



Paycheck Protection Program: A Panacea or Fools Gold?

Since the Coronavirus Aid Relief and Economic Security (CARES) Act was passed by Congress and signed into law by President Trump on March 27, 2020 it has garnered considerable attention among financial advisors. The interest is due not only to its application to clients of the advisor, but also because of its application to financial advisors. While the CARES Act includes many provisions providing relief to individuals, a program that has generated considerable excitement is one that provides relief to small business owners with less than 500 employees. For purposes of the program small business also includes those who are independent contractors or self-employed who do not employ another individual. Thus, it will apply to most financial professional practices.

The program that has generated the most excitement from the small business community is the Paycheck Protection Program (PPP for short). The PPP was initially funded with \$349 billion dollars, but this was depleted within fourteen days. This caused Congress to supplement the program with an additional \$310 billion of funds. So, business owners who missed out on the first round, might want to consider participating in the second round of funding.

Why did millions of business owners rush to their bank to participate in the PPP? It certainly was not because they were eager to saddle themselves with debt. Rather it was the prospect that a large part of the loan can be forgiven – essentially turning the loan into a grant. Even better, while cancellation of debt usually creates taxable income, the CARES Act provides that the forgiveness of the PPP is completely tax-free. Because the PPP offers financial professionals and other small business owners an incredible opportunity for relief from the current economic crisis caused by the Coronavirus, the author felt it important at this time to cover the provisions of this program in this Counselor's Corner.



Who Can Apply for the Paycheck Protection Program?



In general, only businesses that employ 500 or fewer employees that were in existence on February 15, 2020 qualify. This includes independent contractors, self-employed individuals, 501(c) not-for-profits, veteran organizations, and gig economy workers which in the past have not qualified for SBA loans. So, the universe of businesses that qualify is greatly expanded. There are a few exceptions where the SBA has special rules for larger employers. Also, some smaller employers do not qualify such as household employers and businesses engaged in illegal activities. As it relates to financial advisory and insurance practices, most will be able to meet this requirement.

In addition to meeting the size requirement, a business owner must be able to provide a good-faith certification to a few statements. For example, the borrower must certify that the loan is necessary to maintain ongoing operation due to the uncertainty of the current condition. Also, the borrower must certify that the funds will be used for the purposes specified including retaining workers and maintain payroll costs, payment of interest on mortgage obligation, rent, and utilities.



Where Does a Business Owner Apply?

Assuming your client's business or your practice meets the criteria for qualifying for the PPP loan, the next question is where do you go to get a loan? While the PPP is an SBA program Congress recognized that the SBA did not have the manpower to handle the anticipated volume of loans. So, they enlisted banks and other private lenders approved by the SBA to dispense the loans.



Because the loans are being dispensed by numerous lenders don't expect uniformity in processes. You may want to apply with several lenders, starting with the lender where you have your banking relationship assuming it is one approved by the SBA. While the loans are supposed to be on a first come basis it helps to have a relationship with a banker. The loan must be applied for by June 30, 2020; however, it's best to do it as soon as it becomes available. As demonstrated by the initial \$350 billion the additional \$310 billion is likely to be depleted fast.



What Are the Terms of the Loans?

Since the intent of the Act is to make it easy for small business owners to get relief expeditiously many of the normal procedures, costs, and lending criteria were eliminated or relaxed. For example, the application form is just four pages in length and the instructions indicate that it should take less than 8 minutes to complete. The loans are guaranteed by the SBA, so they do not require any collateral or personal guarantee. And lenders do not need to conduct independent verification supporting the loan request. Rather, they are permitted to rely on the certifications and documents of the borrowers to determine eligibility. Finally, the law provides that the lender cannot charge a fee and the loan can be prepaid at any time without incurring a penalty.



While this seems simple enough, ambiguities in the language in the CARES Act used to describe the loan terms and in determining the loan amount created confusion in the initial loan application process. For example, the legislation used language such as interest "not to exceed 4%" and a "maximum maturity of 10 years" to describe the loan terms.

The Treasury Department and SBA have since provided some clarification. Guidance now provides that any portion of the loan not forgiven must be repaid over two years, after no less than a six-month deferral period (and no longer than one-year), at an interest rate of 1%. If the full amount of the loan is forgiven the borrower is not responsible for interest accrued during the 8-week covered period, but for the amount not forgiven the interest will accrue during the deferral period.



