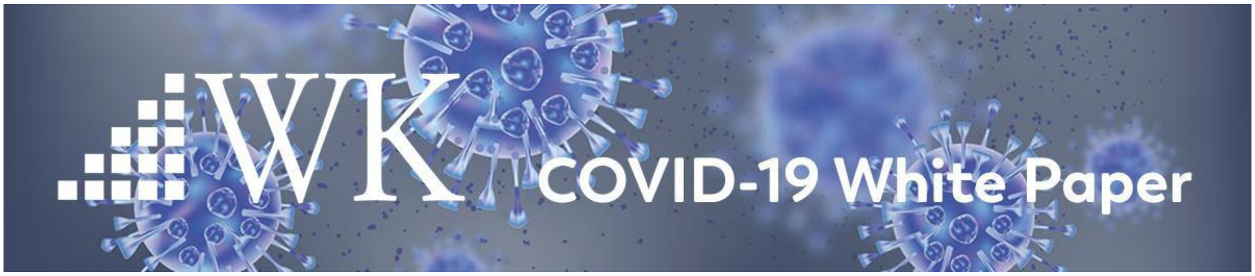

Using Paycheck Protection Program funds effectively

A summary of the things we know today follows. It should be noted that items listed in ***underlined italics*** indicate a subject that requires further clarification from the United States Department of the Treasury.

The PPP is underway, and many businesses and self-employed individuals have been approved to receive program funding. The relevant question for those who have been approved becomes how to measure the amount of the loan that will be forgiven and how to maximize the amount forgiven. To maximize the loan forgiveness, an employer must do the following:

- spend the money on the approved items; and
- pay the right amount to the right number of people.

Spend all the money on the Good Costs

Sec. 1106(b) of the CARES Act forgives only loan amounts spent on the following items we have termed "Good Costs," including:

(a) interest payments on covered mortgage obligations;
(b) payments of covered rent obligations;
(c) payments of covered utilities; and
(d) payroll costs.

These are the only expenses that will produce forgiveness. Although PPP loan proceeds can be used to pay interest on business loans that are not "covered mortgage obligations," such expenditures will not produce forgiveness. Although it is not mandated by the CARES Act, the Small Business Administration (SBA) has issued interim guidance requiring payroll costs to total at least 75 percent of the amount borrowed. Risk exists if payroll costs are less than 75 percent of the borrowed amount and other Good Costs cannot make up the shortfall.

Interest Payments on Covered Mortgage Obligations

This calculation is relatively simple. Only the interest portion of covered mortgage obligations qualifies; the principal portion of those payments do not count.

Qualified interest on debt must meet the following requirements. The interest must be:

- incurred in the ordinary course of business;
- a liability of the borrower;

- a mortgage on real or personal property; and
- incurred before February 15, 2020.

There is currently no limitation on debt owing to related parties if it meets these requirements. Additionally, the interest cannot be accrued. It must be paid.

Finally, an Interim Final Rule was released on April 14 that provided examples of qualified interest. Included was interest on an auto loan on a vehicle used in the business. Thus, qualified debt does appear to include loans secured by personal property.

Covered Rent Obligations

For businesses that rent property as opposed to owning it, rent obligated under a leasing agreement in force before February 15, 2020 will be considered a Good Cost. There is no current limitation on rentals between related parties so long as it meets these requirements.

The April 14 Interim Final Rule included rent on a vehicle used in a trade or business as a qualified expense. Thus, covered rent obligations appear to apply to real and personal property alike.

Covered Utility Payments

Any payment for a service for the following classes of expenses will be considered a Good Cost if the service began before February 15, 2020, including:

- electricity distribution;
- gas;
- water;
- transportation;
- telephone; and
- internet access.

The inclusion of transportation as a covered utility payment has been a cause for questions regarding what specific transportation costs qualify as Good Costs. In the April 14 Interim Final Rule, an example of such a cost was gas used driving a business vehicle.

Payroll Costs

Notwithstanding the nuances of the previously identified definitions, the Payroll Cost definition is the vaguest. The term includes the sum of compensation to employees and compensation to sole proprietors or independent contractors.

Compensation to Employees

The first eligible category of Payroll Costs includes “any compensation with respect to employees” whose principal place of residence is in the United States and for whom compensation fits within specific lists, including:

1. salary, wage, commission, or similar compensation;
2. payment of cash, tip or equivalent;
3. payment for vacation, parental, family, medical, or sick leave;
4. allowance for dismissal or separation;
5. payment required for the provisions of group health care benefits including insurance

premiums; payment of any retirement benefit; and

6. payment of state or local tax assessed on the compensation of employees.

However, the Act excludes from the definition certain amounts including:

- With respect to numeral 1 in the aforementioned list, any salary, wage, etc. that exceeds $100,000 if annualized; and
- any wages paid pursuant to the Emergency Paid Leave or Paid FMLA Leave under the Families First Act.

There is a special rule that attempts to make clear that employer payroll taxes are not part of Payroll Costs, and the salaries, wages, etc. are calculated based on gross wages.

