May 28, 2020 Publication

PPP Loan Forgiveness: SBA Invents New Limits on 'Owner-Employees'

COVID-19 Resource

Updated June 4

The Small Business Administration (SBA) has provided generally business-friendly interpretations of the CARES Act provisions for forgiveness of paycheck protection program (PPP) loans, as we discussed in this article. Notwithstanding their generally sound and borrower-friendly guidance, there is one area this article discusses one area in which the SBA has adopted a different and novel approach: A special, more restrictive, interpretation of payroll costs for *owner-employees* of the businesses that received PPP loans. Special treatment for owner-employees was suggested in the loan forgiveness application and outlined in its May 22 Interim Final Rule (IFR). Although we applaud SBA efforts to prevent abuse, we fear this new undefined category of "owner-employees" will create more confusion than it seems to be worth.

Self-Employed Owners Under Previous IFRs

In an earlier IFR published in the Federal Register on April 20, the SBA (and Treasury Department) addressed three topics, the first of which concerned PPP loans received by businesses of self-employed owners – that is Schedule C filers (sole proprietors) and partners. In that IFR, the SBA confirmed that PPP loans could include "owner compensation replacement." However, the IFR also included a new cap on forgiveness "calculated based on 2019 net profit * * *, with forgiveness of such amounts limited to eight weeks' worth (8/52) of 2019 net profit." In this discussion of forgiveness, the IFR referred to "owners." The context

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indicated that "owners" referred to sole proprietors and partners. The topic of the questions answered in this portion of the IFR was labeled "Individuals with Self-Employment Income *Who File a Form 1040 Schedule C*," (emphasis added). The earlier IFR never used the term "owner-employees."

The loan forgiveness application incorporates the 8/52 limitation described in the April 20 IFR in line 9 of the PPP Schedule A. However, the SBA, without explanation, now subjects a new type of owner to the limitation invented in the April 20 IFR: "owner-employees." That is, while the April 20 IFR only discussed Schedule C files and general partners, Line 9 of PPP Schedule A is for "owner-employees, a self-employed individual, or general partners." There is no explanation in the application of when an employee falls into this new category of "owner-employee" so we initially thought that the SBA was using some sort of short hand to pick up all sole proprietors and "1099 contractors."

New Category for Owner-Employees

But in its IFR released on May 22 (the fourteenth IFR issued by the SBA), the SBA continues the confusion started in the application by providing different forgiveness treatment for compensation paid to (1) "owner-employees," (2) "Schedule C filers" and (3) "general partners." The IFR uses the term *owner-employee* without acknowledging that they have invented a new category, and thus may not appreciate the number of new questions it presents. It would have been better if the SBA had been able to explain the new category and its support in PPP lore or law.

Before we examine the owner-employee concept further, it is worth placing the discussion in context for those who haven't dedicated the last few weeks to reading the PPP tea leaves as they drop from the SBA's website. Payroll costs paid or incurred by a business during the eight-week period for determining forgivable costs generally include (1) cash compensation capped at $15,385 per employee; (2) employer contributions for retirement and healthcare, which have no cap; and (3) state and local taxes assessed on employee compensation. Further, for employees who are not owners, businesses generally can increase payroll cost by paying additional compensation (subject to the $15,385 cap) or increasing contributions for retirement and healthcare.

As described in this article, however, the SBA does not allow for these increases for owners and achieves this result by inventing and imposing an additional limitation on each of the three types of owners:

- Owner-employee: Payroll costs related to compensation during the eight-week period are capped at 8/52 of 2019 total compensation (*i.e.*, cash compensation and benefits). This amount includes employer contributions for retirement and healthcare, but incorporates a limitation based on 2019 total compensation.

- Schedule C Filer: Payroll costs related to compensation during the eight-week period are capped at 8/52 of 2019 net profit. This amount does not include contributions for retirement and healthcare and incorporates a limitation based on 2019 total compensation.

- General Partners: Payroll costs related to compensation during the eight-week period are capped at 8/52 of 2019 net earnings from self-employment (reduced by claimed section 179 expense deduction, unreimbursed partnership expenses, and depletion from oil and gas properties) multiplied by 0.9235. This amount does not include contributions for retirement and healthcare and incorporates a limitation based on 2019 total compensation.

Importantly, each of these caps excludes state and local taxes assessed on employee compensation. The SBA has yet to explain the basis for excluding from its definition of payroll costs an item explicitly included by Congress in its definition of that term.

SBA Rationale & Our Critique

The SBA explained its reason for excluding retirement and healthcare contributions from payroll costs for Schedule C filers and general partners in the May 22 IFR:

“No additional forgiveness is provided for retirement or health insurance contributions for self-employed individuals, including Schedule C filers and general partners, as such expenses are paid out of their net self-employment income.”

