PPP Loans: Use of Proceeds and Forgiveness
NADA Updated Preliminary Guidance

Dealers are obtaining loans under the Paycheck Protection Program (PPP) and having those loans funded. The next set of questions confronting dealers involves what loan proceeds can be used for and whether and to what extent the loans, if used properly, can be forgiven. The following analysis seeks to provide direction on some of the central questions raised in this context.

This analysis has been updated to reflect the forgiveness application documents (Forgiveness Application) published by the Small Business Administration (SBA) and the Department of the Treasury (Treasury) on May 16, 2020. This analysis still contains a number of unanswered questions and open issues. As additional guidance is issued by SBA/Treasury, this analysis will be updated further.

Disclaimer *NADA believes that the analysis that follows will be correct. However, as noted, additional implementing guidance is expected from SBA and Treasury on many of the questions raised. Accordingly, this analysis will change over time with new information and developments. Until guidance confirming this analysis is forthcoming from the SBA, no definitive conclusions may be drawn.* *Furthermore, this analysis does not provide, and is not intended to constitute, legal advice. All content is for general informational purposes only. As necessary and appropriate, dealers should consult an attorney familiar with the federal, state and/or local laws at issue and with dealership operations to obtain advice with respect to any specific legal matters.*

- *Use of Loan Proceeds: For what expenses may the proceeds of PPP loans be used?*
    - *Expenses that are allowable uses*. The CARES Act states that PPP loan proceeds may be used to pay for the following expenses:[1]
        - Payroll Costs (salaries, wages and commissions below $100,000; leave benefits; health care benefits; retirement benefits; and state and local payroll taxes).
            - Health care benefits are payments by a borrower for employee health insurance, including employer contributions to a self-insured, employer-sponsored group health plan, but excluding any pre-tax or after-tax contributions by the employee.
                - Unresolved issue: Do health care benefits include payments for dental plans, health savings accounts, etc.?
        - Salaries and commissions that are excluded from Payroll Costs (e.g., compensation in excess of $100,000).

[1] The CARES Act also states that PPP proceeds may be used for other purposes generally allowed under SBA Section 7(a) programs. However, the SBA/Treasury PPP guidance states that at least 75% of the PPP loan proceeds must be used to cover Payroll Costs.

        - Rent (including rent under a lease agreement).
            - "Rent" includes amounts due on equipment leases and other leases of personal property.
        - Utilities.
            - Payments for the distribution of electricity, gas, water, transportation, telephone, and internet access.
                - Unresolved issue: What "transportation" means in this context.
        - Interest (but only interest) on any "mortgage" obligation.
        - Interest (but only interest) on any "other debt" obligations that were incurred before 2/15/20.
            - "Other debt" likely includes floorplan interest (but not curtailment) for inventory acquired before 2/15/20.
                - Unresolved issue: Whether "other debt" applies to floorplan interest on inventory acquired on or after 2/15/20.
    - *Time period for allowed use*.
        - The CARES Act suggests that the proceeds of a PPP loan are only to be used for the allowed expenses incurred from 2/15/20 through 6/30/20. However, the law also suggests that PPP loans may be originated until 6/30/20. Finally, the loan forgiveness provisions extend to expenses paid or incurred prior to 6/30/20 but do not contain a specific application cutoff.
            - Unresolved issue: It is unclear whether there is a 6/30/20 cutoff limitation on either the use of PPP loan proceeds or the availability of loan forgiveness.

- *Loan Forgiveness: What allowable uses are forgivable*?
    - *In general*. The loan proceed uses that qualify for loan forgiveness are a subset of the universe of allowable uses listed above, and a different time period is involved.
    - *Expenses eligible for forgiveness*. Under the CARES Act, PPP loan proceeds may be forgivable only to the extent they are used to pay for the following expenses within the relevant time period of use. As noted, these categories are subject to more restrictions, and therefore are (or may be) generally narrower, than the allowable uses listed above.
        - Payroll Costs ("Cash Compensation" below $100,000; health care benefits; retirement benefits; and state and local payroll taxes).

