

PPP Loan Forgiveness: Key Lender Considerations

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Background

The CARES Act (Pub. L. No. 116-136) was signed into law on March 27, 2020, in response to the impact of the COVID-19 pandemic. The law established the Paycheck Protection Program (PPP) and origination of loans guaranteed under this program started April 3rd. To date, billions of dollars of loans have been made under this program.

PPP loans are intended to cover certain payroll costs and other costs, such as interest on mortgages, rent under lease agreements, and utilities. A highly attractive feature to borrowers under the PPP is that all or a portion of a loan can be forgiven if certain requirements are met. In light of the adverse economic conditions resulting from the pandemic, the importance of potential PPP loan forgiveness cannot be overstated. PPP loan forgiveness will be integral to restarting the economy and mitigating the financial consequences of this crisis.

This article focuses on considerations for lenders in the forgiveness of all or a portion of amounts borrowed by a small business under a loan made pursuant to the PPP. It is based on SBA guidance issued as of April 29, 2020 (see the [special SBA website page](#)) and is merely a general overview. Additional SBA guidance concerning PPP loan forgiveness is expected. Lenders are anxiously waiting for it and should monitor for developments. Requirements regarding the origination of these loans are complex and not discussed here. A lender should always consult with its own legal advisor and check for new or updated guidance.

Overview

Immediately following enactment of the law, the SBA released guidance for implementing the PPP (“SBA PPP Interim Final Rule”). On April 14, 2020 the SBA promulgated an interim final rule setting forth additional eligibility criteria and requirements for certain pledges of loans (“SBA PPP Additional Guidance”). The SBA PPP Additional Guidance includes additional guidance relating to PPP loan forgiveness. The SBA has also published a series of Frequently Asked Questions with answers, which is being actively updated (“SBA PPP FAQ”).

Section 1106 of the CARES Act sets forth the statutory rules relating to PPP loan forgiveness. In general, whether all or a portion of a PPP loan can be forgiven depends on the amounts for specified expenditures by the borrower during the eight-week period beginning on the date PPP loan proceeds are distributed to the borrower (“Covered Period”). However, there are numerous documentation and process requirements, outlined below, that borrowers and lenders must meet for a loan to be forgiven.

PPP Loan Forgiveness Amount Requirements

As a baseline, the amount of loan forgiveness under the PPP cannot exceed the principal amount of the PPP loan. In addition, at least 75% of the loan amount forgiven must have been used for payroll costs, as discussed in more detail below. Other forgivable use of loan proceeds include “owner compensation replacement” (explained below) and payments for interest on covered mortgages, rent payments, and

utility obligations, all of which are defined below. The amount eligible is also increased by the amount of additional wages paid to tipped workers (described in Sec. 3(m)(2)(A) of the Fair Labor Standards Act of 1938).

The 75% Payroll Cost Requirement

The SBA PPP Interim Final Rule indicates that 75 percent of the amount of loan forgiveness requested by a borrower must be for loan proceeds used for payroll costs and that not more than 25 percent of such amount can be for loan proceeds used for non-payroll costs eligible for loan forgiveness, including qualifying mortgage interest, rent, and utilities payments. Commentators have criticized this 75 percent requirement because it could cause a PPP borrower to request a greater amount of loan forgiveness relating to payroll costs in order to obtain a greater amount of loan forgiveness for qualifying non-payroll costs.

Another issue related to this requirement arises in the context of sole proprietors, including independent contractors. For a sole proprietor, the SBA PPP Additional Guidance provides that he or she can include compensation received as the owner in determining the amount of PPP loan forgiveness that can be requested. The SBA PPP Additional Guidance treats owner replacement cost as separate from payroll costs. As such, it must be considered whether owner replacement cost is treated as payroll costs for purposes of the 75 percent requirement. If not, this could severely hamper the ability of very small businesses (with only one or two employees in addition to the owner) and independent contractors from obtaining PPP loan forgiveness.

