

PPP Updates: Calculation of the Loan Amount and Use of Loan Proceeds for Individuals Who File IRS Form 1040, Schedule C and Revisions to Eligibility Rules

Hinshaw Alert | 10+ min read

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On March 3, 2021, the Small Business Administration (SBA), in conjunction with the U.S. Department of the Treasury, adopted an interim final rule (IFR) that: (1) allows individuals who file an IRS Form 1040, Schedule C to calculate their maximum loan amount using gross income; (2) eliminates the eligibility restriction that prohibits businesses with owners who have non-financial fraud felony convictions in the last year from obtaining Paycheck Protection Program (PPP) loans; and (3) removes the eligibility restriction that prevents businesses with owners who are delinquent or in default on their federal student loans from obtaining PPP loans.

Calculating PPP Loan Amount for Individuals Who File IRS Form 1040, Schedule C

Previously, the PPP rules defined payroll costs for individuals who file an IRS Form 1040, Schedule C as payroll costs (if employees exist) plus net profits, which is net earnings from self-employment. This definition, however, did not take into account fixed and other business expenses that a small business must cover to stay in operation.

Under the new calculation set out in the IFR, a Schedule C filer may elect to calculate the share of its payroll costs that represents compensation of the owner based on either (1) net profit, or (2) gross income, as calculated under the IFR or a borrower's gross income.

This rule change will be implemented with respect to PPP loans that are approved after the effective date of the IFR. A borrower whose PPP loan has already been approved as of the effective date cannot increase its PPP loan amount based on the new calculation methodology.

Calculation of the maximum First Draw PPP Loan amount and the documentation that is required for an individual with income from self-employment and filing an IRS Form 1040

Schedule C Filer Without Employees. If a borrower has no employees, the borrower should calculate the maximum loan amount as follows:

- From the borrower's 2019 or 2020 IRS Form 1040, Schedule C, the borrower may elect to use either the borrower's line 31 net profit amount or the borrower's line 7 gross income amount. (If the borrower is using 2020 to calculate payroll costs and has not yet filed a 2020 return, the borrower should fill it out and compute the value.) If this amount is over \$100,000, reduce it to \$100,000. If both the net profit and gross income are zero or less, the borrower is not eligible for a PPP loan.
- Calculate the average monthly net profit or gross income amount by dividing the amount from Step 1 by 12.
- Multiply the average monthly net profit or gross income amount from Step 2 by 2.5. This amount cannot exceed \$20,833.
- Add the outstanding amount of any Economic Injury Disaster Loan (EIDL) made between January 31, 2020 and April 3, 2020 that the borrower seeks to refinance. Do not include the amount of any advance under an EIDL COVID-19 loan. It does not have to be repaid.

Documentation. The borrower must provide the 2019 or 2020 (whichever it used to calculate its loan amount) IRS Form 1040, Schedule C with the borrower's PPP loan application to substantiate the applied-for PPP loan amount and the appropriate 2019 or 2020 IRS Form 1099-MISC detailing nonemployee compensation received (box 7), invoice, bank statement, or book of record that establishes that the borrower is self-employed. If using 2020 to calculate the loan amount, this is required regardless of whether the borrower has filed a 2020 tax return with the IRS. The borrower must provide a 2020 invoice, bank statement, or book of record to establish that it was in operation on or around February 15, 2020.

Proprietor Expenses. When determining a borrower's eligible expenses and forgiveness amount, the IFR refers to the owner compensation share of a Schedule C filer's loan amount as "proprietor expenses." Such expenses encompass an owner's business expenses and own compensation, but exclude employee payroll costs. This proprietor expenses calculation limits a Schedule C filer that included employee payroll costs in determining the PPP loan amount from taking the full loan amount as owner compensation.

