

# First Look at Applying for PPP Loan Forgiveness

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## Introduction

One of the most valuable features of the CARES Act's Paycheck Protection Program (PPP) loans is the ability for recipients to apply to have the loans converted into nontaxable grants if certain criteria are met.

Details about the forgiveness process were uncertain until May 15, 2020, when the Small Business Administration (SBA) released the [Paycheck Protection Program Loan Forgiveness Application](#) and accompanying schedules and instructions. The instructions address several crucial questions while leaving some unanswered. The SBA has also announced that further regulations and guidance regarding the forgiveness application are forthcoming.<sup>1</sup>

This article discusses the major guidance contained within the application and instructions, including the SBA's response to managing the eight-week Covered Period, non-payroll related expenses paid outside the Covered Period, the computation of full-time equivalent employees, and several other important topics.

Nonprofit leaders will want to follow the application instructions carefully to help ensure as much of their loans are eligible for conversion as possible.

## Background on PPP Loan Forgiveness

Before diving into the PPP Loan Forgiveness Application, let's review the basics of PPP loan forgiveness. A PPP loan may be forgiven to the extent the loan proceeds (or an amount equivalent to the loan proceeds) are spent on qualifying expenses incurred and paid during an eight-week covered period (the Covered Period) commencing with the date on which PPP loan funds are first disbursed, regardless of whether the loan funds are disbursed over multiple days. The concept of "incurred and paid" will be discussed below, along with additional details on the Covered Period.

Qualifying expenses fall into four categories:

1. Payroll costs;
2. Mortgage interest;
3. Rent; and
4. Utilities.

### Payroll Costs

At least 75% of the recipient's loan proceeds must go toward payroll costs. As described in the [First Interim Final Rule](#), qualifying payroll costs consist of a variety of items, including:

- Compensation to employees (whose principal place of residence is the United States) in the form of salary, wages, commissions, or similar compensation;
- Cash tips or the equivalent (based on employer records of past tips or, in the absence of such records, a reasonable, good-faith employer estimate of such tips);
- Payment for vacation, parental, family, medical, or sick leave;
- Allowance for separation or dismissal;
- Payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums, and retirement;
- Payment of state and local taxes assessed on employee compensation; and
- For an independent contractor or sole proprietor who separately applied for a PPP loan, wages, commissions, income, or net earnings from self-employment or similar compensation.<sup>2</sup>

<sup>1</sup> "SBA and Treasury Release Paycheck Protection Program Loan Forgiveness Application," U.S. Treasury Department Press Release (May 15, 2020), [home.treasury.gov/news/press-releases/sm1010](https://home.treasury.gov/news/press-releases/sm1010).

<sup>2</sup> Paycheck Protection Program, First Interim Rule, ¶ 2(f), 85 Fed Reg. 20,811 (April 15, 2020); available at <https://home.treasury.gov/system/files/136/PPP--IFRN%20FINAL.pdf>.

Allowable payroll costs do not include:

- Payments by an employer to independent contractors (in [FAQ 15](#) the SBA made it clear that because independent contractors may apply for their own PPP loan, they are not includible in an employer's PPP payroll costs for loan application purposes or for the purpose of loan forgiveness);
- Salary and wages paid to an employee in excess of \$100,000 computed on an annualized basis;
- Wages paid to employees under the Expanded Family Medical Leave Act and Emergency Paid Sick Leave Acts (both contained within the Families First Coronavirus Response Act (FFCRA)) for which the employer receives the credits provided by the FFCRA;
- The employer's share of FICA and Medicare taxes; and
- Payroll costs related to employees whose principal place of residence is not in the U.S.

A few words of explanation are useful here. First, [FAQ 32](#), published on April 24, 2020, clarified that all cash compensation is includible in payroll costs, including a "housing stipend or allowance." Thus it is now clear that a minister's housing allowance is includible in payroll costs for both the purpose of the loan application and the forgiveness application.

Second, the definition of payroll costs for the purpose of applying for a PPP loan is identical to the definition of payroll costs for the purpose of applying for PPP loan forgiveness. While the SBA has not specifically addressed the question of whether payroll costs omitted during the loan application process may nonetheless be included in payroll costs submitted for loan forgiveness, it does not appear that this omission will be a barrier to including such otherwise eligible payroll costs in your loan forgiveness calculation. For example, if your PPP loan application did not include the minister's housing allowance, there is nothing (yet) in the loan forgiveness application that would preclude you from including the minister's housing allowance in the payroll costs submitted for forgiveness.

Third, the PPP Loan Forgiveness Application instructions clarify that the exclusion of salary and wages paid in excess of \$100,000 on an annualized basis means the maximum amount of salary and wages that can be included for an individual employee for the Covered Period is \$15,385 —  $\$100,000 \div 52 \times 8 = \$15,385$ . This limit only applies to salary and wages. It does not apply to an employee's allocable share of group health care benefits and retirement benefits.

Fourth, in [FAQ 16](#), the SBA clarified that payroll costs begin with gross wages and are not reduced for an employee's federal income tax withheld or an employee's share of FICA and Medicare tax (payroll taxes). However, the FAQ makes it clear that the *employer share of payroll taxes is not includible* in payroll costs.

