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Detailed Analysis of the Loan Forgiveness Provisions in the Paycheck Protection Program

The Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”) includes Title 1, the (“Keeping American Workers Paid and Employed Act”), which adds a new program (the “Paycheck Protection Program” or the “PPP”) to Section 7(a) of the Small Business Act of 1953, as amended (the “Small Business Act”).¹ The PPP is administered by the Small Business Administration (the “SBA”). The legislation modifies certain existing limitations on SBA’s current loan program under section 7(a) of the Small Business Act. The SBA and the U.S. Department of the Treasury have published numerous Interim Final Rules under the PPP (collectively, the “Interim Final Rules”) and frequently asked questions (“FAQs”) to provide additional guidance on application and interpretation of the PPP.

One of the most noteworthy features of the PPP is that qualifying loans may be forgiven, in whole or in part—effectively converting loans into grants. Information regarding loan forgiveness set forth in the PPP has now been significantly supplemented by the SBA’s Loan Forgiveness Application (SBA Form 3508) or lender equivalent (the “Loan Forgiveness Application”), published by the SBA on May 15, 2020, and additional Interim Final Rules, released by the SBA on May 22, 2020.² PPP borrowers should carefully consider the forgiveness guidance to help ensure that they maximize and properly calculate and support the amount of loan forgiveness.³ Below is a detailed analysis of the key aspects of the PPP loan forgiveness guidance, including the Loan Forgiveness Application.

Determination of Forgiveness

The PPP generally provides that loans may be forgiven, in whole or in part, based on the following four expenses:

- eligible payroll costs
- interest on any covered mortgage obligation (on real or personal property)
- covered rent obligations (on real or personal property under a lease)
- covered utility payments (electricity, gas, water, transportation, telephone or Internet access)

To be eligible for forgiveness, these expenses are required to arise during the eight-week period commencing on the date the loan was funded (the “Covered Period”). However, for purposes of determining eligible payroll costs, borrowers that have at least a bi-weekly payroll have the option to select an alternate eight-week period—the first day of the first pay period after their receipt of the covered loan (the “Alternative Payroll Covered Period”). This adjustment may help some borrowers calculate and document their forgivable payroll expenses by avoiding pay periods that straddle the first day and the last day of the Covered Period and may be particularly useful because many borrowers have had little or no control over when their PPP loans were funded. Congress is presently considering legislation to extend the duration of these periods beyond eight weeks, and it appears likely such an extension will ultimately pass.

Eligible Payroll Costs

The “payroll costs” for forgiveness purposes are the same payroll costs used to calculate the amount of a PPP loan, detailed as follows:

- wage, salary, commission or similar compensation
- payment of cash tips or equivalents
- payment for vacation, parental, family, medical or sick leave
- allowance for dismissal or separation (severance)
- payment required for the provision of group health care benefits, including insurance premiums
- payment of any retirement benefits or
- payment of state and local tax assessed on compensation of employees.

The payroll costs calculation **excludes**:

- the compensation of an individual employee in excess of an annual salary of \$100,000 (a pro-rated amount equal to \$15,385 during the forgiveness determination period); the same limits apply to owner-employees and self-employed individuals
- any compensation of an employee whose principal place of residence is outside the United States
- certain employment taxes imposed or withheld under the Internal Revenue Code, including all employee and employer FICA and federal income tax withholding
- any compensation of an employee whose principal place of residence is outside the United States
- qualified sick leave wages or qualified family leave wages, in each case for which a tax credit is allowed under the Families First Coronavirus Response Act
- payments made to independent contractors

To reinforce the guiding principle that forgiveness is intended to encourage maintaining payrolls, not more than 25 percent of the amount forgiven can be attributable to non-payroll costs.⁴ This requirement, imposed by the SBA and not by any provision of the CARES Act, simply means that the maximum amount of forgiveness is determined by reference to the amount of permitted payroll costs, which must constitute at least 75 percent of the total forgiven amount. Additionally, payroll costs paid to employees that have been furloughed can be included in the loan forgiveness calculation.

