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Paycheck Protection Program Loans: Three Things The SBA And Banks Need To Agree On Now

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Taxes

f Dear Treasury Secretary Mnuchin,

tw This past Friday, the federal government rolled out its Paycheck Protection Program (PPP), which was designed by the recently-enacted CARES Act as a way to get \$350 billion into the hands of small business owners.

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As you well know, the motivation behind the PPP was to allow those businesses slowed or stopped by COVID-19 to continue paying their employees for the next few months by allowing banks to join forces with the Small Business Association (SBA) and make hassle-free loans to those in need.

Of course, the best part of the PPP is that amounts borrowed could well turn out to be a loan in name only. After all, the amount of proceeds a borrower spends in the first eight weeks on payroll costs, mortgage payments, rent and insurance can be completely forgiven — tax free, in fact! — provided the borrower doesn't fire employees or slash payroll.



Treasury Secretary Steven Mnuchin discussing the Paycheck Protection Program at the White House on ... [+] GETTY IMAGES

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Free money is hard to pass up, and so last week, businesses were clamoring for Friday to arrive so they could grab their piece of the pie.

As expected with a roll-out of this magnitude, however, there were some procedural problems. A few of the big banks weren't ready to start processing applications, and of those that were, several wouldn't consider an applicant that didn't have a preexisting relationship with the bank, threatening to leave some desperate business owners out in the cold.

My beef, however, has nothing to do with access to a loan. I'm confident that everyone will be able to find a lender that can help. No, my complaint is about something far more fundamental:

Seriously. We're the country behind wonderful inventions like the lunar module, the personal computer, and asbestos, and you're telling me some egghead at the SBA couldn't configure eight rows on a spreadsheet so that EVERYONE can understand how much can be borrowed?

It shouldn't be this hard. We know from the CARES Act that fundamentally, the owner of a business with fewer than 500 employees is entitled to borrow the lesser of:

- their average monthly "payroll costs" multiplied by 2.5, or
- \$10 million.

But somehow, the seemingly simple computation of "payroll costs" has given rise to thousands of different interpretations by borrowers, accountants, and even the banks, which begs the question asked above: why can't the SBA just hand every borrower and bank the same, precise formula and require it to be used in all cases?

In the past few days, I've spoken or emailed with hundreds of accountants, who in turn have sent me hundreds of different "payroll cost calculators" that they or their clients have received from lending institutions. And there are HUGE differences between the methodologies being employed.

This shouldn't be the case; there is no reason we can't design a formula for computing "payroll costs" that every business and bank can understand. Let's start by addressing the three biggest inconsistencies that have plagued the applications:

Do employers get to include payments made to independent contractors in payroll costs?

The legislative text of the CARES Act created no shortage of confusion on this point. In defining "payroll costs," after listing out items such as salaries and wages paid, health and retirement benefits, and severance pay, the text contained the following paragraph

...the sum of payments of any compensation to or income of a sole proprietor or independent contractor that is a wage, commission, income, net earnings from self-employment, or similar compensation and that is in an amount that is not more than \$100,000 in 1 year, as prorated for the covered period.

The structure of this “paragraph bb,” as it’s come to be known, has vexed even the smartest tax minds. Read it once, and your brain selectively grabs hold of the words, “the sum of payments...to...a sole proprietor or independent contractor.” This, of course, leads one to believe that an employer gets to add to their traditional W-2 payroll costs any amounts paid to an independent contractor on Form 1099-MISC.

Read it a few more times, however, and you realize that this paragraph is defining the payroll costs of the *recipient* of the payments, not the *payor*. When looked at through that lens, the above wording provides that the payroll cost of a self-employed taxpayer who has no employees of his or her own is comprised of any payments of compensation he or she has received, be it a wage, commission, or net earnings from self-employment. It’s got *nothing to do* with computing payroll costs for the party PAYING the independent contractor.