Fifth, guidance published to date has not addressed bonuses, raises, hazard pay, and other similar forms of remuneration. In the absence of guidance, careful thought should be given before including these forms of compensation in your forgivable payroll costs. It is unlikely that expenses created solely for the purpose of loan forgiveness will meet the criteria for forgiveness. Accordingly, evaluate any special compensation changes or arrangements occurring during the Covered Period in light of such factors as:

- Whether such compensation is "incurred and paid" during the Covered Period (see discussion below on "incurred and paid");
- Whether changes in compensation, such as merit pay increases, are part of a regularly scheduled compensation review process;
- Whether promotions resulting in increases in pay are related to objective business need and not simply to increase payroll costs eligible for forgiveness; and
- Whether a change in compensation or additions to compensation are rationally related to a change in an employee's responsibilities or additional effort put forth by the employee.

Note that a salary or wage payment made during the Covered Period for hours worked during the Covered Period for the purpose of restoring a cut in an employee's pay rate, or for the purpose of paying an employee for hours they did not work due to a reduction in work hours, should be includible in eligible payroll costs. The basis for this conclusion is that a principal purpose of the PPP loan program is to keep employees employed at their full pay rate for their regularly scheduled number of work hours.

Sixth, the SBA has yet to address the scope of benefits that qualify as group health care coverage. From the quoted text above it is clear this includes employer-paid premiums for group health insurance. It is likely the term includes employer-paid premiums for group vision and dental insurance plans to the extent they are separate policies from a group health insurance plan.

However, it is unclear how employer payments to the following plans are treated:

- Qualified Small Employer Health Reimbursement Arrangements;
- Individual Coverage Health Reimbursement Arrangements;
- Excepted Benefit Health Reimbursement Arrangements; and
- Health Savings Accounts.

Seventh, it is clear that employer costs related to a self-insured health plan are includible. However, the SBA has not provided guidance regarding how these costs are to be computed.

Eighth, it is clear that “state and local taxes assessed on compensation of employees” includes state unemployment tax. In the absence of guidance to the contrary, it is likely this provision includes state programs such as California’s Employment Training Tax (ETT) and State Disability Insurance. New York’s disability insurance premium may be includible if it is incurred and paid during the Covered Period. However, New York’s paid family benefit amount may be paid by an employer or the employee and it is not clear that it is a tax. Therefore it is likely not includible. Finally, worker’s compensation insurance is not a tax assessed on employee compensation. Therefore, in the absence of guidance to the contrary, it is unlikely to be an includible expense.

### **Mortgage Interest**

Mortgage interest is includible so long as the mortgage giving rise to the interest was in place on February 15, 2020. Only interest is includible, not the principal payment portion of your mortgage payment or any prepayment of principal or interest. In addition to real property mortgages, the [Third Interim Final Rule](#) makes it clear that interest on a loan secured by equipment (e.g., an automobile, office equipment, manufacturing equipment) is an eligible expense.<sup>3</sup> Note that to be eligible for inclusion in forgivable expenditures, the mortgage or other loan must be an obligation of the applicant.

The SBA has yet to release guidance regarding mortgages or construction loans in existence on February 15, 2020 that were subsequently refinanced or converted to permanent mortgages after February 15, 2020.

### **Rent**

Rent is includible so long as the rental agreement was in place on February 15, 2020. This includes rent on real property and rent paid for the rental of equipment.<sup>4</sup> The SBA has yet to provide clarity as to whether payments for certain services billed by a landlord along with rent (e.g., property insurance) and sales tax are includible. Note that to be eligible for inclusion in forgivable expenditures, the lease agreement giving rise to the rent payment must be an obligation of the applicant.

While the SBA has not addressed this specific question, it is our belief that rent must be paid to a third party. It would be an aggressive position to treat an internal allocation that is characterized as “rent” (such as between a church and the church’s own preschool program that is not a separate legal entity) as rent for purposes of both a PPP loan application and an application for PPP loan forgiveness.

<sup>3</sup> Paycheck Protection Program, Third Interim Rule, ¶ III.d.iii, 85 Fed Reg. 21,747 (April 20, 2020); available at <https://home.treasury.gov/system/files/136/Interim-Final-Rule-Additional-Eligibility-Criteria-and-Requirements-for-Certain-Pledges-of-Loans.pdf>.

<sup>4</sup> Ibid.

## Utilities

Payments for the following utilities are included in forgivable PPP loan expenses:

- Electricity;
- Gas;
- Water;
- Transportation;
- Telephone (this should include cellphone contracts on which you are the contracting party); or
- Internet service.

The utility service must have been in place on February 15, 2020. The SBA has yet to provide a definition of what is includible in transportation costs. Further, the SBA has not stated whether sewer service, trash collection, cellphone allowances for bring-your-own-device programs, or allowances for home Internet service supporting work-from-home environments are allowable expenses.

