



Memorandum

To: Michael Best Clients with Paycheck Protection Program Loans

From: Martin Tierney, Galen Mason, Vincent Morrone, Greg Lynch, Carrie Byrnes, Mark Lotito

Date: May 6, 2020

Subject: Managing your PPP Loan Proceeds

We have received many questions regarding how and when Paycheck Protection Program (“PPP”) loan proceeds may be used. The CARES Act provides a framework, but very few practical details and the Small Business Administration (“SBA”) has not yet issued detailed regulations. As a result, we are providing this memorandum to our clients to help guide you in your decision-making as of the date of this memorandum. Please understand that this is based upon the current guidance and our current understanding of the rules and standards. The SBA has announced that there will be audits and reviews of how the PPP money was spent and how forgiveness was calculated so not only should the rules be adhered to carefully but you should keep a close eye on changes. Nevertheless, some action must of course be taken now.

To that end, this document is divided into five parts:

- Part 1: Allowable Uses for PPP Loan Proceeds
- Part 2: Calculating PPP Loan Forgiveness
- Part 3: Limitations on and Reductions of Forgiveness
- Part 4: Payroll Costs – Definition and Common Questions
- Part 5: Tax Treatment and Other Miscellaneous Questions

This discussion assumes that you are eligible for and have already received a PPP loan – as a result it does not discuss eligibility for the PPP – be it initial eligibility or a review of your eligibility based on revised standards, the calculation of the amount of the loan, or the loan application process.

Most of the guidance referenced here can be found at: <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses>. This website is updated by the SBA regularly as new guidance is issued. ***As mentioned, guidance in this area is changing quickly, so please be sure to regularly review this and other sources for new rules and changing interpretations.***

The Big Picture

Here's the big picture. The purpose of these loans is to protect paychecks. The forgiveness is based in large part on how much of the proceeds that you spend on Payroll Costs during your eight week covered period, and is reduced if you have a reduction in headcount or wages relative to certain prior periods. In short, if you want maximum forgiveness, rehire your people (or do not terminate them) during the eight week covered period. You can still spend some money on non-payroll costs, but we think focusing on getting to maximum Payroll Costs is in line with the mechanics and spirit of the law.

More importantly, even if you do not care about forgiveness, Small Business Administration ("SBA") guidance appears to be driving you towards using the loan proceeds during the eight week covered period, or at least by June 30, 2020. We believe the funds are indeed a loan and may be repaid over a two year period but the greatest incentives exist to spend during the eight week period.

Finally, please keep in mind that the SBA has indicated that it will be auditing all loans in excess of \$2 million.

Part 1: Allowable Uses for PPP Loan Proceeds

The CARES Act contains a list of allowable uses for PPP loans, but the most important mandate is the 75% Use Requirement which the SBA has applied by regulation to require borrowers to use the PPP loan proceeds to cover Payroll Costs.

1.1. What is the 75% Use Requirement?

In its first Interim final Regulation on the PPP, the SBA declared that "...at least 75 percent of the PPP *loan proceeds* [emphasis added] shall be used for payroll costs."¹ We call this the "75% Use Requirement" throughout this discussion. Take note that this applies to the loan proceeds, and does not appear to be directly linked to forgiveness. For purposes of determining the percentage of use of proceeds for payroll costs, the amount of any Economic Injury Disaster Loan (EIDL) refinanced will be included.²

1.2. By when must we meet the 75% Use Requirement?

We don't know as the SBA has not yet issued guidance on this issue. There are three possible interpretations. The first is that it must be met by the end of the eight week covered period beginning with the disbursement of your loan. The second is that it must be met by June 30, 2020 (because the allowable uses under the statute appear to apply at least through the period ending June 30, 2020). The third interpretation is that it must be met by the end of the 2 year loan amortization period. Although there is language in the first Interim Final Regulation that implies that the 75% Use Requirement is for the loan period, at this time, the safest interpretation is the first one. As a result, we recommend finding a way to meet the 75% Use Requirement by the end of your eight week covered period. To be clear, this means that you need to spend 75% of your loan on payroll costs during the 8 week period. This will not be possible for borrowers whose work force that made up the basis for their total loan was

¹ SBA IFR, April 2, 2020, Section 2r.

