Best Practices for Paycheck Protection Program Loan Forgiveness

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Background

Enacted on 3/27/20, the Coronavirus Aid, Relief, and Economic Security (CARES) Act created the PPP, which seeks to help small businesses (including sole proprietors, independent contractors, and eligible self-employed individuals) negatively impacted by the COVID-19 pandemic. The program provides eligible applicants federally guaranteed loans of up to 2 1/2; times their average monthly payroll costs (up to a maximum of $10 million). Better yet, the full principal amount of the loan, plus any accrued interest, may be forgiven if certain criteria are met. Amounts that aren't forgiven will be subject to a two-year note with a 1% interest rate.

For clients who've received small business loans under the PPP, the next eight weeks are crucial. The actions taken during this timeframe will determine how much of the client's loan will be forgiven. Since cash is king right now, taking the appropriate steps to ensure maximum PPP loan forgiveness should become a priority. Here are five best practices you can share with clients to help them meet the requirements for total loan forgiveness.

Caution: There are still many unknowns regarding the forgiveness provisions of the PPP. Although the Small Business Administration (SBA) has released some guidance, we anticipate more will come. Also, as we saw with the PPP application process, lenders may come up with their own interpretation of the loan forgiveness computation. Be on the lookout for future guidance.

#1: Pay Attention to How Funds Are Used

During the eight-week period following the date the PPP loan proceeds are disbursed, clients will need to be extra diligent in tracking how the funds are used. This is because loan forgiveness depends largely on whether the money is used to pay forgivable expenses. These include (1) payroll costs, (2) interest payments on mortgages incurred before 2/15/20, (3) rent payments on leases dated before 2/15/20, and (4) utility payments under service agreements dated before 2/15/20. However, according to the SBA, not more than 25% of the forgivable expenses may be attributable to nonpayroll costs. In other words, at least 75% of the loan must be used for payroll. *Payroll* includes wages (subject to a $100,000 limit), group health care coverage, retirement plan contributions, and payment of state and local taxes assessed on employee compensation. The term, however, doesn't include federal employment taxes imposed or withheld between 2/15/20 and 6/30/2020, and income taxes required to be withheld from employees during that period.

Note: For self-employed individuals who file a Form 1040 and have no employees, payroll costs equal the individual's *net profit amount* on line 31 of his or her 2019 Schedule C (limited to $100,000). This is known as the *owner compensation replacement*. (If this amount is zero or less, the client isn't eligible for a PPP loan.) According to the SBA, if the client hasn't filed a 2019 tax return, he or she should fill one out and compute the net profit amount. (In our opinion, this return doesn't have to be filed with the IRS immediately, but the calculated net profit amount provided to the bank must match the actual figure reported on the filed return.) However, only eight weeks' worth of payroll costs may be included in determining the amount forgiven under the PPP.

Misuse of PPP Funds. According to the SBA, if a business uses PPP funds for unauthorized purposes, it will have to repay those amounts. If unauthorized use is intentional, the business may be subject to additional liability (such as fraud). If a shareholder, LLC member, or partner uses funds for an unauthorized purpose, the SBA can go after that individual.

Best Practices. To make sure they're using PPP funds for forgivable purposes, clients should carefully track how they use the money in their books and records. Setting up a separate bank account for this purpose may be helpful. In the alternative, clients could deposit PPP funds into their business savings account and transfer the money to checking and payroll accounts when needed. For some clients, creating new general ledger codes for PPP expenses may be beneficial. In addition, before PPP funds are spent, clients should consider the following:

- Payroll periods may need to be modified to ensure at least 75% of PPP funds are used for payroll costs. For businesses with weekly or biweekly payroll periods, this may not be a problem. However, companies with semimonthly payroll periods may struggle to meet the 75% requirement (or may discover too late that they fell short). If needed, businesses can pay bonuses toward the end of the eight-week period to pass the 75% test.
- Mortgage documents, leases, and utility bills should be gathered and analyzed to make sure obligations arose prior to 2/15/20. Also, make clients aware that a document labeled as a “lease” may, in fact, be a financing arrangement (i.e., a capital lease). These arrangements would be excluded from the definition of a *lease* for PPP purposes.
- If forgivable expenses are paid with a business credit card, make sure that portion of the credit card bill is paid with PPP funds before the end of the applicable eight-week period.

#2: Keep Track of Employee Headcount and Salary Levels

Carefully tracking employee headcount and salary levels is now more important than ever. While we assume most businesses already do this, PPP borrowers that don't maintain certain employee and compensation levels will see a decrease in the amount of the loan eligible for forgiveness.

Employee Headcount. Your client's forgivable loan amount (the amount of the loan used to pay forgivable expenses) will be reduced if the average number of Full-time Equivalent (FTE) employees per month during the applicable eight-week period is less than the average during the base period. The *base period* is either (1) 2/15/19 through 6/30/19, or (2) 1/1/20 through 2/29/20. Your client should choose the period that produces the best result (i.e., maximizes loan forgiveness). Once the base period is selected, the forgivable amount will be reduced by the percentage reduction in headcount.

Example 1: PPP loan recipient reduces headcount.