Payments for church parsonage utilities have not been addressed in specific SBA guidance. It would appear that a reasonable argument could be made that these utilities are either part of the cash compensation paid to a minister (in which case they would count as payroll costs in satisfying the 75% payroll cost threshold) or as the payment of utilities on church property.

## Overview of the Application

The [application](#) is available on the Treasury Department website. The application will be filed with the lender servicing your organization's PPP loan at the time you submit your application; this may not be the lender from whom you received your loan. The lender may choose to use an electronic version of the application. It is unclear what degree of flexibility the lender will have to deviate from the SBA-published application, but you should expect they will be substantively the same. While the application is submitted to the lender, it is the SBA that will review the application and determine the loan forgiveness amount.

The application consists of:

- A core form (PPP Loan Forgiveness Calculation Form) that summarizes the component parts of the forgiveness calculation;
- A Schedule A that computes the payroll costs net of reductions;
- A Schedule A Worksheet that is used to compute full-time equivalent employees and the Salary/Wage Reduction amount; and
- A Borrower Demographic Form.

Only the core form and Schedule A are required to be filed. The Borrower Demographic Form is optional and does not appear applicable to nonprofit organizations.

## Certifications

As with the PPP Loan Application, the PPP Loan Forgiveness Application includes several certifications. A loan forgiveness applicant must make the following certifications:

- That the dollar amount for which loan forgiveness is being requested:
  - Was used for eligible expenses;
  - Takes into account applicable deductions for any decrease in full-time equivalent headcount and/or salary and wage reductions;
  - Does not include non-payroll costs in excess of 25% of the amount of loan forgiveness requested; and
  - In the case of any owner-employee, self-employed individual, or general partner does not include more than eight weeks' worth of 2019 compensation.
- That the applicant understands that the federal government may pursue recovery of loan amounts and/or pursue civil or criminal fraud charges if the applicant knowingly used PPP loan funds for unauthorized purposes.
- That the applicant has accurately verified the payments for the eligible payroll and non-payroll costs for which the applicant is requesting forgiveness.
- That the information contained in the PPP Loan Forgiveness Application and all supporting documentation and forms is true and correct in all material respects. Further, the applicant understands that knowingly making a false statement to obtain forgiveness of a PPP loan is punishable under the law by fines and/or imprisonment. (Depending on the federal statute violated, the fine may range from a fine of not more than \$5,000 to a fine of not more than \$1 million and the term of imprisonment may range from a term of two years to term of 30 years).
- That tax documents the applicant submitted to the lender are consistent with those the applicant has or will submit to the IRS and/or a state tax or workforce agency. This certification also serves as permission for the lender to share these documents with the SBA.
- That the applicant understands, acknowledges, and agrees that the SBA may request additional information for the purposes of evaluating the applicant's eligibility for both the PPP loan and for loan forgiveness. Further, a failure to provide additional information requested by the SBA may result in a determination that the applicant was ineligible for the PPP loan or a denial of loan forgiveness.

There are a few takeaways from reviewing these certifications. First, the focus is largely on the completeness and accuracy of the information supplied both on the face of the application and in supporting documentation.

Second, while the references to fines and civil or criminal fraud charges should be taken to heart, they are standard terms and should not make an applicant fearful.

Third, while in [FAQ 46](#) the SBA created a safe harbor around the good faith necessity certification in the PPP loan application for loans with original principal amounts of less than \$2 million, the SBA has reserved the right to review loan eligibility in conjunction with the loan forgiveness application for other reasons. Among the eligibility rules the SBA could review during the forgiveness process are:

- Whether the organization receiving a PPP loan had more than 500 employees, or alternatively, more than the number of employees specified in the size standard published by the SBA for the employer's industry (see [13 C.F.R. 121.201](#) and [FAQ 8 in Frequently Asked Questions for Faith-Based Organizations Participating in the Paycheck Protection Program and the Economic Injury Disaster Loan Program](#)); and
- Whether the organization properly applied the SBA affiliation rules (see the section on Affiliation below).

## Timing of Eligible Payroll Costs

The instructions state that eligible payroll costs are "payroll costs paid *and* payroll costs incurred during the eight-week (56-day) Covered Period..." (Emphasis added.) In addition, the instructions to Line 1 of the application state that the applicant should "Enter the total eligible payroll costs incurred *or* paid during the Covered Period or the Alternative Payroll Covered Period." (Emphasis added.)

There are two possible ways the quoted text above can be interpreted. First, the construction of the phrase "payroll costs paid *and* payroll costs incurred" can be read to be disjunctive. In other words, either condition may be satisfied

in determining whether a given payroll cost is eligible for forgiveness. This interpretation is bolstered by the repeated reference to “payroll costs” before the words “incurred” and “paid.” It is further bolstered by the use of the word “or” between the words “incurred” and “paid” in the instructions to line 1 of the application.