² SBA IFR, April 2, 2020, Section 2r.

substantially larger than their work force during the 8 week period. These borrowers are looking to either increase payroll costs during the 8 week period (through either faux hiring or compensation increases) or they are hoping that the 75% use requirement applies to a longer period like June 30th or the two year loan period – described above.

1.3. What is the “covered period”?

The covered period is defined in the CARES Act twice, with different definitions – apparently this is intentional because it seems to apply differently for different purposes. When discussing the allowable uses of the loan proceeds, the CARES Act refers to the covered period beginning on February 15, 2020 and ending on June 30, 2020.³ When discussing loan forgiveness, however, the CARES Act refers to the 8-week period beginning on the date of the origination of a covered loan⁴ (subsequent SBA guidance has interpreted this as starting on the date of the disbursement of the loan).⁵

1.4. What if we do not meet the 75% Use Requirement?

The first Interim Final Regulation on the PPP does not directly indicate what happens if this threshold is not met. It does, however, indicate that if you use PPP funds for unauthorized purposes, SBA will direct you to repay those amounts. In addition, if you knowingly use the funds for unauthorized purposes, you will be subject to additional liability such as charges for fraud (which also applies directly to misuse by shareholders, members, or partners).⁶ Any finding of fraud may subject you to civil and criminal penalties up to 30 years imprisonment and/or \$1,000,000. Some articles have suggested that the SBA would deny all loan forgiveness if the 75% Use Requirement has not been met. The SBA has not issued formal guidance stating that directly and such an interpretation would appear to be contrary to language in the first Interim Final Regulation that discusses limiting the forgiven amount to more than 25 percent of the non-payroll costs. That being said, it should be considered a potential risk.

1.5. We furloughed/laid-off/terminated people prior to receiving our loan – do we need to rehire them?

Borrowers should consider strongly whether to rehire. The PPP Guidance only addresses that issue indirectly in the form of the 75% Use Requirement and the limitations on loan forgiveness discussed later on. In short, however, since Payroll Costs are the only way to meet the 75% Use Requirement, and are a large driver of forgiveness, we suggest that rehiring individuals is the easiest way to meet those goals.

1.6. Can we pay individuals who are doing little or no work at their full rate in order to meet the 75% Use Requirement?

We believe so. The original PPP certification made by everyone who received a loan is that the money would be necessary to support ongoing operations. It is unclear whether this means operations at the current level (which might be low because of economics or stay-at-home orders) or the pre-COVID levels. In the section of the regulations in which the SBA added the 75% Use Requirement, they referenced the requirement as “...consistent with Congress’ overarching goal of keeping workers paid

³ SBA Section 7(a)(36)(A)(iii).

⁴ CARES Act Section 1106(a)(3).

⁵ SBA FAQ 20.

⁶ SBA IFR, April 2, 2020, Section 2s.

and employed.” Given that overarching goal, and the reference to “paid and employed” we think the 75% Use Requirement can be read as encouraging (or even requiring) borrowers to employ and pay enough individuals to meet the requirement, regardless of available work. While not ideal, this appears to meet the primary goals of the PPP. That being said, we would recommend that employers do their best to find appropriate work for those individuals or to keep them “on call”. In addition, it is worth noting that employers will still need to consult their employee benefits plans to ensure the coverage status under those plans (for example some plans have “actively at work” requirements that may or may not be met for an individual who is providing reduced services).

1.7. Can we just pay everyone who is still employed a bonus in order to meet the 75% Use Requirement?

Possibly, but the rules are unclear. The allowable uses for the loan proceeds include Payroll Costs (the definition of which includes “salary, wage, commission, or similar compensation”⁷ subject to the \$100K Limit (described below in Part 4 under the discussion of Payroll Costs) and the allowable uses also include “employee salaries, commissions, or similar compensations.”⁸ It is not clear whether a bonus would be considered “wages” or “similar compensation” for Payroll Cost purposes. Accordingly, we recommend focusing on paying as much regular salary, wages, and commission as possible, and relying only upon bonuses as a last resort. This, again, pushes employers towards rehiring, rather than paying more to those employees who remain.

1.8. Can we prepay Payroll Costs for services to be provided after the covered period and have them count now for purposes of the 75% Use Requirement?

No. To be an “allowable use” of the PPP loan proceeds, you must “use” the amount during the covered period (which, as noted above, probably means by June 30, 2020 for purposes of the allowable use rules).⁹ This suggests that the “use” would need to be current (in the covered period). Absent further guidance from the SBA, we recommend that a company not materially deviate from its ordinary payroll practices.