The payroll costs for owner-employees are capped at the amount of 2019 employee cash compensation and employer retirement and health care contributions. General partners are capped at 2019 net earnings from self-employment (subject to certain reductions). No additional forgiveness is provided for retirement or health insurance contributions for self-employed

individuals as such amounts are paid out of net self-employment income.

SBA guidance has clarified that payroll costs may include hazard pay or bonuses, and is consistent with the statutory provisions of the PPP. Nonetheless, borrowers should be cautious to ensure that any additional amounts paid during the Covered Period or Alternative Covered Period serve a bona fide business purpose beyond simply increasing the amount of permitted costs that are subject to forgiveness. The SBA has retained the right to review all applications and to determine that forgiveness should be denied in whole or in part based on the SBA’s review of the details of the PPP loan application and the related Loan Forgiveness Application.

Covered Mortgage Obligations

Forgiveness for mortgage expenses is limited to payments of interest on real or personal property for any indebtedness that:

- was incurred in the ordinary course of business;
- is a liability of the borrower;
- is secured by a “mortgage on real or personal property”; and
- was incurred before February 15, 2020.

The forgiveness calculation expressly excludes any mortgage interest prepayments and any payments of principal on mortgage obligations.

There remains some uncertainty regarding the meaning of the statute’s reference to a mortgage on personal property. While the Interim Final Rules clearly state that qualifying payments would include interest on a loan for a business vehicle, it is not clear that a more expansive interpretation was intended or will be permitted—for example, whether interest paid on a loan secured by a security interest on a borrower’s working capital assets can be included in the forgiveness calculation. The SBA has indicated that this would include interest on an auto loan for a vehicle used in the business.⁵

Covered Rent Payments

Forgiveness for rent payments is limited to rent payable under a lease agreement in force before February 15, 2020. The Interim Final Rules specify that rent for this purpose extends to rent paid under a lease for personal property, such as an equipment lease—and expressly includes lease payments on vehicles used in the business.⁶

Covered Utility Payments

Covered utility payments consist of any payments for service covering the distribution of electricity, gas, water, transportation, telephone or internet access for which service began before February 15, 2020. The Interim Final Rules do not provide any meaningful expansion or explanation of what other utilities may be included within this category or how expansively some of the categories can be read. SBA guidance states that gasoline for a leased vehicle would be permitted within this category.⁷

Forgiveness of Accrued Interest on PPP Loans

Presently there is an apparent inconsistency in the SBA guidance regarding whether both the principal and accrued interest on a PPP loan can be forgiven. The Loan Forgiveness Application does not expressly contemplate forgiveness of interest accrued on a borrower's PPP loan. Specifically, the maximum amount of forgiveness on the application is limited to the initial principal amount of the loan. This limitation is inconsistent with both the PPP, which states that upon approval of a Loan Forgiveness Application the SBA will remit to the PPP lender "the amount of forgiveness, *plus any interest accrued through the date of payment*,"⁸ and SBA rules, which state that "the amount of loan forgiveness can be up to the full principal amount of the loan *and any accrued interest*."⁹ The SBA should provide further guidance and clarification on this apparent omission in the Loan Forgiveness Application, but it is reasonable to expect that loan forgiveness will include accrued interest.

Timing Issues Related to Eligible Expenses

The Loan Forgiveness Application makes clear that qualifying expenses are *not* required to be both incurred *and* paid during the applicable test period to be eligible for forgiveness.

Payroll Costs

Covered payroll costs can be included in a borrower's forgiveness calculation so long as the payroll costs are:

- paid during the Covered Period (or Alternative Payroll Covered Period, as applicable); or
- incurred during the Covered Period (or Alternative Payroll Covered Period, as applicable) and paid on or before the borrower's next regular payroll date.

