

# Chapman Client Alert

May 28, 2020

Current Issues Relevant to Our Clients

## Small Business Administration: Loan Forgiveness under the Paycheck Protection Program

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Stability Act, known as the CARES Act, became law. As we have written in previous alerts, the cornerstone of its relief package for small businesses is the Paycheck Protection Program (PPP), under which the Small Business Administration (SBA) originally was authorized to fully guarantee up to \$349 billion in small business loans. The PPP proved enormously popular when the SBA and the U.S. Treasury Department first launched it on April 3, 2020, taking only 13 days to exhaust the PPP's initial funding. A subsequent law<sup>1</sup> authorized the SBA to fully guarantee up to an additional \$320 billion in small business loans. According to data released by the SBA, as of May 23, 2020, more than 4.4 million small businesses have been approved for PPP loans, totaling approximately \$511.232 billion, with more than \$150 million in PPP funds still remaining before the PPP's expiration on June 30, 2020.

One of the PPP's most attractive features for small business borrowers is the possibility that a borrower's loan could be forgiven, in whole or in part, if the borrower uses the PPP loan for certain eligible payroll and other costs during the 8-week period (56 days) after the loan was made. PPP loans were first made in early April, so that 8-week period is now ending for the first round of PPP borrowers. Accordingly, the SBA has recently released additional guidance for borrowers on how to apply for and obtain loan forgiveness, as well as guidance for lenders on how to process these loan forgiveness requests. This alert will address questions about loan forgiveness under the PPP for both borrowers and lenders as known at the current time, but we note that legislative efforts currently underway in both the House and the Senate may change the terms of these loan forgiveness provisions.

### Who Can Request Loan Forgiveness under the PPP?

Any recipient of a PPP loan may request loan forgiveness. Not all recipients, however, may receive full or even partial loan forgiveness.

Under the PPP, loans may be forgiven, in whole or in part, if borrowers use the loan proceeds to maintain their payrolls and pay other specified expenses. This feature effectively allows a borrower to convert its PPP loan into a grant, provided that the borrower complies with the PPP's loan forgiveness conditions. Any loan forgiveness amount will **not** be treated as gross income for federal income tax purposes.

### How Much Will Be Forgiven?

The loan forgiveness amount of a PPP loan cannot exceed that loan's principal amount. By application of the "75% rule," which provides that at least 75% of eligible loan forgiveness expenses must go towards payroll costs, the maximum eligible loan forgiveness amount is a borrower's payroll expenses during the related 8-week period divided by 0.75.

In determining the amount of possible loan forgiveness, a PPP borrower generally should follow three steps:

- determine the maximum amount of possible loan forgiveness based on the borrower's expenditures during the related 8-week period;
- determine the amount, if any, by which the maximum loan forgiveness will be reduced because the borrower reduced employment levels or reduced salaries and wages; and
- apply the "75% rule."

We describe each step in greater detail below:

#### 1. Maximum Amount of Possible Loan Forgiveness

The following expenses incurred or paid by the borrower during the 8-week period are *eligible* for forgiveness:

- "payroll costs"
  - salary, wages, commissions, tips, hazard pay, bonuses (not exceeding \$15,385 per employee)<sup>2</sup>

- employee benefits<sup>3</sup>
- state and local taxes assessed on compensation
- for a sole proprietor or independent contractor, wages, commissions, income, or net earnings from self-employment (capped at \$15,385 per employee)
- “non-payroll costs”
  - interest on mortgage obligations incurred before February 15, 2020
  - rent payments under lease agreements in force before February 15, 2020
  - utilities<sup>4</sup> for which service began before February 15, 2020

We note that a sole proprietor or independent contractor must have claimed, or be entitled to claim, a deduction for these non-payroll expenses on its 2019 Form 1040 Schedule C in order to claim them as expenses eligible for PPP loan forgiveness in 2020.

There are two ways to calculate the 8-week period used in determining the maximum loan forgiveness amount:

- the 8 weeks (56 calendar days) beginning on the day the PPP loan was disbursed
  - the loan disbursement date counts as part of the 56 days
- for borrowers with a biweekly or more frequent payroll schedule, the 8 weeks (56 calendar days) beginning on the first day of the first pay period after the PPP loan was disbursed.