Express Service, Inc. secured a PPP loan of $250,000 on 4/13/20 and received the funds on 4/17/20. During the eight-week period following 4/17/20, the average number of FTE employees per month employed by Express Service was 35. From 2/15/19 through 6/30/19, the average number of FTE employees per month employed by Express Service was 55. From 1/1/20 through 2/29/20, that number was 50.

To maximize loan forgiveness, Express Service will choose a base period of 1/1/20 through 2/29/20. Based on that period, the company's headcount was reduced by 30% [1 - (35 / 50)]. As such, Express Service must reduce its forgivable loan amount by 30% (from $250,000 to $175,000, assuming the entire loan is forgivable). This means that the company will have to repay $75,000 of the PPP loan.

Salary Levels. Your client's forgivable loan amount also will be reduced if salary levels are cut by more than 25%. For each employee who earns less than $100,000, you compare total salary paid during the eight-week period following receipt of the loan proceeds with that employee's salary during the most recent full quarter. If the reduction is greater than 25%, a corresponding reduction must be made to the forgivable loan amount. Note that this test requires the business to look at every employee individually.

Best Practices. If your clients have already laid off or furloughed workers, encourage them to restore employee headcount and salary levels by 6/30/20. For purposes of the employee and compensation tests, headcount and salary reductions occurring between 2/15/20 and 4/26/20 (30 days after enactment of the CARES Act) are ignored if your clients eliminate the reductions no later than 6/30/20. To take advantage of this provision, a business doesn't have to rehire the same employees—it merely has to have the same average number of FTE employees as it had during the base period. Also, the PPP doesn't require rehired workers to actually perform customary work duties. The intent of the PPP is to have a workforce in place as soon as businesses are ready to reopen.

Caution: Before taking action, clients should consult with their labor and employment attorney to work out the terms for rehiring workers.

#3: Focus on Recordkeeping

Now that they've received PPP funds, clients should do everything in their power to ensure the forgiveness application process (discussed later) goes as smoothly as possible. That's where good recordkeeping comes into play. As mentioned earlier, borrowers will need to prove they used PPP funds for forgivable purposes. To help your clients get started, encourage them to create a spreadsheet of all forgivable expenses as they're incurred. Clients also should maintain a special folder (electronic or otherwise) that houses all supporting documentation. The folder should contain the following items:

(1.) FTE employee headcount calculations.

(2.) Payroll tax filings (both federal and state).

(3.) Mortgage documents, leases, and utility bills.

(4.) Cancelled checks and payment receipts.

(5.) Bank statements for the separate account used to pay forgivable expenses. If a separate bank account wasn't set up, include copies of other bank statements with forgivable expenses highlighted to support any Electronic Funds Transfer (EFT) payments.

(6.) For self-employed individuals, the 2019 Schedule C (Form 1040). The bank will use this to determine the amount of net profit allocated to the owner during the applicable eight-week period.

Being prepared with these documents will make it easier for the banker, which should increase your clients' chances of receiving maximum PPP loan forgiveness.

#4: Understand the Forgiveness Application Process

Clients need to understand that although their PPP loan is guaranteed by the SBA, it's their bank that will ultimately decide the forgivable amount. As with the initial loan application process, banks may implement their own procedures for determining loan forgiveness. There are, however, a few things to keep in mind. First, your clients may not apply for forgiveness until at least eight weeks after receiving PPP funds. If clients followed your advice and maintained proper records, the process should go fairly quickly. Clients that are less organized and require more time should apply for loan forgiveness within two or three months after the eight-week period.

In addition, clients need to be prepared to make the required certifications when applying for loan forgiveness. An authorized representative of the business must certify that (1) the documentation presented is true and correct and (2) 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. Once the bank receives your client's loan forgiveness application, it has 60 days to review and either approve or deny it.

#5: Prepare for Future Obligations

In some cases, the entire PPP loan will be forgiven. If only a portion of the loan is forgiven, your client will need to fulfill all remaining payment obligations. The unforgiven portion of the loan will be subject to a two-year note with a 1% interest rate. Fortunately, no payments will be due for the first six months (although interest will continue to accrue). In addition, no collateral or personal guarantee is required, and there are no prepayment penalties.

From a tax perspective, the forgiven amount of the PPP loan isn't taxable [i.e., it's excluded from gross income—see CARES Act Sec. 1106(i)]. However, there's some uncertainty as to whether forgivable expenses paid for by PPP proceeds are deductible for federal income tax purposes. Under IRC Sec. 265, expenses allocable to one or more classes of tax-exempt income are nondeductible. Are forgivable expenses under the PPP, such as compensation and utility payments, subject to IRC Sec. 265 ? It's possible. However, disallowing deductibility of these expenses goes against the whole point of the CARES Act, which is to increase the cash flow of businesses negatively affected by the novel coronavirus. In our opinion, IRC Sec. 265 shouldn't apply; however, IRS guidance is needed in this area. Stay tuned for future developments.

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Conclusion

Now that they have PPP funds, your clients should spend the next eight weeks taking steps to ensure their loans are forgiven. To help them get started, consider sending the ***attached sample client letter*** . As a subscriber to this newsletter, you may edit and distribute the letter to clients, potential clients, and referral sources. However, please remember that the material is copyrighted. You may not use it for any other purpose, such as posting it on a website area available to the public or sharing it with another firm.