However, a second interpretation is that the use of the conjunction “and” in the phrase “payroll costs paid *and* payroll costs incurred” is conjunctive, meaning both conditions must be true at the same time. This interpretation is bolstered by a more nuanced reading of the instructions and highlighting these four points:

1. The instructions not only reference the eight-week Covered Period, but make a point of emphasizing that this period is 56 days in length.
2. The instructions clarify that “Payroll costs are considered incurred on the day that the employee’s pay is earned.” This appears to be a reference to the employee having actually worked on that day.
3. The instructions provide a workaround for payroll incurred (i.e., earned) but not paid during the 56-day Covered Period, by permitting such costs to be included so long as they are “paid on or before the next regular payroll date.”
4. If payroll costs could be “incurred” or “paid,” then there would be no reason to create the Alternative Payroll Covered Period because the combination of including payroll paid during the Covered Period and permitting the workaround for the last payroll period that concludes after the Covered Period would resolve the dilemma created by the Covered Period failing to align with pay periods.

Reading these four points together results in an interpretation that ensures that every employer that pays employees for 56 days of payroll qualifies for 56 days of payroll costs — and no more.

If the first interpretation described above is correct, it would create the perverse result that the number of days of payroll forgiveness would vary from employer to employer based on the number of days in a given employer’s pay periods and the date on which the employer’s PPP loans funds were initially disbursed. For example, assume the following facts:

- Employer A and Employer B each received their PPP loan funds on Monday, April 20, 2020.
- The Covered Period for each employer therefore concludes on Sunday, June 14, 2020.
- Employer A pays employees each week on Friday.
- Employer B pays employees bi-weekly on Fridays.
- Employer B’s next payroll date after April 20 is Friday, April 24.

If the first interpretation is correct, then both Employer A and Employer B would include their full payrolls paid on April 24, despite the fact that Employer B’s payroll covers seven more days than Employer A’s payroll.

Now fast forward to the end of the Covered Period. Because the Covered Period is an even number of week, the last payroll for both employer’s after Sunday, June 14 would occur on Friday June 19. Each employer would only include payroll paid on that Friday that is also incurred (i.e., earned). So both employers would include the same number of days of payroll costs on this end of the Covered Period.

The end result is that if first interpretation is correct, Employer B was able to include 65 days of payroll costs in the forgiveness amount while Employer A was able to include 58 days in the forgiveness amount.

In this article, we have assumed the second interpretation was correct.

## Managing the Covered Period

Much has been written about the Covered Period during which allowable payroll and non-payroll costs must be expended as specified in the CARES Act. The Covered Period commences on the date the lender first disbursed loan funds to the borrower.<sup>5</sup> The instructions to the application explicitly state the Covered Period includes the date of disbursement. To illustrate this point, the instructions describe a loan applicant whose PPP loan funds are disbursed on Monday, April 20, 2020. Thus the first day of the Covered Period is April 20 and the last (56<sup>th</sup>) day is Sunday, June 14, 2020.

The SBA has addressed the principal concerns regarding this time period in three significant ways.

### When Are Payroll Costs Incurred?

First, the instructions address the question of when payroll costs are incurred and when they are paid. Payroll costs are “incurred on the day the employee’s pay is earned.” Thus, if the Covered Period begins mid-pay period, only pay related to the days in the pay period that are also within the Covered Period are includible in payroll costs. (We will address the other end of the Covered Period in a moment.)

**Example.** A borrower’s Covered Period begins on April 20, 2020. Assume the next bi-weekly pay period end date (and therefore a payday) is Saturday, April 25, 2020. This means that pay earned on April 20-April 25 is includible in payroll costs during the Covered Period.

This definition of incurred also means that if payroll is paid in arrears, then a payday early within the Covered Period may cover no days for which pay was earned in the Covered Period. This also means that to be forgivable, PPP loan funds may not be used to pay back pay to workers.

**Example.** A borrower’s Covered Period begins on April 20, 2020. Assume the next *weekly* pay period end date (and therefore a payday) is Saturday, April 25, 2020. Pay for hourly workers is paid one week in arrears while salaried workers are paid for days worked during the pay period. This means that the pay period ending April 25, 2020 is paying hourly workers for hours worked during the week that began on April 12, 2020, and ended on April 18, 2020.

In this example, none of the pay to hourly workers paid on April 25, 2020 would be includible in payroll costs, while pay earned by salaried workers from Monday, April 20, 2020 through Saturday, April 25, 2020 would be includible.

To accommodate the fact that the Covered Period may *end* midway through a pay period, the instructions provide that all pay *earned* between the last pay period before the end of the Covered Period and the end of the Covered Period is includible in payroll costs and “eligible for forgiveness if paid on or before the next regular payroll date.”

**Example.** A borrower’s Covered Period begins on April 20, 2020 and ends on Sunday, June 14, 2020. Assume the borrower pays bi-weekly such that June 14 falls between its Saturday, June 6, 2020 and Saturday, June 20, 2020 payroll dates. In this scenario, all payroll earned through June 14, 2020 is includible and eligible for forgiveness so long as it is paid on the June 20, 2020 payroll date.

**Example.** Assume the same facts as the previous example, except further assume that the cutoff date for including hours worked by hourly workers in payroll is Saturday, June 13, 2020 such that hours worked on Sunday, June 14, 2020 will not be paid until the Saturday, July 4, 2020 payroll date. In this case, the pay earned on June 14, 2020 by hourly workers is includible in forgivable payroll costs so long as it is paid with the July 4, 2020 payroll.