Payroll costs are generally incurred on the day the employee worked. For employees who are not performing work but are still on the PPP borrower’s payroll (such as furloughed employees), payroll costs are incurred based on the schedule established by the PPP borrower, which typically would be each day that the employee would have worked.

Payroll costs are considered paid on the day that paychecks are distributed or the PPP borrower originates an ACH credit transaction. In general, payroll costs must be paid during the 8-week period to be eligible for forgiveness. However, payroll costs incurred during the PPP borrower’s last pay period of the 8-week period are eligible for forgiveness if they are paid on or before the next regular payroll date.

A non-payroll cost is eligible for forgiveness if it was:

- paid during the 8-week period; or
- incurred during the 8-week period and paid on or before the next regular billing date, even if the billing date is after the 8-week period.

Neither principal nor advance payments of interest on an eligible mortgage obligation are eligible for loan forgiveness.

## 2. Amount, if any, by which the Maximum Loan Forgiveness will be Reduced

Section 1106 of the CARES Act requires certain reductions in a PPP borrower’s loan forgiveness amount if, during the related 8-week period, the borrower reduces the number of full-time equivalent employees (FTEs) or reduces employees’ salary or wage levels.

### *Reduction in Average Number of FTEs*

A PPP borrower’s loan forgiveness amount will be reduced if the average number of FTEs during the related 8-week period is less than the average number of FTEs during the reference period chosen by the PPP borrower. In that case, the loan forgiveness amount will be reduced proportionally by the percentage reduction in FTEs.

The borrower can choose from the following reference periods:

- February 15 to June 30, 2019;
- January 1 to February 29, 2020; or
- in the case of a seasonal employer, either of the two preceding methods or a consecutive 12-week period between May 1 and September 15, 2019.

The SBA and the U.S. Treasury Department have created a *de minimis* exemption to reductions in loan forgiveness amounts when the changes in employee headcount result from employee actions and requests. Therefore, a PPP borrower will not be penalized – and their loan forgiveness amount will not be reduced – if either of the following occurred:

- the borrower made a good-faith, written offer to rehire the employee during the related 8-week period
- the employee was fired for cause, voluntarily resigned, or voluntarily requested a reduced schedule

Borrowers that avail themselves of this *de minimis* exemption must maintain records evidencing that this exemption applies in respect of one or more of their employees.

There is a safe harbor allowing a PPP borrower to avoid having its loan forgiveness amount reduced due to a reduction of the employee headcount during the related 8-week period. Specifically, if a borrower reduced its number of FTEs during the period from February 15 to April 26, 2020, but restored the number of FTEs to the level existing on February 15, 2020 – and the borrower does so by June 30, 2020 – there will be no reduction in the forgivable loan amount.

#### *Reduction in Salaries or Wages of More Than 25%*

In general, a PPP borrower's loan forgiveness amount will be reduced if the borrower reduces an employee's salary or wages by more than 25%. With respect to each employee who earned \$100,000 or less in 2019 and each new employee in 2020, the loan forgiveness amount will be reduced for each employee whose average pay (salary or hourly wage) during the related 8-week period is less than 75% of their average pay from January 1 to March 31, 2020. The amount of the reduction in loan forgiveness amount is proportional to the amount of reduction in pay. This reduction calculation must be performed on a *per employee* basis, not in the aggregate.

However, a safe harbor exists to allow a PPP borrower to avoid having its loan forgiveness amount reduced. Specifically, if the employee's annual salary or hourly wage on June 30, 2020 is equal to or greater than the employee's annual salary or hourly wage on February 15, 2020, the PPP borrower's loan forgiveness amount will not be reduced.

Further, to ensure that PPP borrowers are not double penalized when they reduce both the number of FTEs and the employees' salaries and wages, any salary/wage reduction applies *only* to the portion of the reduction in employee salary and wages that is *not* attributable to the FTE reduction.<sup>5</sup>

### 3. Application of the 75% Rule

No more than 25% of non-payroll costs may be included in a PPP borrower's eligible loan forgiveness expenses. If a borrower's non-payroll costs exceed 25% of the total eligible expenses, a borrower's loan forgiveness amount could be reduced by that excess amount.

