

Reproduced with permission. Published July 14, 2020. Copyright © 2020 The Bureau of National Affairs, Inc. 800-372-1033. For further use, please visit <https://www.bloombergindustry.com/copyright-and-usage-guidelines-copyright/>

INSIGHT: Loan Forgiveness for Payroll Costs for Owner-Employees



BY LEWIS HOROWITZ AND ERIC KODESCH

The Small Business Administration (SBA), which has generally provided business-friendly interpretations regarding forgiveness of paycheck protection program (PPP) loans, has made one aspect even more complex with updates to its guidance for special treatment of the payroll costs for owner-employees—a category wholly created by SBA and outside of the enabling legislation.

Although we have consistently applauded most of SBA's efforts, as discussed in this [article](#), we have [lamented](#) how the SBA created this new category but never really illuminated the concept. Unfortunately, the SBA has doubled down by reaffirming and complexifying the special treatment of owner-employees in its [revised forgiveness application](#) and [instructions](#), and its [18th IFR](#) and [19th IFR](#), which the SBA issued to update its guidance in light of the Paycheck Protection Program Flexibility Act (PPPFA).

With an eight-week covered period, the SBA capped forgivable payroll costs of owner-employees at 8/52 of 2019 compensation. Although the PPPFA increased the covered period to 24 weeks, the SBA did not increase this cap to 24/52 of 2019 compensation. Instead, the SBA only increased the cap to 2.5 months of 2019 compensation—the PPP loan amount received with respect to compensation paid to the owner-employees. However, none of the recently issued guidance explains when a shareholder of a corporate borrower should be characterized as an “owner-employee.”

This article examines the special treatment for owner-employees, describes the special limitations applicable to their payroll costs, and presents examples of questions that remain unanswered. Consideration of forgiveness computations for sole proprietorships and general partners of borrowers that are tax partnerships (including most LLCs) generally is beyond the scope of this article.

IFRs issued in connection with the PPPFA.

On June 22, the SBA provided the following guidance in the 19th IFR (emphasis added):

“Part III.3.c of the First Loan Forgiveness Rule (85 FR 33004, 33006) is revised to read as follows:

c. Are there caps on the amount of loan forgiveness available for owner employees and self-employed individuals' own payroll compensation?

Yes. For borrowers that received a PPP loan before June 5, 2020 and elect to use an eight-week covered period, the amount of loan forgiveness requested for owner-employees and self-employed individuals' payroll compensation is capped at eight weeks' worth (8/52) of 2019 compensation (i.e., approximately 15.38 percent of 2019 compensation) or \$15,385 per individual, whichever is less, in total across all businesses. For all other borrowers, the amount of loan forgiveness requested for owner-employees and self-employed individuals' payroll compensation is capped at 2.5 months' worth (2.5/12) of 2019 compensation (i.e., approximately 20.83 percent of 2019 compensation) or \$20,833 per individual, whichever is less, in total across all businesses. **In particular, C-corporation owner-employees are capped by the amount of their 2019 employee cash compensation and employer retirement and health insurance contributions made on their behalf. S-corporation owner-employees are capped by the amount of their 2019 employee cash compensation and employer retirement contributions made on their behalf, but employer health insurance contributions made on their behalf cannot be separately added because those payments are already included in their employee cash compensation.** Schedule C or F filers are capped by the amount of their owner compensation replacement, calculated based on 2019 net profit. [See

85 FR 21747, 21749 (April 20, 2020).] General partners are capped by the amount of their 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. For self-employed individuals, including Schedule C or F filers and general partners, retirement and health insurance contributions are included in their net self-employment income and therefore cannot be separately added to their payroll calculation.

The Administrator, in consultation with the Secretary, determined that it is appropriate to limit the forgiveness of owner compensation to either eight weeks' worth (8/52) of their 2019 compensation (up to \$15,385) for an eight-week covered period or 2.5 months' worth (2.5/12) of their 2019 compensation (up to \$20,833) for a 24-week covered period per owner in total across all businesses. This approach is consistent with the structure of the CARES Act and its overarching focus on keeping workers paid, and will prevent windfalls that Congress did not intend. Specifically, Congress determined that the maximum loan amount is generally based on 2.5 months of a borrower's average monthly payroll costs during the one-year period preceding the loan. 15 U.S.C. 636(a)(36)(E). For example, a borrower with one other employee would receive a 4 See 85 FR 21747, 21749 (April 20, 2020). 15 maximum loan amount equal to 5 months of payroll (2.5 months of payroll for the owner plus 2.5 months of payroll for the employee). If the owner laid off the employee and availed itself of the exemption in the Paycheck Protection Program Flexibility Act of 2020 (Flexibility Act) related to reductions in business activity described in e. below, the owner could treat the entire amount of the PPP loan as payroll, with the entire loan being forgiven. This would not only result in a windfall for the owner, by providing the owner with five months of payroll instead of 2.5 months, but also defeat the purpose of the CARES Act of protecting the paycheck of the employee. For owners with no employees, this limitation will have no effect, because the maximum loan amount for such borrowers already includes only 2.5 months of their payroll."

