

Mike O'Donnell
Executive Director
Colorado Lending Source
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A Deep Dive into the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) of 2020 - Part 1

The 880-page CARES Act contains many new rules and regulations designed to assist the broader US economy and slow the inevitable decline into recession caused by Covid-19 while laying the groundwork for a speedy economic recovery.

In this two-part series, I will focus on key aspects of the new legislation directly impacting small businesses and their employees.

The Act itself was signed into law by the President on Friday March 27 2020, although, as with all legislation, the implementation of the new rules and regulations won't be instantaneous, especially given the far-reaching nature of the new programs being created, some of them from scratch. There are still many details to be worked out before the benefits of the new legislation will flow through into the small business entrepreneurial eco-system although foreknowledge of what is to come will hopefully encourage hope that we can move through this crisis reasonably quickly.

In this first update, I am focusing on Title I of the Act which is called the ***Keeping American Workers Paid and Employed Act*** and specifically section 1102, which creates the ***Paycheck Protection Program***, along with section 1106, which provides for ***Loan Forgiveness***.

Paycheck Protection Program: Section 1102

The Paycheck Protection Program loan is a new variation on the U.S. Small Business Administration (SBA) 7(a) Loan Program / SBA Guarantee Loan Program, which allows a lender, usually a bank, to make a loan to a small business for an eligible business purpose with the SBA guaranteeing a percentage of that loan amount to minimize the risk to the lender of making that loan.

The final rules associated with how the new Paycheck Protection loans will ultimately operate are to be defined and proscribed by the SBA, and I present this caveat as I share this detailed write-up

with you. This is my own interpretation of how the program will operate and the SBA may interpret some of the sections differently.

Paycheck Protection (PP) loans will be available to small businesses, self-employed individuals, “gig economy” individuals, 501C3 nonprofit entities, 501C19 veteran organizations, and tribal businesses during the “covered period” of the Covid-19 crisis. The covered period for these loans is defined in the Act as beginning on February 15, 2020 and ending on June 30, 2020.

PP loans are uniquely different from regular SBA 7(a) loans for the following reasons:

- The maximum loan available is capped at 2.5 times the employer’s average monthly “payroll costs” during the last twelve months (there are special exceptions for seasonal employers) plus the outstanding balance of a loan received since 01/31/20 to help with payroll costs OR \$10 million, whichever is less;
- The maximum interest rate is 4.00%;
- There are NO borrower or bank fees, as there are with typical 7(a) loans;
To put that into perspective, a small business borrower would pay a SBA guarantee fee of \$138,125 on a typical \$5 million 7(a) loan.
- Personal guarantees are NOT required;
- Collateral is NOT required;
- PP loans will be fully deferred at funding for between six and twelve months;
- The bank receives a 100% guarantee from the SBA;
- There are NO prepayment penalties;
- There is NO “credit elsewhere” test;
- Nonprofit 501C3 organizations and veteran 501C19 organizations are eligible to apply for PP loans;
- A business can be too big for a regular 7(a) loan, but a PP loan can be made to a large and otherwise SBA-ineligible firm if it is in the accommodation and food services sector (NAICS code 72) and employs not more than 500 employees per physical location of the business; and,

- The affiliation test is waived under the PP program for firms in the accommodation and food services sector (NAICS code 72) with less than 500 employees, and it is also waived for franchises that have an assigned SBA franchise identifier code.

For the purpose of calculating a borrower's maximum loan amount under the PP program, the term "payroll costs" is defined in the Act as follows:

- For an **employer**, it is the sum of payments of any compensation with respect to employees that includes:
 - salary, wage, commission, or similar compensation;
 - payment of cash tips or equivalent;
 - payment for vacation, parental, family, medical, or sick leave;
 - allowance for dismissal or separation;
 - payment required for the provisions of group health care benefits, including insurance premiums;
 - payment of any retirement benefit; or
 - payment of State or local tax assessed on the compensation of employees.
- For a **sole proprietor** or **independent contractor**, it is the sum of payments of any compensation with respect to employees that includes:
 - wage, commission, income, net earnings from self-employment, or similar compensation and that is in an amount that is not more than \$100,000 in 1 year, as prorated for the covered period.
- For employers, sole proprietors and independent contractors, "payroll costs" **DO NOT** include:
 - the compensation of an individual employee with an annual salary in excess of \$100,000, as prorated for the covered period;
 - taxes imposed or withheld under chapters 21, 22, or 24 of the Internal Revenue Code of 1986 during the covered period;
 - any compensation of an employee whose principal place of residence is outside of the United States;
 - qualified sick leave wages for which a credit is allowed under section 7001 of the Families First Coronavirus Response Act (Public Law 116-127); or

- qualified family leave wages for which a credit is allowed under section 7003 of the Families First Coronavirus Response Act (Public Law 116-127).