If, for example, a borrower's payroll costs for the related 8-week period total \$75,000, the borrower's loan forgiveness amount could not exceed \$100,000.

**In summary, a PPP borrower's maximum loan forgiveness amount will equal the smallest of:**

- **the PPP loan amount;**
- **the maximum loan forgiveness amount from Step 1 minus any reduction from Step 2; and**
- **eligible payroll costs during the related 8-week period divided by 0.75.**

### What if a PPP Loan is Not Fully Forgiven or Not Forgiven at All?

For any PPP loan amounts that are not forgiven, for any reason, the original loan terms will apply: two-year maximum loan at 1% interest rate with principal and interest payment deferred for the first six months following loan disbursement. There are no prepayment penalties or fees.

### What is the General Process for Obtaining Loan Forgiveness?

A PPP borrower must complete the Loan Forgiveness Application (SBA Form 3508 or a lender's equivalent form) and submit it to its lender.<sup>6</sup> In general, the lender will review the application and make the decision regarding loan forgiveness. As described in more detail in questions below, however, the SBA will undertake reviews of certain loans and, in some cases, will determine whether loan forgiveness will be granted.

Once the lender has received a complete application, it has 60 days to issue a decision to the SBA. This requirement applies in all cases, whether the lender decides to grant full loan forgiveness, partial loan forgiveness, or no loan forgiveness. If the lender determines that the borrower is entitled to receive full or partial loan forgiveness, the lender will request payment from the SBA for that forgiveness amount. The lender's payment request must be made at the same time it issues the loan forgiveness decision to the SBA.

Subject to any SBA review of the loan or the loan application, SBA will remit the appropriate forgiveness amount to the lender, plus any interest accrued through the date of payment, not later than 90 days after the lender issues its decision to the SBA. If the PPP borrower has any outstanding advance amounts from an Economic Injury Disaster Loan, the SBA will deduct those amounts from the forgiveness amounts it remits to the lender.

If the SBA determines that the borrower was ineligible for a PPP loan based on the provisions of the CARES Act, SBA rules, or guidance available *at the time of the borrower's loan*

*application*, or based on the terms of the borrower's loan application, the loan will not be eligible for loan forgiveness.

As noted above, if the loan is only partially forgiven or not at all, any remaining balance due on the loan must be repaid by the borrower to the lender based on the loan's original terms.

The lender is responsible for notifying the borrower of any loan forgiveness decisions, including any amount of loan forgiveness.

The Loan Forgiveness Application notes that a PPP borrower must retain PPP documentation in its files for six years after the loan is forgiven or repaid in full, as well as allow the SBA access to those files upon request.

### What is the SBA's Role in Determining Loan Forgiveness?

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On May 22, 2020, the SBA issued an interim final rule detailing its PPP loan review procedures, including borrower and lender responsibilities.<sup>7</sup> The SBA expressly noted that it may undertake a review of individual PPP loans at any time, as well as a review of a borrower's representations and statements relating to:

- borrower eligibility;
- loan amounts and use of loan proceeds; and
- loan forgiveness amounts.

This means that the SBA *may* review PPP loans smaller than \$2 million, although FAQ46 indicates that the SBA's audit focus will be on PPP loans of \$2 million or greater.

If the SBA undertakes a review of a PPP loan, the borrower will have an opportunity to respond to any questions that the SBA has. If loan documentation submitted to the SBA by the lender or any other information indicates that the borrower may be ineligible for a PPP loan or may be ineligible to receive the loan amount or loan forgiveness amount claimed by the borrower, then the SBA will direct the applicable lender to contact the borrower in writing to request additional information. The SBA also may request information directly from the borrower.

Failure to respond to the SBA's request for additional information (including requests made through the lender) may result in an adverse determination against the borrower.

If the SBA determines that a borrower is ineligible for the PPP loan, the SBA will direct the lender to deny the loan forgiveness request. Similarly, if the SBA determines that the borrower is ineligible for the loan amount or loan forgiveness

amount claimed by the borrower, the SBA will direct the lender to deny the loan forgiveness request in whole or in part, as appropriate. It also could seek repayment of the outstanding PPP loan balance or pursue other available remedies.