1.9. Are there other Allowable Uses for the PPP Loan Proceeds?

Yes. Specifically, the CARES Act¹⁰ lists the following:

- Payroll Costs (discussed below in Part 4)¹¹
- Costs related to the continuation of group health care benefits during periods of paid sick, medical, or family leave, and insurance premiums
- Payments of interest on any mortgage obligation (not including any prepayment of or payment of principal on a mortgage obligation)

⁷ SBA Section 7(a)(36) (A)(viii)(I)(aa)(AA).

⁸ SBA Section 7(a)(36) (F)(i)(III).

⁹ SBA Section 7(a)(36)(F).

¹⁰ This list is from SBA Section 7(a)(36)(F), except where it was modified by Section 2r of the SBA IFR, April 2, 2020.

¹¹ SBA IFR, April 2, 2020, Section 2r. Note that Section 2r of the IFR did not reference “Employee salaries, commissions, or similar compensations” which is specifically referenced in the CARES Act as an allowed use. This may be intentional because Payroll Costs do not include such amounts to the extent they are in excess of \$100,000 for any single employees (as prorated over the covered period). In short, do not assume that employee salaries, commissions, or similar compensation in excess of the \$100,000 is an allowable use.

- Rent (including rent under a lease agreement)
- Utilities
- Interest on any other debt obligations that were incurred before the February 15, 2020
- Refinancing an SBA EIDL loan made between January 31, 2020 and April 3, 2020¹²

Notice that this list is different from the forgiveness list (which is a very important distinction).

There is also ambiguity as to whether PPP loan proceeds can be used for much broader purposes – as has been the case under historical SBA small business loans. We can provide more detail on this possibility at your request, but at this time we are recommending that clients stay within the enumerated uses in the CARES Act.

1.10. Given the potential scrutiny, how should we be tracking the use of the loan proceeds?

Although it is not legally required, we generally advise keeping the PPP loan proceeds in a separate bank account to more easily track this use for forgiveness and compliance purposes. In addition, keep in mind that when forgiveness is requested, borrowers are required to provide detailed documentation.¹³ This includes documentation verifying the number of full-time equivalent employees on payroll and pay rates (e.g., payroll tax filings reported to the IRS, State income, payroll, and unemployment insurance filings), documentation verifying payments on covered mortgage obligations, payments on covered lease obligations, and covered utility payments (e.g., cancelled checks, payment receipts, transcripts of accounts, or other documents), and a certification from the company that the documentation presented is true and correct and 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.¹⁴

¹² Added by SBA IFR, April 2, 2020, Section 2r. If your EIDL loan was not used for payroll costs, it does not affect your eligibility for a PPP loan. If your EIDL loan was used for payroll costs, your PPP loan must be used to refinance your EIDL loan. Proceeds from any advance up to \$10,000 on the EIDL loan will be deducted from the loan forgiveness amount on the PPP loan.

¹³ CARES Act Section 1106(f).

¹⁴ CARES Act Section 1106(f).

Part 2: Calculating PPP Loan Forgiveness

2.1. What amount of the PPP loan may be forgiven under the CARES Act?

Although subject to the limitations and reductions described in Part 3, a PPP borrower is 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.¹⁵

- Payroll Costs, discussed below in Part 4.
- Covered Mortgage Obligations¹⁶ (not including any prepayment of or payment of principal on a covered mortgage obligation). For purpose of forgiveness, this means any indebtedness or debt instrument incurred in the ordinary course of business that (1) is a liability of the borrower; (2) is a mortgage on real or personal property; and (3) was incurred before February 15, 2020.
- Covered Rent Obligations.¹⁷ For purpose of forgiveness, this means rent obligated under a leasing agreement in force before February 15, 2020.
- Covered Utility Payments.¹⁸ For purpose of forgiveness, this is defined as payments for a service for the distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020.

2.2. What is the “covered period” for purposes of the forgiveness provisions of the CARES Act?

As noted above, the CARES Act defined “covered period” for purposes of the forgiveness provisions as the eight week period beginning on the date of the origination of a covered loan¹⁹ (subsequent SBA guidance has interpreted this as starting on the date of the disbursement of the loan).²⁰

2.3. What does the reference to “costs incurred and payments made” mean for purposes of determining when an amount can be counted for forgiveness purposes?

