Paycheck Protection Program (PPP) Loans – Phase II
Strategic Management of Loan Proceeds
April 16, 2020

Executive Summary of Key Action Steps

- **Understand that loan forgiveness is not automatic and will require planning and management. Planning must begin immediately upon receipt of loan proceeds.**
- Understand the key points in managing loan funds strategically.
    - Deposit the loan proceeds in a separate account to the extent feasible. While not required, it may assist with future tracking and documentation.
    - Understand the four eligible expense categories.
    - Do not manage for "forgiveness at any cost."
- Understand the key metrics (head count and wage continuation) in determining loan forgiveness.
- Understand the documentation required to achieve loan forgiveness.
- Contact us to assist you through the forgiveness process.

Introduction

The PPP loan program was enacted into law just over two weeks ago on March 28, 2020. The process of developing a program of this magnitude has been challenging for all parties involved: loan applicants, lenders, professional advisors and the government officials charged with rolling out the program. Hastily passed legislation and a huge sense of urgency resulted in sparse details and confusing provisions that literally changed by the hour – and are still changing.

Loan applicants are in various stages of the process, ranging from still waiting to be able to complete an application to having received funding. In advising our clients, we are separating the strategic elements of the PPP loan process into three phases:

- Phase I – application and approval
- Phase II – funding of loan and strategic use of the loan proceeds
- Phase III – documentation of use of loan proceeds and achieving forgiveness where appropriate.

For our clients in Phase I, we urge you to stay in contact with your lender where that is possible. Each lending institution is following its own process and has its own documentation requirements. We are working with multiple lenders and are available to assist where needed.

If you have received funding, you are now in Phase II and need to consider how the loan proceeds are spent. This is a critical factor from both a strategic cash flow perspective, as well as ensuring forgiveness if that is appropriate.

Phase III is the process of submitting documentation to your lender to request forgiveness. This phase is related to Phase II and is a function of how the loan proceeds are used.

In this article we focus on Phase II - basic strategic cash flow considerations for the use of the loan as well as requirements for forgiveness.

Overview of PPP Loan Program

PPP loans are made by a private lender and guaranteed by the Small Business Administration (SBA). The loans carry a 1% interest rate and a two-year term. There is no collateral requirement, no personal guaranties and no payments for six months.

An essential provision of a PPP loan is the potential for part or all the loan to be forgiven. The loan will be forgiven to the extent proceeds are spent on four specific categories of expenses (payroll, utilities, rent and interest). These categories are discussed in more detail below. Loan forgiveness can be up to the full principal amount of the loan and any accrued interest.

Coordination With Retention Credit

Another provision enacted in response to the COVID-19 crisis is a refundable tax credit to encourage employers to keep their workers on the payroll. That credit was discussed in our communication dated CARES Act Tax Provisions

Key consideration: you cannot take advantage of both a PPP loan and the retention credit. If you accept PPP funds, you are no longer eligible to claim the Retention Credit. In most cases, the PPP loan and potential forgiveness is the better option but there are circumstances where the Retention Credit may be the better alternative. Contact us if you have questions about this.

Strategic Cash Flow Considerations

Loan recipients each have their own specific circumstances, ranging from use of the funds for survival to keeping the funds as a safety net and all variations in between. Keep in mind that the PPP is first and foremost a loan program – which has exceptionally favorable terms.

Certainly, forgiveness is a key aspect of the program, but it must be viewed in broader strategic terms. In many, if not most cases, managing the funds for forgiveness will be the proverbial “no brainer.” In specific situations, possibly not. There are circumstances where it may be more strategic to spend the loan proceeds on expenses that don’t result in forgiveness or not spend the money at all.

Loan forgiveness involves managing resources for an eight-week period. Broader strategic objectives may point to a longer time frame and numerous other considerations including length of business closure (if applicable), cash reserves, other funding sources, nature of employee work during the eight-week testing period.

These decisions and considerations are situationally specific. We are working with our clients in a variety of ways to determine the best course of action.

Strategic Personnel Planning

We strongly recommend that sound personnel policies be considered alongside loan forgiveness actions. Most organizations have been required to pivot their personnel decisions in numerous ways since the onset of the epidemic and that will undoubtedly continue. However, decisions to maintain unhealthy employee relationships simply for the sake of obtaining loan forgiveness should be closely analyzed.

Managing Loan Proceeds for Forgiveness

Just as with the eligibility for PPP loans and the application process, the forgiveness process is wrought with uncertainty and unanswered questions. We anticipate additional guidance will be forthcoming in the very near future.

PPP loans are forgivable if headcount and salaries of employees are maintained at the pre-COVID-19 levels. To the extent these are not maintained, potential forgiveness will be reduced.

Loan proceeds are forgivable to the extent they are spent on four specific categories of expenses (payroll, rent, utilities and interest). Forgiveness applies to these expenses paid during the eight-week period immediately after your receipt of the loan proceeds. Amounts spent outside the eight- week period, or outside one of the four permitted categories of expense, are not forgivable and will need to be repaid within the two-year loan term. The eight-week forgiveness period begins on the date the loan proceeds are disbursed.