        - "Cash Compensation" is defined as paid or incurred gross salary, gross wages, gross tips, gross commissions, paid leave (vacation, family, medical or sick leave, but not including Families First Coronavirus Response Act leave), and allowances for dismissal or separation.

        - Health care benefits are payments by a borrower for employee health insurance, including employer contributions to a self-insured, employer-sponsored group health plan, but excluding any pre-tax or after-tax contributions by employees.

            - Unresolved issue: Do health care benefits include payments for dental plans, health savings accounts, etc.?

        - Retirement benefits include the total amount paid by a borrower for employer contributions to employee retirement plans but excluding any pre-tax or after-tax contributions by employees.

        - State and local payroll taxes include the total amount paid by a borrower for employer state and local taxes assessed on employee compensation (e.g., state unemployment insurance tax), but not including any taxes withheld from employee earnings.

    - Non-Payroll Costs.

        - Rent (on a leasing agreement in force before 2/15/2020).

            - "Rent" includes amounts due on equipment leases and other leases of personal property.

        - Utilities for which service began before 2/15/2020.

            - Payments for the distribution of electricity, gas, water, transportation, telephone, and internet access.

            - Unresolved issue: What "transportation" means in this context.

        - Interest (but only interest) on mortgages on real estate or personal property (originated before 2/15/2020).

            - Unresolved issue: Whether a floorplan line of credit qualifies as a "mortgage on . . . personal property."

- *Timing issues for forgivable uses*.

    - General: To qualify for forgiveness, PPP loan proceeds must generally be used for the foregoing expenses incurred, and payments made, during the 8 weeks immediately following initial disbursement of the funding of the loan (the "Covered Period").

    - Alternative Payroll Covered Period**:** For administrative convenience, a borrower with a biweekly (or more frequent) payroll schedule may elect to calculate eligible Payroll Costs using the eight-week (56-day) period that begins on the first day of its first pay period following initial disbursement of loan proceeds.

    - Timing of Payroll Costs: Payroll Costs are considered paid on the day paychecks are distributed or a borrower originates an ACH credit transaction. Payroll Costs are considered incurred on the day that an employee's pay is earned. Payroll Costs incurred but not paid during a borrower's last pay period of the Covered Period (or Alternative Payroll Covered Period) are eligible for forgiveness if paid on or before the next regular payroll date. Otherwise, Payroll Costs must be paid during the Covered Period (or Alternative Payroll Covered Period). Payroll Costs that were both paid and incurred may be counted only once.

        - Unresolved issue: Whether a borrower with multiple pay periods applicable to its employees may apply those multiple pay periods for PPP loan forgiveness purposes.

    - Timing of Non-Payroll Costs: Eligible Non-Payroll Costs must be paid during the Covered Period or 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. Non-Payroll Costs that were both paid and incurred may be counted only once.

- *Loan Forgiveness: What Triggers a Reduction in Loan Forgiveness?*

    - *Why has Congress set limits on the forgivable amounts to begin with*?

        - Congress created the PPP to put people back on the payroll, even if there is no work for those employees. Congress intended for people to get paid, even if hotel rooms are not occupied, if meals are not served, if cars are not sold or repairs are not made.

        - The extraordinary nature of this program is that the federal government is using private sector payroll departments to deliver a government benefit to employees. As a result, the level of loan forgiveness (in essence, the extent of the government grant) is heavily tied to Payroll Costs incurred over an 8-week period and is reduced based on certain payroll-related calculations.

- *<u>How are loan forgiveness reductions calculated?</u>*

    - <u>Types of loan forgiveness reduction</u>. Three types of events can trigger a reduction in the amount of loan forgiveness: 1) a reduction in employee pay level ("Pay Level Reduction Basis"); 2) a reduction in employee headcount ("Headcount Reduction Basis"); and 3) the use of more than 25% of loan proceeds for non-Payroll Cost expenses ("75%/25% Reduction Basis"). These three reduction types are described below along with some of the unresolved questions applicable to each.[2]

    - <u>Order of application of the forgiveness reduction bases</u>. In the Forgiveness Application, SBA/Treasury determined that the three reduction types are to be applied in the following order: first the Pay Level Reduction Basis, then the Headcount Reduction Basis, and finally the 75%/25% Reduction Basis.

