goulston&storrs

UPDATED: Summary COVID-19: Paycheck Protection Program (PPP)

April 7, 2020

The U.S. Small Business Administration (SBA) is authorized to guarantee up to $349 billion in loans to eligible borrowers through the Paycheck Protection Program (PPP). As detailed below, these loans are then forgiven after an eight-week period, if certain conditions are met. Special provisions extend PPP eligibility to borrowers that would not normally meet the definition of a small business, including in particular those in the hospitality and restaurant industries. The PPP terms and guidance are set forth in:

- Title I of the Coronavirus Aid, Relief, and Economic Security Act (Act);
- The Interim Final Rule issued by SBA on April 2, 2020 (IFR);
- A supplemental Interim Final Rule on affiliation issued by SBA on April 3, 2020 (IFRAffiliation) and associated SBA guidance (Affiliation Guidance);
- SBA's SOP 50 10 5(K) (SOP), which is referenced in the IFR;
- The updated FAQs issued by the Treasury Department on April 6, 2020;
- The Borrower Application Form (Borrower Form) and associated SBA guidance for the borrowers (Borrower Guidance); and
- The Lender Application Form (Lender Form) and associated SBA guidance for the lenders (Lender Guidance).

Guidance and rules are expected to be updated further, so the information set forth below is subject to change on what appears to be a daily basis.[1]

Eligible Borrowers

For purposes of the PPP, an eligible borrower includes for-profit businesses, non-profit businesses, veterans organizations, and tribal business concerns that employ the greater of either 500 employees or the applicable size standard established by the SBA, as well as individuals who operate as sole proprietors, independent contractors, and self-employed individuals. Important limitations are outlined below.

- How do I measure the number of employees? For purposes of eligibility, the number of employees is measured on a headcount basis (i.e., including full-time, part-time, or other employees). The FAQs confirm four methods for counting employee headcount (see Q14):

- For businesses that have not been operational for 12 months, average headcount for each pay period that the business has been operational.
- Average headcount per pay period in the 12 completed calendar months prior to the date of the loan application (i.e., the existing SBA calculation)
- Average headcount over the previous 12 months.
- Average headcount over calendar year 2019

- Is revenue relevant? The SBA ordinarily also applies a revenue limit test to determine eligibility, but this test is not relevant for the PPP program based on the clear language in the CARES Act. However, some companies with more than 500 employees may qualify as a "small business concern" based on the traditional SBA rules (which evaluate both the number of employees and the revenue of an applicant and its affiliates) and guidance from SBA indicates those companies remain eligible for PPP loans. See FAQs 2, 3 and 5, IFR and IFR-Affiliation referenced above.
- What certifications must I make? The Borrower Application includes a list of questions, representations, and certifications, among which the borrower must certify that the borrower is **eligible to receive a loan under the rules in effect at the time the application is issued** (including the rules outlined below), the loan is **necessary to support ongoing operations due to current uncertain economic conditions** and acknowledge **the funds will be used** to **retain workers and maintain payroll** or make mortgage interest payments, lease payments, and utility payments.

Ineligible Borrowers (Passive Entities): Pursuant to the IFR and SOP, certain industries and entities are ineligible for the PPP program. This list includes banks and passive real estate businesses owned by developers and landlords that do not actively use or occupy the applicable real estate assets. There are then exceptions to these exceptions, which include hotels that derive 50% or more of their revenue from transient accommodations, landlords that derive 50% or more of their revenue from "services" rather than rent, certain residential facilities that provide healthcare or medical advisors, and Eligible Passive Companies (e.g., a landlord that leases real estate to an operating company).

Borrowers must certify that they are "eligible to receive the loan under the rules in effect at the time the application is submitted"—including the limitations on ineligible entities set forth in the IFR and SOP, and the guidance distinguishing the payroll of a borrower from the payroll of its independent contractors, as set forth in the IFR and FAQs. Accordingly, **passive, property-owning special purpose entities (SPEs) with no employees are currently not a good candidate for a PPP loan, unless the SPE-owned asset is a hotel or an "active" business (such as a restaurant or a golf course). For other real estate companies, the entity that is more likely to be eligible is the property management company or a holding company that is an Eligible Passive Company with payroll-related expenses**. The applicant entity, whether a holding company, property management company, or property-owning SPE gaining eligibility through one or more of the exceptions would still need to comply with the 500-employee limit, accounting for employees of affiliates.

