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INSIGHT

SBA's Paycheck Protection Program (PPP) Loans and Self-Employed Individuals

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To provide short-term, economic relief to certain small businesses and nonprofits, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act; P.L. 116-136) created the Small Business Administration's (SBA's) Paycheck Protection Program (PPP).

On April 14, 2020, SBA issued an Interim Final Rule (IFR) detailing how the PPP will be applied in the case of self-employed individuals (e.g., sole proprietors and partnerships, with and without employees, and independent contractors). The IFR supplements SBA's previously issued PPP rules and guidance that have been coordinated with the Department of the Treasury. This Insight describes PPP-related statutes, regulations, and guidance that apply to self-employed individuals.

Eligibility

In addition to the general PPP eligibility criteria, self-employed individuals can apply for a PPP loan if

(1) they were in operation on February 15, 2020;

(2) they had self-employment income (e.g., an independent contractor or a sole proprietor);

(3) their principal place of residence is in the United States; and

(4) they have filed or will file a 2019 Form 1040 Schedule C.

SBA is to issue additional guidance for those individuals with self-employment income who (1) were not in operation in 2019 but were in operation on February 15, 2020, and (2) will file a Form 1040 Schedule C for 2020.

Partners may not file separate PPP loan applications for themselves. Instead, the self-employment income of "general active partners" may be reported as a payroll cost, up to $100,000 annualized per person on a PPP loan application filed by or on behalf of the partnership. The April 14 IFR does not define a "general active partner," but this term could be intended to distinguish between those who actively participate in the day-to-day management and business activities compared to a limited partner, who does not. Further, the April 14 IFR does not define "self-employment income" of general active partners with precise references to lines on partnership tax forms. Some tax practitioners have commented that partners should

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include the amount listed on line 14 ("Self-employment earnings") of their Schedule K-1, Form 1065 for the purposes of "payroll costs." Further guidance might be needed.

As per regulations, independent contractors are not included in the PPP loans of other businesses (e.g., their clients or the business that provides them with work). Independent contractors must file their own PPP application. Additionally, self-employed individuals with more than one eligible business must roll all of their expenses into a single PPP loan application.

Loan Amount Calculation

Step 1 in the PPP loan calculation depends on whether or not the self-employed individual has employees.

- For self-employed individuals *with no employees*, take the 2019 IRS Form 1040 Schedule C line 31 net profit amount (even if the individual has not yet filed a 2019 return, they must fill it out and compute the value). If this amount is over $100,000, reduce it to $100,000.
- For self-employed individuals *with employees*, compute 2019 payroll costs by adding 2019 IRS Form 1040 Schedule C line 31 net profit amount (up to $100,000 annualized), plus certain forms of employee compensation detailed in the April 14 IFR (pp. 7-8).

After Step 1, the remaining steps are the same for all self-employed individuals:

- Step 2: Divide the amount from Step 1 by 12 to determine the average monthly amount.
- Step 3: Multiply the average monthly amount from Step 2 by 2.5. This amount cannot exceed $10 million.
- Step 4: If applicable, add the outstanding amount of any SBA Economic Injury Disaster Loan (EIDL) made between January 31, 2020, and April 3, 2020, to be refinanced, less the amount of any advance under an EIDL COVID-19 loan (because the advance does not have to be repaid).

Use of PPP Loan Proceeds

PPP loan amounts can be used for "owner compensation replacement," calculated based on the 2019 net profit and the other allowable uses listed in the CARES Act (e.g., employee payroll costs, and certain business expenses). The April 14 IFR (p. 10) limits self-employed individuals to using their PPP loans only for types of allowable uses for which the borrower made expenditures in 2019. This includes up to $100,000 of annualized pay per employee and for the self-employed business owner for eight weeks (a maximum of $15,385 per individual). Owner compensation replacement for self-employed individuals is based on the amount they paid themselves in 2019.

Under earlier regulations still in force, if the borrower wants the maximum amount of loan forgiveness available, then no more than 25% of the loan amount can be used for non-"payroll costs."

PPP Loan Forgiveness

Up to eight weeks' worth of eligible expenses, including principal and accrued interest, can be forgiven. By regulation, payments on interest and principal are deferred for the first six months of the loan, though. Thus, PPP borrowers might not have to make any payments before applying for forgiveness.

For self-employed individuals *with no employees*, the April 14 IFR (pp. 12-13) limits forgivable expenses of owner compensation replacement to eight weeks of their 2019 average net profit calculation (described in Step 1, above, under "Loan Amount Calculation"), or a maximum of $15,385. The April 14 IFR (pp. 13-14) contains more information on the documents that the borrower must provide to substantiate their application for forgiveness.

For self-employed individuals *with employees*, the two-part formulas specified in the CARES Act determine whether the amount of forgiveness will be reduced. Broadly speaking, these formulas reduce the amount to be forgiven if the business does not maintain employment or salaries at certain levels. Specifically, if the business (1) does not maintain at least the same number of full-time equivalent employees during defined time periods; or (2) decreases salaries and wages by more than 25% for any employee that makes less than $100,000 annualized in 2019 during the eight-week period after the loan's origination date, then the forgiven amount is reduced. For any amounts not forgiven, the terms of the loan are 1% interest rate for a term of two years.

There is ambiguous and potentially contradictory language in the April 14 IFR (for example, see p. 12) as to whether forgiveness for self-employed individuals is limited solely based on owner compensation replacement or whether it can include nonpayroll costs. This could potentially be a drafting error, as it would imply that self-employed individuals could not claim forgiveness for expenses related to employee compensation, rent, utilities, etc.

As of the publication date of this Insight, SBA has not provided detailed guidance on how the PPP forgiveness process will work. According to the CARES Act, borrowers must apply to their lender for forgiveness and provide documentation substantiating their actual expenses during the eight-week period after disbursement of their PPP loan. They must also certify that they used the loan proceeds only for eligible purposes. The SBA Administrator may issue further regulations on documentation requirements. The CARES Act requires lenders to issue a decision no later than 60 days after receiving an application for loan forgiveness. The SBA Administrator is required to remit to the lender an amount equal to the forgiveness, plus any interest accrued through the date of payment not later than 90 days after the date on which the forgiveness amount is determined.

Under the CARES Act, forgiven loan amounts are not to be included in the borrower's taxable gross income. Otherwise, this type of "cancellation of indebtedness income" would be subject to income tax.

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