# LOAN FORGIVENESS
# UNDER THE PAYCHECK PROTECTION PROGRAM

April 18, 2020

Loan forgiveness under the Paycheck Protection Program ("**PPP**") is a complex and evolving topic. The U.S. Department of the Treasury is expected to issue supplemental guidance on this topic by April 26, 2020. However, loan forgiveness is based on how loan proceeds are spent, and how the business is operated, during the eight week period following the date of disbursement of the loan (the "**Covered Period**"). Since some loans have already been approved and disbursed, we want to provide some practical guidance to those who have already received, or will soon receive, PPP loans. This guidance is based on information that is currently available and what we are seeing in the marketplace.

The purpose of this Client Alert is to highlight some key issues you may want to consider regarding your PPP loan and ways to maximize loan forgiveness. However, this Client Alert is not intended to provide a comprehensive list of all of the issues your business may face. **We strongly encourage you to consult with your accountant or attorney now** since loan forgiveness is highly fact-specific and complicated. Moreover, given the frequently evolving rules and guidance from the Treasury Department as to which businesses were eligible for PPP loans and which costs could be included in determining the maximum amount of PPP loans, we recommend that you periodically check the most current guidance and thinking about how to maximize loan forgiveness. In particular, you should check such guidance about 2 weeks before the end of your applicable Covered Period, and if you have reduced your headcount or compensation during the Covered Period check again before June 30, 2020.

- **Even though PPP loans are not supposed to be personally guaranteed or secured, if an individual or corporate shareholder has an outstanding guaranty of a pre-existing loan from its PPP lender, or if the pre-existing loan is secured by an outstanding lien on the assets of the business, the portion of the PPP loan that is not forgiven might (inadvertently) be included as an obligation covered by the lien and/or the personal guaranty.** You should carefully review your existing loan documents to determine if the lien on the business assets and/or the personal guaranty cover "any and all debts" owed to your PPP lender or contains other expansive language that could capture the obligations under the PPP loan.

- We have not seen any PPP loan documents that address either the inadvertent guaranty or security interest issue. However, we have seen loan documents that vary significantly from lender to lender, and some loan documents have included unexpected terms. If possible, you should consider having an attorney review your PPP loan documents before you sign them. Even if you have already signed your PPP loan documents, you should still consider having an attorney review them so that you understand the terms and conditions contained in those documents. We are available to assist you in reviewing your existing loan documents and/or your new PPP loan documents.

- **We strongly recommend opening a separate bank account solely for the proceeds of the PPP loan** so you can carefully track and certify how the loan proceeds are spent. In any event, you should keep detailed records of and backup documents for all expenditures made from the

PPP loan proceeds during the Covered Period, and be prepared to share those records and documents with your PPP lender when you apply for loan forgiveness.

- During the Covered Period, the PPP loan proceeds can only be used for certain expenses ("**Permitted Expenses**") listed in the CARES Act and related Treasury Department guidance. It remains unclear whether PPP loan proceeds can be used for other purposes after the Covered Period expires. The Permitted Expenses are limited to:

    - Payroll costs (see below) incurred during the Covered Period;
    - Interest on any mortgage obligation that was incurred before February 15, 2020 (not including any prepayment or payment of principal);
    - Rent under a lease agreement that was in force before February 15, 2020 (it is unclear if rent is limited to real property or might also include equipment subject to a lease);
    - Utilities for which service began before February 15, 2020; and
    - Interest payments on any debt obligations (other than mortgage obligations referred to above) that were incurred before February 15, 2020.

- **It remains unclear whether in order to be eligible for loan forgiveness (a) at least 75% of the loan proceeds must be spent on payroll costs incurred and paid during the Covered Period, and/or (b) at least 75% of the forgiveness amount requested has to consist of payroll costs.** The following amounts qualify as "payroll costs" under the PPP that could be used in determining the amount of loan forgiveness:

    - Cash compensation in the form of salaries, wages, commissions or tips (capped at $100,000 annually for each employee and prorated for the Covered Period);
    - Payments for severance, vacation, parental, family, medical or sick leave (other than sick and family leave for which a credit is allowed under the Families First Coronavirus Response Act);
    - Payments required for group health benefits, including insurance premiums;
    - Payments of any retirement benefits, including employers' matching contributions to a 401(k) or similar plan; and
    - Payments of state or local taxes assessed on the compensation of employees.