For anyone applying for a PP loan, the first thing they need to do is collect and document the above information for the last twelve months so that they can establish their baseline average payroll cost number. This average payroll cost number *times* 2.5 establishes the threshold maximum loan amount possible.

Although the program is referred to as the Payroll Protection program, loan proceeds may assist a business with any of the following types of expenses:

1. payroll costs;
2. costs related to the continuation of group health care benefits during periods of paid sick, medical, or family leave, and insurance premiums;
3. employee salaries, commissions, cash tips, retirement contributions, or similar compensations;
4. payments of interest on any mortgage obligation (except for any prepayment of or payment of principal on a mortgage obligation);
5. rent (including rent under a lease agreement);
6. utilities; and
7. interest on any other debt obligations that were incurred before the covered period.

It is good to see that the Act requires the SBA to prioritize PP loans to small business concerns and entities in underserved and rural markets, including veterans and members of the military community, small businesses owned and controlled by socially and economically disadvantaged individuals, women, and businesses in operation for less than 2 years. We'll see how all that pans out.

PP loans will be available immediately after the final rules are released by the SBA and can be accessed through the more than 800 existing SBA-certified lenders nationwide, which includes banks, credit unions, and other financial institutions. The Act also requires the SBA Administrator and the Treasury Secretary to potentially bring additional lenders into the program if required,

which they will more than likely need to do given the incredibly short window potential borrowers have to apply for these loans and the overwhelming demand for needed assistance.

From the lender's perspective, in addition to understanding an applicant's average monthly payroll cost number, they must make sure that the borrower:

- was in operation on February 15, 2020; and
- had employees for whom the borrower paid salaries and payroll taxes; or paid independent contractors, as reported on a Form 1099-MISC.

From the borrower's perspective, in addition to documenting their average monthly payroll cost number, they will be asked to make good faith certifications:

- that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient;
- acknowledging that funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments;
- that the eligible recipient does not have a duplicate application pending for the same purposes; and
- during the period beginning on February 15, 2020 and ending on December 31, 2020, that the eligible recipient has not received amounts for the same purpose under any other loan.

To provide an incentive for lenders to participate in the program and make these loans available, the Act requires the SBA to reimburse lenders within five days of funding a PP loan, a one-time fee based on the loan amount. This fee equals:

- 5 percent, for loans of up to \$350,000;
- 3 percent, for loans of more than \$350,000 and less than \$2,000,000; and
- 1 percent, for loans of more than \$2,000,000.

The Act specifically states that anyone who has received an economic injury SBA disaster loan made during the period beginning on January 31, 2020 through the time PP loans become available, for a purpose other than paying payroll costs or the other obligations for which a PP loan is eligible, can also apply for a PP loan.

Loan Forgiveness: Section 1106

This never-before seen element of any small business legislation, ever, allows for the Paycheck Protection loans defined in section 1102 of the Act to be eligible to be **forgiven** in whole or part in an amount equal to the sum of the following costs incurred and payments made during the 8-week period beginning on the date of the origination of a PP loan:

- (1) Payroll costs.
- (2) Any payment of interest on any covered mortgage obligation, which the Act defines as any indebtedness or debt instrument incurred in the ordinary course of business that is (a) a liability of the borrower; (b) a mortgage on real or personal property; and (c) was incurred before February 15, 2020;
- (3) Any payment on any covered rent obligation, which the Act defines as any rent obligated under a leasing agreement in force before February 15, 2020;
- (4) Any covered utility payment, which the Act defines as any payment for a service for the distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020.

The amount of loan forgiveness can't exceed the amount borrowed, obviously, but the amount of forgiveness **will be reduced**, potentially, if there is a reduction in the number of employees OR a reduction of greater than 25% in wages paid to employees.

This is certainly worth emphasizing because the objective of the PP program is to encourage employers to rehire anyone they may have had to let go as a result of forced closures or an immediate downturn in sales because of the Covid-19 crisis.

The Act specifically states that there will be **NO reduction in forgiveness** related to reductions in employment and wages that occurred during the period 02/15/20 and 04/26/20 **IF** by June 30, 2020, the borrower has eliminated the reductions in employment and wages, and everything is back to the way it was on February 14, 2020. Please keep this in mind as you read through the next part of this article.