We do not find fault with this position. Indeed, we appreciate that the April 20 IFR explained the rationale for the "8/52 of 2019 net" cap for Schedule C filers:

For individuals with self-employment income who file a Schedule C, the Administrator, in consultation with the Secretary, has determined that it is appropriate to limit loan forgiveness to a proportionate eight-week share of 2019 net profit, as reflected in the individual's 2019 Form 1040 Schedule C. This is because many self-employed individuals have few of the overhead expenses that qualify for forgiveness under the Act. For example, many such individuals operate out of either their homes, vehicles or sheds and thus do not incur qualifying mortgage interest, rent or utility payments. As a result, most of their receipts will constitute net income. Allowing such a self-employed individual to treat the full amount of a PPP loan as net income would result in a windfall. The entire amount of the PPP loan (a maximum of 2.5 times monthly payroll costs) would be forgiven even though Congress designed this program to limit forgiveness to certain eligible expenses incurred in an eight-week covered period. Limiting forgiveness to eight weeks of net profit from the owner's 2019 Form 1040 Schedule C is consistent with the structure of the Act, which provides for loan forgiveness based on eight weeks of expenditures. This limitation will also help to ensure that the finite appropriations are directed toward payroll protection, consistent with the Act's central objective.

In the May 22 IFR, the SBA neither reiterates nor expands on this justification. Nor does it indicate that these reasons apply to partners.[1] Regardless, the logic is apparent and the rule consistent with respect to sole proprietors and partners whose 2019 self-employment earnings generally were used to determine the amount of payroll costs that served as the basis for determining the amount of the PPP loan itself.[2]

In contrast, compensation paid to owner-employees of corporate borrowers was treated the same as payroll costs paid to any employees when determining the PPP loan amount, and the prior-articulated rationale for partners and shareholders is not necessarily correct or appropriate when applied to owner-employees who are shareholders of corporations.[3]

For example, before the introduction of an owner-employee classification, we knew the answers to the following questions:

1. What if an owner-employee works more hours or in a different position with a different salary than they did in 2019?

2. What if an owner-employee was not an owner in 2019 but is in 2020?

3. What if an owner was not an employee in 2019 but is in 2020?

4. What if the owner-employee was not eligible to participate in the retirement plan in 2019 but is in 2020, or vice versa?

Now we await additional SBA guidance to answer these and similar questions.

As described above, the SBA was concerned with PPP loans resulting in a "windfall" for sole proprietors. That is, that sole proprietors (and presumably partnerships) with low non-payroll costs theoretically could use PPP loan proceeds to line their pockets (subject to the $15,385 cap). It is the paycheck **protection** program, not the paycheck **enhancement** program.

However, the SBA's additional limits for owner-employees is harder to understand. As an initial matter, the SBA never defines this term. The terms "Schedule C filers" and "general partners" are self-explanatory. "Owner-employee," on the other hand, is far less clear and does not appear in the CARES Act.[4] One could simply define the term as any employee who also is a shareholder of a C corporation or S corporation for tax purposes because it is well-established that an owner cannot be an "employee" of a sole proprietorship and a partner cannot be an "employee" of a partnership. Although this has superficial appeal, it quickly becomes as absurd as defining a hot dog as a flaming canine. Many employees of corporate businesses own some equity in the business. But those owner-employees may have only a small or nominal ownership interest with no control over management, or their ownership interest may be via restricted stock that has not vested, or the stock owned by the employee may be nonvoting, etc. Imposing an additional limitation on these employees does not seem fair – or implementable – at least not without some meaningful guidance. Indeed, if the SBA is concerned about potential abuse, employees who happen to own non-controlling shares, but have no management authority, could not make abusive decisions.

Further, there is no basis in the CARES Act for disparate treatment of employees depending on ownership of a corporate borrower. Although we have seen on several occasions that the SBA does not feel bound by the language of the enabling statute, most of those regulatory changes fall into two categories: (i) promote the articulated purpose of the CARES Act even if they deviate from the actual language or (ii) facilitate administrative convenience for borrowers.[5]

Implications

We are not simply noting a procedural footfall by the SBA. Creating and imposing a limitation not based on the CARES Act has real implications. For example, because the SBA now discriminates against employees who happen to own shares of the business's stock, the business now has to identify these employees and undertake special calculations for these employees — possibly penalizing employers who have enabled employees to participate in ownership. These are significant burdens at a time when the business should be focusing on safely reopening. They are also particularly egregious when the borrower has already made business decisions such as how much to pay employees who are working extra hard during these difficult times and to sell additional shares to some employees to raise capital to support operations.