How Much Can be Borrowed?

In general, the Act states that the maximum loan amount is the lesser of \$10 million or an amount equal to 2.5 times the “average monthly payroll costs.” What constituted “payroll costs” caused mass confusion during the application process because the Act indicates that payroll does not include federal income tax withholding on employee wages as well as the employer’s and employees’ share of Social Security and Medicare taxes.

Consequently, some banks were lending based on an employer’s net 2019 payroll while other banks based lending on gross payroll plus employer’s share of payroll taxes. Ultimately, when the dust settled SBA determined payroll costs include:



- Gross salary, wages, commissions or cash tips (or equivalent) unreduced by federal income tax withholding and employee’s share of payroll taxes for employees (not independent contractors) whose principal place of residence is in the United States capped at \$100,000 on an annual basis;
- Employee benefit costs for vacation, parental, family, medical or sick leave; allowance for separation or dismissal; payment for the provision of employee benefits consisting of group health care coverage including insurance premium; payment of retirement benefit; and
- Payment of state or local tax assessed on the compensation of employees.
- For self-employed individual’s payroll costs was defined as net income reported on 2019 Form 1040 Schedule C, Line 31 limited to the \$100,000 maximum.
- Excludes the employer’s portion of federal employment taxes imposed or withheld between 2/15/2020 – 6/30/2020 and qualified sick leave and family leave wages for which a credit is allowed under Family First Coronavirus Response Act.

To determine the maximum loan amount you “simply” take the prior year’s payroll (subject to the \$100,000 cap and factors described above) divide it by twelve and multiple this by 2.5. For example, if the prior year payroll is \$600,000, the maximum loan will be \$125,000 ($600,000/12 \times 2.5$).



How Can the Loan Proceeds be Used – What are Eligible Expenses?

Since the primary objective of the Paycheck Protection Program is to help small business owners to maintain their workforce the Treasury Department established specific limitations on how the proceeds can be used. Borrowers that use proceeds for unauthorized purposes will be directed by the SBA to repay those amounts and may be subject to liability for fraud. Allowable uses include:



- Payroll costs as described above
- Rent under lease agreement in force before 2/15/2020
- Utilities which service began before 2/15/2020 (CARES Act defines utilities as electricity, gas, water, transportation, telephone or internet service)
- Interest on mortgage obligations and other debt obligations incurred before 2/15/2020.



Can the Loan Be Used on Any Combination of Eligible Expenses?



While the amount that can be borrowed under the PPP is based on payroll costs, the loan can be used for eligible non-payroll expenses. However, since the primary objective of the PPP is to encourage employers to maintain their workforce, in a recent guidance the SBA stated that no more than 25% of the forgivable portion of the loan can be used for non-payroll costs. So, to achieve the maximum forgiveness a minimum of 75% of the loan must be used for payroll costs. This is bad news for employers with small payroll or who laid off workers.



What is the “Covered Period” for Use of the Loan Proceeds?



The CARES Act provides two different “covered periods.” First, it provides that PPP loans are only available during the covered period of February 15 to June 30 and during that time may only be used for payroll costs, mortgage interests, rent, utilities and interest on other debt.

The Act also provides that only amounts spent during the covered period are eligible for forgiveness. For forgiveness purposes the covered period is defined as the eight-weeks following the receipt of the loan. Obviously, this covered period will be different for each borrower. For example, if the loan proceeds are made available to a business on April 15th the business can only use the funds for eligible expenses incurred during the next eight weeks, regardless of whether the business has restarted operations. To receive the maximum forgiveness a minimum of 75% of the loan proceeds must be used on payroll. This could mean that a business may need to pay employees who are not working.

Given that we are now entering our second wave of funding it’s possible that a borrower may not receive proceeds until the middle of May, not leaving 8 weeks before June 30. It’s not clear if eligible expenses paid after June 30, but within the eight weeks, will qualify for forgiveness, making it all the more important to apply as early as possible.



What Expenses Paid with PPP Proceeds May be Subject to Forgiveness?



One of the most significant benefits of the PPP loan is the loan forgiveness feature. In fact, it’s likely that most businesses obtained the loans with the intent of having all or most of the proceeds qualify for tax-free forgiveness. Borrowers wanting to take advantage of loan forgiveness must comply with detailed requirements starting with making sure the loan proceeds are used to pay for eligible forgivable expenses. So, what expenses can be subject to forgiveness?

