
Should I Give Back My PPP Loan?

By William E. Sigler

What began as a bridge over troubled financial times has recently begun to cause as much heartburn as the pandemic. After navigating a stormy application process, many businesses that obtained loans under the Paycheck Protection Program (“PPP”) are now facing the rocky shoals of proving the “necessity” for the loan, re-examining affiliation rules, and satisfying the myriad requirements to obtain loan forgiveness.

Economic Necessity

The need to prove economic necessity for a PPP loan revolves around language in the CARES Act itself, which requires borrowers to certify that “the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient.” The spark that ignited the controversy involved large companies with easy access to the capital markets. But, the SBA subsequently pointed out in their FAQs that the requirement applies to all PPP Loans. For borrowers who, in retrospect, conclude that they do not need the loan, the SBA gave them until May 7th to return it. That deadline was then extended to May 14th.

Exacerbating the concern is that the PPP application identifies several criminal statutes that are violated by the provision of false information: 18 U.S.C. § 1001 (false statements to federal officials) punishable under 18 U.S.C 3571 by imprisonment of not more than five years and/or a fine of up to \$250,000; 15 U.S.C. § 645 (misrepresentation of size status) punishable by imprisonment of not more than two years and/or a fine of not more than \$5,000; and 18 U.S.C. § 1014 (false statements to a lending institution) punishable by imprisonment of not more than thirty years and/or a fine of not more than \$1,000,000.

The SBA and Department of Treasury have indicated that they will be reviewing all loans in excess of \$2 million. But, even businesses with smaller loans should be concerned. So, what should a business do if it revisits the decision to apply for a PPP loan and elects to retain the funds? It would certainly be prudent, prior to

May 14th, to collect the pertinent records and document the need for the loan, and then prepare an internal memorandum summarizing the analysis. Examples of Issues to consider include the following:

- The economic uncertainty the business has faced or will face as a result of COVID-19, including the impact on its customer base, product or service affordability, and supply chain.
- How the business is expected to fare when compared with its budgeted revenues.
- The impact of increasing debt on future operations.
- Limitations on accessing existing lines of credit.
- Any recently denied requests for loans or funding increases.
- The existence of unfunded deferred compensation agreements or other obligations where payment is subject to solvency requirements and necessary funds cannot be borrowed.
- Reductions to previously planned capital expenditures and hiring freezes due to COVID-19.
- Increases in the business' allowance for bad debts due to the economic uncertainty.
- The extent to which customers have requested longer payment terms or discounts in fees or service charges.
- The effect of State and CDC social distancing and similar recommendations, as well as OSHA guidelines, on vendors, customers and employees.
- The ability to retain employees who might go elsewhere if compensation or staffing levels are reduced.
- Decreases in employees' production and efficiencies due to working remotely because of COVID-19, such as competing home-schooling obligations relating to employees' children.
- Staffing or payroll reductions made by competitors who did not obtain a PPP loan.
- Workforce expenses that were alleviated due to the receipt of the PPP funding.
- The anticipated economic impact on the business of a second wave of the virus.

This contemporaneous documentation of the company's justification for seeking a PPP loan – if current, accurate and complete – could provide helpful support for the company's good faith basis for making the "necessity" certification, if this is

questioned in the future.

Affiliation Rules

Another area keeping PPP borrowers up at night concerns the SBA's affiliation rules. These rules permeate the classifications of businesses that are eligible for a PPP loan, which consists of the following:

- Any business if, together with its affiliates, it has 500 or fewer employees whose principal place of residence is in the United States.
- Any business which, together with its affiliates, meets the SBA employee-based size standard for the North American Industry Classification System ("NAICS") code applicable to its primary industry.
- Any business whose primary industry is included in NAICS category 72 (accommodations and food service) and which has, together with its affiliates, no more than 500 employees per physical location.
- Any business which on its own meets the size standard (employee-based or receipts-based) established by the SBA for the NAICS code applicable to its primary industry and, together with its affiliates, meets the size standard (employee-based or receipts-based) established by the SBA for the NAICS code applicable to either its primary industry or the primary industry of itself and its affiliates on a combined basis, whichever standard is higher.
- Any business which has, together with its affiliates, \$15 million or less of tangible net worth as of March 27, 2020, and \$5 million or less of average net income after Federal income taxes (excluding carry-over losses) for the last two full fiscal years before the date of its application.