Owner Compensation Replacement

The SBA PPP Additional Guidance provides specific rules relating to the eligibility of owner compensation from a sole proprietorship for loan forgiveness (“Owner Compensation Replacement”). It provides in relevant part that it is “calculated based on 2019 net profit as described [in connection with the determination of the amount that can be borrowed under a PPP loan], with forgiveness of such amounts limited to eight weeks’ worth (8/52) of 2019 net profit.” However, such guidance specifically provides that it cannot include any qualified sick leave or qualified family leave equivalent amount for which a tax credit is claimed under Secs. 7002 and 7004 of the Families First Coronavirus Response Act.

As discussed in our related article, [“Calculating the Amount that Can Be Borrowed from the CARES Act Paycheck Protection Program,”](#) important requirements apply in determining the amount of a sole proprietor’s 2019 net profit. The focus on 2019 net profit reported for federal income tax purposes permits tax return verification for straightforward administration and may provide a benefit for businesses that are experiencing reduced business activity in 2020 as compared to 2019. The SBA PPP Additional Guidance indicates that it was also intended to prevent a windfall for business owners (rather than employees) in connection with potential 2020 net profits.

Understanding the Employee Number Reduction and Employee Compensation Reduction Rules

The amount eligible for loan forgiveness is reduced depending on the *number* of employees retained and the *compensation* of those employees. The mechanics of these reduction rules are detailed below.

The Act provides that the amount of loan forgiveness is reduced if a business has a *fewer number* of employees in the Covered Period than the average number of employees it has had in the past. The

amount of the reduction is calculated by dividing the average number of full-time equivalent employees employed per month during the Covered Period by either the average number of full-time equivalent employees employed per month between February 15, 2019 and June 30, 2019, or the average number of full-time equivalent employees employed per month between January 1, 2020 and February 29, 2020. Note that the SBA PPP FAQ clarifies that the definition of “full-time equivalent employees” is a term of art that is different from the definition of full-time employees that is used to compute the maximum amount of a PPP loan. The denominator is chosen by the business owner. However, seasonal businesses, as determined by the SBA, must use the February 15, 2019 to June 30, 2019 period for the denominator.

The Act also provides for a reduction in loan forgiveness if *employee compensation is reduced*. This covers employees who made wages or salaries of less than \$100,000 at an annualized rate of pay for all pay periods during 2019. However, this does not apply to a reduction in the wages of eligible employees during the period from February 15, 2020 to April 27, 2020 provided the small business has eliminated the wage reduction no later than June 15, 2020. This rule focuses on the reduction in compensation for only employees making less than \$100,000 (at an annualized rate of pay for all pay periods during 2019). Contrast the focus of this rule compared to the inclusion of compensation (but only up to \$100,000) for employees who make more than \$100,000 per year for purposes of computing “payroll costs,” either for purposes of computing payroll costs for calculating the amount that can be borrowed or for purposes of computing the amount that can be forgiven for PPP loans.

These reduction rules have savings provisions which provide that they do not apply if, respectively, the small business has eliminated the related reduction in the number of employees and re-hired employees no later than June 15, 2020 or the small business has eliminated the related compensation reduction no later than June 15, 2020.

These reduction rules have been criticized by some commentators. Some have focused on the complexity in the calculation of the respective reductions. Others have focused on the appropriateness of these reduction rules incentivizing the rehiring of employees, given potentially continuing adverse business conditions during the Covered Period, by June 15, 2020 or later.

Covered Period Costs

As noted earlier, qualifying costs eligible for forgiveness only include amounts incurred and expended by the borrower during the Covered Period. Section 1106(b) of the CARES Act frames eligible costs as limited to the sum of specified “costs incurred and payments made during” the Covered Period. However, the law is not explicit regarding whether the “and” in this clause requires both conditions (accrual and payment) to be met with respect to a specific cost during the Covered Period or specific amounts paid qualify provided either that the payments relate to costs incurred before (or after) the Covered Period *or* relate to amounts accrued during the Covered Period but are paid later. Note that many expenses are accrued and subsequently invoiced and paid. Accordingly, qualifying costs accrued during the Covered Period might actually be paid in the ordinary course of business *after* the expiration of the Covered Period. To date, SBA guidance does not provide clarity on this issue.

