

SBA Provides De Minimis Threshold on PPP Forgiveness Limits for Owner-Employees

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In an [Interim Final Rule](#) (IFR), the Small Business Administration (SBA) has revised its artificial limitations on payroll costs for “owner-employees” for Paycheck Protection Program (PPP) loan forgiveness with the adoption of a *de minimis* exception for employee-shareholders. 85 Fed. Reg. 52,881 (Aug. 27, 2020). However, that still may not cure the flaws inherent in the SBA’s interpretations that exceed its statutory authority. In addition, the SBA invented a new restriction on forgiveness for related-party rent and mortgage interest payments. Finally, the SBA has provided some clarifications for subleases and home office expenses. These most recent changes bring a measure of sanity to one part of the rules, while injecting greater complexity to other parts. The result may be further incentive for Congress to adopt automatic forgiveness for the vast majority of PPP loans.

Background

PPP loans, introduced under the Coronavirus Aid, Relief, and Economic Security (CARES) Act (Pub. L. No. 116-136),

provide relief to businesses under the economic burden of the coronavirus pandemic in the form of the federal government paying for certain costs (Covered Costs) of a small business over an eight-week period (the Eight-Week Period). Pub. L. No. 116-136, Div. A, Title I, §§ 1101-1114, and see [SBA FAQs, Eight Week Forgiveness Period](#). So long as the small businesses used the loan proceeds for qualifying purposes, the entire loan could be forgiven. As amended by the Paycheck Flexibility Program Flexibility Act (PPPFA), this eight-week period was extended to 24 weeks or December 31, 2020, whichever is first. Pub. L. No. 116-142, § 3.

The PPP program starts when an applicant secures a government guaranteed PPP loan from a lender in an amount equal to 2.5 times its average monthly *Payroll costs* (the PPP loan). The PPP loan is forgiven to the extent that the business uses the loan for *Covered Costs* over the 24-Week Period after the bank makes the first disbursement of loan proceeds. Reductions in employee headcount or salary also may reduce forgiveness of the PPP loan. Lane Powell’s [COVID-19 Resource Center](#) includes several articles summarizing PPP loans (as enacted and as revised by the SBA), as well as a [spreadsheet](#) for computing the amount and forgiveness components of PPP loans.

Owner-Employees Excluded if They Have Less Than Five Percent Equity Ownership

As we [previously wrote](#), the SBA created an artificial limit for PPP loan forgiveness attributable to amounts paid to “owner-employees” – a term the SBA never defined but subsequently indicated would include all shareholders who are also employees of the corporation borrowing the PPP funds. We have identified a number of ongoing questions

presented by the SBA's contortions to apply their owner-employee limitation in light of the longer 24-week covered period (allowed for paying or incurring forgivable costs under the PPPFA).

Businesses receive PPP loan forgiveness for payroll costs paid or incurred during the covered period, with cash compensation capped at \$100,000 annualized. Thus, for a 24-week covered period, the cap is \$46,154. However, the SBA imposed a limit on forgiveness attributable to compensation paid to owner-employees. The amount is equal to the lesser of:

- 5 months' worth of the specific owner-employee's 2019 compensation – or –
- \$20,833

The SBA described the owner-employee limit as necessary to prevent abuse – to stop owner-employees from laying off workers and using PPP funds to pay themselves. We criticize this explanation for several reasons, including how the SBA should have defined “owner-employee” by reference to some level of control or threshold ownership level.

In its latest IFR the SBA seems to agree that the limit should **not** apply to owner-employees that have a *de minimis* share ownership.

- **5% threshold.** A five percent ownership threshold is now required before triggering the special limits on forgivable payroll costs for owner-employees of a corporate borrower.
 - o The SBA has explained that this threshold “is intended to cover owner-employees who have no meaningful ability to influence decisions over how loan proceeds are allocated.” Obviously, it is unclear whether a five percent owner could have such an influence. Although we can quibble with whether five percent is an appropriate threshold for irrefutably presuming that the individual has control over staffing decisions or their own pay, this *de minimis* exception is a welcome development.
 - o There is still no guidance of how to determine the five percent stake. Is it determined by voting rights? Value? Is ownership by related parties attributed to the owner-employee?
- **C and S corporations, and LLCs taxed as corporations.** This threshold applies to owner-employees of both C and S corporations, including LLCs that have elected to be taxed as corporations.

We note that this *de minimis* exception does not alter our conclusion that *any* reduction in forgiveness attributable to compensation paid to owner-employees (other than

the \$100,000 cap applicable to all employees) exceeds the statutory authority granted by the enabling legislation, and may be arbitrary and capricious. We also conclude that the forgiveness limit on compensation paid to owner-employees is meaningless for most borrowers now that the PPPFA expanded the period for paying or incurring forgivable expenses from eight to 24 weeks.

Related Party Payments: Rent Now Limited and Mortgage Interest No Longer a Forgivable Expense

Costs that support PPP loan forgiveness include rent paid pursuant to a lease in force before February 15, and interest on indebtedness incurred in the ordinary course of business before February 15 that is secured by a mortgage on real or personal property. In an earlier PPP loan [article](#), we noted that “[n]othing in the CARES Act appears to disqualify rent paid to a related person.” Although we did not say the same about mortgage interest, nothing in the CARES Act appears to disqualify mortgage interest paid to a related person.