The four eligible cost categories:

Payroll costs – Payroll costs include gross salaries and wages of employees up to a cap of $100,000 per year per employee, employer-paid group health insurance, employer-paid 401k matching contributions and other retirement plan contributions and employer-paid state and local taxes on payroll (e.g., unemployment insurance). Payroll costs do not include the employer's portion of payroll tax expenses such as Social Security and Medicare, nor does it include payments to independent contractors (1099s).

Rent Obligations – This includes payments under a lease agreement in force before February 15, 2020. This includes rent payments on both real estate as well as personal property (vehicles, equipment, etc.).

Utilities –Includes electricity, gas, water, transportation (vehicle operating costs), telephone, or internet service for which service began before February 15, 2020.

Interest – Interest on a "covered mortgage obligation," are eligible for forgiveness. Interest payments can be for any debt obligation that is a liability of the borrower incurred before February 15, 2020. It does not include payments or prepayments of principal. The underlying debt must be a "mortgage on real or personal property." It is still unclear but could include debt on real property that is secured by a traditional mortgage, working capital lines of credit and other indebtedness where a UCC-1 is filed on the borrower's personal property. Additional guidance and clarification is anticipated.

75% Payroll Requirement – At least 75% of the loan proceeds must be spent on payroll costs for the entire loan amount to be forgiven. To the extent more than 25% of loan proceeds are spent on non-payroll costs, the excess of non-payroll cost over 25% of the loan amount will not be forgiven.

Tax Considerations

Forgiveness of debt under the PPP program is not taxable income to the borrower. It is assumed that the borrower will not be able to take a tax deduction for expenses paid with the loan proceeds, but this has not been totally clarified.

Maintaining Headcount and Payroll

Once your business has determined the payments eligible for forgiveness, you will need to complete two additional, somewhat complex calculations to determine if the loan forgiveness amount may be reduced. The purpose of these calculations is to ensure that loan forgiveness is directly related to the purpose of the PPP loan program – to keep employees working at wages comparable to pre-COVID-19 levels.

Both calculations are based on your payroll: the first is a measurement of your number of employees and the second is a measurement of compensation to individual employees. Both measurements compare amounts during the eight-week loan forgiveness period to a pre COVID-19 period (different options, see below). To the extent either of these amounts are reduced, loan forgiveness will also be reduced proportionally. There are many unanswered questions about how these calculations will be made. Additional guidance and clarification is anticipated.

Period to Compare

For comparison purposes, the borrower has the option of choosing either of two time frames as the base period for comparison:

- February 15, 2019 through June 30, 2019, or
- January 1, 2020 through February 29,2020.

Certain seasonal businesses are required to use the 2019 dates. Organizations that were not in operation between February 15, 2019 through June 20, 2019 will presumably use the 2020 period.

Organizations that ramped up later in 2019 and early 2020 can use the 2019 dates to reduce their base amounts. Conversely, organizations that contracted during the same period can use the 2020 dates to minimize potential adverse impacts on loan forgiveness.

Headcount Analysis

To prevent reduction of forgiveness, a borrower must maintain headcount during the eight-week forgiveness period equal to the headcount during the base period selected above. Any reduction in headcount will result in a proportionate reduction in the amount of the loan forgiven.

Headcount will be determined based on full time equivalents (FTE's). For the purposes of the calculation, the current thinking is that one FTE equals one employee that worked at least 30 hours in a week. Additional guidance is expected for this calculation.

Wage Analysis

An objective of the PPP loan program is to ensure that companies were hiring back employees at a wage rate similar to pre-COVID-19 levels. Accordingly, loan forgiveness will be reduced to the extent an individual employee's compensation is reduced more than 25% compared to the most recent quarter before the PPP loan was made (first quarter of 2020 for most borrowers).

For purposes of this calculation, however, businesses only need to consider employees who make $100,000 or less per year. Removing employees that made over $100,000 from this calculation will help employers manage higher paid employees without being penalized and, at the same time, incentivize them to fully restore the wages of those making $100,000 or less.

The law as enacted compares compensation during the eight-week forgiveness period to a three-month base period (preceding quarter) and it is unclear how these two differing periods will be reconciled. We anticipate further guidance and clarification of this calculation.

Exemption for Re-Hires

A special rule applies for borrowers who reduced headcount or employee wages for the period between February 15, 2020, and April 26, 2020. These borrowers will have until June 30, 2020 to increase their headcount and wage amounts to February 15, 2020 levels. If this is accomplished, loan forgiveness will not be reduced. Additional guidance is expected on how this exemption will operate.

Documentation Requirements

Loan forgiveness will not take place until appropriate documentation is submitted to the lender. Specific documentation requirements have not been released and we expect requirements will differ by lender. Requirements will likely include, among other things:

- Verification of number of employees and pay rates, including payroll tax returns.
- Cancelled checks, payment receipts, account transcripts or other verification of payments for mortgages, leases and utilities.