Schedule C Filer With Employees. If the borrower has employees, the borrower should calculate the maximum loan amount as follows:

- Compute 2019 or 2020 payroll (using the same year for all items) by adding the following:
 - At the borrower's election, either: (1) the net profit amount from line 31 of the 2019 or 2020 IRS Form 1040, Schedule C, or (2) 2019 or 2020 gross income minus employee payroll costs, calculated as the borrower's

gross income reported on IRS Form 1040, Schedule C, line 7, minus the borrower's employee payroll costs reported on lines 14, 19, and 26 of IRS Form 1040, Schedule C (for either option, if the borrower is using 2020 amounts and has not yet filed a 2020 return, the borrower should fill it out and compute the value), up to \$100,000 on an annualized basis, as prorated for the period during which the payments are made or the obligation to make the payments is incurred (if this amount is over \$100,000, reduce it to \$100,000, or if this amount is less than zero, this amount should be set at zero);

- 2019 or 2020 gross wages and tips paid to employees whose principal place of residence is in the United States, computed using 2019 or 2020 IRS Form 941 taxable Medicare wages and tips (line 5c, column 1) from each quarter plus any pre-tax employee contributions for health insurance or other fringe benefits excluded from taxable Medicare wages and tips; subtract any amounts paid to any individual employee in excess of \$100,000 on an annualized basis, as prorated for the period during which the payments are made or the obligation to make the payments is incurred, and any amounts paid to any employee whose principal place of residence is outside the United States; and
- 2019 or 2020 employer contributions to employee group health, life, disability, vision, and dental insurance (portion of IRS Form 1040, Schedule C line 14 attributable to those contributions); retirement contributions (IRS Form 1040, Schedule C, line 19); and state and local taxes assessed on employee compensation (primarily under state laws commonly referred to as the State Unemployment Tax Act (SUTA) from state quarterly wage reporting forms).
- Calculate the average monthly amount by dividing the amount from Step 1 by 12.
- Multiply the average monthly amount from Step 2 by 2.5.
- Add the outstanding amount of any EIDL made between January 31, 2020 and April 3, 2020 that the borrower desires to refinance. Do not include the amount of any advance under an EIDL COVID-19 loan. It does not have to be repaid.

To avoid double counting, the expenses reported on lines 14, 19, and 26 of IRS Form 1040, Schedule C must be subtracted from the owner compensation share of payroll costs if the owner uses gross income to calculate its loan amount.

Documentation. The borrower must supply its 2019 or 2020 (whichever was used to calculate the loan amount) IRS Form 1040, Schedule C; Form 941 (or other tax forms or equivalent payroll processor records containing similar information); and state quarterly wage unemployment insurance tax reporting forms from each quarter in 2019 or 2020, or equivalent payroll processor records, along with evidence of any retirement and health insurance contributions, if applicable. A payroll statement or similar documentation from the pay period that covered February 15, 2020 must be provided to establish that the borrower was in operation on February 15, 2020.

Limited safe harbor with respect to certification concerning need for PPP loan request for Schedule C filers for First Draw PPP Loans

Each applicant applying for a PPP loan must certify in good faith “that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing obligations” of the applicant.

Borrowers that (1) elect to use gross income to calculate their maximum loan amount for a First Draw PPP Loan, and (2) report more than \$150,000 in gross income on the Schedule C that was used to calculate the borrower's loan amount, will not automatically be deemed to have made the required certification concerning the necessity of the loan request in good faith.

The SBA has stated that it will review a sample of the population of First Draw PPP Loans made to Schedule C filers using the gross income calculation if the gross income on the Schedule C used to calculate the borrower's loan amount exceeds the \$150,000 threshold. If a borrower exceeds this threshold, then the SBA will, for the sample drawn, assess whether these borrowers complied with the PPP eligibility criteria, including the good faith loan necessity certification.

If the SBA determines that a borrower lacked an adequate basis to make the required certification, it may determine that the borrower was not eligible for the loan, for the loan amount, or for loan forgiveness.

The SBA provides a safe harbor for borrowers that, together with their affiliates, receive PPP loans with an original principal amount of less than \$2 million. This safe harbor will not apply to Schedule C filers that elect to use gross income to calculate their loan amount on a First Draw PPP Loan if the borrower reports more than \$150,000 in gross income on the Schedule C and that was used to calculate the borrower's loan amount.