### When Are Payroll Costs Paid?

The instructions clarify that “[p]ayroll costs are considered paid on the day that paychecks are distributed or the Borrower originates an ACH credit transaction.” This means that payroll is paid on the date when it is paid to employees and not on the date that funds are remitted to a payroll processing firm. Given the latitude described above for pay earned at the end of the Covered Period, this definition of “paid” should not result in hardship.

<sup>5</sup> “Paycheck Protection Program Loans Frequently Asked Questions,” FAQ 20, U.S. Treasury (May 13, 2020), available at <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf>.

## The Alternative Payroll Covered Period

The second way in which the SBA has responded to concerns regarding the Covered Period is to create an “Alternative Payroll Covered Period” that aligns with an employer’s pay periods. The Alternative Payroll Covered Period is only available to PPP loan forgiveness applicants that use a bi-weekly or more frequent payroll period. It begins on the first day of the first pay period that commences after the first PPP loan disbursement. As explained in the instructions:

[I]f the Borrower received its PPP loan proceeds on Monday, April 20, and the first day of its first pay period following its PPP loan disbursement is Sunday, April 26, the first day of the Alternative Payroll Covered Period is April 26 and the last day of the Alternative Payroll Covered Period is Saturday, June 20.

If the Alternative Payroll Covered Period is selected, it must be used consistently for all payroll-related calculations throughout the application. The Alternative Payroll Covered Period is only applicable to payroll costs; it is not permitted for non-payroll costs.

Note that selecting the Alternative Payroll Covered Period will simplify some of the payroll cost-related computations, but it will not alleviate issues with payroll paid in arrears as described above. If the Alternative Payroll Covered Period is selected, pay would have to be earned during the Alternative Payroll Covered Period to be incurred within the Alternative Payroll Covered Period.

## Treatment of Non-Payroll Related Costs

The third way in which the SBA has responded to concerns regarding the Covered Period is to permit the inclusion of non-payroll-related costs in forgivable expenditures so long as they are “incurred during the Covered Period and paid on or before the next regular billing date, even if the billing date is after the Covered Period.”

In addition, the instructions state that non-payroll costs “paid during the Covered Period” are includible, but fail to reference whether such costs must have been incurred during the Covered Period. This seems inconsistent with the statute and you should wait to see if the SBA addresses this question in further guidance.

While the ability to pay on the next regular billing date will assist in some cases, it does not address amounts that are paid in advance. For example, rent is generally paid in advance. As the rule is worded, a tenant that pays a quarterly rent payment in advance on April 1 and whose Covered Period begins and ends within the second calendar quarter (i.e., April 1 – June 30) would not meet the condition of incurring the expense within the Covered Period and paying for those incurred expenses on the next regularly scheduled billing date, i.e., July 1.

## How Is the 75% Payroll Cost Rule Applied?

The [First Interim Final Rule](#) requires that “[a]t least 75 percent of the expected forgiveness amount... be for payroll costs.” The PPP Loan Forgiveness Application mechanically applies this rule at Line 10 by dividing the total payroll costs reported on Line 1 by 0.75. The resulting amount is then compared to (a) the PPP loan amount and (b) the sum of payroll costs (adjusted by the salary/wage reduction amount and headcount reduction factor) and non-payroll costs. The smallest of these three amounts then becomes the loan forgiveness amount.

The bottom line is that you need to spend at least 75% of your total PPP loan includible expenditures on payroll.

**Example.** Assume the following:

PPP loan amount	\$100,000
Total payroll costs (before adjustments for salary/wage reduction or headcount adjustment factor)	\$70,000
Dollar amount of salary/wage reduction and headcount adjustment factor	\$10,000
Non-payroll costs	\$15,000

The three amounts to compare are:

PPP loan amount	\$100,000
Total payroll costs ÷ 0.75	\$93,333
Total forgivable payroll costs and non-payroll costs less salary/wage reduction and headcount adjustment factor	\$75,000

The smallest of the three amounts is \$75,000. Therefore this is the loan forgiveness amount.

Note that it is clear from the PPP Loan Forgiveness Application that a failure to use at least 75% of your loan proceeds for payroll costs will *not* result in the total forfeiture of loan forgiveness. It will only reduce the amount that will be forgiven.

## Salary and Wage Reduction Amount<sup>6</sup>

The Salary and Wage Reduction Amount (SWRA) considers whether an employee's annual salary or hourly wage during the Covered Period declined by more than 25% when compared to the period beginning on January 1, 2020 and ending on March 31, 2020 (the most recent full calendar quarter before the Covered Period).

For the purpose of this computation, exclude any employee who received during any pay period in 2019 more than \$100,000 in wages or salary on an annualized basis. Since this exclusionary rule applies to wages or salary, do not consider bonuses or other similar supplemental earnings when determining the applicability of the rule.

