I Have the Money! How Do I Get Forgiveness?

It is the next natural question, right? If you are a business lucky enough to have been approved by the Small Business Administration (SBA) for a loan from the Paycheck Protection Program, you have likely received the proceeds of the loan or will within the next few days. One of the features that made the loans so popular is the forgiveness feature. So, now that you have the money, what should you do to maximize the amount of forgiveness? There are five things to keep foremost in mind:

1. Only spend the loan proceeds on forgivable uses;
2. Spend the loan proceeds within the "covered period;"
3. Spend at least 75% of the loan proceeds on payroll costs;
4. By June 30, 2020, any reductions in full-time equivalents (FTEs) and/or salaries and wages of eligible employees made between February 15, 2020 and April 26, 2020, must be restored to pre-February 15, 2020 levels.
5. Maintain documentation to support the spending of the proceeds, average FTEs, and salary and wage levels.

Note:

Guidance on the calculation of the forgiveness of loans made under the Program is minimal. That limited guidance forms the basis of this article. The SBA should issue additional guidance at any time. The guidance issued by the SBA could vary significantly from the information here. To obtain the latest information related to the Program, click here and look for an "Interim Final Rule" addressing forgiveness, and check for updates to Frequently Asked Questions.

Forgiveable uses

The Paycheck Protection Program, as outlined in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act or Act) and interpreted by the Treasury Department and SBA (collectively SBA), makes a distinction between "allowable" and "forgivable" uses of a loan. While there are six allowable uses of loan proceeds, as listed below, only four of those uses are forgivable. The following chart highlights the differences.

Allowable Uses

1. Payroll costs
2. Payments of interest on mortgage obligations
3. Rent
4. Utilities
5. Interest on *other* indebtedness incurred before February 15, 2020
6. Refinance of Economic Injury Disaster Loans (EIDL)

Forgiveable Uses

1. Payroll costs
2. Payments of interest on mortgage obligations
3. Covered rent obligations
4. Covered utility payments

As with all things created by statute, definitions are fundamental. Thank goodness, the definition of "payroll costs," is the same for both allowable uses and forgivable uses.

"Payroll costs" are gross wages, including cash tips or their equivalent, plus group health insurance benefits, retirement benefits, and state or local unemployment compensation taxes paid by an employer. "Covered mortgage obligation" means indebtedness incurred in the ordinary course of business secured by a mortgage on real or personal property, and incurred before February 15, 2020. Rent due under a leasing agreement in force before February 15, 2020 is referred to as a "covered rent obligation." "Covered utility payment" means payment for electricity, gas, water, transportation, telephone, or internet access for service that began before February 15, 2020.

The covered period

An understanding of "covered period" is critical to maximizing the forgiveness of the loan. Section 1102 of the CARES Act defines "covered period" as beginning February 15, 2020 and ending on June 30, 2020. During this covered period, a borrower may use the proceeds of the loan as described above.

However, "covered period" has a different meaning for purposes of forgiveness. Section 1106 of the Act, which governs forgiveness, requires a borrower seeking maximum forgiveness to spend its loan proceeds within eight weeks from the date of the first disbursement of loan proceeds. Thus, loan proceeds disbursed by a lender on April 15, 2020 must be spent by June 10, 2020. Amounts spent after June 10, 2020, maybe allowable, but not forgivable. Borrowers should carefully calculate the end date of the eight weeks.

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The 75% rule

Payroll costs must equal or exceed 75% of the loan proceeds. This requirement is not part of the CARES Act but was added by the SBA in its Interim Final Rule issued April 2, 2020. The IFR states, "At least 75 percent of the expected forgiveness amount shall be for payroll costs." There may be more than one way to interpret this language. Until further guidance is issued, the safest thing to do is spend at least 75% on payroll costs.

Reductions in forgiveness based on FTEs and salary wage levels

To avoid a potential reduction in loan forgiveness, a borrower has to restore any reduction in (a) FTEs and (b) employee salary and wage levels to pre-COVID-19 amounts. The SBA says a borrower will owe money if (1) the borrower's FTEs are reduced, and (2) salaries and wages are reduced by more than 25% for any employee that made less than $100,000 annualized in 2019. Proposed calculations of these reductions already litter dozens of pages. Rather than speculate, we are awaiting guidance from the SBA. A renowned commentator on small business taxation said the following after trying to understand the reduction calculations: "I give up. You should too. We need guidance." (Anthony J. Nitti, "Ten Things We Need to Know About Paycheck Protection Program Loan Forgiveness," Forbes, April 15, 2020).

Document, document, document

When applying for loan forgiveness, borrowers must provide the lender documentation verifying payroll costs, covered mortgage interest, covered rent, covered utilities, the number of FTEs as of the date of the application for forgiveness or June 30, 2020, and that no employee is making less than 75% of what the employee made pre-COVID-19. Form 941, state quarterly wage unemployment tax forms, payroll records, evidence of payment of health insurance and retirement benefits, and evidence of payment of covered interest, rent, and utilities are required. Also, borrowers must certify that the records provided are identical to those provided to the IRS.

A note to self-employed individuals that file an IRS form 1040, Schedule C

All of the preceding guidance applies to self-employed individuals, especially those with employees. There is one nuance, however. In its Interim Final Rule published April 14, 2020, the SBA states that forgiveness of owner compensation replacement is limited to "eight-weeks' worth (8/52) of 2019 net profit." Owner compensation replacement is the amount on line 31 of 2019 IRS Form 1040 Schedule C reduced by any amount over $100,000. The SBA states this limitation places self-employed individuals on a level playing field with other small businesses and reflects the intent of the statute.

Now, what?

While waiting for additional guidance on forgiveness, borrowers should do four things. First, calculate the end date of their covered period (eight weeks from the date of distribution of loan proceeds). Second, calculate 75% of loan proceeds and spend that amount on eligible payroll costs during the covered period. Third, work toward restoring FTEs to pre-COVID-19 numbers. And, fourth, make sure that individual employees are making at least 75% of their salary or wages before the COVID-19 pandemic.

Post-script

Hopefully, the additional guidance will address the following frequently asked questions:

1. Can I pay bonuses?
2. Are there other creative things I can do to make sure at least 75% of my spending is on payroll costs?
3. Can I prepay rent and utilities? As well as all the other questions that are floating around.

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