The SBA is not excluding this safe harbor protection to Second Draw PPP Loans because those applicants are required to certify that they have realized a reduction in gross receipts in excess of 25% relative to the relevant comparison time period.

Maximum Amount of Second Draw PPP Loans

Schedule C Filer Without Employees. For a borrower that has income from self-employment and does not have any employees, the maximum loan amount is the lesser of the product obtained by multiplying:

- the net profit or gross income of the borrower in 2019 or 2020, as reported on IRS Form 1040, Schedule C, that is not more than \$100,000, divided by 12; and
- 5 (or, only for a borrower assigned a NAICS code beginning with 72 as defined in Subsection (f)(10) at the time of disbursement, 3.5). This amount cannot exceed \$29,167 for NAICS code 72 borrowers and \$20,833 for all other borrowers.

Documentation. The borrower will provide the same documents described above.

Schedule C Filer With Employees. For a borrower that has income from self-employment and has employees, the maximum loan amount is the lesser of the product obtained by multiplying:

- the sum of (1) one of the two following options, up to \$100,000; if this amount is less than zero, set this amount at zero (if the borrower is using 2020 and has not yet filed a 2020 return, the borrower should fill it out and compute the value):
 - the borrower's net profit reported on IRS Form 1040, Schedule C for 2019 or 2020, divided by 12; or

- line 7 from the borrower's 2019 or 2020 IRS Form 1040, Schedule C, minus lines 14, 19, and 26, divided by 12; and
- (2) Add the average total monthly payment for employee payroll costs incurred or paid by the borrower during the same year elected by the borrower; by 2.5 (or, only for a borrower assigned a NAICS code beginning with 72 at the time of disbursement as defined in Subsection (f)(10), 3.5);
- or \$2 million.

Documentation. The borrower will provide the same documents described above.

Use of PPP loan proceeds by individuals with income from self-employment who file an IRS Form 1040, Schedule C

The proceeds of a PPP loan are to be used for the following:

Payroll Costs. For borrowers that use net profit to calculate the loan amount, owner compensation replacement, calculated based on 2019 or 2020 (using the same year that was used to calculate the loan amount) an amount equal to net profit from line 31 of Schedule C.

For borrowers that use gross income to calculate the loan amount, proprietor expenses (business expenses plus owner compensation), calculated based on 2019 or 2020 (using the same year that was used to calculate the loan amount) an amount equal to the gross income from line 7 of Schedule C. This amount cannot exceed \$20,833.

For borrowers that used gross income to calculate the loan amount and have no employees, an amount equal to the proprietor expenses, which equals gross income.

For borrowers that used gross income to calculate the loan amount and have employees, an amount equal to the proprietor expenses, which equals the difference between gross income and employee payroll costs.

If the borrower has employees and uses gross income, the employee payroll costs for employees whose principal place of residence is in the United States.

Mortgage Interest; Rent and Utility Payments. Mortgage interest payments (but not mortgage prepayments or principal payments) on any business mortgage obligation on real or personal property (*e.g.*, the interest on the mortgage for the warehouse the borrower purchased to store business equipment or the interest on an auto loan for a vehicle the borrower used to perform the business), business rent payments (*e.g.*, the warehouse where the borrower stores business equipment or the vehicle the borrower uses to perform your business), and business utility payments (*e.g.*, the cost of electricity in the warehouse rented or gas used driving the business vehicle).

The borrower must have claimed, or be entitled to claim, a deduction for such expenses on the borrower's 2019 or 2020 (whichever was used to calculate loan amount) IRS Form 1040, Schedule C for these expenses to be a permissible use. For example, if the borrower did not claim or is not entitled to claim utilities expenses on the borrower's 2019 or 2020 IRS Form 1040, Schedule C, the borrower cannot use the proceeds for utilities.

Interest on Other Debt Obligations. Interest payments on any other debt obligations that were incurred before February 15, 2020, but they are not eligible for PPP loan forgiveness.

Refinancing an SBA EIDL Loan. Refinancing an SBA EIDL loan made between January 31, 2020 and April 3, 2020 (maturity will be reset to PPP's maturity of two years for PPP loans made before June 5, 2020 unless the borrower and lender mutually agree to extend the maturity of such loans to five years, or PPP's maturity of five years for PPP loans made on or after June 5).