For reference, the table below shows the amount of gross wages or salary that equates to \$100,000 on an annualized basis:

Pay Period Frequency	Amount
Monthly	\$8,333.33
Semi-Monthly	\$4,166.67
Bi-Weekly	\$3,846.15
Weekly	\$1,923.08

The SWRA computation first looks at whether an employee's *rate of pay* has decreased by more than 25%. If an employee's rate of pay has changed by more than 25%, then the computation converts the amount of the decrease into a dollar amount.

**Example.** Consider the following employee roster and methods and rates of pay.

Employee	Method of Pay	Average Rate of Pay		
		Covered Period	Prior Calendar Qtr	Change in Rate of Pay
John	Salary	\$55,000/year	\$77,000/year	(28.57%)
Sue	Salary	\$85,000/year	\$90,000/year	(5.56%)
Ellen	Salary	\$65,000/year	\$65,000/year	0.00%
Mary	Hourly	\$17.50/hour	\$27.50/hour	(36.36%)
Bill	Hourly	\$22.00/hour	\$25.00/hour	(12.00%)
Steve	Hourly	\$23.00/hour	\$23.00/hour	0.00%

<sup>6</sup> This discussion represents our best interpretation of the ambiguous language in the instructions.

In this simple example, Sue, Ellen, Bill, and Steve experienced a decrease in average annual salary or hourly wage of less than 25%. Therefore, they do not contribute toward any salary and wage reduction amount. John and Mary, however, each suffered a greater than 25% decrease in their salary or hourly wage. Therefore, the next portion of the calculation must be performed.

	John	Mary
(a) Average rate of pay for prior quarter	\$77,000/year	\$27.50/hour
(b) 75% of Prior Calendar Qtr Rate of Pay	\$57,750/year	\$20.63/hour
(c) Average rate of pay for the Covered Period	\$55,000/year	\$17.50/ hour
(d) Row (b) less row (c)	\$2,750	\$3.13/hour
(e) For salaried workers, multiply the result in row (d) by 8 and divide the result by 52	$\$2,750 \times 8 \div 52 = \$423$	
(f) Average hours worked per week in the Prior Calendar Quarter		40
(g) Multiply the amount on row (f) by the amount on row (d)		\$125
(h) multiply the amount on row (g) by 8		\$1,002 <sup>7</sup>

In conclusion, the total salary reduction amount in this example is \$423 + \$1,002, or \$1,425.

Note that the instructions do not provide guidance on the following relevant points:

- How is the average annual salary or hourly wage computed for an employee who is hired during the first quarter?
- What is the effect on the computation of an employee's average annual salary or hourly wage when an employee is hired, furloughed, laid off, or terminated, with or without cause, during the Covered Period?

## Computing Full-time Equivalent Employees

The instructions provide the following process for computing full-time equivalent employees (FTEs)<sup>8</sup>:

1. For each employee, determine the number of hours paid each week during the period for which FTEs are being computed.
2. For each employee, compute the average number of hours paid per week during the relevant period.
3. For each employee, divide the amount from Step 2 by 40, rounding the result to the nearest tenth. The result should not be greater than 1. Then an employee who works on average more than 40 hours per week can never count as more than one employee.
4. Sum the amounts computed in Step 3.

Note that this computation looks at the number of hours for which you paid an employee. Accordingly, in the circumstance where an employee was kept on the payroll but was not performing services, they are included in the FTE computation based on the number of hours you chose to pay them.

The instructions provide a simplified method for completing the FTE calculation. In this version, an employee working at least 40 hours a week counts as 1 FTE, and an employee working less than 40 hours a week counts as 0.5 FTE. If you choose to use the simplified method, you must use it for all FTE calculations.

<sup>7</sup> This amount is different from  $\$125 \times 8 = \$1,000$  due to rounding.

<sup>8</sup> This is our best attempt to interpret the somewhat ambiguous text of the instructions.

If the number of employees in each category has been stable across all time periods, the simplified method should produce a comparable result that will not negatively affect the outcome of the various tests. However, if there is more than an insignificant amount of movement between employees working 40 or more hours per week and employees working fewer than 40 hours a week, you should avoid the simplified method.

**Example.** Assume an employer with seven employees. John, Sue, Ellen, and Sally are salaried employees who each work 40 hours per week. Mary is an hourly employee who works 40 hours a week while Bill and Steve are hourly employees who work less than 40 hours per week. Bill's hours are steady while Steve's vary from week to week. During the Covered Period, the hours worked for all seven employees are as follows.

Employee Name	Hours Worked Per Week								Avg. Hours Worked Per Week	Avg. FTEs Over Covered Period	
	Week 1	Week 2	Week 3	Week 4	Week 5	Week 6	Week 7	Week 8			
John	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	1.0
Sue	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	1.0
Ellen	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	1.0
Mary	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	1.0
Bill	25.00	25.00	25.00	25.00	25.00	25.00	25.00	25.00	25.00	25.00	0.6
Steve	12.00	15.00	10.00	14.00	17.00	20.00	12.00	15.00	14.38	14.38	0.4
Sally	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	40.00	1.0
<b>Totals:</b>	<b>237.00</b>	<b>240.00</b>	<b>235.00</b>	<b>239.00</b>	<b>242.00</b>	<b>245.00</b>	<b>237.00</b>	<b>240.00</b>	<b>239.38</b>	<b>6.0</b>	

In this example, there are seven employees, but this converts to six FTEs for the Covered Period. You will need to compute FTEs for at least five periods:

1. The Covered Period or, if elected, the Alternative Payroll Covered Period;
2. The reference period you select;
3. The payroll period that includes February 15, 2020;
4. The period February 15, 2020 through April 26, 2020; and
5. June 30, 2020.