There will be an appeals process by which a borrower may appeal the SBA's determination that it is ineligible for a PPP loan or ineligible for the loan amount or loan forgiveness amount claimed by the borrower. The SBA intends to issue a separate interim final rule addressing that process.

### What is a Lender's Role in Determining Loan Forgiveness?

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As noted above, the applicable lender will review the borrower's Loan Forgiveness Application and generally will make the initial decision regarding loan forgiveness, subject to the SBA's authority to review PPP loans in its discretion.

Once the lender has received a complete application, it has 60 days to issue a decision to the SBA. This decision may be an approval (in whole or part), denial, or (if directed by the SBA) a denial without prejudice due to a pending SBA review of the PPP loan for which forgiveness is sought. In the case of a denial without prejudice, the borrower may subsequently request that the lender reconsider its Loan Forgiveness Application, unless the SBA has determined that the borrower is ineligible for a PPP loan.

With respect to a Loan Forgiveness Application, the lender must confirm:

- receipt of the borrower certifications in the Loan Forgiveness Application;
- receipt of the documentation that a borrower must submit to verify payroll costs and non-payroll costs (as specified in the instructions to the Loan Forgiveness Application);
- the borrower's calculations on the Loan Forgiveness Application by reviewing the documentation submitted with the Loan Forgiveness Application; and
- that the borrower correctly calculated its maximum loan forgiveness amount by dividing the borrower's eligible payroll costs by 0.75.

The borrower is responsible for providing an accurate calculation of the loan forgiveness amount and, on the Loan Forgiveness Application, the borrower must attest to the accuracy of its reported information and calculations. The lender may rely on the borrower's representations, with no need to independently verify the borrower's reported information if the borrower submits documentation to support

its loan forgiveness request and attests that it accurately verified the payments for eligible costs.

Nevertheless, the SBA expects the lender to perform a good faith review, in a reasonable time, of the borrower's calculations and supporting documentation. While the lender may rely on the borrower's representations, it should work with the borrower to remedy any issues if the lender identifies errors in the borrower's calculations or a material lack of substantiation in the borrower's supporting documents.

The lender may not determine that a borrower is entitled to receive loan forgiveness unless the borrower submits all required documentation to the lender.

When the lender issues its decision to the SBA to approve a loan forgiveness request (whether in whole or in part), it must include the PPP Loan Forgiveness Calculation Form and PPP Schedule A, both of which are part of the Loan Forgiveness Application. If the borrower submits the optional PPP Borrower Demographic Information Form to the lender, then the lender should also submit that form to the SBA. In addition, the lender must confirm that the information it provides to the SBA accurately reflects the lender's records for the PPP loan and that the lender has made its loan forgiveness decision in accordance with applicable requirements.

If the lender determines that the borrower is entitled to receive at least some amount of loan forgiveness, the lender will request payment from the SBA for that forgiveness amount. The lender's payment request must be made at the same time it issues the loan forgiveness decision to the SBA.

Subject to any SBA review of the loan or the loan application, SBA will remit the appropriate forgiveness amount to the lender, plus any interest accrued through the date of payment, not later than 90 days after the lender issues its decision to the SBA. If the PPP borrower has any outstanding advance amounts from an Economic Injury Disaster Loan, the SBA will deduct those amounts from the forgiveness amounts it remits to the lender.

If the lender issues a decision to the SBA that a borrower is not entitled to any loan forgiveness, the lender must include its reason for denial, the PPP Loan Forgiveness Calculation Form, PPP Schedule A, and, if provided to the lender by the borrower, the optional PPP Borrower Demographic Information Form. As with loan forgiveness approvals, the lender must confirm that the information it provides to the SBA accurately reflects the lender's records for the PPP loan and that the lender has made its loan forgiveness decision in accordance with applicable requirements. It also must notify the borrower in writing that the lender has issued a decision to the SBA denying the loan forgiveness request.

The SBA reserves the right to review a lender's loan forgiveness decision in its sole discretion.

### What if the Lender Denies the Loan Forgiveness Request?

As noted above, the lender must render a decision on loan forgiveness within 60 days after receiving a completed Loan Forgiveness Application from the borrower. The lender issues this decision to the SBA and, in the case of a denial of a loan forgiveness request, notifies the borrower in writing.