Covered Expenditures. The expenditures described below (Covered Expenditures) were added as part of the Economic Aid Act. A detailed discussion of them may be found in the Hinshaw Client Alert issued on February 24, 2021 "[SBA and US Treasury Issue Interim Final Rule on Paycheck Protection Program Loan Forgiveness.](#)"

- Covered operations expenditures, as defined in Section 7A(a) of the Small Business Act, to the extent they are deductible on IRS Form 1040, Schedule C.
- Covered property damage costs, as defined in Section 7A(a) of the Small Business Act, to the extent they are deductible on IRS Form 1040, Schedule C.
- Covered supplier costs, as defined in Section 7A(a) of the Small Business Act, to the extent they are deductible on IRS Form 1040, Schedule C.
- Covered worker protection expenditures, as defined in Section 7A(a) of the Small Business Act, to the extent they are deductible on Form IRS 1040, Schedule C.

Caps on the amount of loan forgiveness available for owner-employees and self-employed individuals

Forgiveness is capped at 2.5 months' worth (2.5/12) of an owner-employee or self-employed individual's 2019 or 2020 compensation (up to a maximum \$20,833 per individual in total across all businesses). The individual's total compensation may not exceed \$100,000 on an annualized basis, as prorated for the period during which the payments are made or the obligation to make the payments is incurred.

For example, for borrowers that 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 or 2020 compensation (i.e., approximately 15.38 percent of 2019 or 2020 compensation) or \$15,385 per individual, whichever is less, in total across all businesses.

For borrowers that elect to use a 10-week covered period, the cap is 10 weeks' worth (10/52) of 2019 or 2020 compensation (approximately 19.23 percent) or \$19,231 per individual, whichever is less, in total across all businesses.

For a covered period longer than 2.5 months, 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 or 2020 compensation (up to \$20,833) in total across all businesses.

C-corporation owner-employees are capped by the prorated amount of their 2019 or 2020 (using whatever year was used to calculate the loan amount) employee cash compensation and employer retirement and health, life, disability, vision, and dental insurance contributions made on their behalf.

S-corporation owner-employees are capped by the prorated amount of their 2019 or 2020 (using whatever year was used to calculate the loan amount) employee cash compensation and employer retirement contributions made on their behalf. However, employer health, life, disability, vision, and dental insurance contributions made on their behalf cannot be separately added; those payments are already included in their employee cash compensation.

Schedule C or F filers are capped by the prorated amount of their owner compensation replacement (calculated based on 2019 or 2020 net profit) or proprietor expenses (calculated based on 2019 or 2020 gross income). For self-employed borrowers with no employees that file IRS Form 1040, Schedule C, that used gross income to calculate the loan amount, proprietor expenses equals gross income.

For self-employed borrowers with employees that file IRS Form 1040, Schedule C, that used gross income to calculate the loan amount, proprietor expenses equals the difference between gross income and employee payroll costs. For self-employed borrowers that file IRS Form 1040, Schedule F and have no employees, gross income may be used instead of net profit throughout this calculation. For self-employed borrowers that file IRS Form 1040, Schedule F and have employees, the difference between gross income and employee payroll costs may be used instead of net profit throughout this calculation.

General partners are capped by the prorated amount of their 2019 or 2020 net earnings from self-employment (reduced by claimed Section 179 expense deduction, unreimbursed partnership expenses, and depletion from oil and gas properties) multiplied by .9235.

For self-employed individuals, including Schedule C or F filers and general partners, retirement and health, life, disability, vision, or dental insurance contributions are included in their net self-employment income. Consequently, such costs cannot be separately added to their payroll calculation.

Limited liability company (LLC) members are subject to the rules based on their LLC's tax filing status in the reference year used to determine their loan amount.