For this purpose, payroll costs are generally considered incurred on the day that the employee's pay is earned—the day the employee worked—and are considered paid on the day paychecks are distributed or the day the borrower originates an ACH credit transaction. In the case of furloughed

employees who are receiving compensation, payroll costs are considered incurred based on a schedule established by the borrower—typically the day the employee would have performed work.

Non-Payroll Costs

Similarly, covered mortgage, rent and utility expenses can be included in a borrower's forgiveness calculation so long as those non-payroll costs are:

- paid during the Covered Period; or
- incurred during the Covered Period and paid on or before the next regular billing date.

While the guidance set forth in the Loan Forgiveness Application provides a certain level of flexibility regarding the timing of forgivable expenses, borrowers should ensure that relevant expenses incurred or paid during the Covered Period are supported by a bona fide business purpose. The PPP expressly states that prepayment of mortgage interest is not eligible for forgiveness. Similarly, although not expressly stated in the PPP, the Interim Final Rules, the FAQs or the Loan Forgiveness Application, accelerating certain payroll costs (*e.g.*, employee bonuses and 401(k) matching payments) or other non-payroll costs solely to increase the forgiven amount of a PPP may be denied forgiveness and could attract negative attention from reviewing lenders, the SBA or other relevant regulators.

Reduction of Amounts Eligible for Forgiveness

Once the maximum forgiveness amount is determined using the criteria set forth above, a borrower must then reduce that amount based on certain employee headcount reductions and certain salary or wage reductions.

FTE Reduction Calculations

The PPP provides that loan forgiveness is subject to reduction based on employee terminations or furloughs. Full-time equivalent employees ("FTEs") will be calculated on the basis of a 40-hour work week. In particular, if a borrower has reduced the number of its employees during the Covered Period (or Alternative Payroll Covered Period, as applicable) compared to the Reference Period (defined below), then the PPP states that forgiveness will be reduced by multiplying the eligible forgiveness amount by the quotient of:

- the average number of FTEs per month employed during the Covered Period (or Alternative Payroll Covered Period, as applicable), *divided by*

- the average number of FTEs per month employed during one of the following periods (as elected by the borrower, the “Reference Period”): (i) February 15, 2019 through June 30, 2019 or (ii) January 1, 2020 through February 29, 2020¹⁰

The Loan Forgiveness Application provides the formula borrowers must use to determine the average number of FTEs in each applicable period.

- The average FTE for each employee is calculated as: (i) the average number of hours worked per week during the applicable period, *divided by* (ii) 40. This result is then rounded to the nearest tenth, subject to a cap for each employee of 1.0.
- As an alternative, the Loan Forgiveness Application allows borrowers to use an average FTE of 1.0 for any employee who works 40 or more hours per week and 0.5 for any employee who works less than 40 hours per week. Borrowers who elect to use this methodology must use it for all employees.
- The average FTE for all employees are added together—the result is the average number of FTEs for the applicable period.

The FTE calculation will create a reduction in forgiveness for employers with hourly employees who worked reduced hours after February 15, 2020. For example, an employee who worked a 40-hour week in the first quarter of 2020, but worked a 30-hour week during the Covered Period (or Alternative Payroll Covered Period) would be 0.75 FTE for purposes of calculating the FTE reduction.

FTE Reduction Exceptions

In certain cases, former employees (and the reduced hours of employees that remain employed) may nevertheless be included in calculating average FTEs during the Covered Period (or Alternative Payroll Covered Period, as applicable). Specifically, the FTE calculation will include former employees when:

- a borrower made a good-faith, written offer to rehire an employee (or restore the employee’s reduced hours) during the Covered Period (or Alternative Payroll Covered Period, as applicable) for the same salary or wage previously earned and same number of hours previously worked, and the employee rejected the offer;¹¹ or
- an employee was fired for cause, voluntarily resigned or voluntarily requested and received a reduction of hours.