The SBA helped clarify this interpretation by issuing instructions to its PPP application form that explained paragraph bb the way the CARES Act should have by stating that payroll costs include:

For a *sole proprietor or independent contractor*: wages, commissions, income, or net earnings from self-employment, capped at \$100,000 on an annualized basis for each employee.

Of course, this language didn’t mean that a business paying independent contractors couldn’t ALSO add those payments to its payroll costs, and so that item was left unaddressed.

eligible for a PPP loan if it “either had employees for whom you paid salaries and payroll taxes or *paid independent contractors, as reported on Form 1099-MISC.*” This led many readers, including myself, to conclude that the SBA WAS going to allow 1099-MISC payments from a business to independent contractors to count as payroll costs.

That conclusion was short-lived, however; on page 11 of the same interim guidance, the SBA provided the following Q&A:

h. Do independent contractors count as employees for purposes of PPP loan calculations? No, independent contractors have the ability to apply for a PPP loan on their own so they do not count for purposes of a borrower’s PPP loan calculation.

Case closed, right? After all, this is the correct result. Otherwise, businesses would be able to borrow based in part on what they paid to independent contractors, and then in turn, those contractors would be able to borrow based on what they were paid by businesses. This avoids double dipping.

So then why do so many of the calculators being sent out by banks look like this?

Estimated Loan Availability			
Below is a calculator to estimate the maximum loan available:			
		Last 12 Months	Average Month
Maximum loan available:			
Payroll costs:*			
Employee compensation, as defined		\$ 196,000	\$ 16,33
Group health insurance premium payments		28,800	2,40
Retirement benefit payments		7,840	65
State/local taxes on employee compensation (i.e., state unemployment tax)		1,080	9
Self-employed income (and independent contractors) not to exceed \$100K per year per self-employed prorated for the 12 months preceding the application date		40,000	3,33
			22,81
			2.
Subtotal			\$ 57,02
Maximum loan amount (lesser of a. or \$10 million)			
			\$ 57,02

This is a sample that was sent to me, pre-populated by a bank that shall remain nameless. It endeavors to compute the payroll costs of a business, yet there, right at the bottom, is a line for self-employed income and independent contractors. Why?

The only possible explanation for this type of calculation is if this were intended for a sole proprietor who in turn has his or her own employees. But those types of borrowers won't be able to apply for a loan until next Friday. This line only serves to confuse both the bank and borrower, and add to the likelihood that an applicant will overstate their eligible proceeds by including payments to independent contractors.

Look, we're printing \$350 BILLION to provide these loans. Is it too much to ask to have TWO completely separate spreadsheets: one for a traditional employer to tally wages and the like, with NO MENTION of the items focused on self-employed taxpayers in paragraph bb, and a second spreadsheet for self-employed taxpayers or sole proprietor that will move paragraph bb to the top of the calculation?

Until that's done, applicants and banks are going to continue to make mistake after mistake.

How do we apply the \$100,000 per-employee cap on compensation?

In defining payroll costs, the legislative text removes from the computation "the compensation of an individual employee in excess of an annual salary of \$100,000, as prorated for the covered period."

The first debate that erupted around this language was whether an employee earning in excess of \$100,000 was completely eliminated from consideration, or if only the compensation *in excess of \$100,000* was excluded from the formula. While the CARES Act is far from clear on the topic, logic dictated that it was the latter; otherwise, a cliff effect would be created where one employee earning a \$98,000 salary would be counted in full while another earning \$102,000 wouldn't count at all. To avoid this result, it makes sense that if an employee earns \$130,000 of salary for a year, only the first \$100,000 should be included in payroll costs.

someone was making \$50,000 during the stretch from February 15, 2020 to June 30, 2020, because they would be earning more than \$100,000 on an annualized basis, their salary would be subject to reduction. But as we'll see below, now that the salaries being taken into account are based on 2019 annual data, this "covered period" doesn't factor into the formula.