Payroll Costs Defined

The PPP does not treat all potential payroll costs as qualifying costs, either for purposes of calculating the amount that can be borrowed under the PPP or for purposes of determining the amount of payroll

costs that can be forgiven. For additional details and considerations, see our related article titled “Calculating the Amount that Can Be Borrowed from the CARES Act Paycheck Protection Program” dated April 28, 2020.

In general, the CARES Act provides that payroll costs include:

- 1) Salaries, wages, commissions, or similar compensation;
- 2) Payments of cash tips or equivalents;
- 3) Payments for vacation, parental, family medical or sick leave;
- 4) Allowances for dismissal or separation;
- 5) Payments required for group health care benefits including any insurance premiums;
- 6) Payments of retirement benefits;
- 7) State or local taxes assessed on employees’ compensation; and
- 8) The sum of payments of any compensation of a sole proprietor or independent contractor that is a wage, commission, income, net earnings from self-employment or similar compensation that is in an amount not in excess of \$100,000 for the year.

Note that the SBA PPP FAQ clarifies that housing stipends and allowances are payroll costs and count for purposes of “the \$100,000 annual compensation per employee limitation.”

For computing eligible payroll costs, the CARES Act excludes:

- The compensation of any employee in excess of \$100,000 for the year;
- Imposed or withheld federal income taxes (under IRC Chapters 21, 22 & 24);
- Any compensation for an employee whose principal residence is outside the U.S.;
- Qualified sick leave wages for which a credit is allowed under Section 7001 of the Families First Coronavirus Response Act (Pub. L. No. 116-27, the Families First Coronavirus Response Act); or
- Qualified family leave wages for which a credit is allowed under Section 7003 of the Families First Coronavirus Response Act.

In addition, “owner compensation replacement” is not treated as payroll costs. It is discussed separately in the next section below.

Covered Mortgages, Rent and Utilities Defined

A “covered mortgage” is defined as (1) a debt obligation that (2) is an obligation of the borrower, (3) includes a related mortgage on real or personal property, and (4) was entered into before February 15, 2020. A “covered rent obligation” is “rent obligated under a leasing agreement in force before February 15, 2020.” A “covered utility obligation” is “a service for the distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020.”

Note the explicit exclusion of mortgage prepayments or principal payments from forgiveness, and the precise definition of utilities as only including electricity, gas, water, transportation, telephone, or internet access. Requested forgiveness amount applications will likely need to be scrutinized given these limitations.

Related Employees and “Self Rent”

The CARES Act does not provide any explicit restriction on the eligibility of payroll costs in determining the amount that can be forgiven concerning employees who are related to the owner of the small business. Similarly, the CARES Act does not provide explicit restrictions on the eligibility of qualifying mortgage interest expense or rents that are paid by the small business to a related business entity. Accordingly, some commentators have suggested that the lack of such restrictions may facilitate potential abuse or provide planning opportunities.

PPP Loan Forgiveness Timing and Required Steps

There are various steps that must be completed in order for a loan to be forgiven under the PPP. A summary of the steps that borrowers must take follows immediately below. Other considerations for lenders with respect to the timing and process requirements are presented throughout this section. Importantly, forgiveness is not available unless all the requirements are met. To request loan forgiveness, the borrower must:

- Determine the amount that can be forgiven
- Submit an application for loan forgiveness
- Provide required documentation
- Certify that the documentation is true and correct and that the amount for which forgiveness is requested was used for appropriate purposes; and
- Certify as to any other documentation that the SBA determines is necessary.

After obtaining the required documentation, the lender must issue a decision and notify the borrower within 60 days of the receipt of an application for forgiveness by the borrower. The lender notifies the borrower regarding the amount of the loan forgiven and the applicable effective date, as well as the adjusted amount of the PPP loan (plus accrued interest), if any, that remains outstanding.

The SBA must then remit the amount forgiven plus accrued interest (accrued through the date of payment) to the lender within 90 days of the date on which the amount of forgiveness is determined.