The average FTE calculation will include these limited classes of former employees in calculating the average number of FTEs during the Covered Period (or Alternative Payroll Covered Period, as applicable) unless that employee’s position was filled by a new employee. In order to ensure that borrowers can take advantage of these exceptions, those borrowers should retain documentation relating to those offers and rejections or terminations.

FTE Reduction Safe Harbor

The Loan Forgiveness Application also provides clarity on determining the calculations for restored employees. The PPP provides that FTE reductions that are *fully* restored will eliminate any reduction arising under the forgiveness calculations. A borrower will not be subject to a reduction in forgiveness for FTE reductions if the borrower:

- reduced its FTEs in the period beginning February 15, 2020 and ending April 26, 2020; and
- restored its FTEs by not later than June 30, 2020 to the FTE level for the pay period that included February 15, 2020.

The language of the PPP and the Loan Forgiveness Application make clear that the safe harbor is all or none. A partial restoration of FTEs will not impact the reduction calculation, but a full restoration will result in no reduction to forgiveness.

While the PPP and the commentary in the Loan Forgiveness Application each state that the restoration should occur “by not later than June 30, 2020,” the worksheet for the safe harbor provides for the calculation only as of June 30, 2020. This approach indicates that the FTE adjustments must be effective as of June 30, 2020. As this has a potentially significant impact on forgiveness, borrowers should be cautious to ensure that any FTE adjustments remain in effect at least through June 30, 2020.

While the safe harbor is calculated in terms of the FTE as of June 30, 2020, it is important to note that the calculation in neither the Loan Forgiveness Application nor the Interim Final Rules with respect to the FTE calculation on June 30th is explained in any detail. Borrowers wishing to avail themselves of the safe harbor should carefully consider how they intend to calculate the FTE on June 30.

Wage and Salary Reduction Calculations

The amount of loan forgiveness will also be reduced by the amount of any reduction in average hourly wage or average annual salary of any employee during the Covered Period (or

Alternative Payroll Covered Period) that exceeds 25 percent of the average hourly wage or average annual salary of that employee during period from January 1, 2020 through March 31, 2020. While similar to the FTE reduction calculations described above, it should be noted that forgiveness reductions based on salary and wage reductions are calculated on an individual employee basis whereas FTE reductions, while calculated on an employee-by-employee basis, are only applicable to the total number of FTEs. In addition, to avoid a double penalty to borrowers, this wage and salary reduction applies only to the portion of the decline in wages and salary this is not attributable to an FTE reduction. For example, where an employee's average weekly hours worked during the Covered Period are reduced by 50 percent, but the employee's hourly wage remains the same, the borrower's forgiveness amount will not be reduced based on a wage reduction for this employee.

The Interim Final Rules and the PPP Schedule A Worksheet included in the Loan Forgiveness Application exclude any employee who received compensation at an annualized rate of more than \$100,000 for any pay periods in 2019. Accordingly, any reduction of salary or wages to any such employee would not impact the amount of forgiveness regardless of the amount of reduction. Alternatively, any newly hired employee (after the end of 2019) would be included regardless of whether the compensation for that employee exceeded \$100,000 on an annualized basis (and in which case a reduction in compensation in excess of 25 percent would reduce forgiveness). This is an anomalous result in the treatment of highly compensated employees, but appears to be the result of the plain meaning of the provisions of the Loan Forgiveness Application and is consistent with the similar statutory language in the PPP.

Wage and Salary Reduction Safe Harbor

Similar to the safe harbor provided for FTE reductions, in determining the wage and salary forgiveness reduction, a borrower will not be subject to a reduction in forgiveness for reduction of an employee's wage or salary if the borrower:

- reduced the employee's wage or salary during the period beginning February 15, 2020 and ending April 26, 2020; and
- restored it's the wage or salary by not later than June 30, 2020 to the level for the pay period that included February 15, 2020.