Compensation to independent contractors

The second category of eligible Payroll Costs includes "the sum of payments of any compensation to or income of a sole proprietor or independent contractor that is a wage, commission, income, net earnings from self-employment, or similar compensation and that is in an amount that is not more than $100,000 in one (1) year, as prorated for the covered period." There is great uncertainty about what figures should be used for individuals who operate under a sole proprietorship, as an independent contractor or as an eligible self-employed individual.

The Interim Final Rule released on April 14 provides guidance on how some self-employed individuals can apply for a PPP loan. See article here.

Pay the right amount to the right number of people

In this example, consider that after a business owner has pulled together his or her records and combined all Good Costs for the eight-week period after closing on the PPP loan, the total is at least equal to the amount of the loan. More calculations are necessary to ensure the loan amount meets forgiveness guidelines.

The purpose of a PPP loan is to help employers keep people on the job at close to normal pay. The Good Costs producing forgiveness will be watered down if the business does not employ enough people, or if the business does not pay them enough, and fails to cure this defect. Several important factors must be considered.

The business must employ enough people

To achieve full forgiveness, the business must pay enough people during the eight-week period after the loan closes. The amount subject to forgiveness will be decreased (but not increased) by applying the following factor to the Good Costs.

$$\frac{Average\ (full-time\ equivalency\ employees) FTEs\ for\ 8\ weeks\ after\ funding}{Either\ (a)\ Average\ FTEs\ for\ Feb.\ 15\ 2019\ thru\ June\ 30\ 2019\ OR\ (b)\ Average\ FTEs\ for\ Jan.\ 1\ 2020\ thru\ Feb.\ 29, 2020}$$

The business gets to pick and will most likely prefer the lower of option (a) or (b) in the denominator.

The business must pay people enough

For the purposes of our example, we can assume our business has enough Good Costs and FTEs during our eight-week measurement period after loan closing. But what if wages had to be cut to get to that result? There would be one more hurdle to clear before the entire PPP loan amount is forgivable.

The business would need to identify its employees who made less than $100,000 per year on an annualized basis and compare those employees' wages during the eight-week period to their annualized wage for the preceding full-calendar quarter. For most businesses, the preceding quarter will be 2020 Q1. If any employee suffered more than a 25 percent reduction in pay, then the forgiven amount will be reduced by the excess reduction. While the requirement to hire enough people is imposed on a full-time equivalent (FTE) basis (i.e., without tracing of specific individuals employed before and after the crisis), the requirement to pay people enough requires tracing and only applies to those employed before the PPP loan is funded.

The "Do Over"

As a final review, the example business navigated the aforementioned rules successfully and assumed it was doing great and eligible for full forgiveness of its PPP loan. Then, we applied a test to determine whether it paid the right amount to the right number of people and determined there was a defect causing the business to fail to pay the right amount to the right number of people.

The Act gives businesses a chance to fix any reduction that would result from paying the wrong amount or from employing the wrong number of FTEs. If an employer satisfies two conditions, then the requirement to pay the right amount to the right number of people is waived, which means the only requirement is to spend all the money on the right costs. The requirements for a "do over" are as follows.

- **Flunked FTE Requirement:** If the business had more FTEs on February 15, 2020 than it had in the period beginning *February 15, 2020* through *March 27, 2020 plus 30 days (April 26)* and the business rehires enough FTEs on or before June 30, 2020 to restore the workforce to February 15, 2020 levels, then the requirement to employ enough people for the eight-week period does not apply.
- **Flunked 75 Percent Salary Requirement:** If the business reduced the wage of any employee during the period beginning February 15, 2020 through *March 27, 2020 plus 30 days (April 26)* and the business *"eliminates the reduction"* for all affected employees on or before June 30, 2020, then the requirement to pay at least 75 percent of the wage rate paid the prior quarter does not apply.

There are numerous ambiguities and unclear parts of the "Do Over" scenario. WK anticipates receiving Department of the Treasury clarification about this aspect of the PPP and will distribute related information in a timely manner.

Conclusion

The good news for business owners who are concerned about maximizing forgiveness is there is almost no mistake you can make that would require full repayment as long as you're paying some wages to some employees. Any watering down of the amount forgiven will be proportionate, which is a more comfortable regime considering the high number of unanswered questions. To follow are some of the key questions for which we continue to seek definitive guidance.

(1) *For the FTE computations based on a single date (e.g., Saturday, February 15, 2020), how should a business determine the FTE count?*

(2) *How will pay reductions driven by decreased hours for employees who had overtime hours reduced impact the determination whether someone has had a more than 25 percent pay reduction?*

(3) *How will pay-reduction calculations for hourly & salary employees differ?*

(4) *The chance to cure is conditioned on a reduction in FTEs between Feb 15, 2020 and roughly April 26, 2020. Did Congress really mean, for example, a business with 100 FTEs, reducing to 50 FTEs 1-31-2020 and holding steady at 50 FTEs thru 12-31-2020 will not qualify for the forgiveness, while the same business would qualify if it fired an employee between February 15 and April 26 and subsequently hired a replacement employee prior to June 30?*

(5) *What must an employer do to "eliminate [a pay] reduction" to cure a flunked requirement to pay an employee the right amount? Write the employee a check to get him or her to 75 percent of 2020 Q1 pay? 100 percent of 2020 Q1 pay? Or adjust 2020 Q3 compensation to match 2020 Q1 pay?*