The cap of 8/52 of "employee cash compensation and employer retirement and health care contributions" has an additional fundamental flaw: it only kicks in for lower-income owner-employees. This can be demonstrated by comparing two hypothetical businesses, each with one owner-employee. For Business 1, owner-employee, Joe, received total compensation in 2019 of $125,000, consisting of $90,000 of a salary, $20,000 of employer contributions for healthcare and $15,000 of employer contributions for retirement. For Business 2, owner-employee, Thurston, received total compensation of $360,000, consisting of $300,000 of salary, $20,000 of employer contributions for healthcare and $40,000 of employer contributions for retirement. For 2020, Joe and Thurston each received a $10,000 raise and an additional $5,000 retirement contribution. In addition, the healthcare premium increased for each by $2,000.

Absent the 8/52 cap, the forgiveness for Joe is $21,846.54 and the forgiveness for Thurston is $25,692.69 — the $3,846.15 difference results entirely from the $25,000 difference between the retirement contributions ($25,000 * 8/52 = $3,846.15). The 8/52 cap **reduces** the forgiveness for Joe to $19,230.77 ($125,000 * 8/52). The 8/52 cap has **no impact** on forgiveness for Thurston because 8/52 of Thurston's 2019 total compensation is $55,384.62, well above the normal forgivable amount. It is inconceivable that the SBA intended to discriminate in favor of the wealthy.

We hope that the SBA will reconsider its position on employer-owners or at least explain what the rationale so we have a basis for understanding how to apply this new concept.

Unanswered Questions

In the meantime, query whether the following employees should be classified as owners-employees:

1. An employee who holds .01 percent of the equity; is the answer different if the employee owns three percent or 49 percent.

2. An employee who holds one percent non-voting shares; is the answer different if the employee owns 49 percent or 51 percent of the equity but has no vote; is the answer different if the bylaws give non-voting shareholders negative covenants to block certain actions.

3. An employee who owns phantom stock or a stock appreciation right (SAR).

4. An employee whose parents own 100 percent of stock.

5. An employee with unvested options or vested options not yet exercised.

6. An employee with unvested restricted stock; is the answer different if the stock is considered vested for tax purposes by reason of an IRC § 83(b) election.

7. An employee whose spouse owns the stock (or options or phantom equity contemplated above) — as community property; is the answer

different if the property is separate property or held in a state without community property or if the employee owns shares sometime during the eight-week forgiveness period because their spouse just died and left them their stock or who just shared the stock via a martial gift.

8. An employee who acquired his/her interest on January 1 of this year but who was a non-owner employee last year or who was not even an employee last year.

9. An employee of a company owned by an ESOT or ESOP where the employee is also a beneficiary of the plan.

In sum, good writers do not introduce a new character late in a novel without any explanation of why that character is needed thematically or to further the plot. Accordingly, we are perplexed by this new category of owner-employee and wonder whether the SBA has inadvertently opened a Pandora's Box of new issues. Absent further clarification of scope, intent and rationale, we suspect many corporate PPP borrowers and their advisors may feel comfortable relying on the only definition of owner-employee available to them (in IRC Section 401(c)(3); see footnote 4) when completing their forgiveness applications, and that definition excludes shareholder-employees.

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1 We note that the CARES Act appeared to exclude partners from PPP loans. In the April 20 IFR, the SBA allowed partnerships to include a partner's self-employment income as part of the partnership's payroll costs. We are thus hesitant to be too critical of limitations on forgiveness with respect to PPP loan amounts that arguably were not authorized in the first place.

2 As we suggested here, sole proprietors and partners effectively receive their PPP forgiveness tax free (because there is no tax deduction involved) whereas owner-employees of corporate borrowers are taxed on their PPP forgiveness when they receive their compensation and the borrower business is denied a tax deduction.

3 E.g., shareholder-employees of a corporate borrower generally had their health insurance paid by their employer, and thus did not pay such cost out of their net income from self-employment.

4 The term “owner-employee” is used in IRC Section 401(c)(3) (relating to qualified retirement plans) to refer to sole proprietors and 10 percent partners. It is certainly possible that the SBA was thinking of this definition. If so, it would be most helpful for the SBA to include a cross reference, especially since that definition is expressly limited in application to IRC Section 401. Such a cross-reference would eliminate the consternation expressed in this article.

5 For example, the SBA capped the total forgivable amount at payroll costs divided by 75 percent. Similarly, the SBA allowed borrowers to select an alternative eight week period that accomplished the statutory objective with less complexity. In each of those cases, the SBA provided a rational justification for their position, even though Congress is poised to alter both rules via the PPPFA, discussed here.