/or children during the covered period, keep them on the payroll prior to June 30, 2020, and then terminate them after June 30, 2020 without any impact on the PPP loan forgiveness?

Arguably, all of these scenarios are possible based on the CARES Act and current SBA guidance, but one wonders how much this stays within the intention of the Act. With June 30, 2020 as the "magic date" for the PPP loans, there are definite possibilities and options for borrowers to consider in order to get their business back in operation with the federal funds and maximize the amount forgiven, but still address a downtown or a slowing of revenues as the economy inches back into focus for the rest of 2020 (and beyond).

It would not be unreasonable for a borrower to use the PPP loan funds to reopen its operations and rehire its employees with the full knowledge that it will need to lay off and/or furlough employees after June 30, 2020 due to slow sales or reduced supplies. A restaurant receiving a PPP loan may open with social distancing and other mandated requirements, rehire all of its employees (even though they are not all needed and it takes them off unemployment), and operate as "normal" prior to June 30, 2020... and then lay off or terminate a number of those employees because the crowds are not only missing, but they cannot come back in light of the state or local mandates. Again, we will watch for further guidance from the SBA or Treasury, but the June 30, 2020 date may provide some interesting planning options and opportunities for PPP loan borrowers.

10. Guidance to Banks on Forgiveness Process

Finally, much like the PPP application process, borrowers will have to endure the "Wild West" approach with their banks and lenders when applying for the PPP loan forgiveness. The CARES Act provides that a borrower must submit an "application" to its funding lender together with the following:

- Documentation verifying the number of FTE employees and their pay rates during the 8-week covered period, including payroll tax filings reported to the IRS and state income, payroll and unemployment insurance filings;

- Documentation, in the form of cancelled checks, payment receipts, account transcripts or other documents, evidencing payments of mortgage interest, lease payments and utility payments eligible for loan forgiveness;
- A certification by a representative of the borrower that documentation provided is true and correct and the amount for which forgiveness is requested was used to retain employees and make payments eligible for loan forgiveness; and
- Any other documentation the SBA may require.

Simple, right? If we learned nothing else from the PPP loan application process, we learned that the SBA loves to change and modify requirements such as these. The number of different forms of borrower applications that were drafted by the SBA until they settled on a final version is just one example of such changes. Thus, we need and expect the SBA to issue additional guidance with respect to PPP Loan forgiveness, which may change these documentation requirements.

Also, loan forgiveness is not guaranteed, and the CARES Act states that any borrower who fails to provide a complete application is not eligible for loan forgiveness. However, upon application for forgiveness to the lender, the Act requires the lender to issue a decision on the forgiveness application within sixty (60) days of its receipt of the application. At this point, there is no additional guidance on how the lender will advise the borrower of the forgiveness amount or how it will document the forgiveness. Furthermore, there is no current guidance on when a borrower can apply for forgiveness. We know that the earliest any forgiveness application could be made is after the expiration of the 8-week covered period - as only after that point would the borrower be able to provide the required documents evidencing forgivable costs – but should or does the borrower still need to wait until after June 30, 2020?

So, while the CARES Act states that as long as the lender receives the required documentation and certifications from the borrower, the lender will not be subject to SBA enforcement action or penalties if the lender chooses to forgive the loan, we have to wonder how the forgiveness decision will play out in real-life? As we saw with the PPP loan application process, in the absence of additional guidance, every lender will come up with their own application and their own interpretation of key terms and computational formulas (and some of them may be incorrect). Unfortunately, this may result in some borrowers getting more forgiveness than other borrowers for practically the same types of costs and expenses.

Conclusion?

Needless to say, there are a number of areas needing further guidance from the SBA, IRS and Treasury for PPP loan forgiveness. The CARES Act requires the SBA to issue regulations and guidance on the implementation of the forgiveness provisions of the PPP loan program not later than Sunday April 26, 2020.

Unfortunately, as of the publication date of this article (April 28, 2020), we are still waiting. With any hope, guidance will follow soon. We will keep our eyes open – because guidance is needed and it is needed badly (and sooner, not later).

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