  The following amounts do <u>not</u> qualify as "payroll costs" under the PPP:
    - Cash compensation in excess of $100,000 annually, prorated for the Covered Period;
    - Taxes imposed or withheld under Chapters 21, 22 or 24 of the Internal Revenue Code;
    - Any compensation to an employee whose principal place of residence is outside of the United States; and
    - Sick and family leave for which a credit is allowed under the Families First Coronavirus Response Act.

- **Evaluate if your PPP loan creates an opportunity to help problematic or "on the edge" employees transition to another employment situation**. As noted above, permitted payroll costs include severance payments made during the Covered Period. However, it is important to consider the timing of any employee separations as it may impact the amount of loan forgiveness under the FTE test described in the next bullet.

- **Maximize your full-time equivalent employees ("FTEs") during the Covered Period.** The amount of the PPP loan that is eligible to be forgiven is based on the ratio of (a) the average number of FTEs employed during the Covered Period to (b) the average number of FTEs per month employed during either (at the option of the business) (i) February 15, 2019 through June 30, 2019, or (ii) January 1, 2020 through February 29, 2020 (the "**FTE Base Period**").

- **Avoid reducing the total salary or wages of any employee by more than 25% during the Covered Period.** The amount of loan forgiveness will be reduced dollar for dollar by any reduction in total salary or wages of any employee in excess of 25% of his or her total salary or wages during the most recent full quarter prior to the Covered Period during which such employee was employed. This calculation is done for each individual employee. The 25% limitation does not apply to an employee whose 2019 annual salary and wages was in excess of $100,000.

- **Participation in a "short-time compensation program", such as the Connecticut Shared Work Program, may reduce the amount of loan forgiveness.** Since an employee who is covered by a short-time compensation program will be working reduced hours and receiving a comparable reduction in salary or wages, the amount of loan forgiveness will likely be impacted as described above. Even if a business reduces its employees' hours by no more than 25% and pays those employees at least 75% of their salary and wages, the average number of FTEs during the Covered Period may fall below the number of FTEs during the FTE Base Period, and the loan forgiveness amount may be reduced accordingly.

- **You will have until June 30, 2020 to eliminate reductions in FTEs and salary levels made between February 15, 2020 and April 26, 2020 in order to avoid such reductions negatively impacting the amount of your loan forgiveness.** The CARES Act (a) uses the phrase "has eliminated the reduction" with respect to FTEs, and (b) provides that the date for measuring any employment restoration is June 30, 2020, rather than the last day of the Covered Period (which for many PPP loan recipients will occur before June 30$^{th}$). We expect further guidance from the Treasury Department on precisely what the elimination concept means and how to apply it. Also, the calculation of FTE's is done on a gross number of employees and you do not need to re-hire the same employees when restoring your FTE count.

- **If you have an S Corp, pay yourself a salary during the Covered Period in lieu of distributions.** Many S Corp owners take out distributions during the year for some portion of their compensation. Distributions do <u>not</u> constitute payroll costs under the PPP but salary payments do count.

- **Permitted Expenses that are forgiven may not be deductible for income tax purposes.** The CARES Act is clear that the amount forgiven on a PPP loan will not be taxable to you. What is unclear is whether the Permitted Expenses paid with a PPP loan will be deductible from income. We expect the IRS to issue guidance on this topic.

- **You will apply to your PPP lender for loan forgiveness.** That lender makes the threshold decision on the amount of your loan forgiveness. Stay in contact with your lender to understand what supporting information they will need and ideally the format they prefer or require (including spreadsheets) that might expedite the lender's review of your application for forgiveness. Forgiveness applies to both the principal and accrued interest thereon. The portion of the loan that is not forgiven will continue to accrue interest at 1% per annum and be payable in equal monthly installments over the balance of the 2-year period from the date of the PPP loan.