Loan forgiveness documentation that individuals with self-employment income who file an IRS Form 1040, Schedule C or F must submit to their lender

Borrowers that received loans of \$150,000 or less that use SBA Form 3508S must submit the certification and information required by Section 7A(l)(1)(A) of the Small Business Act and, for a Second Draw PPP Loan and revenue reduction submit documentation if such documentation was not provided at the time of application.

All other borrowers must submit the certification required by Section 7A(e)(3) of the Small Business Act, and (if the borrower has employees) IRS Form 941 and state quarterly business and individual employee wage reporting and unemployment insurance tax forms or equivalent payroll processor records that best correspond to the

covered period (with evidence of any retirement and group health, life, disability, vision, and dental insurance contributions).

Whether the borrower has employees, the borrower must submit evidence of business rent, business mortgage interest payments on real or personal property, business utility payments, or payments for a covered operations expenditure, covered property damage cost, covered supplier cost, or covered worker protection expenditure during the covered period if the borrower used loan proceeds for those purposes. This documentation may include cancelled checks, payment receipts, transcripts of accounts, purchase orders, orders, invoices, or other documents verifying payments on nonpayroll costs.

For all loans, the 2019 or 2020 IRS Form 1040, Schedule C or F that the borrower provided at the time of the PPP loan application must be used to determine the amount of net profit or proprietor expenses allocated to the owner for the covered period.^[1]

The SBA has developed new borrower application forms for use by borrowers that are Schedule C filers and elect to calculate their loan amount using gross income, as allowed under the IFR.

SBA Form 2483-C will be used by such borrowers when applying for First Draw PPP Loans and SBA Form 2483-SD-C will be used by such borrowers when applying for Second Draw PPP Loans.

Eligibility – Felons

The previous rule provided, among other things, that a PPP loan applicant is ineligible if an owner of 20 percent or more of the equity of the applicant has been convicted of, pleaded guilty or *nolo contendere* to, or commenced any form of parole or probation (including probation before judgment) for (1) a felony involving fraud, bribery, embezzlement, or a false statement in a loan application or an application for federal financial assistance within the last five years, or (2) any other felony within the last year.

The IFR eliminates the one-year lookback restriction related to non-financial fraud felonies. The five-year lookback restriction for those felonies involving fraud, bribery, embezzlement, or a false statement in a loan application or an application for federal financial assistance are still in place.

Eligibility – Federal Student Loans

The previous final rule provided that a PPP loan applicant is ineligible for a PPP loan if the applicant, or any business owned or controlled by the applicant or any of its owners, has ever obtained a direct or guaranteed loan from the SBA or any other federal agency that is currently delinquent or has defaulted within the last seven years and caused a loss to the government.

The IFR eliminates this restriction to the extent it applies to federal student loans. This change applies to new PPP applicants as well as those borrowers who have already received a PPP loan. In this way, PPP borrowers with delinquent or defaulted student loan debts are treated equally, without regard to when they submitted their PPP application. This change will be applied to any First Draw PPP Loan or Second Draw PPP Loan, regardless of when the PPP loan was made.

“Federal student loans” means programs under Parts B, D, and E of the Higher Education Act of 1965, as amended, as well as other programs now administered by the U.S. Department of Education (DOE). These include loans under the William D. Ford Federal Direct Loan Program, the Federal Family Education Loan Program, the Federal Perkins Loan Program, the Health Education Assistance Loan Program, and the Teacher Education Assistance for College and Higher Education Grant Program if those awards have converted into loans. These delinquencies include loans owed directly to the DOE, as well as federal student loans held by institutions of higher education or those guaranteed or insured by the DOE and which are held by private lenders or guaranty agencies.

[1] For self-employed borrowers with no employees that file IRS Form 1040, Schedule C, that used gross income to calculate the loan amount, proprietor expenses equal gross income.

For self-employed borrowers with employees that file IRS Form 1040, Schedule C, that used gross income to calculate the loan amount, proprietor expenses equal the difference between gross income and employee payroll costs.

For self-employed borrowers that file IRS Form 1040, Schedule F and have no employees, gross income may be used instead of net profit.

For self-employed borrowers that file IRS Form 1040, Schedule F and have employees, the difference between gross income and employee payroll costs may be used instead of net profit.

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