        - <u>Pay Level Reduction Basis</u>

            - Generally, if employee pay levels go down during the Covered Period (or Alternative Payroll Covered Period) relative to the earlier measuring period, the dealer will have to reduce the level of forgiveness by a specific dollar amount.

                - <u>Unresolved issues</u>: Although SBA/Treasury have provided some guidance, this reduction basis remains confusing. Additional guidance from SBA is expected.

            - Calculation of the pay level forgiveness reduction **(Note: the following calculations are specific to individual employees**):

                - For each employee who is on a borrower's payroll at some point during the Covered Period (or Alternative Payroll Covered Period) determine the average annual salary or hourly wage rate paid to that employee for Q-1 of 2020. (This is the base level of salary and wages used to assess reductions based on pay level in comparison to the levels paid during the Covered Period (or Alternative Payroll Covered Period).)

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[2] An earlier version of this analysis employed different names for the three reduction bases. The old and new nomenclature is as follows:

<u>Former name</u>	<u>Current name</u>
Reduction Basis 1	Headcount Reduction Basis
Reduction Basis 2	Pay Level Reduction Basis
Reduction Basis 3	75%/25% Reduction Basis

The change in nomenclature aims to avoid confusion in light of the guidance in the Forgiveness Application regarding the order in which these three reduction bases are to be applied.

        - <u>But</u>, exclude any employee who earned an annualized pay rate of more than $100,000 in any single pay period in 2019.

    - For each employee not excluded, determine the average annual salary or hourly wage rate paid to that employee during the Covered Period (or Alternative Payroll Covered Period).

        - <u>Unresolved issue</u>: How to calculate the average annual salary or hourly wage rate of an employee who was on the borrower's payroll for only a portion of either the Q-1 of 2020 or the Covered Period (or Alternative Payroll Covered Period). It is assumed that the average will be calculated with reference only to the time worked, but guidance from SBA/Treasury is needed to definitively resolve this issue.

    - Utilizing the formula set out in the Forgiveness Application:

        - First, determine whether the amount of any employee's average annual salary or hourly wage rate deceased during the Covered Period (or Alternative Payroll Covered Period) by more than 25% of the average annual salary or hourly wage rate paid to that employee in Q-1 2020.

        - Then, calculate the dollar amount of any actual payroll payment reductions that resulted from a pay rate reduction in excess of 25%.

        - Then, reduce the amount eligible for forgiveness by that dollar amount.

- <u>Headcount Reduction Basis</u>

  - Generally, if a dealer's employee headcount is lower during the Covered Period (or Alternative Payroll Covered Period) relative to the chosen earlier measuring period, the dealer will receive a pro rata reduction in the overall amount of forgiveness.

  - Key terms for the determining headcount-based reductions (positions, <u>**not**</u> specific people):

    - Average Full-time Equivalents (AFTEs): the average number of full-time equivalent employees (FTEs) for each pay period falling within a month. An FTE involves 40 hours per week of work. Borrowers have two alternative options for calculating AFTEs but should consistently use the same method for all FTE-related calculations:

- Option 1: For each employee, enter the average number of hours paid per week, divide by 40, and round the total to the nearest tenth. The maximum for each employee is capped at 1.0.

- Option 2: Assign a 1.0 for employees who work 40 hours or more per week and 0.5 for employees who work fewer hours.

▪ Total Expenses: Loan proceeds used to pay Payroll Costs and other forgivable costs incurred or paid during the Covered Period (or Alternative Payroll Covered Period) less any amounts subtracted by virtue of the application of the Pay Level Reduction Basis (above).

o Calculation of the headcount-based forgiveness reduction:

▪ Compute both Options 1 and 2 and, to minimize the reduction amount, dealers will likely want to choose the higher of the two resulting percentages:

Option 1 AFTEs during Covered Period (or Alternative Payroll Covered Period) ÷ AFTEs during 2/15/19 to 6/30/19 = ____%

OR, at the borrower's option,

Option 2 AFTEs during Covered Period (or Alternative Payroll Covered Period) ÷ AFTEs during 1/1/20 to 2/29/20 = ____%

▪ Then apply the percentage chosen to the Total Expenses incurred as follows:

- Total Expenses X _% from Option 1 or 2 = $ ___

▪ The resulting dollar amount is the most that a dealer would be able to have forgiven.