Within 30 days of written notice from the lender, a borrower may request that the SBA review the lender's decision. According to the interim final rule, if the SBA undertakes such a review, it will use the statutory 90-day period to review the PPP loan and forgiveness documentation and render a decision.

### What Should a Lender Do If It Receives Notice That the SBA is Reviewing a Loan?

If the SBA undertakes a review of a PPP loan, in its sole discretion and whether or not at the request of a borrower, the SBA will notify the lender in writing. The lender must then notify the borrower in writing within five business days of the lender's receipt of such notice.

Also within five business days of the lender's receipt of such notice, the lender shall submit electronic copies of the following documents to the SBA:

- the borrower's PPP application form and all supporting documentation provided by the borrower;
- the Loan Forgiveness Application and all supporting documentation;
- a signed and certified transcript of account;
- a copy of the executed note evidencing the PPP loan; and
- any other documents related to the PPP loan requested by the SBA.

If the SBA notifies the lender that it has undertaken a review of a PPP loan, the lender shall not approve any application for loan forgiveness until the SBA provides written notice to the lender that it has completed its review.

## What Happens to a Lender's Processing Fee if a Borrower is Determined to be Ineligible?

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If the SBA conducts a PPP loan review and determines that the borrower was ineligible for a PPP loan, the lender is not eligible for a processing fee. The SBA will seek repayment of the lender's processing fee with respect to any SBA-reviewed loan if, within one year after the loan was disbursed, the SBA determines that the borrower was ineligible for a PPP loan.

It is important to note, however, that the SBA's determination regarding borrower eligibility has no effect on the SBA's 100% guaranty of the PPP loan if the lender complied with its obligations under applicable PPP regulations and program requirements. If the lender has not complied with its obligations, then the SBA will seek repayment of the processing fee and may determine that the PPP loan is not eligible for the guaranty.

## What are the Document Retention Requirements for PPP Loans?

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A borrower must retain PPP documentation in its files for six years after the date the loan is forgiven or repaid in full.

A lender must comply with applicable SBA requirements for records retention, which for federally regulated lenders means compliance with the requirements of their federal financial institution regulator and for SBA supervised lenders means compliance with the requirements set out in 13 CFR 120.461.

### For More Information

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We will be monitoring developments in the PPP, as well as other SBA lending programs to address the coronavirus pandemic, and we will advise you of any changes or updated information.

If you would like further information concerning the matters discussed in this article or any matter related to the COVID-19 pandemic, please visit our [COVID-19 Insights](#) webpage or contact the Chapman attorney with whom you regularly work.

- 1 Pub. L. No. 116-139, The Paycheck Protection Program and Health Care Enhancement Act (signed into law on Apr. 24, 2020).
- 2 This amount includes salary, wages, or commissions paid by the PPP borrower to furloughed employees. The \$15,385 cap per employee represents the 8-week portion of the \$100,000 annual salary cap established by the CARES Act and its implementing regulations.
- 3 These include (i) costs for vacation, parental, family, medical, or sick leave, (ii) allowance for separation or dismissal, (iii) payments required for the provisions of group health care benefits including insurance premiums, and (iv) payment of any retirement.
- 4 These include (i) electricity, (ii) gas, (iii) water, (iv) transportation, (v) telephone, and (vi) internet access.
- 5 The SBA's interim final rule provides the following example: An hourly wage employee had been working 40 hours per week during the PPP's chosen reference period and the borrower reduced the employee's hours to 20 hours per week during the related 8-week period. There was no change to the employee's hourly wage during the 8-week period. Because the hourly wage did not change, the reduction in the employee's total wages is entirely attributable to the FTE employee reduction and the borrower is not required to conduct a salary/wage calculation for that employee.
- 6 The application can be found at <https://home.treasury.gov/system/files/136/3245-0407-SBA-Form-3508-PPP-Forgiveness-Application.pdf>.
- 7 <https://home.treasury.gov/system/files/136/PPP-IFR-SBA-Loan-Review-Procedures-and-Related-Borrower-and-Lender-Responsibilities.pdf>.

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