Note that Sec. 1106(c)(4) of the CARES Act permits a lender to request that the SBA purchase PPP loans in advance based on the expected amount of forgiveness ("PPP Loan Advance Purchase"). This method effectively gets funds relating to expected forgiveness into the hands of lenders faster. It does not provide borrowers any relief from the steps set forth above that must be satisfied for all or a portion of a PPP loan to be forgiven.

In order for a lender to effectuate a PPP Loan Advance Purchase, it must "report to the [SBA] an expected forgiveness amount on a covered loan or on a pool of covered loans of up to 100 percent of the principal on the covered loan or pool of covered loans." Under the law, the SBA "shall purchase the expected forgiveness amount ... as if the amount were the principal amount of a loan guaranteed under section 7(a) of the Small Business Act..." A PPP Loan Advance Purchase can also be made, at the discretion of the SBA, to a third-party participant in the secondary loan market.

Borrower Certification

As noted above, Section 1106(e)(3) requires that a representative of the borrower must certify (1) that the documentation presented in connection with the request for PPP loan forgiveness is true and correct; (2) as to "the amount for which forgiveness is requested [that] was used [during the Covered

Period] to retain employees, make interest payments on a covered mortgage obligation, make payments on a covered rent obligation, or make covered utility payments” (presumably this includes the amount expended by the borrower during the Covered Period related to Owner Compensation Replacement); and (3) as to any other documentation that the SBA determines is necessary.

The SBA has not provided guidance concerning the due diligence required by a lender in reviewing the specified certifications of the borrower requesting PPP loan forgiveness.

Borrower Loan Forgiveness Documentation

There are extensive documentation requirements under the PPP that apply to a borrower in connection with a request for loan forgiveness. The SBA PPP Interim Final Guidance explicitly notes that “[f]or purposes of loan forgiveness, however, the borrower will have to document the proceeds used for payroll costs in order to determine the amount of forgiveness.”

The SBA PPP Additional Guidance provides additional clarification:

- Payroll costs should be evidenced by IRS Form 941 and state quarterly wage unemployment insurance tax reporting forms or equivalent payroll processor records that best correspond to the covered period with evidence of any retirement and health insurance contributions.
- For non-payroll costs, borrower should submit evidence of business or mortgage interest payments on real or personal property, or business utility payments. Section 1106(e)(2) of the CARES Act specifies that required documentation can include “cancelled checks, payment receipts, transcripts of accounts, or other documents verifying payments on covered mortgage obligations, payments on covered lease obligations, and covered utility payments.”
- To determine net profit, the borrower must submit as documentation the 2019 Form 1040 Schedule C that was provided at the time of the PPP loan application.

Due Diligence and Regulatory Compliance

The SBA has not yet issued specific guidance relating to a lender’s due diligence obligations for loan forgiveness related documentation and certifications provided by a requesting PPP borrower. The SBA has issued guidance, however, with respect to the documentation and certifications required to be submitted by borrowers in connection with a PPP loan application. Presumably, similar due diligence obligations may apply to lenders in connection with the review of loan forgiveness documentation and certifications provided by borrowers seeking PPP loan forgiveness.

Given the risk of fraud, lenders should carefully consider the likelihood that the documentation and certifications submitted by borrowers in connection with requests for PPP loan forgiveness and the nature of the related review and decision by lenders will likely be scrutinized by regulators. The news media has already reported commentary that the costs eligible for forgiveness should be expanded. This suggests that some borrowers may expansively seek PPP loan forgiveness in a manner that could be challenged by regulators in the future.

Note, however, that lenders may be protected if they qualify for the hold harmless provision of the CARES Act related to PPP loan forgiveness discussed in the next section.

Hold Harmless

Section 1106(h) of the Act provides relief for a lender from an enforcement action related to loan forgiveness, but only if the lender received the required documentation for a borrower attesting to the accuracy of the amounts sought for loan forgiveness. Protection from liability under this provision is limited to enforcement action under section 47(e) of the Small Business Act (which covers informal and formal enforcement actions against lenders) and any penalties by the SBA Administrator “relating to loan forgiveness for the payments for payroll costs, payments on covered mortgage obligations, payments on covered lease obligations, or covered utility payments, as the case may be.”