The CARES Act provides that the amount forgiven is equal to the sum of the “costs incurred and payments made” during the covered period for the following expenses:

- Payroll costs
- Payment on rent under lease agreement in force before 2/15/2020
- Utilities which service began before 2/15/2020 (electricity, gas, water, transportation, telephone or internet service)
- Payments of interest on covered mortgage obligations incurred before 2/15/2020

At this point we know that no more than 25% of the amount forgiven can be for the non-payroll expenses. We also know the time period the covered eight-weeks includes. We still lack clarity concerning what expenses are forgivable.¹ Finally, the phrase “costs incurred and payments made” can be subject to two possible interpretations.

One interpretation would require both the expenses to be incurred and paid during the eight-week period. So, assume a business that gets a PPP loan on April 2 has payroll attributed to work performed in March that is payable on April 3. Under this interpretation since the expenses were incurred before the eight-week period they would not qualify as forgivable expenses. The other interpretation would permit both expenses incurred as well as expenses paid during the eight-week period. With this interpretation the March payroll would qualify as forgivable because they were paid in the eight-week period. Bottom line, this ambiguity needs to be clarified.



Determining the Amount of Loan Forgiveness

It’s possible that the full principal amount of the loan and any accrued interest can be forgiven. However, to achieve full forgiveness the borrower must comply with several detailed requirements. Specifically, the business owner must use the loan proceeds for eligible expenses; at least 75% must be used for payroll costs and the number of full-time employee and compensation levels must be maintained.



Once the business determines the payments eligible for forgiveness, two additional computations must be made to determine the amount ultimately forgivable. Both calculations are based on payroll. The first is a measurement of “Full Time Equivalents” (FTEs), which is a headcount, and the second is a measurement of the actual salary expense. The purpose of these calculations is to make sure that the debt forgiveness is related to the purpose of the CARES Act – to keep employees working at wages comparable to the pre-Coronavirus levels. A reduction of either the number of fulltime employees and salary paid to any employee will reduce the amount of loan that can be forgiven.



How is Forgiveness Affected by a Reduction in Fulltime Employees?

If a business reduces its fulltime employees during the eight-week covered period the forgiveness is reduced by a ratio defined as the average number of FTEs during the covered period divided by the average number of FTEs during the “base period.” The business can select the most favorable base period from the following options:

- Average number of FTEs per month from February 15, 2019 through June 30, 2019 (this is also used for seasonal businesses)
- Average number of FTEs per month from January 1, 2020 through February 29, 2020

So, to determine if a business has met this requirement determine average FTEs for:

- a. the 8 weeks following loan origination
- b. for the period covering 2/15/2019 to June 30, 2019 and
- c. for the period covering 1/1/2020 to 2/29/2020

Divide a/b and a/c. Take the larger of the two. If this ratio results in a number equal to or larger than 1, the business has successfully maintained its FTE and will have met this requirement. If the ratio is less than 1 then take the ratio and multiply it by the loan amount that can be forgiven to get the amount that can be forgiven after reduction for decrease in FTEs. For example, if “a” is 55 and “b” and “c” is 65 the ratio is 55/65 which is less than 1 to cause a reduction in loan that can be forgiven. If the loan amount that can be forgiven is \$500,000 $\times 55/65 = \$423,077$ amount able to be forgiven after this reduction.

There are points that need to be clarified concerning this calculation. One critical point of clarification is how to determine FTEs. For example, do two half-time employees count as one full time? How do people who retire or quit get counted?



How is Forgiveness Affected by a Reduction in Compensation Paid?

To assure that employees' wages are similar to the pre-Coronavirus level there is a penalty for businesses that reduce wages of any employee by more than 25% when compared to the most recent quarter before the PPP loan was made.¹¹ However, for purposes of this calculation only employees who make less than \$100,000 need to be considered. This incentivizes businesses to restore wages of those making \$100,000 or less. For example, assume the loan went into effect on April 15. In the most recent quarter (twelve-weeks) assume an employee's salary or wages is \$20,000. Further assume that the employee's salary during the eight-week period is reduced to \$14,000. A 25% reduction of \$20,000 would be \$15,000. Since the eight-week salary of \$14,000 is a reduction of more than 25% by \$1,000 the forgiveness will be reduced.