Your payroll service provider may be able to perform these computations for you.

## Full-time Equivalent Reduction Quotient

The full-time equivalent reduction quotient (FTERQ) is an adjustment to the loan forgiveness amount. A careful reading of CARES Act section 1106(d)(2)(A) validates that the PPP Loan Forgiveness Application correctly applies the FTERQ to both payroll costs and non-payroll costs. The FTERQ is computed on Schedule A using Lines 11 through 13.

The FTERQ is computed by dividing the total average FTEs during the Covered Period by the total average FTEs during a reference period. The quotient may never be greater than 1.0. A borrower may choose between up to three different reference periods:

1. February 15, 2019 to June 30, 2019 (a period of 19 weeks);
2. January 1, 2020 to February 29, 2020 (a period of 9 weeks); or
3. (For seasonal employers only) any twelve-week consecutive period between May 1, 2019 and September 15, 2019.

**Example.** Assume the following FTE headcounts:

During the Covered Period 30.2

During the period February 15, 2019 to June 30, 2019 29.3

During the period January 1, 2020 to February 29, 2020 31.5

Using the February 15, 2019 to June 30, 2019 measurement period, the FTERQ is  $30.2 \div 29.3 = 1.03$ , which by rule converts to 1.0.

Using the January 1, 2020 to February 29, 2020 measurement period, FTERQ is  $30.2 \div 31.5 = 0.9587$ .

Because you have the choice of measurement periods, you would choose the February 15, 2019 to June 30, 2019 measurement period as this period results in no reduction of our loan forgiveness amount.

### **Full-time Equivalent Reduction Quotient Relief in Certain Cases**

The instructions provide for FTERQ relief in four instances:

1. Where an employer makes a good-faith, written offer to rehire an employee during the Covered Period and the employee declines, see [FAQ 40](#);
2. Where an employee is terminated for cause;
3. Where an employee voluntarily resigns (presumably this includes retirement); and
4. Where an employee voluntarily requests and receives a reduction in hours.

The nature of the relief is that you are permitted to include these employees in your FTE headcount for the Covered Period. However, if you replace an employee described in items 1 through 4, you are not allowed to include them in this FTE adjustment (because this would mean the position represented by the otherwise excepted employee would be double-counted).

Notably missing from this list is the normal annual temporary cessation of operations by a seasonal employer, preschool, or school.

### **FTE Reduction Safe Harbor**

The CARES Act provides a safe harbor for employers who decreased their FTE headcount at the outset of the COVID-19 pandemic and then restore headcount by June 30, 2020. You are eligible for this safe harbor if two conditions are met:

1. You had a decrease in your FTE headcount during the period February 15, 2020 through April 26, 2020; and
2. Your headcount on June 30, 2020 is greater than or equal to your headcount on February 15, 2020.

To calculate your eligibility for the FTE Reduction Safe Harbor, complete the following steps:

Step 1. Compute your FTE headcount for the payroll period that included February 15, 2020.

Step 2. Compute your FTE headcount for the period February 15, 2020 through April 26, 2020.

Step 3. If your FTE headcount in Step 1 is greater than your FTE headcount in Step 2, then you reduced your FTE headcount and you must demonstrate that you restored your FTE headcount to avoid a reduction in loan forgiveness. Therefore, proceed to Step 4.

Step 4. Compute your FTE headcount at June 30, 2020. If your FTE headcount at June 30, 2020 is greater than or equal to your FTE headcount in Step 1, then you are eligible for the FTE Reduction Safe Harbor and your loan forgiveness amount will not be reduced.

**Example.** Step 1. Your FTE headcount for the payroll period that includes February 15, 2020 is 30.2.

Step 2. Your FTE headcount for the 10-week period between February 15, 2020 and April 26, 2020 is 27.6.

Step 3. Because your FTE headcount in Step 2, 27.6, is less than your FTE headcount in Step 1, 30.2, you must go to Step 4 and compute your FTE headcount at June 30, 2020.

Step 4. Your FTE headcount at June 30, 2020 is 30.3. Because 30.3 is greater than the Step 1 FTE headcount of 30.2, you are eligible for the FTE Reduction Safe Harbor and your loan forgiveness amount is not reduced.