Affiliation: The IFR and IFR-Affiliation confirm that the SBA's affiliation rules apply to PPP loans. **In general, affiliation is broadly defined**, and there are several specific categories of affiliation, some with exceptions and carve-outs -- but the overarching principle behind each test is whether there is common control between or among parties. **With the affiliation rules, the Act's seemingly bright-line 500-employee rule becomes highly variable and business-specific in light of the requirement to consider the employees of all affiliates of the Borrower**. Examples of affiliation include ownership, common management, or identity of interest, and encompass affirmative and negative control rights of minority shareholders. FAQ Q6 clarifies that if a minority shareholder irrevocably waives or relinquishes such control rights, it will no longer be an affiliate of the business (assuming no other relationship that triggers the affiliation rules). The affiliation inquiry can be highly fact-dependent.

Employees of "affiliates" count toward the 500-or-less employee test, unless an exception to affiliation applies. Again, borrowers must certify that they are eligible to participate in the PPP based on applicable rules—including the affiliation rules and any related imputed employees. In order to document potential affiliation, borrowers are required to provide a list of businesses that a borrower (or owner of a borrower) owns or has common management. The SBA advised that the purpose of this list is to cause the PPP loan applicant to consider the aggregate number of employees for the applicant and all affiliates listed.

Special Provisions Affecting Hospitality and Restaurant Industries. Businesses that employ up to 500 employees **per physical location** in the "accommodation and food services" industries are eligible to receive a covered loan (i.e. businesses assigned with a North American Industry Classification System code beginning with 72).[2] Furthermore, the SBA's affiliation rules are waived for the "accommodation and food services" industries (defined as businesses with an NAICS code beginning with 72), franchisees of certain franchises previously approved by the SBA, and other companies receiving financial assistance from SBICs.

See our April 6th advisory for additional information tailored to the hospitality industry.

Priority. The Act provides for prioritization for borrowers in underserved and rural markets as well as those owned by veterans and members of the military community, socially and economically disadvantaged individuals, women, and businesses in operation less than two years. Guidance on such prioritization is supposed to be provided by the SBA to lenders and agents, though it is still forthcoming.

Program Details – Loan Amount and Use of Loan

Loan Amount and Payroll Costs. Broadly, the PPP loan amount is calculated as 2.5 times the borrower's average monthly payroll costs, up to a maximum of $10 million. The same definition of "payroll costs" also governs the permitted use of the majority of the loan and the permitted costs that count toward forgiveness of the majority of the loan. We urge all borrowers to carefully review and re-review the precise language in the Act and IFR. Items included as payroll costs are enumerated in the Act as well as Section 2F of the IFR. Items excluded from payroll costs are enumerated in the Act as well as Section 2G of the IFR.

- How do I apply the $100,000 Limit on Compensation? One major exclusion is compensation of individual employees in excess of an annual salary of $100,000, prorated as necessary depending on whether payroll costs are being used to calculate the loan amount, permitted use of loan proceeds, or permitted costs eligible for forgiveness. As confirmed in the FAQs (Q7), this limit applies to "cash compensation." **Eligible payroll costs toward employee health care and retirement benefits are not counted in the $100,000 limit per employee for purposes of calculating payroll costs.**
- Are Federal Taxes and Withholding Included in Payroll Costs? Generally, yes. **For purposes of calculating the loan amount, payroll costs are calculated on a gross basis and should not be reduced by the employee's share of federal taxes (FICA and railroad retirement taxes) and employee withholding.** (Borrowers should not, however, add in the employer's share of payroll tax.)
    - However, per the FAQs, **those federal taxes and employee withholding should be excluded from payroll costs for purposes of loan use and loan forgiveness.** (As explained in footnote 2 to Q16 of the FAQs, this goes beyond the period of such exclusion set forth in the Act, between February 15, 2020 and June 30, 2020 (i.e., the "covered period" for purposes of PPP loans).)
- Are Life Insurance Benefits Included? Based on our review of the Act and IFR, we do not believe that life insurance premiums paid by employers can be included in "payroll costs."
- Are payments made to an independent contractor included? No. Per the FAQs, amounts paid to independent contractor are excluded from a borrower's payroll costs.

Calculating Average Monthly Payroll Costs. The Act provides for a number of methods for calculating average monthly payroll costs. For many borrowers, the amount will be calculated based on the aggregated payroll costs over a 12-month period, less compensation per employee over an annual salary of $100,000, divided by 12. (See Section 2E of the IFR.)

- What is the 12-month period for measuring payroll costs? As with number of employees, either average headcount over calendar year 2019 or average headcount over the previous 12 months.
- What if I don't have a full 12-month period to measure payroll costs? While the Act provides alternative methodologies for new businesses (average monthly payments from 1/1/20 to 2/29/20) and seasonal businesses (average monthly payments from 2/15/19 to 6/30/19), neither the Act nor the IFR nor the FAQ clarifies how to calculate average monthly payroll costs when an existing and non-seasonal business nevertheless lacks a full 12-month period of payroll costs (for example, if management changed hands).