Many borrowers were surprised to learn after getting their PPP loans that the SBA's affiliation rules are much broader than those under the tax rules with which they are familiar. Generally, businesses are affiliates of each other when one controls or has the power to control the other, or a third party or parties control or have the power to control both. It does not matter whether control is exercised, so long as the power to control exists. Affiliation can be established under any of the following circumstances:

- A concern is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50 percent of the concern's voting equity. If no individual, concern, or entity is found to control more than 50 percent of

the concern's voting equity, the SBA will deem the board of directors, president or CEO (or other officers, managing members, or partners who control the management of the concern) to be in control of the concern. The SBA will deem a minority shareholder to be in control if that individual or entity has the ability under the concern's charter, by-laws, or shareholder's agreement to prevent a quorum or otherwise block action by the board of directors or shareholders.

- The SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. The SBA treats those options, convertible securities, and agreements as though the rights granted have been exercised.
- Affiliation arises where the CEO or president of the concern (or other officers, managing members, or partners who control the management of the concern) also controls the management of one or more other concerns. Affiliation similarly arises where a single individual, concern, or entity that controls the board of directors or management of one concern also controls the board of directors or management of one of more other concerns, and where a single individual, concern or entity controls the management of the applicant concern through a management agreement.
- Affiliation arises when there is an identity of interest between close relatives with identical or substantially identical business or economic interests (such as where the close relatives operate concerns in the same or similar industry in the same geographic area). Where the SBA determines that interests should be aggregated, an individual or firm may rebut that determination with evidence showing that the interests deemed to be one are in fact separate.

These affiliation rules are waived for (i) any business concern with not more than 500 employees that, as of the date on which the loan is disbursed, is assigned a North American Industry Classification System code beginning with 72; (ii) any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and (iii) any business concern that receives financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958.

Tentative Forgiveness Amount

As frustrating as the application process may have been, obtaining forgiveness of

a PPP loan is likely to be equally challenging. PPP loans can be forgiven up to an amount equal to the sum of the following costs incurred and payments made during the eight-week period beginning on the date the loan is funded (“covered period”):

- Payroll costs (which must account for at least 75 percent of the use of the PPP loan proceeds);
- Covered utility payments;
- Covered rent obligations; and
- Interest payments on any covered mortgage obligation (excluding any payment or prepayment of principal).

“Payroll costs” means payments of any compensation with respect to employees, and includes:

- Salary, wage, commission, or similar compensation;
- Payment of cash tip or equivalent;
- Payment for vacation, parental, family, medical, or sick leave;
- Allowance for dismissal or separation;
- Payment required for the provisions of group health care benefits, including insurance premiums;
- Payment of any retirement benefit; and
- Payment of state or local tax assessed on the compensation of employees.

Compensation excludes the following:

- The compensation of an individual employee in excess of an annual salary of \$100,000, as prorated for the covered period;
- Taxes imposed or withheld under Internal Revenue Code chapters 21, 22, or 24 (employment taxes) during the covered period;
- Any compensation of an employee whose principal place of residence is outside of the United States;
- Qualified sick leave wages for which a credit is allowed under the Family First Act (i.e., payroll tax credit for required paid sick leave);
- Qualified family leave wages for which a credit is allowed under the Family First Act (i.e., payroll credit for required paid family leave); and
- Payments to independent contractors.

A “covered utility payment” means the payment for a service for the distribution of electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020. A “covered rent obligation” means rent obligated under a lease in force before February 15, 2020. A “covered mortgage obligation” means any indebtedness or debt instrument incurred in the ordinary course of business that is a liability of the borrower, is a mortgage on real or personal property, and was incurred before February 15, 2020.

Reduction in Tentative Forgiveness Amount for Reduction in Headcount

The amount of loan forgiveness must be reduced (but not increased) by multiplying the tentative forgiveness amount by the quotient obtained by dividing:

- A. The average number of full-time equivalent employees per month employed by the borrower during the covered period; by
- B. At the election of the borrower, either: (i) the average number of full-time equivalent employees per month employed by the borrower during the period beginning on February 15, 2019, and ending on June 30, 2019; or (ii) the average number of full-time equivalent employees per month employed by the borrower during the period beginning on January 1, 2020, and ending on February 29, 2020.

If the borrower is a seasonal employer under the SBA’s rules, then the borrower is required to use for the denominator the average number of full-time equivalent employees per month employed by the borrower during the period beginning on February 15, 2019, and ending on June 30, 2019. The average number of full-time equivalent employees is determined by calculating the average number of full-time equivalent employees for each pay period falling within a month.