- <u>Unresolved issue</u>: In calculating the amount of loan forgiveness reductions under the Headcount Reduction Basis, the Forgiveness

Application states that FTE reductions resulting from employees who during the Covered Period (or Alternative Payroll Covered Period) (1) decline re-hire offers, (2) are fired for cause, (3) voluntarily resign, or (4) request and are given a reduction in hours worked, will not operate to reduce the borrower's loan forgiveness. The Forgiveness Application is unclear on how these FTE reduction exceptions will be implemented, or whether other employment termination scenarios will be similarly treated.

- **Practical tip: To the extent possible, dealers should attempt to have on their payrolls during the Covered Period (or Alternative Payroll Covered Period) the same number of AFTEs as they did during whichever measuring period they choose. This could involve re-hiring employees previously terminated.**

- 75%/25% Reduction Basis

  - Generally, at least 75% of the PPP loan forgiveness must be for proceeds applied to Payroll Costs. In other words, Payroll Costs must account for at least 75% of the loan forgiveness.

  - Calculation of the 75%/25% Reduction Basis:

    - As indicated above, SBA/Treasury has now confirmed that the 75%/25% Reduction Basis will be applied last.

    - Utilizing the formula set out in the Forgiveness Application, determine whether the 75%/25% Reduction Basis requires additional reduction in the amount of loan forgiveness.

- *Loan Forgiveness Reduction Avoidance: If my anticipated loan forgiveness is subject to reduction, can I avoid any of those reductions in the amount forgivable*?

  - *In general*.

    - As described above, three types of events can trigger a reduction in the amount of loan forgiveness: 1) a reduction in employee pay levels, 2) a reduction in employee headcount, and 3) the use of more than 25% of loan proceeds for non-Payroll Cost expenses.

        - However, the CARES Act provides alternative means ("safe harbors") to avoid the loan forgiveness reductions that could result under the Headcount Reduction Basis and the Pay Level Reduction Basis.

        - In particular, the Act recognizes two "circumstances" in which otherwise mandated reductions in forgiveness will be avoided if headcount reductions or pay level reductions made during the period beginning on 2/15/20 and ending on 4/26/20 are eliminated by 6/30/2020.[3]

    - *SBA/Treasury implementation of forgiveness reduction avoidance*.

        - In general. Under the SBA/Treasury forgiveness reduction avoidance interpretation, Path One avoids forgiveness reductions based on headcount reductions and Path Two avoids forgiveness reductions based on pay level reductions. As a result, if a dealer is facing loan forgiveness reductions based on both headcount reductions and pay level reductions, both forgiveness reduction avoidance Paths will need to be present for the dealer to fully benefit.

        - Application of the two circumstances that avoid forgiveness reduction under the SBA/Treasury interpretation. A description of the two Paths to avoiding forgiveness reduction follows.

            - Path One – Headcount. To use the first Path, a borrower needs to follow the formula set out in the Forgiveness Application. This would, in effect, take that borrower through the following three step evaluation:

                - Count the number of FTEs the dealer had on its payroll on 2/15/2020 (the "2/15 Number");

                    - For purposes of this calculation, the Forgiveness Application provides that the number of FTEs on 2/15/2020 will be equal to the number of FTEs on the borrower's payroll during the pay period of which 2/15/2020 was a part.

                - Confirm that, at some point during the period beginning on 2/15/20 and ending on 4/26/20, the number of FTEs employed by the dealer dropped below the 2/15 Number; and

                - Ensure that the number of FTEs on the dealer's payroll on 6/30/20 is equal to or greater than 2/15 Number.

