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Improper Paycheck Protection Program Loans May Be Subject to Unrelated Business Income Tax

On September 21, 2022, the Internal Revenue Service ("IRS") Chief Counsel's Office issued an Advice Memorandum confirming that improperly forgiven Paycheck Protection Program ("PPP") loans are taxable. Thus, even if PPP loan forgiveness was obtained, the exclusion from income tax is inapplicable if the loan recipient was not an eligible recipient. For Internal Revenue Code ("IRC") Section 501 (c)(7) social clubs which received PPP loans, even if such loans have been forgiven, such amounts may be considered unrelated business income ("UBI").

The guidance stipulates that when a taxpayer's PPP loan is forgiven based upon misrepresentations or omissions, the taxpayer is not eligible to exclude the forgiveness from taxable income and must include in income the portion of the PPP loan proceeds that were forgiven based upon misrepresentations or omissions. Taxpayers who inappropriately received forgiveness of their PPP loans are encouraged to take steps to come into compliance by, for example, filing amended returns that include forgiven PPP loan proceeds in taxable income.

Under the terms of the PPP loan program, lenders can forgive the full amount of the PPP loan if the loan recipient meets three conditions:

1. The loan recipient was eligible to receive the PPP loan.
2. The loan proceeds were used to pay eligible expenses, such as payroll costs, rent, interest on the business' mortgage, and utilities.
3. The loan recipient applied for loan forgiveness. The loan forgiveness application required a loan recipient to attest to eligibility, verify certain financial information, and meet other legal qualifications.

If the three conditions cited above were met, then under the PPP loan program the forgiven portion is excluded from income. If the conditions were not met, then the amount of the PPP loan proceeds that were forgiven but do not meet the conditions must be included in UBI and any additional income tax, and applicable interest and penalties, must be paid.

In determining eligibility and/or forgiveness, the Small Business Administration ("SBA") allows lenders to rely on prospective recipients' certifications and documentation. Lenders are held harmless for recipients' failure to comply with program criteria if the lender acted in good faith and complied with relevant statutory and regulatory requirements. Subsequent to a lender granting PPP loan forgiveness, if the SBA determines that forgiveness was not proper, the SBA may seek repayment of the loan. In such case, civil and criminal remedies (including recoupment of the improperly forgiven amount) are also available in coordination with the Department of Justice.

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