The reduction in loan forgiveness does not apply to the extent that (i) the reduction in the number of full-time equivalent employees occurred between February 15, 2020, and April 26, 2020, and (ii) the employer eliminates the reduction no later than June 30, 2020. The exemption for re-hires appears to be an all-or-nothing proposition. There is no provision in the statute for restoring some, but not all, of the lost headcount. The exemption does not apply to reductions in employee headcount occurring after April 26, 2020, even if the reductions are reversed by June 30, 2020.

The SBA issued a FAQ on May 3, 2020, clarifying that the recipient of a PPP loan

won't have its forgiveness amount reduced if it lays off an employee and then offers to rehire them but they refused to come back. According to the FAQ, that position will be added in an interim final rule and will take the form of a *de minimis* exemption. The guidance will provide that to qualify for the exemption, a company must make a good-faith effort to rehire the worker and that offer must be in writing. As for the worker, their rejection of the offer must be documented.

Reduction in Tentative Forgiveness Amount for Reduction in Total Salary or Wages

The amount of loan forgiveness must also be reduced by the amount of any reduction in total salary or wages of any employee during the covered period that is in excess of 25 percent of the total salary or wages of the employee during the most recent full quarter during which the employee was employed before the covered period. For purposes of applying this rule, an "employee" is defined as any employee who did not receive, during any single pay period during 2019, wages or salary at an annualized rate of pay in an amount more than \$100,000. Once again, the reduction in loan forgiveness does not apply if the reduction in salary or wages occurred between February 15, 2020, and April 26, 2020, and the employer eliminates the reduction no later than June 30, 2020.

Applying for Forgiveness

A borrower seeking loan forgiveness under the PPP is required to submit an application to the lender that is servicing the PPP loan. The application must include:

- Documentation verifying the number of full-time equivalent employees on payroll and their pay rates, including payroll tax filings reported to the IRS and State income, payroll and unemployment insurance filings. This information is used to determine whether a reduction in the amount forgiven due to a reduction in employee count or salaries and wages is required.
- Documentation, including cancelled checks, payment receipts, transcripts of accounts or other documents verifying payments on covered mortgage obligations, payments on covered lease obligations, and covered utility payments.
- A certification from an authorized representative of the borrower that the documentation presented is true and correct, and that the amount for which

forgiveness is requested was used to retain employees, make interest payments on covered mortgage obligations, make payments on covered rent obligations, or make covered utility payments.

- Any other documentation the SBA determines to be necessary.

Decisions on applications for loan forgiveness must be made by the lender that is servicing the PPP loan no later than 60 days after the date on which the lender receives the application for loan forgiveness.

Self-Employed Individuals

Self-employed individuals, such as independent contractors, are treated differently. A self-employed individual must have been in business on February 15, 2020, and have filed or will file a Form 1040, Individual Income Tax Return, Schedule C, for 2019. For purpose of determining loan forgiveness relating to an individual's self-employment income, the amount is roughly equal to $\frac{8}{52}$ of self-employment income in 2019. In other words, forgiveness is not based on performance during the eight-week period following loan origination, but is based on past performance, i.e., average self-employment income in 2019.

More specifically, if the self-employed person has no employees, then the amount that can be borrowed is determined as follows:

Step 1: Start with the 2019 IRS Form 1040, Schedule C, line 31, net profit amount. If the 2019 return hasn't been filed yet, then fill it out and compute the value. If this amount is over \$100,000, reduce it to \$100,000. If this amount is zero or less, then the individual is not eligible for a PPP Loan.

Step 2: Calculate the average monthly net profit amount by dividing the amount from step 1 by 12.

Step 3: Multiply the average monthly net profit amount from step 2 by 2.5.

Step 4: Add any outstanding amount from an Economic Injury Disaster Loan (EIDL) received between January 31, 2020 and April 3, 2020, that is being refinanced, less the amount of any advance received.

If the self-employed person has employees, then the amount that can be borrowed is determined as follows:

Step 1: Compute 2019 payroll as follows:

1. Start with the 2019 IRS Form 1040, Schedule C, line 31, net profit amount. If the 2019 return hasn't been filed yet, then fill it out and compute the value. If this amount is over \$100,000, reduce it to \$100,000. If this amount is zero or less, then the individual is not eligible for a PPP Loan.
2. Add 2019 gross wages and tips paid to employees. Subtract any amounts paid to any individual employee in excess of \$100,000 annualized and any amounts paid to any employee whose principal place of residence is outside the United States.
3. Add 2019 employer health insurance contributions (i.e., the health insurance component of Form 1040, Schedule C, line 14), retirement contributions (Form 1040, Schedule C, line 19), and state and local taxes assessed on employee compensation.