This language is difficult for two reasons:

- **Joint vs Separate Requirements.** First, it is not clear whether these are separate concepts or whether they are meant to be read conjunctively. If read conjunctively, then they represent two requirements, both of which must be met (i.e. the cost must have been incurred in the covered period and the payment for that cost must have been made in the covered period). This would be problematic, for example, when applied to the first and last payroll periods that straddle the beginning and end of the covered period. Arguably, the services provided before the covered period do not represent a cost incurred during the covered period. We say arguably because when the cost for payroll is incurred is its own question – is it incurred when the services are provided or when the obligation to pay occurs. Similarly, for the last payroll that straddles the covered period, the services have been provided, but payment does not occur until after

¹⁵ CARES Act Section 1106(b).

¹⁶ As defined in CARES Act section 1106(a)(2).

¹⁷ As defined in CARES Act section 1106(a)(4).

¹⁸ As defined in CARES Act section 1106(a)(5).

¹⁹ CARES Act Section 1106(a)(3).

²⁰ SBA FAQ 20.

the covered period. Although we think reading these conjunctively would be unnecessarily punitive, we cannot rule out that interpretation at this time. The alternative reading is that “costs incurred” and “payments made” are separate concepts, and either one will qualify the amounts for forgiveness. The “separate concepts” reading would support a more common-sense approach to the covered period.

- **Cash vs. Accrual.** It is not clear whether this rule will be applied on a cash or an accrual basis. It may be that the SBA tells borrowers to apply their normal method for this purpose, but the statute and current FAQs do not appear to provide any guidance. This is further complicated by the conjunctive language vs. separate concepts discussed above.

We are expecting regulations on these issues, but at this time we would counsel borrowers to track their forgiveness keeping in mind the possibility that this “costs incurred and payments made” language could result in the exclusion of some costs and payments that the borrower might otherwise expect to be forgivable.

2.4 Does rent include equipment leases?

Probably not, but this issue is not directly addressed in any guidance at this time.

Part 3: Limitations on and Reductions of Forgiveness

There are three limitations or reduction rules that can lower your forgiveness from the amount determined in Part 2, (A) the 25% Rent, Utility, Mortgage (RUM) Limit, (B) the Headcount Reduction Rule, and (C) the Wage Reduction Rule.

3.1. What is the 25% RUM Limit?

In its first Interim final Regulation on the PPP, the SBA declared that “...not more than 25 percent of the loan forgiveness amount may be attributable to non-payroll costs.”²¹ Non-payroll costs that are forgivable are Covered Rent Obligations, Covered Utility Payments and Covered Mortgage Obligations (these will be referred to as “RUM” and the limit is the “25% RUM Limit”). In describing the reason for this requirement, SBA calculated that 75% of the loan proceeds would be equal to eight weeks of payroll costs. Thus, the purposes of this rule is clearly to encourage the payment of Payroll Costs during the covered period. This may sound familiar, but it appears to be entirely separate from the 75% Use Requirement, which is not worded as encouragement, but as a requirement.²²

As simple mathematical way to think about this limit is to realize that the total forgiveness cannot exceed 1.3333333 times the Payroll Costs (nor can it exceed the loan amount, of course). For example, if you received a \$1,000,000 loan and you spend \$750,000 on Payroll Costs and \$250,000 on RUM during the covered period, then your loan forgiveness is not limited by the 75% RUM Limit. If, however, you spend \$600,000 on Payroll Costs and \$400,000 on RUM during the covered period, your maximum loan forgiveness is \$800,000 (\$600,000 on Payroll Costs and \$200,000 on RUM). Note that in this second example you will have failed to meet the 75% Use Requirement as well, which could have additional impacts as described above in Part 1 (depending on the time period during which the 75% use is required).

3.2. What is the Headcount Reduction Rule?

The amount of loan forgiveness is reduced (but not increased) by multiplying the amount described above in Part 2 by a fraction. The numerator of the fraction is the average number of full-time equivalent employees per month employed by the borrower during the covered period. The denominator is the borrower’s choice of (A) the average number of full-time equivalent employees 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 full-time equivalent employees per month employed by the borrower during the period beginning on January 1, 2020, and ending on February 29, 2020.