Note, however, that this provision does not provide explicit protection to a lender from potential liabilities pursuant to other federal laws and regulations applicable to such lender that are outside the scope of the SBA. For example, UDAAP considerations in how loans were initially marketed or fair lending concerns in processing loan forgiveness requests.

Terms and Conditions of Loan That Survive Forgiveness

Section 1106(j) of the CARES Act also makes it clear that “[t]he cancellation of indebtedness on a covered loan under this section shall not otherwise modify the terms and conditions of the covered loan.”

Thus, it seems clear that the borrower’s promises and obligations as agreed at the time the PPP loan survive *any* forgiveness of any amount due on the loan.

Tax Relief from Cancellation of Indebtedness Income Due to Loan Forgiveness

Although this article focuses on lender considerations, the CARES Act includes noteworthy borrower tax relief relating to PPP loan forgiveness. Generally, the forgiveness or cancellation of indebtedness can give rise to taxable income to the borrower whose debt is forgiven or cancelled under federal income tax law pursuant to Section 108(e) of the Internal Revenue Code unless a specific exception applies. The CARES Act, however, provides a special exception from this general rule for PPP loans forgiven under these special rules and exempts “any amount which...would be includible in gross income of the eligible recipient by reason of forgiveness.”

A related tax issue concerns the deductibility of business expenses. Ordinarily, a small business’ expenses for payroll, mortgage interest, rent and utilities are generally deductible business expenses for federal income tax purposes. All or a portion of these expenses may be funded from PPP loan proceeds that a small business receives and, as discussed above, all or a portion of these expenses may qualify for PPP loan forgiveness and would be excludible from taxable income. Conversely, Sec. 265 of the Internal Revenue Code provides in part that no tax deduction is allowed for expenses where “[a]ny amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this subtitle.”

The CARES Act does not explicitly deny these deductions, but the language of Sec. 265 is broad. Some tax practitioners have raised concerns that expenses funded out of loan proceeds (where it is known in the same tax year as the expense that the obligation to repay such proceeds is forgiven) are not deductible for federal income tax purposes because of Sec. 265. On April 30, 2020, the IRS released Notice 2020-32, which “clarifies that no deduction is allowed under the Internal Revenue Code (Code)

for an expense that is otherwise deductible if the payment of the expense results in forgiveness” of a PPP loan.

Note that small businesses and their tax advisors are also assessing these issues (cancellation of indebtedness income and deductibility of related expenses) under applicable state income tax laws.

Additional Guidance Is Likely

The guidance issued to date is not comprehensive. The SBA has not yet promulgated a loan forgiveness form or specified the level of due diligence that lenders must perform in reviewing borrower-provided documentation and certifications. Moreover, it seems likely that there may be challenges regarding some of the requirements that have been laid out in guidance so far. Accordingly, borrowers and lenders must remain diligent and ready to react to additional, updated or revised guidance concerning PPP loan forgiveness.

Conclusion

The PPP provides important relief that is focused on small businesses in the U.S., and loan forgiveness is a key aspect of the program. However, the computation of the amount that can be forgiven under the law is complex. Lenders should anticipate that the computations and analysis of qualifying costs may be challenging for some small business borrowers. Moreover, it seems expected that there will be attempts by borrowers to obtain forgiveness for costs that may not qualify. Although the documentation and certification requirements are clearly intended to limit these attempts, there will likely be challenges. It should be expected that borrowers and their advisors will raise concerns that a lender’s due diligence and scrutiny of PPP loan forgiveness requests inappropriately impede a borrower’s efforts to obtain loan forgiveness. However, lenders should carefully consider that the SBA and other regulators will likely review a lender’s efforts through the 20/20 lens of hindsight. And it must be remembered by both borrowers and lenders that Section 1106(f) of the CARES Act is clear that only qualifying loan forgiveness that is properly documented *before* submission to the lender is eligible for loan forgiveness.

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