What the SBA Is Saying

Again, focusing only on owner-employees that are shareholders of corporations (which we will entitle "shareholder-employees" to reduce confusion), we learn that payroll costs attributable to their compensation is capped at different amounts (and different formulae) depending on whether the borrower elects to use the original eight-week covered period or the 24-week covered period provided by the PPPFA.

If a business uses the eight-week covered period, then forgiveness attributable to compensation paid to shareholder-employees is capped at the lesser of (1) eight weeks (8/52) of 2019 compensation (i.e., approximately 15.38% of 2019 compensation) or (2) \$15,385 per individual plus eight weeks of 2019 employer retirement contribution and, if the borrower is a C corporation, 2019 employer healthcare contributions, in total across all businesses that received PPP loans.

If a business uses the 24-week covered period, then forgiveness attributable to compensation paid to shareholder-employees is capped at the lesser of (1) 2.5 months (2.5/12) of 2019 annualized compensation (i.e.,

approximately 20.83% of 2019 compensation) or (2) \$20,833 per individual plus 2.5 months of 2019 employer retirement contribution and, if the borrower is a C corporation, 2019 employer healthcare contributions, in total across all businesses that received PPP loans.

Problems with the Special Limit for Shareholder-Employees

As a threshold matter, this shareholder-employee limit applies across all businesses, so that the cap may be significantly less than the PPP loan received by the business with respect to the 2019 payroll costs paid to the shareholder-employee. For example, an individual could be a shareholder-employee of multiple businesses that acquired a PPP loan (either a single loan as an affiliated group or separate loans). The PPP loan(s) would include the separate compensation paid by each business, subject to the \$100,000 cap on cash compensation. However, the forgivable payroll costs of these businesses with respect to the shareholder-employee are collectively limited to the single cap.

This raises the question of how, in seeking forgiveness, to allocate that limit among the businesses (assuming each business knows that the individual is a shareholder-employee of other businesses). Divvying the limit pro rata in accordance with compensation paid by each during the covered period may make sense, but only if each business knows the amount paid by the other. However, even this is fraught with questions. For example:

- Do the businesses allocate the limit based on actual cash compensation or cash compensation capped at \$100,000? For instance, if one business paid the shareholder-employee \$300,000/year and another business paid the shareholder-employee \$60,000 per year, is the allocation 80% to the first business (300/360) and 20% to the second business (\$60/360), or 62.5% to the first business (100/160) and 37.5% (50/160) to the second?

- Do you exclude amounts associated with 2020 raises when undertaking the allocation?

The SBA's use of 2.5 months of 2019 compensation as a cap for forgiveness presents a more fundamental flaw. We understand the rationale behind this cap: the SBA seeks to limit the forgiveness for an owner's payroll costs to the PPP loan amount the business received with respect to the owner. The SBA also has provided, in the 19th IFR, an example of the type of abuse it seeks to prevent:

"For example, a borrower with one other employee would receive a maximum loan amount equal to five months of payroll (2.5 months of payroll for the owner plus 2.5 months of payroll for the employee). If the owner laid off the employee and availed itself of the safe harbor in the Flexibility Act from reductions in loan forgiveness for a borrower that is unable to return to the same level of business activity the business was operating at before February 15, 2020, the owner could treat the entire amount of the PPP loan as payroll, with the entire loan being forgiven. This would not only result in a windfall for the owner, by providing the owner with five months of payroll instead of 2.5 months, but also defeat the purpose of the CARES Act of protecting the paycheck of the employee."

We question the validity of this example as justification for the rule. After all, this type of planning would

not have worked before the PPPFA given the SBA's cap on the forgivable amount of payroll costs over eight weeks divided by 75%. Also, an owner willing to fire an employee to claim all of the PPP loan as the owner's own compensation could achieve the same result by replacing the fired employee with a spouse or other family member (assuming the family member actually provides services that justify the compensation level). Even when we suspend our disbelief for purposes of this article, the example assumes a level of managerial control that many shareholder-employees often do not possess.

Indeed, the example itself highlights the problem with the SBA imposing a limit on "owner-employees" without defining the term. If the SBA imposed the limit to prevent the abuse described in the example, the SBA should have defined "owner-employee" by reference to some level of control or threshold ownership level. For example, for the [PPP loan application](#) and eligibility requirements discussed in the [1st IFR](#), a 20% threshold applies. Although a 20% shareholder-employee may not have sufficient management control to manipulate payroll as suggested by the example used to justify this rule, at least it would have avoided painting all shareholder-employees with the same brush. (SBA, if you are listening, it's not too late to use this 20% threshold for triggering the special cap for owner-employees!)