Example. Assume that a borrower has calculated a top-line loan forgiveness amount of \$1,000,000. Also assume that the average number of full-time equivalent employees per month employed by the borrower during the eight week covered period is 90. If the borrower’s best number for the denominator (between (A) and (B), above) is 100, then the loan forgiveness will be reduced to 90% or \$900,000.

3.3. How is the average number of full-time equivalent employees determined?

²¹ SBA IFR, April 2, 2020, Section 2o.

²² SBA IFR, April 2, 2020, Section 2o.

That is not crystal clear. The statute indicates that the average number of full-time equivalent employees per month is determined by calculating the average number of full-time equivalent employees for each pay period falling within a month. That's great, but the covered period is an eight week period, not a two month period. It could span three months. As a result it is not clear which payroll period will count. Similarly, one of the periods that can be chosen for the denominator includes only one half of a month. We expect more guidance on how this is intended to be applied. In addition, under the Rehire Rule (discussed below), it may be possible to ignore some of this reduction.

3.4. How do we count full-time equivalent employees?

The PPP part of the CARES Act does not contain any definition of full-time equivalent employee.²³ Another part of the statute references the definition from the Affordable Care Act, but that reference is specific to the section in which it is used.²⁴ Accordingly, our advice has been to use whatever measure you normally use for other purposes and await further guidance. In addition, we have noted that the definition should be consistent for the denominator and the numerator of the Headcount Reduction fractions. As a result, a surprise in the definition is not likely to have a great impact for most employers.

3.5. Do independent contractors count as employees for purposes of PPP loan forgiveness?

No. Independent contractors do not count for purposes of a borrower's PPP loan forgiveness.²⁵

3.6. What is the Wage Reduction Rule?

Under this rule, the amount of loan forgiveness is reduced by the amount of any reduction in total salary or wages of certain employees during the covered period that is in excess of 25 percent of the total salary or wages of the employee during the most recent full quarter during which the employee was employed before the covered period. The "certain employees" are those employees who did not receive, during any single pay period during 2019, wages or salary at an annualized rate of pay in an amount more than \$100,000.

Unfortunately, the statutory language is incredibly unclear. Taken on its face, the 25% reduction is calculated against the most recent full quarter during which the employee was employed. Assuming a steady wage rate, this would be 25% of three months of wages. That number is, however, compared against the eight week covered period. This provision is awkward, at best. Some have interpreted this as a reduction in the wage or salary rate (instead of the wage or salary amount). That makes a bit more sense, but that raises other questions. No guidance has been issued at this time.

In addition, under the Rehire Rule, it may be possible to ignore some of this reduction.

3.7. For purposes of the Wage Reduction Rule, do we only look at employees employed during the covered period or do we also look at those who are not employed?

That is not clear from the language. We think the better interpretation is that the Headcount Reduction Rule is designed to capture those who are no longer employed, so that only those employed during the covered period could effectively generate wage or salary reductions. Although there is no guidance on

²³ CARES Act Section 1106.

²⁴ CARES Act Section 2301(c)(3).

²⁵ SBA IFR, April 2, 2020, Section 2p.

this point, a recently released SBA FAQ (discussed in the next question) suggests that instead that the SBA will interpret the Wage Reduction Rule to apply to employees who are not rehired during the covered period. The details are unclear at this point.

3.8 Will our forgiveness be reduced under the Headcount Reduction Rule or the Wage Reduction Rule if we laid off an employee and offered to rehire the employee during the covered period, but the employee refused?

No, but only if the borrower made a good faith, written offer of rehire, and documents the employee's rejection of that offer. According to SBA FAQ #40, SBA intends to issue an interim final rule excluding laid-off employees whom the borrower offered to rehire (for the same salary/wages and same number of hours) from the CARES Act's loan forgiveness reduction calculation. The interim final rule will specify that, to qualify for this exception, the borrower must have made a good faith, written offer of rehire, and the employee's rejection of that offer must be documented by the borrower. The SBA guidance also notes that employees and employers should be aware that employees who reject offers of re-employment may forfeit eligibility for continued unemployment compensation. This puts employers whose employees earn less than the now federally subsidized unemployment benefits in a tough position with respect to their employees – get your employees to come back to work for less than they make staying on unemployment or suffer a harsh head count reduction impact on your forgiveness calculation.

3.9. If we have a reduction in headcount that is also coupled with a reduction in wages, is our forgiveness reduced by both rules?