## What About Economic Injury Disaster Loan Advances?

The CARES Act specifies that the PPP loan forgiveness amount is reduced by any amount of an Economic Injury Disaster Loan (EIDL) advance you receive. The PPP Loan Forgiveness Application addresses this by capturing the amount of your EIDL advance and the EIDL application number assigned to you when you obtained your advance. But the instructions then include this cryptic statement, “If applicable, SBA will deduct EIDL Advance Amounts from the forgiveness amount remitted to the Lender.” Accordingly, if you enter an EIDL advance amount on your loan application, expect that the actual amount of your loan forgiveness will be the amount shown on Line 11 of the PPP Loan Forgiveness Application less the amount of your EIDL advance.

## What Happens if Your Loan is Not Fully Forgiven?

If your loan is not fully forgiven you have two options. First, you can repay the unforgiven part in full. There is no prepayment penalty, although you will likely have to pay interest at the annualized rate of 1% on the unforgiven balance from the date the loan disbursed until the date you pay the loan back. You will want to ask the lender servicing your loan for a loan payoff amount.

Second, you can choose to pay the unforgiven portion back over the remaining life of the loan. There is a potential trap here. If the loan repayment schedule is computed using the original principal balance of your loan, it is likely that (after the expiration of the loan deferral period) you will have large monthly payments due relative to the unforgiven balance. This will effectively mean the loan term is much shorter than the two-year term in the loan agreement.

## Required Documentation

The instructions to the PPP Loan Forgiveness Application include a detailed list of supporting documentation that should be gathered in support of your application. The instructions clarify documentation that must be submitted with the loan application, along with documentation that should be maintained by the applicant but is not required to be submitted. Significantly, applicants are instructed to maintain this documentation for a period of “six years after the date the loan is forgiven or repaid in full.” In addition, the documents are to be made available upon request to an authorized SBA representative or a representative of the SBA’s Office of Inspector General.

## Affiliate Relationships

The application requires organizations that, together with their affiliates, received PPP loans in the aggregate with an *original* principal balance of more than \$2 million to check a box. Presumably this means that an affiliate whose own original principal balance is less than \$2 million must check this box if it is a member of an affiliate group that borrowed more than \$2 million in the aggregate.

Note that in its [Second Interim Final Rule](#) (second IFR) published in the Federal Register on April 15, the SBA addressed the application of the affiliation rules to faith-based organizations. The SBA acknowledged “that the organizational structure of faith-based entities may itself be a matter of significant religious concern” and that Supreme Court precedents guarantee to faith-based organizations “the ‘power to decide for themselves, free from

state interference, matters of church government as well as those of faith and doctrine” (citing *Kedroff v. St. Nicholas Cathedral of Russian Orthodox Church in N. Am.*, 344 U.S. 94, 116 (1952)).

In addition, the Religious Freedom Restoration Act, together with Supreme Court, precedents, prevent the government from substantially burdening the exercise of religion without a compelling governmental interest. The SBA has determined that applying the SBA affiliation rules to faith-based organizations would impose a substantial burden without a compelling governmental interest.

For this reason, the affiliation rules:

... do not apply to the relationship of any church, convention or association of churches, or other faith-based organization or entity to any other person, group, organization, or entity that is based on a sincere religious teaching or belief or otherwise constitutes a part of the exercise of religion. This includes any relationship to a parent or subsidiary and other applicable aspects of organizational structure or form.

However, to avoid the application of the affiliation rule, a faith-based borrower must make a “reasonable, good-faith interpretation” that the affiliation rules should not apply to a given relationship because the relationship is “based on a sincere religious teaching or belief” or in some manner “constitutes a part of the exercise of religion.” The application of this standard to a church, or an association or convention of churches or their integrated auxiliaries, is likely to be more straightforward than its application to parachurch ministries.

## Outstanding Questions

The PPP Loan Forgiveness Application and instructions fail to address every question we’ve received and reinforce some of the structural issues inherent in the CARES Act.

For example, questions remain regarding:

- Whether it is permissible to include the cost of buying back accrued vacation in forgivable payroll costs
- Whether PPP loan proceeds can be used to make special, unscheduled employer retirement plan contributions and whether such retirement plan contributions are includible in forgivable payroll costs
- Whether a portion of rent paid in advance of the Covered Period for time periods contained within the Covered Period is a forgivable amount
- The manner in which the normal cessation of operations of preschools and schools before the conclusion of the Covered Period impacts the headcount reduction factor and salary/wage reduction amount

In addition, the effect of an eight-week (56-day) covered period on includible payroll costs makes it clear that two full months of pay will not be forgiven since only pay earned during the Covered Period is forgivable.

Please contact us at [info@capincrouse.com](mailto:info@capincrouse.com) with any questions. You can access articles, blog posts, recorded webcasts, and other COVID-19 resources [on our website](#).

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As a certified public accountant and tax counsel, Ted advises exempt organizations of all sizes on a wide range of issues. This includes consulting on tax and employee benefit related matters, representation before state and federal tax authorities, and assistance with firm audit or advisory engagements to formulate advice and counsel on important operating and tax issues. Ted also leads the firm's tax preparation practice, including IRS Forms 990 and 990-T and related state forms.

**Note: Although licensed to practice law in Indiana, Ted's services through CapinCrouse do not involve the practice of law and consequently do not result in the creation of an attorney-client relationship.**

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