

Better Late Than Never(?): The SBA Issues Second Interim Final Rule on Paycheck Protection Program Implementation

Corporate and Securities Alert | April 20, 2020

By: Ryan J. Udell and Adam Chelminiak

On April 15, 2020, the U.S. Small Business Administration (SBA) released a second interim final rule (the Second Rule) announcing SBA's formal interpretation of the implementation of the Paycheck Protection Program (PPP), which was created by Sections 1102 and 1106 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The Second Rule supplements SBA's first interim final rule (the Initial Rule).

The Second Rule focuses primarily on individuals with self-employment income and partnerships. While this guidance provides welcome clarity in a number of areas that the CARES Act and previous SBA releases had not addressed, it also creates additional confusion in the case of partnerships that have already applied for PPP loans prior to the release of the Second Rule. Moreover, and of significant importance for all PPP loan recipients, the limitations introduced with respect to loan forgiveness for self-employed individuals suggest that pending SBA guidance on PPP loan forgiveness may contain some unanticipated requirements.

This alert outlines the key points addressed in the Second Rule.

Eligible Self-Employed Individuals. Individuals with self-employment income are eligible for a PPP loan if the individual:

1. was in operation on February 15, 2020;
2. is an individual with self-employment income (such as an independent contractor or sole proprietor);
3. has a principal place of residence in the United States; and
4. filed, or will file, a Form 1040 Schedule C for 2019.

Per the Second Rule, expenses incurred between January 1, 2020 and February 14, 2020 (which by definition will not be reflected on the borrower's 2019 Form 1040 Schedule C) may not be considered because of the lack of verifiable documentation for these periods. The Second Rule suggests that the SBA will issue additional guidance for individuals who were not in operation in 2019 but were in operation on February 15, 2020.

Loan Amount. Self-employed individuals that have no employees should determine their maximum loan amount by (i) dividing the net profit amount listed on line 31 of the applicant's 2019 Form 1040 Schedule C (up to \$100,000) by 12 (to determine the average monthly net profit amount) and (ii) multiplying that average monthly net profit amount by 2.5. The Second Rule refers to the amount calculated in the preceding sentence as the "Owner Compensation Replacement."

Self-employed individuals with employees, however, determine their maximum loan amount as (A) the sum of (i) the individual's Owner Compensation Replacement, plus (ii) 2019 gross wages and tips the individual paid to employees whose principal place of residence is in the U.S. (up to \$100,000 annualized per employee), plus any pre-tax employee contributions for health insurance or other fringe benefits excluded from taxable Medicare wages and tips, plus (iii) 2019 employer health insurance contributions, retirement contributions, and state and local taxes assessed on employee compensation, multiplied by (B) 2.5.

Whether or not the self-employed individual has employees, the amount of any Economic Injury Disaster Loan (EIDL) to be refinanced should be added to the self-employed individual's maximum loan amount and the amount of any EIDL advance should be subtracted. If any proceeds from an EIDL loan were used for payroll costs, the PPP loan must be used to refinance the EIDL loan. As is the case with all PPP borrowers, a self-employed individual's eligibility for a PPP loan is not affected if the EIDL loan was not used for payroll costs.

Permitted Uses by Self-Employed Individuals. PPP loan proceeds may be used by a self-employed individual for:

1. the self-employed individual's compensation replacement (based on 2019 Schedule C net profits);
2. employee payroll costs;
3. mortgage interest payments (but not prepayment or principal payments) on any business mortgage obligation, business rent payments, business utility payments; and
4. interest payments on debt obligations incurred before February 15, 2020 (but the Second Rule provides that any amounts used for such purpose are not eligible for PPP loan forgiveness).

However, the Second Rule further limits a self-employed individual's use of PPP loan proceeds to those allowable uses listed above for which the borrower made expenditures in 2019. SBA states that this limitation is required to support the applicant's required certification that the loan is necessary to "support the ongoing operations" of the borrower (as opposed to business expansion).

Furthermore, as with other PPP loan recipients, at least 75% of the PPP loan proceeds (including refinanced EIDL amounts) must be used for payroll costs.

Loan Forgiveness For Self-Employed Individuals. The full PPP loan principal amount plus accrued interest are eligible for forgiveness. The actual amount of forgiveness will be calculated based on:

1. payroll costs, including salary (a maximum of \$15,385 per individual during the eight-week covered period) and covered benefits for employees (but not owners);
2. the self-employed individual's Owner Compensation Replacement, but only up to an amount limited to eight weeks' worth (8/52) of the 2019 Schedule C net profit amount (excluding amounts for which a credit is claimed under either Section 7002 or Section 7004 of the Families First Coronavirus Response Act);
3. payments of interest on covered mortgage obligations incurred before February 15, 2020 (to the extent deductible on Form 1040 Schedule C);

4. covered rent payments under lease agreements in force before February 15, 2020 (to the extent deductible on Form 1040 Schedule C); and
5. covered utility payment under lease agreements dated before February 15, 2020 (to the extent deductible on Form 1040 Schedule C).

The Second Rule explains that the limiting forgiveness with respect to the Owner Compensation Replacement to an amount equal to eight weeks (8/52) of 2019 net profit is consistent with the “overarching focus on keeping workers paid, and preventing windfalls that Congress did not intend” and “will also help to ensure that the finance appropriations are directed toward payroll protection, consistent with the Act’s central objective.” In addition, the Second Rule confirms that the requirement in the Initial Rule that 75% of the amount forgiven must be attributable to payroll costs (applies to self-employed individuals’ loans).

Partners in Partnerships. The Second Rule adds important new guidance in an area that previously had not been addressed by the CARES Act or the Initial Rule. Under the Second Rule, a partner in a partnership (including members in an LLC taxed as partnership) may not submit a separate PPP loan application as a self-employed individual. Instead, the self-employment income of general active partners (e.g., partners’ K-1 distributions and LLC members’ guaranteed payments) should be reported as a payroll cost (up to \$100,000 annualized) on a PPP application filed by the partnership. The SBA’s approach to partners is a pragmatic approach for those that are actively involved in a trade or business.

However, this new guidance could mean that a partnership that submitted a PPP application prior to the release of the Second Rule with the belief that it satisfied the 500-employee size threshold because partners should not be included in employee headcount, might now (unless the business could fit within an alternative size) exceed the threshold due to the inclusion of partners. And, active partners in a partnership that thought they could apply for PPP loans separately as self-employed individuals will not now receive PPP funds for their compensation (up to \$100,000). It is not immediately clear how SBA will address PPP applications that are not in compliance with the Second Rule but were submitted in good faith prior to the publication of the Second Rule.

Borrowers Associated with Lenders. The Second Rule clarifies that businesses owned by directors or shareholders of an approved PPP lender are eligible to apply for a PPP loan. Such applicants would generally be disqualified from SBA loan programs due to the creditworthiness assessment and the risk of underwriting bias with an associated lender. Because these underwriting requirements are not applicable to the PPP, standard SBA regulations prohibiting a business owned, in whole or in part, by an equity owner of a PPP lender are not applicable for purposes of obtaining a PPP loan.

If you have questions or would like more information, please contact Ryan J. Udell (udellr@whiteandwilliams.com; 215.864.7152), Adam Chelminiak (chelminiaka@whiteandwilliams.com; 215.864.7078) or another member of the Corporate and Securities Group.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates [here](#).



This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only, and you are urged to consult a lawyer concerning your own situation and legal questions.