At this time, under a plain English reading of the statute, it appears that the answer is “Yes”. For example, if an employee's time is reduced during the covered period such that they move from 1.0 to 0.5 in terms of full-time equivalency and, as a result they also have a 50% wage reduction, then it appears that both reduction rules are triggered. This seems to be a harsh and unintended consequence that would create some perverse incentives (e.g., the employer in this example could instead simply reduce the wage rate by 50% but keep the individual employed for the same number of hours, arguably avoiding the Headcount Reduction). As a result, we expect further guidance on this issue detailing that wage reductions must relate to the same amount of work or some similar correction designed to resolve this double impact.

3.10. What is the “Rehire Rule” mentioned above?

This is perhaps the most difficult rule in the CARES Act. It is poorly written and its purpose is unclear. Nonetheless, we will try to summarize it here. In the circumstances described below, the amount of loan forgiveness under this section is determined without regard to a reduction in the number of full-time equivalent employees or a reduction in the salary of 1 or more employees, as applicable, during the period beginning on February 15, 2020, and ending on April 26, 2020. The “circumstances” are different for purposes of the Wage Reduction Rule and the Headcount Reduction Rule (the rule also applies if both circumstances apply). The circumstances are:

- *Rehire Rule Circumstances for Headcount Reduction:* During the period beginning on February 15, 2020, and ending on April 26, 2020, there is a reduction, as compared to February 15, 2020, in the number of full-time equivalent employees of a borrower AND not

later than June 30, 2020, the borrower has eliminated the reduction in the number of full-time equivalent employees.

- *Rehire Rule Circumstances for Wage Reduction:* During the period beginning on February 15, 2020, and ending on April 26, 2020, there is a reduction, as compared to February 15, 2020, in the salary or wages of 1 or more employees of the borrower AND not later than June 30, 2020, the borrower has eliminated the reduction in the salary or wages of such employees.

Unfortunately, the statutory language raises a host of unanswered questions:

- What does it mean to have eliminated the reduction? For a salary reduction, must the difference be made up or is it sufficient to have been returned to the previous rate? For a headcount reduction, would it be acceptable to rehire the person on June 30th, then re-fire then on July 1st? It seems unlikely that the regulators would find that acceptable.
- What does it mean to determine the application of the rule without regard to the reduction? For the Headcount Reduction Rule, we would expect that this is intended to mean that the person may be counted in the numerator. For the Wage Reduction, we would expect that this means that the reduction is simply ignored.

As we said at the outset, this is a poorly written rule, and we caution against relying upon it as a means of addressing your forgiveness numbers. Instead, the best approach is to be sure that your topline forgiveness number is as high as possible, and to make sure that the Headcount Reduction Rule and the Wage Reduction apply to the smallest extent possible. Also, if you do not rehire employees until June 30, 2020 (or at some point later in the eight week forgiveness period), absent sizable increases in compensation to your work force, you will have naturally have spent less on Payroll Costs, which reduces your maximum potential forgivable amount and could also affect your ability to meet the 75% Use Requirement because you would not be spending the PPP loan proceeds on Payroll Costs during the eight week forgiveness period. Therefore, if your goal is to maximize loan forgiveness and ensure you satisfy the 75% Use Requirement, it will be in your best interest to rehire employees ***as soon as possible*** during the eight week forgiveness period to ensure you spend at least 75% of the PPP loan proceeds on Payroll Costs during the eight week forgiveness period (which, as mentioned above, is our safest interpretation of when you likely need to satisfy the 75% Use Requirement).

3.11. Do any special rules apply to seasonal employers?

Yes. In the case of a borrower that is a seasonal employer, the denominator of the fraction for calculating the Headcount Reduction Rule is the average number of full-time equivalent employees per month employed by the borrower during the period beginning on February 15, 2019 and ending on June 30, 2019.²⁶

3.12. Are there special rules for tipped workers?

Yes. A borrower with tipped employees described in section 3(m)(2)(A) of the Fair Labor Standards Act of 1938 (29 U.S.C. 203(m)(2)(A))(the “FLSA”) may receive forgiveness for additional wages paid to those employees. It is not clear how this is intended to work, but it is worth noting that this rule is not under the definition of Payroll Costs. Instead it is described in the section of the law addressing forgiveness.