There are a several points that are not clear with this calculation. First, there is a substantial calculation issue because the calculation compares salary earned in a 12-week quarter against salary earned during an 8-week period. Even if salary is not reduced, eight weeks of compensation will normally be less than twelve weeks. Second, it is not clear if the forgiveness amount will be reduced by the excess over 25% (\$1,000 in the example) or by the full compensation reduction (\$6,000). Also, it is not clear what happens if an employee retires or quits during the period or if a new employee is hired.



Can a Business Remedy a Reduction in Staff Levels and Wages to Restore Forgiveness Amount?

The CARES Act allows businesses to remedy any reduction by restoring an employee's wage and hiring back furloughed employees by June 30, 2020. However, at the current time it is not clear whether the correction eliminates the forgiveness reduction that otherwise would occur.



What Are the Tax Effects of Forgiveness? Are Payments Made with Forgiven Funds Deductible?



The CARES Act provides that the amounts forgiven on a PPP loan are excluded from gross income for federal income tax purposes. It is not clear what amount might be subject to state or local taxes. Many of the eligible expenses are typically deductible by the business. This has raised the question, “Is it possible to get both tax-exempt income and a deduction?” IRC §265 provides expenses allocated to tax-exempt income are not deductible. This is to prevent double dipping where you get a deduction and tax-exempt income on the same transaction. However, it’s possible that Congress intended this generous outcome.



How Can a Borrower Request Forgiveness?



The request for loan forgiveness is made to the lender servicing the loan. At this time there is no guidance when a borrower can apply for forgiveness, but clearly the earliest is after expiration of the eight-week covered period.



What Information and/or Documents is the Lender Likely to Require for Loan Forgiveness?



Each lender may require additional or different information, but below is a general list that the lender will most likely request:

- The documentation / information used to calculate FTE along with pay rates for the same period that was used to calculate the pay and staffing requirements.
- Payroll reports (preferably from independent source)
- Form 941 (payroll tax filings)
- State payroll filings
- Documentation verifying health and retirement amounts
- Documentation for payments made for rent, interest on mortgage and utilities for which you are asking forgiveness for (bank statements, canceled checks, receipts)

In addition to providing documentation, the business owner or representative must certify that the documentation/information is true and correct and that the amount for which forgiveness is requested was used to retain employees and make payments eligible for forgiveness. If a business owner cannot provide a complete application the CARES Act provides that the loan is not eligible for forgiveness. Once the application and documentation are submitted to the lender it must respond within 60 days.



What If the Full Loan is Not Forgiven?



If the full loan is not forgiven the lender will provide documentation as to the decision and may allow you to provide additional information so that the decision can be reevaluated.



Are There Other Options Available in the CARES Act to Help Small Business Owners?



While the PPP is an intriguing opportunity that small business owners who are experiencing economic fallout from the Coronavirus should consider, it is not the only relief available to them under the CARES Act. More specifically, business owners should also be aware and consider the benefits of an Economic Injury Disaster Loan (EIDL), the Employee Retention Credit and the option to defer the employer portion of payroll before pursuing a PPP loan. It is possible for a business to participate in both the EIDL and the PPP loan provided the EIDL is used for expenses that the PPP loan is not used for. Unfortunately, a business cannot participate in the PPP and apply for the Employee Retention Credit or exercise the ability to defer the employer payment of employer payroll taxes. The point is that financial professionals have an opportunity to help small business owners understand their options.

In summary, the computation of both the amount of PPP loan and the amount eligible for forgiveness is no simple matter. The lack of clarity and ambiguity regarding the key term “payroll costs” created confusion in the initial application process. Unless we receive guidance soon regarding key loan forgiveness provisions the forgiveness process is likely to be even more chaotic, changing a program that some businesses believed to be a panacea for the current economic environment into a solution with as much value as fool’s gold.

ⁱ Many business owners own the real estate used in the business. Often the real estate is owned in a separate business entity and rented back to the business. We do not know whether this rent is forgivable although the CARES Act does not make a distinction. Also, it’s interesting to note that interest on non-mortgage debt does not appear to be forgivable, even though the Act states that PPP proceeds can be used to pay “interest on other debt obligations that were incurred before the covered period.”

ⁱⁱ It is not clear whether the quarter is the last full calendar quarter or the last non-calendar fiscal quarter for borrowers with fiscal years.

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