Step 2: Calculate the average monthly net profit amount by dividing the amount from step 1 by 12.

Step 3: Multiply the average monthly net profit amount from step 2 by 2.5.

Step 4: Add any outstanding amount from an Economic Injury Disaster Loan (EIDL) received between January 31, 2020 and April 3, 2020, that is being refinanced, less the amount of any advance received.

The self-employed person will need to provide his or her 2019 Form 1040 Schedule C, Form 941's, and state quarterly wage unemployment insurance tax reporting forms for each quarter, along with evidence of any retirement and health insurance contributions. Once received, the PPP loan can be used for the following purposes:

- Owner compensation replacement as calculated based on 2019 net profits determined as provided above;
- Employee "payroll costs," as that term is defined for other PPP purposes, provided that the self-employed person has employees;
- Mortgage interest payments on debt incurred prior to February 15, 2020;
- Rent for leases that were in place before February 15, 2020; and
- Utilities for services that were in place before February 15, 2020.

At least 75 percent of the requested forgivable dollars must be used for payroll

costs. For purposes of determining the percentage of use of proceeds for payroll costs, the amount of any refinanced EIDL is included. The proceeds from any advance up to \$10,000 on an EIDL is deducted from the loan forgiveness amount.

The amount of loan forgiveness can be up to the full principal amount of the loan plus accrued interest. The actual amount of loan forgiveness will depend, in part, on the total amount spent over the covered period on:

- Payroll costs including salary, wages, and tips, up to \$100,000 of annualized pay per employee (for eight weeks, a maximum of \$15,385 per individual), as well as covered benefits for employees (but not owners), including health care expenses, retirement contributions, and state taxes imposed on employee payroll paid by the employer (such as unemployment insurance premiums);
- Owner compensation replacement, calculated based on 2019 net profit as described above, with forgiveness of such amounts limited to eight weeks' worth (8/52) of 2019 net profit, but excluding any qualified sick leave equivalent amount for which a credit is claimed under section 7002 of the Families First Coronavirus Response Act ("FFCRA") or qualified family leave equivalent amount for which a credit is claimed under the FFCRA;
- Payments of interest on mortgage obligations on real or personal property incurred before February 15, 2020, to the extent they are deductible on Form 1040, Schedule C (business mortgage payments);
- Rent payments on lease agreements in force before February 15, 2020, to the extent they are deductible on Form 1040, Schedule C (business rent payments); and
- Utility payments under service agreements dated before February 15, 2020 to the extent they are deductible on Form 1040, Schedule C (business utility payments).

In addition to a borrower certification, if the self-employed person has employees, then in order to substantiate the request for loan forgiveness he or she must submit Form 941 and state quarterly wage unemployment insurance tax reporting forms or equivalent payroll processor records that best correspond to the covered period (with evidence of any retirement and health insurance contributions). Whether or not the self-employed person has employees, he or she must submit evidence of business rent, business mortgage interest payments on real or personal property, or business utility payments during the covered period if any of

the loan proceeds were used for those purposes. The 2019 Form 1040, Schedule C that was provided at the time of the PPP loan application will be used to determine the amount of net profit allocated to the owner for the eight-week covered period.

Partners in Partnerships

A partner in a partnership can't submit a separate application for a PPP loan as a self-employed individual. Instead, the self-employment income of general active partners may be reported as a payroll cost, up to \$100,000 annualized, on a PPP loan application filed by or on behalf of the partnership.

No Deduction

The CARES Act provides that amounts which are forgiven, and which would otherwise be includible in the gross income of the borrower as cancellation of indebtedness income, are excluded from gross income. However, the payroll costs, rent, and the other allowable PPP expenses paid with the loan proceeds are not deductible to the extent the loan is later forgiven.

Parting Thoughts

It's a shame that necessary guidance has been lagging the PPP since its inception. Perhaps that's the byproduct of a program hastily put together in the breach to help address a problem of unprecedented magnitude. Perhaps it's just a little too complicated considering the immediacy of the problem. But, as they say, this too will pass. In the meantime, it's important to keep a clear head, to not act precipitously, and to always document the reasoning for the steps taken along the way. That will promote analysis, and analysis will keep the thoughtful PPP borrower in the center of the lane. And, the center of the lane usually proves to be the fastest way to the destination. In this case, that's hopefully loan forgiveness and a brighter economic future.

Read the follow up article, [“You Mean I can Keep My PPP Loan?”](#)