²⁶ Although the SBA released guidance on seasonal employers April 28, 2020, that guidance only applied for purposes of determining the maximum loan amount, not for purposes of forgiveness.

One interpretation is that it means that the employer can pay a tipped worker a tip replacement amount and receive forgiveness for it. Note, however, that the law and regulations are currently silent, so please watch for additional guidance.

3.13. Will forgiveness include the interest on the loan?

No. The forgiveness may not exceed the principal on the loan.²⁷

3.14. Which of these limitations and reductions applies first?

We do not know. Our best guess is that the 25% RUM Limit applies first, followed by the Headcount Reduction Rule, then the Wage Reduction Rule.

3.15. Can we furlough employees immediately after the end of our eight week forgiveness period, even if that date is before the end of the “covered period” (i.e., June 30, 2020), without it having an adverse impact on the forgiveness of our loan?

Probably yes. There is no explicit restriction in the CARES Act on your ability to implement furloughs after the end of your forgiveness period. Also, the forgiveness calculations (and reductions) are based on the amount you spend during the eight week period after the disbursement of your loan (not during the covered period through June 30, 2020) and the Headcount Reduction Rule and Wage Reduction Rule only take into account changes related to the eight week forgiveness period (not changes made during the covered period through June 30, 2020). That being said, keep in mind that all other wage and hour laws continue to apply (e.g., such as the requirement to provide WARN notices, if applicable). And be aware that an applicant must make a good faith certification that the loan proceeds will be used to maintain payroll.

²⁷ CARES Act Section 1106(d)(1).

Part 4: Payroll Costs – Definition and Related Questions

One of the lynchpins to multiple aspects of the PPP is the definition of Payroll Costs. This section addresses the basic definition, as well as numerous questions that have arisen in its practical application.

4.1. What are Payroll Costs for purposes of the PPP?

Payroll Costs are the sum of all compensation paid to employees that are:

- salary, wage, commission, or similar compensation²⁸
- payment of cash tip or equivalent
- payment for vacation, parental, family, medical, or sick leave
- allowance for dismissal or separation
- payment required for the provisions of group health care benefits, including insurance premiums
- payment of any retirement benefit
- payment of State or local tax assessed on the compensation of employees

Payroll Costs exclude the following:

- the cash compensation of an individual employee in excess of an annual salary of \$100,000, as prorated for the covered period (the “\$100K Limit”)
- any compensation of an employee whose principal place of residence is outside of the United States
- qualified sick leave wages for which a credit is allowed under section 7001 of the Families First Coronavirus Response Act (the “FFCRA”); or
- qualified family leave wages for which a credit is allowed under section 7003 of the FFCRA.

4.2. Do Payroll Costs include or exclude the employee’s portion of Social Security, Medicare, and federal income tax withholding?

This has been a source of much confusion. The statutory language specifically indicated that these withholdings are excluded from Payroll Costs, BUT then the SBA stepped in and interpreted the statute to mean that the exclusion of a withholding is actually an inclusion. As a result, contrary to the language in the statute, the current rule is that Payroll Costs are calculated on a gross basis without regard to (i.e., not including subtractions or additions based on) federal taxes imposed or withheld, such as the employee’s and employer’s share of Social Security, Medicare, and federal income taxes. Here is the example from the SBA’s FAQ:

For example, an employee who earned \$4,000 per month in gross wages, from which \$500 in federal taxes was withheld, would count as \$4,000 in payroll costs. The employee would receive \$3,500, and \$500 would be paid to the federal government.²⁹

²⁸ SBA Section 7(a)(36) (A)(viii)(I)(aa)(AA).

²⁹ SBA FAQ #16.

4.3. Do Payroll Costs include the employer's portion of Social Security, Medicare, and federal income tax withholding?

No.

4.4. How does the 100K Limit apply in practice? Do we need to count non-monetary benefits?

When calculating Payroll Costs, no amount should be included for cash compensation paid to an employee that would exceed \$100,000 as prorated for the covered period. We believe that this can be simplified to mean that no amount of cash compensation paid to an employee from PPP loan proceeds during the covered period can exceed \$15,384.62 (which is 8/52 x \$100,000) for Payroll Cost purposes. In addition, in an important FAQ from the SBA, they also indicated that the \$100K Limit only applies to cash compensation. All non-cash compensation that would otherwise be considered a Payroll Cost can be counted as Payroll Cost without regard to the 100K Limit. The FAQ specifically cites as non-cash compensation the following items:

- employer contributions to defined-benefit or defined-contribution retirement plans,
- payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums; and
- payment of state and local taxes assessed on compensation of employees.