As with the FTE safe harbor described above, the wage and salary reduction safe harbor is all or none. A partial restoration will not impact the reduction calculation, but a full restoration

will result in no reduction to forgiveness. Additionally, while the PPP states that the restoration should occur "by not later than June 30, 2020," the worksheet for the safe harbor in the Loan Forgiveness Application provides for the calculation only as of June 30, 2020. This approach indicates that the salary and wage adjustment must be effective as of June 30, 2020 in order to qualify for the safe harbor.

Similar to the FTE reduction safe harbor, borrower must calculate the applicable salary or wages as of June 30, and the Loan Forgiveness Application and related Interim Final Rules provide no details for what documentation or other information is necessary to determine the salary or wages on June 30.

Applying for Forgiveness

Borrowers seeking loan forgiveness will need to complete the Loan Forgiveness Application and submit it to their lender along with required supporting documentation. The Loan Forgiveness Application includes detailed instructions for completion, a loan forgiveness calculation form—along with a schedule and a worksheet to be used for completing the loan forgiveness calculation form—and a set of representations and certifications to be made by the borrower.

Borrower Representations and Certifications

The Loan Forgiveness Application requires borrowers to make certain representations and certifications, including that the requested forgiveness amount:

- was used to pay costs that are eligible for forgiveness;
- includes all applicable reductions due to decreases in the number of FTEs and salary/wage reductions;
- does not include nonpayroll costs in excess of 25 percent of the total amount requested; and
- does not exceed eight weeks' compensation for any owner-employee or self-employed individual/general partner.

Borrowers also are required to acknowledge that *knowingly* using PPP funds for unauthorized purposes may result in civil or criminal fraud charges and that making false statements on the Loan Forgiveness Application could result in fines or imprisonment.

Finally, the Loan Forgiveness Application requires borrowers to self-report whether the amount of the PPP loan received, together with PPP loans received by all of their affiliates (as determined under SBA rules, including giving effect to waivers of certain affiliation rules under the PPP), exceeds two million dollars. The inclusion of this item on the Loan Forgiveness

Application highlights the SBA's stated intent to review all PPP loans in excess of two million dollars in the aggregate as part of the forgiveness determination.

Supporting Documentation

The Loan Forgiveness Application provides a detailed list of supporting documentation that borrowers must deliver with their application.

For payroll costs, borrowers must submit the following:

- bank account statements or third-party payroll service provider reports evidencing cash compensation paid to employees;
- certain tax forms, including forms provided to the IRS and state taxing authorities; and
- payment receipts, cancelled checks or account statements documenting health insurance and retirement plan contributions.

To support FTE calculations, borrowers must submit documentation showing the average number of FTE employees during the relevant periods used in calculating whether any forgiveness reductions are required to be made based on employee terminations. This documentation may include payroll tax filings reported to the IRS and relevant state taxing authorities.

To support non-payroll costs, borrowers must submit detailed information regarding eligible costs. For mortgage interest payments, borrowers must provide either:

- a lender amortization schedule and receipts or cancelled checks verifying payments; or
- lender account statements from February 2020 and from the Covered Period (or Alternative Payroll Covered Period, as applicable) through one month after the end of the Covered Period (or Alternative Payroll Covered Period, as applicable) verifying eligible payments.

To evidence rent or lease payments, borrowers must provide either:

- a copy of the current lease agreement and receipts or cancelled checks verifying payments; or
- lessor account statements from February 2020 and from the Covered Period (or Alternative Payroll Covered Period, as applicable) through one month after the end of the Covered Period (or Alternative Payroll Covered Period, as applicable) verifying eligible payments.

For utility payments, borrowers must provide each of the following:

- copies of invoices from February 2020 and those paid during the Covered Period (or Alternative Payroll Covered Period, as applicable); and
- receipts, cancelled checks or account statements verifying eligible payments.