Use of the PPP Loan. The PPP assistance may be used for **payroll costs** (inclusive of certain health care and retirement benefits and other inclusions, and exclusive of compensation per employee that exceeds an annual salary of $100,000 and other exclusions), **mortgage interest, rent, and utility payments,** and interest on certain other debt obligations. There are two important qualifications to the use of the PPP assistance. First, **at least 75% of the proceeds must be**

used toward payroll costs. Second, **only payroll costs, mortgage interest, rent, and utility payments qualify for forgiveness**, as detailed below.

- When can I spend the loan proceeds? Congress wants you to spend the money now. As the Act is written, the proceeds must be used for costs between February 15, 2020 and June 30, 2020 (the "covered period" for purposes of PPP loans).
- Cash or Accrual Basis? The Act and IFR do not provide guidance on whether the proceeds are used for costs during the covered period on a cash or accrual basis.
- Can I prepay mortgage interest? Although loan proceeds may be used to pay mortgage interest, it may not be used to prepay interest or pay principal.
- Can I use the loan to pay other debt? Yes, interest on other debt obligations is a permitted use of loan proceeds, but it is not eligible for forgiveness and, furthermore, is part of the universe of non-payroll costs capped at 25% or less of the loan proceeds.

Loan Terms. The loan has an interest rate of 1% and it is due in 2 years.[3] No guidance has yet been given on whether the amounts are amortized over the period of the loan or not. No payments are due for 6 months following disbursement, but interest will accrue during that period. There is no penalty for prepayment of the loan.

Loan Qualifications and Lender Review. No personal guarantee is required. No collateral is required. No "credit elsewhere" check is required. All the lender is required to do is confirm receipt of the Borrower Application with required certifications, receipt of information demonstrating borrower had employees for whom salaries and payroll taxes were paid, receipt of payroll documentation of the average monthly payroll costs, and following certain Bank Secrecy Act requirements. If the quality of the supporting documents is high (e.g., a payroll report from a recognized third-party payroll processor), then the lender can provide a minimal review of calculations.

Note, however, that consent for the PPP loan may be required from the borrower's existing lenders; loan documents should be carefully reviewed with counsel.

Loan Forgiveness

Overview of Forgiveness. Under certain conditions, the entire amount of a PPP loan may be forgiven. Broadly, the amount expended over the first eight weeks after origination of the loan ("forgiveness period"[4]) will be forgiven, so long as (1) the amount is expended only on payroll costs, mortgage interest payments, rent, and utilities; (2) no more than 25% of the amount is expended on mortgage interest, rent, and utilities; and (3) the borrower maintains employee and compensation levels. The forgiveness amount cannot exceed the principal amount of the loan. **Further guidance on the mechanics of forgiveness is anticipated based on the relative lack of detail on forgiveness in the IFR.**

- When does the forgiveness period start? The Act states "origination of the loan." We believe this may mean the date of disbursement.

- Cash or Accrual Basis? (Part II) Again, the Act and IFR do not explicitly state how to proceed. Here, however, the Act does provide for forgiveness of "costs incurred and payments made" during the forgiveness period.
- Mortgage Interest (Part II) Again, prepayment of interest, or payment of principal, cannot be used to achieve forgiveness.
- What are the tax consequences of forgiveness: Forgiveness is excluded from gross income for tax purposes.

Impact of Reduction in Employees. The primary purpose of the PPP is to keep workers on payroll. As a result, forgiveness is reduced proportionately by reductions in employee count. Here, employee count is measured based on the average number of full-time equivalent (FTE) employees per month. The Act states that the average number of FTEs per month is determined by calculating the average number of FTEs for each pay period falling within a month, but detail has not yet been provided on the basis for determining what constitutes an FTE.

For most employers, the amount of forgiveness is reduced proportionately based on the ratio of the average number of FTEs per month employed during the 8-week forgiveness period to either:

- The average number of FTEs per month employed from 2/15/19 to 6/30/19; OR
- The average number of FTEs per month employed from 1/1/2020 to 2/29/2020.

The borrower may choose which of the above two periods to use to determine the reduction in forgiveness. For seasonal employers, the reduction must be based on the ratio of the average number of FTEs per month employed during the 8-week forgiveness period to the average number of FTEs employed from 2/15/19 to 6/30/19.

Impact of Reduction in Compensation. Again, the purpose of the PPP is to keep workers paid. Accordingly, forgiveness is also reduced by the amount of any reduction in salary or wages of an employee during the forgiveness period that exceeds 25% of the total salary or wages of that employee during the most recent full quarter period prior to the forgiveness period. For purposes of this provision, only reductions in pay to employees who make $100,000 or less is counted.