With those issues (kind of) settled, the conversation turns to a debate that is STILL raging in accounting and lending circles: is it only the employee's SALARY that is capped at \$100,000 — with any additional payroll costs, such as state income taxes, retirement benefits or health care costs being allowed in addition to \$100,000 of salary — or is the SUM of all of those items allocable to any one employee capped at \$100,000?

It's easy to reach the latter conclusion from the text of the CARES Act. On the top of page 11, it defines payroll costs as the "sum of payments of *compensation*," with compensation then further defined as including not only wages and salary, but also health care, retirement, and state income tax costs, among others. Then, page 12 limits the "compensation" of any one employee to \$100,000. Use of the word "compensation" in both sentences would seem to indicate that ALL costs for any one employee, when combined, can't exceed \$100,000.

The instructions to the SBA application seemed to confirm this contention, by stating that average monthly payroll excludes "costs" over \$100,000 on an annualized basis for each employee.

But then the interim guidance came out. And it states that payroll costs exclude, "the compensation of an individual employee in *excess of an annual salary of \$100,000*, prorated as necessary."

Use of the word "salary" would indicate that only *that item* is capped at \$100,000, with any remaining allocable costs added on top. As you can see, some banks have adopted that methodology in their calculations:

	Last 12 Months	Average Month
Maximum Loan Amount:		
Payroll Costs:*		
Salaries, wages, commissions, vacation and sick pay (not to exceed \$100K per employee) other than qualified sick or family leave	\$ 1,500,000	\$ 125,000
Group Health Insurance	85,000	7,083
Retirement Benefit Costs	50,000	4,167
State/Local Taxes on Employee Compensation (i.e., employer U.C. tax)	6,000	500

PPP calculation NITTI

Other banks, however, are less clear, choosing instead to lay out all the payroll cost items before asking the applicant to back out “compensation” in excess of \$100,000 without clarifying what constitutes compensation. And other banks, well...other banks don’t have any reference to the \$100,000 cap included in their computations at all, which is less than comforting.

Can’t the SBA just issue one sentence of guidance that answers this question definitively?

How do you treat employer federal income tax withholding and payroll taxes on employee wages?

The first two issues we’ve dealt with; they’re more minor annoyances, and in the case of the independent contractor payments, a mistake would work in the borrower’s favor. This one...well, this one has the potential to greatly impact a borrower’s loan proceeds in a negative manner, and the banks are all over the map in how they handle the issue.

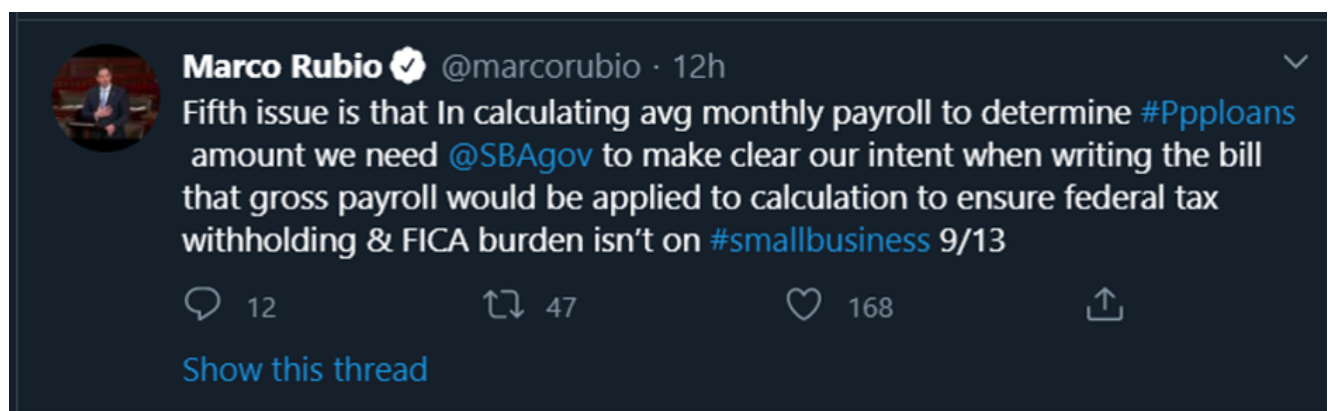
The source of the problem is found in the CARES Act. When listing the items excluded from payroll costs, the bill added:

(bb) taxes imposed or withheld under chapters 21, 22, or 24 of the Internal Revenue Code of 1986 during the covered period.

that payroll costs do NOT include these items, which led some to conclude that only net wages paid to an employee were included in the computation.