4.5. Are payments to independent contractors or sole proprietors part of Payroll Costs?

No. Although the statutory language suggested that this might be the case, the SBA subsequently addressed this issue in their FAQs.³⁰

4.6. Do housing stipends or allowances provided to an employee as part of compensation count toward Payroll Costs?

Yes. Payroll costs includes all cash compensation paid to employees, subject to the \$100K Limit.³¹

4.7. Are bonuses considered “salary, wage, commission, or similar compensation”?

Possibly, but the rules are unclear. A bonus is generally distinct from salary. That being said, the definition of wages varies greatly for multiple purposes. Under the Internal Revenue Code, wages would generally include a bonus (as part of “all remuneration for employment”).³² The Merriam-Webster Dictionary definition of “wage” is “a payment usually of money for labor or services usually according to contract and on an hourly, daily, or piecework basis...” With that definition, the SBA could take the position that “wage” is meant to capture hourly pay in contrast to salary, but does not include bonuses. That being said, in more recent guidance, the SBA, in answering the question of whether a housing allowance is included in payroll costs, indicated that “Payroll costs **includes all cash compensation paid to employees**, subject to the \$100,000 annual compensation per employee limitation.”³³ [Emphasis added]. This answer is not focused on bonuses, however, so we recommend focusing on paying as much regular salary, wages, and commission as possible, and relying only upon bonuses as a last resort.

³⁰ SBA FAQ #15.

³¹ SBA FAQ #32.

³² Code section 3121(a).

³³ SBA FAQ #32.

4.8. Can we prepay wages during the covered period for future work and count that as Payroll Costs?

Although there is no specific guidance on this subject, we believe that this would clearly be in opposition to the intent of the loan forgiveness rules. It is clearly prohibited for similar expenses such as mortgage interest. We do not recommend it.

4.9. Can we accelerate payments that we would normally have made after the covered period into the covered period and count those as Payroll Costs?

That is not clear. We recommend against changing your normal payroll procedures to fit payments within the covered period, as that may be viewed as manipulation. That being said, payment of amounts without strings attached (i.e., without a requirement to provide future services) would not seem to be in violation of the intent of the loan forgiveness rules.

4.10 How do we calculate the Payroll Costs for group health care benefits provided under a self-insured plan?

There is no guidance on this issue. There are a couple of possibilities to consider. The first would be to use actual costs during the covered period (assuming the focus of the question is on forgiveness). That being said, the lag in claims and claims payment may make this impossible as of the time by which the employer must apply for forgiveness. In addition, this raises all of the incurred, accrued, and paid issues described under Question 2.3. Another possibility is to use the actuarial costs that is often used for purposes of determining COBRA premiums (probably without the additional amount for administrative expenses).

Part 5: Tax Treatment and Other Miscellaneous Questions

5.1. If we receive forgiveness of the PPP loan will that forgiveness be taxable?

No, but that's not the whole story. The IRS released Notice 2020-32 in which it dredged up a seldom used section of the Internal Revenue Code (the "Code") to conclude that because the loan forgiveness is not included in income **the related expenses cannot be deducted**. In other words, even though the PPP loan proceeds are not income if they are forgiven, the expenses that the PPP loan was used to cover do not generate deductions to the extent the PPP loan was forgiven. This interpretation appears to be at odds with Congress's intent. As a result, we recommend watching for developments on this position.

To provide further detail, Section 1106(i) of the CARES Act specifically provides that any amount that would be includible in gross income of the recipient by reason of forgiveness described in section 1106(b) shall be excluded from gross income. Regardless of this provision in the CARES Act, the Treasury references Code section 265 (as well as relevant case law) which provides that, "No deduction shall be allowed for - [a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income... wholly exempt from the taxes imposed by this subtitle..." Citing the purpose of denying taxpayers a double tax benefit, the Treasury has interpreted Code section 265 to disallow "...any otherwise allowable deduction under any provision of the Code, including sections 162 and 163, for the amount of any payment of an eligible [CARES Act] section 1106 expense to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven) because such payment is allocable to tax-exempt income."³⁴

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³⁴ Notice 2020-32.