The Act provides several different ways to calculate the forgiveness reduction factor if there is a reduction in the number of employees and gives the borrower the option of choosing between two different calculation methods for determining this so that the borrower can choose the one that best minimizes or eliminates forgiveness reduction.

Option #1: Average Monthly Payroll Cost number used to apply for the PP loan

Multiplied by

Average Number of Full Time Equivalent Employees per month for the 8-week period beginning on the date of the origination of the PP loan

Divided by

Average Number of Full Time Equivalent Employees per month from **February 15, 2019 to June 30, 2019**

Using this option as an example, if your average monthly payroll cost number was \$50,000 and you have ten full time equivalent (FTE) employees per month on average during the 8 weeks after you get your PP loan, and you had an average of 12 FTEs per month last year between 02/15/19 and 06/30/19, the math would be: $(50,000 \times 10)/12 = 41,666 = 83.33\%$ of 50,000, which means that 83.33% of the amount you spent on payroll costs, interest on any covered mortgage obligation, covered rent obligation and covered utility payments during the 8-week period beginning on the date of the origination of your PP loan, would be forgiven. Your loan balance would be reduced accordingly, and you would continue to pay the balance of the loan over the term negotiated when the loan was put in place.

Option #2: Average Monthly Payroll Cost number used to apply for the PP loan

Multiplied by

Average Number of Full Time Equivalent Employees per month for the 8-week period beginning on the date of the origination of the PP loan

Divided by

Average Number of Full Time Equivalent Employees per month from **January 1, 2020 to February 15, 2020**

Under this option, if your average monthly payroll cost number was \$50,000 and you have FTEs per month on average during the 8 weeks after you get your PP loan, and you had an average of 10 FTEs per month between 01/01/20 and 02/15/20, the math would be: $(50,000 \times 10)/10 = 50,000 = 100\%$ of 50,000, which means that 100% of the amount you spent on payroll costs, interest on any covered mortgage obligation, covered rent obligation and covered utility payments during the 8-week period beginning on the date of the origination of a PP loan, would be forgiven in full.

For purposes of these calculations, the Act states that the average number of full-time equivalent employees (FTEs) will be determined by calculating the average number of full-time equivalent employees *for each pay period* falling within a month.

The forgiveness reduction factor related to a reduction of greater than 25% in wages paid to employees appears to be an equivalent dollar reduction amount. What the Act says is that if you pay employees (other than highly compensated employees making more than \$100,000 on an annualized basis in 2019) more than 25% less in the 8-week period beginning on the date the PP loan was funded, than you did during the most recent full quarter that they were employed, the difference will reduce how much of your loan is forgiven.

On the opposite side of the forgiveness scale, the Act allows that an employer with tipped employees may receive forgiveness for additional wages paid to those employees during that eight-week period after receiving a PP loan.

Of course, the borrower will need to assemble some documentation to apply for loan forgiveness from their lender, when they are ready to do so. This includes (and it is worth knowing this in advance):

- documentation verifying the number of full-time equivalent employees on payroll and pay rates for the different periods mentioned above, including:
 - payroll tax filings reported to the Internal Revenue Service; and
 - State income, payroll, and unemployment insurance filings;

- documentation, including 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;
- a certification that (1) documentation presented is true and correct, and (2) the amount for which forgiveness is requested was used to retain employees, make interest payments on a covered mortgage obligation, make payments on a covered rent obligation, or make covered utility payments; and
- any other documents the SBA might decide to add to this list once the rules are promulgated.

The lender has 60 days to verify and process the forgiveness request for the borrower and then the SBA has 90 days to reimburse the lender for the forgiveness amount plus any interest accrued through the date of payment.

All amounts forgiven will be considered canceled indebtedness, which is an important designation for borrowers because it won't be used against them by credit agencies. Equally as important for borrowers, any loan amounts forgiven under the CARES Act will NOT be taxed as income by the IRS.

This concludes my own assessment and analysis of sections 1102 and 1106 of the CARES Act. This ended up being a little longer more detailed than I anticipated but given the unprecedented breadth and scope of the Act, I wanted to ensure that any reader fully understand how this new legislation is intended to work and how it will hopefully help small businesses, self-employed individuals, "gig economy" individuals, 501C3 nonprofit entities, 501C19 veteran organizations, and tribal businesses navigate the worst economic crisis in the history of the United States since the Great Depression.