Re-Hires to Avoid Forgiveness Penalties. Congress recognized that many borrowers may have to furlough workers or reduce compensation until the PPP program is in full swing. Accordingly, for any reduction in employees or compensation[5] during the period between 2/15/20 and 4/26/20, the Act includes a mechanism for borrowers to rehire workers or restore compensation to reach full forgiveness. So long as the borrower rehires the employees and restores the compensation by 6/30/20, the borrower will be treated as if there has been no reduction in employees or compensation for purposes of forgiveness.

- Can I really wait until June 30 to rehire or restore compensation? That's how the law is structured. Practically speaking, however, since the amount of your loan is determined based on last year's payroll, and 75% must be spent on payroll costs, the only realistic way to expend the loan proceeds within the eight-week forgiveness period will be to rehire a sufficient number of employees and/or restore compensation.

- What if I don’t want to rehire employees or restore compensation during the forgiveness period? You can spend the loan proceeds on payroll and other costs outside of the forgiveness period and within the original covered period (that is, anytime from 2/15/2020 to 6/30/2020). However, such amounts will require repayment with interest, and are still subject to the overall limitations on use as well as the minimum requirement that 75% of loan proceeds be spent on payroll costs.

Relationship to Other CARES Act and Other Relief

The CARES Act includes other economic relief, as summarized in our March 26th advisory. A PPP loan may restrict or preclude participation in some of these and other programs aimed at small businesses.

- Economic Injury Disaster Loans (EIDLs). Broadly, borrowers may seek both a PPP loan and an EIDL loan, although the funds may not be used for the same purpose. Indeed, the CARES Act reiterates that businesses may apply for assistance under both programs, extends the EIDL program to include the same universe of entities eligible for PPP (but without special waivers for hotels and restaurants, franchises, and SBIC-funded businesses), and establishes an ability to seek a $10,000 advance on a loan to be used for paid sick leave, maintaining payroll, paying rent or mortgage payments, or other purposes. To the extent that a borrower has already received an EIDL between 1/31/2020 and 4/3/2020, the outstanding amount of that EIDL may be rolled into a PPP loan, less the amount of the $10,000 advance on an EIDL described above. If your EIDL loan was used for payroll costs, and you then apply for a PPP loan, your PPP loan must be used to refinance your EIDL loan.
- Employee Retention Tax Credit (Retention Tax Credit). Recipients of a PPP loan are not eligible for the Retention Tax Credit created by Section 2301 of the CARES Act.
- Employer Payroll Tax Deferral (Payroll Tax Deferral). Recipients of a PPP loan who have indebtedness forgiven are not eligible for the Payroll Tax Deferral created by Section 2302 of the CARES Act.
- Economic Stabilization Assistance. The CARES Act does not automatically preclude recipients of a PPP loan from also receiving assistance from the Main Street Lending Program or other loans and support that will be made available pursuant to Title IV of the CARES Act. However, Title IV is intended for larger “eligible businesses” that have “not otherwise received adequate economic relief” under the CARES Act, and even the Main Street Lending Program is targeted at mid-market (500-10,000 employee) enterprises.
- Family and Medical Leave / Sick Pay Credits. Recipients of a PPP loan are still eligible for FMLA and sick pay credits under the Families First Coronavirus Response Act. However, those credits cannot be included as payroll costs toward the amount of the loan, use of the loan, or forgiveness of the loan.

[1] Of some comfort, the April 6 FAQ indicates that already-filed applications do not need to be updated to reflect the new guidance in the FAQ, though a borrower may choose to do so if the application has not yet been processed.

[2] NAICS Code 72 includes other accommodations as well, including rooming and boarding houses and dormitories. Note also that National Multifamily Housing Council (NMHC) is working with Congress and SBA in an effort to broaden the affiliate aggregation exemption to include NAICS Code 53 (real estate companies) and to exclude passive real estate companies from the list of ineligible entities for purposes of PPP loans. Given the COVID-19 related "stay at home" orders across the country, it seems appropriate to provide relief to the multifamily property owners who own, develop and manage millions of those homes.

[3] The Act originally provided for a 4% rate over 10 years. The SBA originally issued guidance suggesting the rate would be 0.5%, but settled on a 1% loan in the IFR.

[4] Both Sections 1102 and 1106 use the term "covered period" to refer to different periods of time. To avoid confusion, we refer to the latter period as the "forgiveness period."

[5] Although not explicitly stated, the structure of the Act suggests that only compensation for employees making $100,000 needs to be restored to 75% or more of the employee's prior compensation.