Unfortunately, the SBA does not provide any ownership threshold for applying the forgiveness cap on compensation of shareholder employees. However, as noted above, the SBA excludes employer-provided healthcare costs from the forgivable payroll costs of shareholder-employees of an S corporation "because those payments are already included in their employee cash compensation." Pursuant to tax code [Section 1372](#), as amended, this inclusion only applies to shareholder-employees of an S corporation that own 2% or more of the corporation. Accordingly, the SBA may be using a 2% minimum ownership threshold to trigger this reduced cap. If so, we hope the SBA articulates this *de minimis* limit more clearly.

This absence of an explicit threshold leaves open questions about whether the following employees should be classified as owners-employees:

- An employee who holds .01% of the equity. Query whether the answer is or should be different if the employee owns 3% or 49%.
- An employee who holds 1% non-voting shares; is the answer different if the employee owns 49% or 51% of the equity but has no vote; is the answer different if the bylaws give non-voting shareholders negative covenants to block certain actions.
- An employee who owns phantom stock or a stock appreciation right (SAR).
- An employee whose parents or siblings own 100% of stock.
- An employee with unvested options or vested options not yet exercised.
- An employee with unvested restricted stock; is the answer different if the stock is considered vested for tax purposes by reason of an tax code [Section 83\(b\) election](#).
- 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 forgiveness period because their spouse just

died and left them their stock or who just shared the stock via a marital gift.

- An employee who acquired his/her interest in 2020 but who was a non-owner employee last year, or who was not even an employee last year.
- An employee whose job responsibilities or hours have changed materially between 2019 and 2020.
- An employee of a company owned by an employee share ownership trust (ESOT) or employee stock ownership plan (ESOP) where the employee is also a beneficiary of the plan.

These issues call into question whether a special cap on owner-employees is even administrable. Not to mention whether the SBA has now inserted a good deal of unnecessary complexity to avoid only a small (and largely theoretical) risk that PPP funds might be forgiven for the "wrong reasons"—particularly when most PPP borrowers will easily secure full forgiveness anyway given the 24 week covered period and lowered 60% threshold for payroll costs under the PPPFA.

Even assuming that a corporation can make the necessary calculations for the cap for its shareholder-employees, a more fundamental issue emerges: there is no statutory basis for a special limit on shareholder-employees.

Nothing in the CARES Act as originally passed, or as amended by the PPPFA, limits forgiveness for the payroll costs paid to, or incurred for, an employee to that employee's 2019 compensation or the amount of the PPP loan. Similarly, nothing in the law allows for disparate treatment of forgiveness for an employee, depending on whether the employee happens to own stock of the corporation. We speculate (always dangerous) that no such limits were ever contemplated because the annualized \$100,000 cap provided the tool necessary to prevent manipulations by shareholder employees of the type feared in the SBA's example discussed above.

Further, Congress passed the PPPFA *after* the SBA issued the 14th IFR with the special cap on owner-employees. The SBA used the length of the covered period (at the time, eight weeks) as the numerator of the 8/52 ratio used for the cap. By extending the covered period to 24 weeks, Congress presumably intended to change the ratio for the cap to 24/52. Indeed, the SBA followed Congress's lead with respect to computing forgivable cash compensation for other employees—increasing it from 8/52 of \$100,000 (\$15,385) to 24/52 of \$100,000 (\$46,154). Unfortunately, rather than make the same adjustment to its cap on shareholder-employees, the SBA invented a new cap based on 2.5 months of 2019 compensation.

We would like to see the SBA eliminate the special cap for shareholder-employees. Elimination of the cap would eliminate both unnecessary complexity and the need for addressing the questions above. Failing that, we would like to see the SBA define the term owner-employee in the corporate context to employees who own directly, or by attribution under tax code [Section 318](#), 50% or more of the total outstanding shares entitled to vote. Such a limit would be a better targeted approach to the perceived problem.

Since the inception of the PPP, people have questioned whether PPP loans constitute a grant or a loan. The PPPFA, along with the other, pro-business, guidance from the SBA, has significantly reduced the barriers to full forgiveness (*i.e.*, the PPP loan is effectively a grant subject to use restrictions). The special cap on

forgivable payroll costs for shareholder-employees is an outlier. At this point, we do not know if it will have a material impact on forgiveness. We also do not know how the SBA will attempt to administer the cap in its review of forgiveness determinations issued by banks or in an audit. However, we anticipate litigation by any businesses denied full forgiveness because of this cap. Although all litigation depends on the facts and circumstances for the case, we believe that these businesses will have a strong argument based on current law.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Lewis M. Horowitz is a shareholder and taxation team chair at Lane Powell.

Eric Kodesch is a shareholder at Lane Powell and counsels clients on a wide array of federal income tax, and state and local tax issues in both transactional and litigation matters.