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[3] The provision of the CARES Act laying out these circumstances is subject to at least two interpretations as to how it will be implemented, and an earlier version of this analysis set out both interpretations. SBA/Treasury, however, has now clarified that what was identified as "the more conservative approach" in the earlier version is the one PPP borrowers will need to follow. Accordingly, the analysis in the text below walks dealers through the approach that SBA/Treasury has opted to follow.

  - If the number of FTEs on the dealer's payroll on 6/30/20 is equal to or greater than 2/15 Number, then the dealer would not be subject to any forgiveness reduction based on headcount.

- Path Two – Pay levels. To use the second Path, a borrower needs to follow the formula set out in the Forgiveness Application for each employee on its payroll during the Covered Period (or Alternative Payroll Covered Period) This would, in effect, take that borrower through the following three step evaluation:

  - Determine what the rate of pay for that employee was on 2/15/2020;

  - Confirm that the average rate of pay for that employee was reduced at some point during the period beginning on 2/15/20 and ending on 4/26/20; and

  - Ensure that as of 6/30/20 the average annual rate of pay for that employee (assuming he or she is still on the borrower's payroll) is equal to or greater than the annual rate of pay at which that person was paid on 2/15/20.[4]

  - If the circumstance described in the preceding bullet is true, then the borrower would not be subject to any forgiveness reduction based on pay levels.

  - Unresolved issue: The Forgiveness Application does not clearly address how borrowers are to perform pay level-based forgiveness reduction avoidance calculations for employees who voluntarily depart a borrower's employ during the Covered Period (or Alternative Payroll Covered Period) and are for that reason not on a borrower's payroll as of 6/30/2020. This is in contrast to the situation under Path One, where the Forgiveness Application addresses how to handle such departed employees.

[4] There is a possible alternative interpretation of Path Two that would require this step to be restated as follows: "Ensure that each employee who was on the dealer's payroll on 2/15/20 is also on the dealer's payroll on 6/30/20 and ensure that as of 6/30/2020 the average annual rate of pay for each of those employees is equal to or greater than the annual rate of pay at which that person was paid on 2/15/20." Of course, this alternative language would reduce the value of this avoidance path significantly. Until guidance is obtained from the SBA, it is not possible to know which interpretation is correct.

- *Loan Forgiveness Process and Documentation*

    - The Forgiveness Application provides guidance on how the forgiveness process will work:

        - First, forgiveness applications must be submitted by borrowers to their lenders and not to the government.

        - Second, unless a borrower is not subject to any forgiveness reduction under either the Pay Level Reduction Basis or the Headcount Reduction Basis, it is expected that borrowers will not begin to file forgiveness applications until after 6/30/2020. This is because most borrowers will likely want to see if they are able to avail themselves of the avoidance Paths described above, which will require information about the state of their payrolls as of 6/30/2020.

    - The Forgiveness Application also lists many of the documents that borrowers will need both to submit along with their formal applications and to retain for their own records.

        - Review carefully the documentation provisions of the Forgiveness Application.

        - The Forgiveness Application states that required documents must be preserved and retained for 6 years after a PPP loan is fully forgiven or paid in full.

Practical Tips to Minimize Loan Forgiveness Reduction

Based on the foregoing analysis, a dealer PPP loan borrower seeking to maximize its loan forgiveness should, to the extent possible, consider the follow practical tips:

1. Avoid reducing employee headcount or compensation during the Covered Period.

2. Try to ensure that at least 75% of the loan proceeds used to pay permitted expenses are used for Payroll Costs and that no more than 25% are used for non-Payroll Costs.

3. Headcount: Choose the Option that results in the lower number of AFTEs as the base number. If the average headcount at the end of the Covered Period is less than the base number, it may be possible to avoid any headcount-based forgiveness reduction if you restore any headcount reductions by 6/30/20.

4. Compensation: During the Covered Period (or Alternative Payroll Covered Period) avoid reducing the rate of compensation of any employee who earned less than $100,000 (annualized in 2019) by more than 25% of their rate of compensation in the first quarter of 2020. Also, it may be possible to avoid any pay level-based forgiveness reduction if you fully restore any rate of compensation reductions by 6/30/20.