And that makes no sense. After all, if an employer pays A wages of \$90,000, but remits \$20,000 in federal tax withholding and payroll taxes owed by the employee directly to the government so that A receives only \$70,000 of net pay, it doesn't change the fact that the employer had to shell out \$90,000. And if the purpose of the PPP loan is to allow an employer to make payroll for the next eight weeks, that employer is going to need to borrow the GROSS amount of wages it owes its employees, not the NET amount.

In fact, Senator Marco Rubio, who was intimately involved with the CARES Act as it made its way through the Senate, confirmed this thinking on Saturday in a tweet:



Rubio tweet NITTI

But before we just conclude that payroll costs are intended to be gross, rather than net, we have to acknowledge the language in the legislative text. But perhaps it means something different than we originally thought?

The CARES Act provides that payroll costs do not include withholding and payroll tax FOR THE COVERED PERIOD, which runs from February 15, 2020 through June 30, 2020.

Originally, in computing average monthly payroll costs, applicants were required by the CARES Act to total costs for the 12 months prior to the loan origination. But if a borrower used a period from April 4, 2019 to April 3, 2020 to determine payroll costs, what would it accomplish to reduce those costs by federal income tax withholding and

What makes the requirement to reduce by these costs even more nonsensical, however is that the SBA has ordered the banks to diverge from the requirement in the CARES Act that an applicant compute payroll costs for the prior 12 months, and instead use the borrower's 2019 payroll data, a directive —by the way — that many banks have failed to adhere to. But for those who have, why would an applicant basing its payroll costs on 2019 data reduce those costs for withholding and payroll taxes paid in March and April of 2020?

That, obviously, makes even LESS sense than the *last thing* that made no sense, and so banks are instead asking applicants to provide the NET wages they paid in 2019, a request that 1) does not adhere to either the CARES Act OR the SBA guidance, and 2) stands to greatly understate the amount an applicant is entitled to borrow. Even worse, common payroll providers like ADP are doing the same:

CARES SBA-PPP: Monthly Payroll Cost From: 01/01/19 To: 12/31/19

This report provides payroll data needed to complete the SBA loan application under the CARES Act Paycheck Protection Program (PPP). If you were not a client of ADP for the full period selected in this report you may need to obtain data from your prior provider or your own records.

Month	Earnings	Taxes (Federal)	Taxes (State and Local - Employer)	Charitable, 401(k), 529, etc. (SS/MED)	Other Deductions (Employer)	Retirement Benefits (Employer)	Payroll Cost
Jan-19	316361.40	32975.28	5812.68	23592.87	0.00	8300.47	27390
Feb-19	317131.85	32479.79	3692.11	23651.74	0.00	8482.30	27316
Mar-19	318485.26	32649.05	643.07	23745.90	0.00	8389.83	27112
Apr-19	322806.09	34036.32	261.39	24070.17	0.00	8457.55	27343
May-19	324208.82	33738.86	103.12	24145.18	0.00	8708.49	27513
Jun-19	327832.65	34610.37	0.00	24487.52	0.00	8815.19	27754
Jul-19	319581.32	33741.59	0.00	23866.14	0.00	8854.53	27080
Aug-19	291218.31	30143.55	267.92	21786.22	0.00	8038.89	24759
Sep-19	281194.85	28394.83	12.58	19492.57	0.00	7508.59	22282
Oct-19	243388.39	24037.56	190.69	18146.10	0.00	6915.48	20831
Nov-19	201903.08	20199.26	250.26	15108.83	0.00	5616.78	17246
Dec-19	231048.48	22773.47	120.05	17386.21	0.00	6481.19	19750
TOTALS	3475160.51	357779.83	11373.86	259499.23	0.00	94557.27	2963811

ADP NITTI

If you can read that (you can't), you'd see ADP is computing payroll costs by reducing gross wages for 2019 by federal income tax withholding and payroll taxes.