In addition, Borrowers are required to maintain (but not file with their application) certain additional documentation for a period of *six years* after the date the loan is forgiven *or* fully repaid. The list of documents includes the detailed calculation worksheet used to prepare the Loan Forgiveness Application, along with documentation supporting the information used on the worksheet. It further requires borrowers to maintain all records relating their PPP loan, including loan application information, and documentation supporting borrower's certification as to necessity of the loan request and eligibility for a PPP loan.

Forgiveness Timeline and SBA Review

The SBA has announced that it will review every application for a PPP loan for any recipient that has received, together with its affiliates, a PPP loan in excess of two million dollars to determine eligibility of the recipient before forgiveness can be granted. In addition, the SBA has noted that it retains the right to review any application or borrower at any time. If the SBA determines that a borrower was not eligible for a PPP loan, the loan is not eligible for forgiveness and SBA may require repayment.

Once a lender has received a complete application, it is required to issue a decision within 60 days following lender's receipt of the borrower's application. Forgiven loans will be purchased by SBA in accordance with existing guarantee purchase procedures, with remittance made by the SBA to the lender within 90 days after the lender has issued its forgiveness decision to the SBA.

To the extent that the SBA determines to review any loan, the lender will be given notice and will be precluded from granting forgiveness while any SBA review is pending. Lenders are required to notify their borrowers within five days following receipt of notice that the SBA is reviewing a loan. The Interim Final Rules provide borrowers with an opportunity to appeal an SBA determination that a loan is ineligible for forgiveness, noting that separate rules will be issued addressing the appeals process.

Effects of Forgiveness

Any amount of a PPP loan that is forgiven will be excluded from the borrower's gross income for federal tax purposes, but this is not necessarily the same as the treatment that will be reflected in financial statements under generally accepted accounting principles. The Internal Revenue Service has announced that any related expenses that are subject to forgiveness will not be deductible for tax purposes. Accordingly, a PPP loan, to the extent forgiven, will have no net tax impact on the borrower. There is substantial question as to whether the loss of the deduction for the related expenses is expected under the legislation. It is possible that Congress will take further action to reverse the Internal Revenue Service's position on this issue.

Partial forgiveness will not otherwise modify the terms and conditions of the remaining balance of the PPP loan. It should also be noted that if a borrower is granted forgiveness for any portion of a covered loan, the borrower is not permitted to further defer payment of its payroll taxes pursuant to Section 2302 of the CARES Act. Borrowers should consult with their tax advisors in order to determine the best timing of forgiveness in conjunction with any end of payroll tax deferral.

Determining PPP loan forgiveness requires complex analyses of numerous variables to ensure that the calculations are complete, correct and properly supported. Ensuring maximum forgiveness will require careful consideration and should be accomplished with input from financial, accounting and legal advisors who will be able to assist in making the determinations and calculations necessary. We are available to assist our clients in this process.

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1. 15 U.S.C. § 636(a)
2. The Loan Forgiveness Application is available [here](#) and [here](#).
3. We note that, as of May 28, 2020, various revisions to the PPP are pending in Congress. It is widely anticipated that the period for forgiveness will be expanded beyond the 8-week period provided for in the CARES Act. It is also expected that the Congress may adjust the required percentage of PPP proceeds that are used for payroll costs. PPP borrowers should remain aware of these potential pending changes as any such changes, if enacted into law, may alter the possibility of borrowers to attain greater forgiveness in some circumstances.
4. As noted above, pending legislation may alter the limitation on forgiveness of non-payroll costs.
5. 85 F.R. 21,747, 21,749 (April 20, 2020).
6. *Id.*
7. *Id.*
8. CARES Act, Section 1106(c)(3).
9. 85 Fed. Reg. 20,811, 20,813 (April 15, 2020).
10. Seasonal employers have the option to elect any consecutive 12-week period between May 1, 2019 and September 15, 2019.
11. Additionally, the borrower must inform the applicable state unemployment insurance office of the employee's rejection within 30 days.