Many small businesses rent their property from some or all of their owners. Other small businesses pay mortgage interest to related parties. For purposes of computing qualified forgiveness expenses, the CARES Act does not distinguish between rent or mortgage interest paid to a related party from similar payments paid to an unrelated party. Rather, the enabling legislation protects against abuse by requiring, as a condition of forgiveness, that the rent or mortgage interest be paid pursuant to leases or mortgages in effect before February 15, when COVID-19 began to brutalize our economy and triggered the enactment of the CARES Act.

New Limitations

The SBA now fears that Congress' approach to preventing abuse was insufficient, so it has invented new limitations for related party rent and mortgage interest:

- Forgivable rent payments to a related party are now capped at “the amount of mortgage interest owed on the property [by the related party] during the Covered Period that is attributable to the space being rented by the business.”
 - o Thus, the PPP borrower paying rent to a related party now needs to know the amount of mortgage interest paid by the related party during the covered period, and then somehow apportion such interest between space directly used in the borrower's business and

space sublet to others. It is unclear whether sublets to related parties should be treated differently and whether it should make a difference if the subtenant has their own PPP loan.

- o The SBA provides no guidance for determining the interest attributable to the rented space – is it based on square footage, relative fair market value of the space, share of total rent, something else? Hopefully, any reasonable basis for allocation should survive scrutiny.
- “[M]ortgage interest payments to a related party are not eligible for forgiveness.”

Imposing these new limitations so late in the PPP process, without any statutory authority, will undoubtedly frustrate the reasonable expectations and planning for many borrowers – at least until impacted borrowers challenge these new rules in the courts.

In justifying these new limits, the SBA asserts, without any support:

“PPP loans are intended to help businesses cover certain nonpayroll obligations **that are owed to third parties, not payments to a business’s owner** that occur because of how the business is structured. This will maintain equitable treatment between a business owner that holds property in a separate entity and one that holds the property in the same entity as its business operations.” (Emphasis added.) 85 Fed. Reg. 52,882.

This explanation makes little sense. Rent and mortgage interest remains fully forgivable if paid to an unrelated party. Those same payments now result in less forgiveness or no forgiveness if paid to a related party. Thus, two businesses paying the same, fair market value, rent or mortgage interest can have different forgiveness depending on the recipient and the extent to which the recipient has debt on the property.

Further, if Congress had intended to limit forgivable rent and mortgage interest payments to those made to third parties, it could have easily done so. There are myriad examples of Congress imposing limitations on related party transactions. Accordingly, we expect that the SBA’s explanation will not prevent the rule from being successfully challenged in the courts as exceeding interpretive authority of the SBA.

The SBA did provide a seemingly simple rule for determining whether parties are related for these purposes: “Any ownership in common between the business and the

property owner is a related party for these purposes.” Like many seemingly simple rules, however, application can be complicated, silly or unfair.

- For example, the rule makes no sense for mortgage interest because the business (*i.e.*, the PPP loan borrower) is the property owner.
- The SBA’s simple rule does not incorporate attribution or constructive ownership rules. For example, is a business owned by one person related to an entity owned by the person’s spouse or children? Is the SBA really worried more about a one percent overlap in ownership by one individual than it is by 100% overlap by family members?
- For entities owned by a trust, does “ownership” refer to legal ownership (trustee) or equitable ownership (beneficiary)? Do the grantor trust rules impact this determination, e.g., what happens if the property is owned by a revocable living trust of which one business owner is the trustee?

Adjustment to Rent for Space Leased to Sub-tenants

The new IFR also imposes other limitations on sub-leased space. Forgivable nonpayroll costs (mortgage interest, rent and utilities) exclude any amount attributable to the business operation of a tenant or sub-tenant of the PPP borrower or, for home-based businesses, household expenses. The IFR provides an example for each nonpayroll cost and one for home office nonpayroll costs to illustrate the application of this new rule.

Frankly, precluding forgiveness for expenses attributable to non-business expenditures seems logical, and we do not challenge its wisdom. We simply note that this latest IFR adds complexity for many borrowers and lacks statutory support. These new rules also come very late in the process, after some borrowers have even submitted their forgiveness applications. Finally, the abuse this rule is aimed at preventing seems far more theoretical than real. For example, assume a PPP borrower has a qualifying lease to a third party and that such lease includes several parking spaces normally subleased to employees. Now the PPP borrower presumably has to figure out what portion of its main lease payments constitutes forgiveness-qualified rent. (This determination becomes even more complicated for mortgage interest on property subleased out because it is based on “the percent share of the fair market value of the space that is not leased out to other businesses.”)

Summary

The most recent IFR brings some sanity to the SBA's efforts to limit forgiveness for amounts paid to owner-employees, though greater sanity could have been achieved by simply repealing the limitation on payments to owner-employees. More significantly, this latest IFR also adds additional complexity when computing the forgivable amount of qualifying rent and mortgage interest — and it does so very late in the PPP administration process and without statutory authority based on questionable logic.

There is a silver lining. Every additional bit of complexity added by the SBA likely increases support in Congress for providing automatic forgiveness (on a one-page form) for PPP loans under a certain threshold (currently \$150,000 is seen as a reasonable threshold because that will cover a little over 70 percent of all PPP loans). That said, we anticipate that PPP borrowers seeking to avail themselves of such a simplified forgiveness process will be expected to certify that they are entitled to full forgiveness based on all of the PPP rules published by the SBA. Of course, most borrowers will make that certification with the same thoughtful consideration they apply when accepting the terms of service for new apps.

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- [Pratt's Journal of Bankruptcy Law 16-4-VI "The CARES Act: Paycheck Protection Program Provides Historic Relief for Small Businesses"](#)
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