I get it; criticism is easy. And fun, too! But what SHOULD banks be doing about this legislative mandate that payroll costs do not include federal income tax withholding and payroll taxes for the period February 15, 2020 through June 30, 2020?

applicant could borrow, but rather the amount the *borrower can have forgiven*.

As a reminder, the maximum amount of the loan that is eligible for forgiveness is the amount of “payroll costs,” mortgage interest, rent and utilities paid within the 8 week period beginning on the date of the loan. Forbidding a borrower to pay income and payroll taxes with forgiven money makes sense; if an employer owes employee A gross wages of \$10,000 during that period — paying A \$8,000 of net pay and remitting \$2,000 of federal income tax withholding and payroll taxes to the government — it is reasonable to conclude that the government doesn’t want to effectively pay the taxes *owed to itself* by forgiving that \$2,000 of the borrower’s loan. In other words, the government will subsidize the net amount the employer pays the employee directly, but not the amount the employer pays back to the government on behalf of its employees.

There is other support for items excluded from the definition of “payroll costs” by the CARES Act to only come into play upon forgiveness, rather than at the time of borrowing. For example, the CARES Act removes from payroll costs “qualified family leave and sick wages” for which the employer can claim a payroll tax credit. Those credits, however, were added to the law just three weeks ago by the Families First Coronavirus Relief Act, and by definition, wages qualifying for the credit can only be paid AFTER April 1, 2020. As a result, excluding them from an applicant’s annualized payroll costs would have no effect, particularly now that borrowers are using 2019 costs to determine proceeds. Removing them from the costs that can be FORGIVEN, however, would prevent a taxpayer from receiving a credit for wages that the government effectively paid, and that is perfectly reasonable. Federal income tax withholding and payroll taxes should be viewed the same way: leave them in for computing loan proceeds; remove them when paid during the 8-week period to determine forgiveness.

Mr. Mnuchin, putting it all together, the proper formula for an employer OTHER than self-employed taxpayer or sole proprietor should be the following. Take the sum of:

- GROSS wages and salary paid to *employees* — independent contractors not included — for all of 2019. This amount, and only this amount, should be capped at \$100,000 per employee,

- 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.

Then, reduce this sum by any amount paid to any employee whose principal place of residence is outside the U.S. Take this net amount, divide it by 12, and multiply it by 2. Done and done.

<i>Represents the maximum amount a qualified borrower may apply for.</i>			
		2019	Average Month
Maximum Loan Amount:			
Add: 2019 Gross payroll amounts			
Salaries, wages, commissions, vacation and sick pay (not to exceed \$100K per employee)		\$ 1,500,000	\$ 125,000
Group Health Insurance		85,000	7,083
Retirement Benefit Costs		50,000	4,167
State/Local Taxes on Employee Compensation (i.e., employer U.C. tax)		6,000	500
Subtract:			
Salary for any one employee in excess of \$100,000		(90,000)	(7,500)
Salary for any employee whose principal place of business is outside the U.S.		(45,000)	(3,750)
Total		1,506,000	125,500
Subtotal		a) \$ 313,750	

calculator NITTI

Once the business has borrowed its \$313,750, it can start spending on payroll, mortgage interest, rent and utilities. Then, when determining the amount of costs eligible for forgiveness during the 8-week period following the origination of the loan, the bank should exclude any federal income tax withholding and payroll taxes paid during that period, as well as any qualified family leave or sick leave wages.

So Steven, if you could get this formula out to the banks, we'd be off to a good start. Then we can reconvene next week and do it all over again for sole proprietors and self-employed individuals.

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