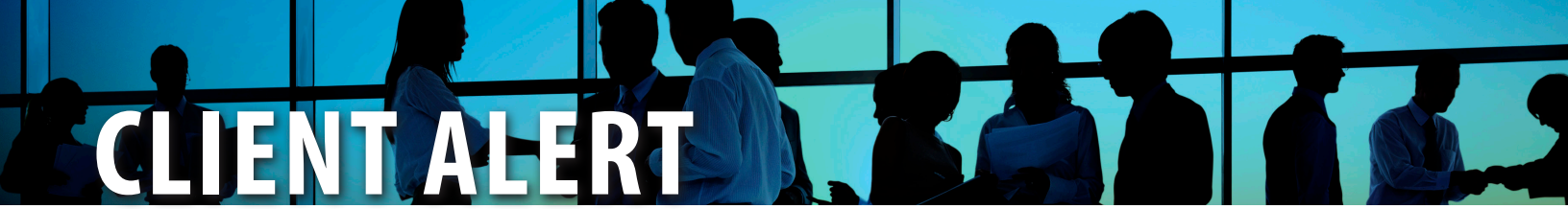


IRS ORDERS IMMEDIATE STOP TO NEW EMPLOYEE RETENTION CREDIT CLAIMS AND ANNOUNCES FUTURE SETTLEMENT PROGRAM

By Eric W. Gregory

The Employee Retention Tax Credit ("ERC"), enacted as a part of the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"), is a fully refundable tax credit for employers, which is up to $26,000 per eligible employee. Because of the potentially large value of the ERC to employers, the Internal Revenue Service ("IRS") has become increasingly "alarmed about small business owners being scammed by unscrupulous" promoters attempting to "con" ineligible employers into claiming the credit based on "inaccurate information related to eligibility and computation of the credit." The IRS listed these false promotions as part of its "Dirty Dozen" list of tax scams, and has now announced an immediate moratorium through at least the end of 2023 on processing new claims for the ERC.

Additionally, the IRS announced that it is developing new initiatives to help businesses who became victims of aggressive tax promoters. This includes a yet-to-be-implemented settlement program for repayments for those who received an improper ERC payment, with more details "to be released in the fall."

Employers who have filed an ERC claim using the services of a tax promoter should carefully consider whether the claim is justified under the guidance issued by the IRS on the ERC. Employers may wish to consult with an experienced tax professional, especially if significant diligence was not done on an ERC claim, and should carefully monitor for new announcements regarding the IRS settlement program.

Warning Signs of Aggressive ERC Marketing

The IRS has identified the following warning signs to watch out for in aggressive ERC marketing from promoters:

- Unsolicited calls or advertisements mentioning an "easy application process." Promoters often point to similar employers who "applied for" and were "approved for" the credit when, in reality, there is no "application process." An employer simply claims the credit but bears the burden of proof that the claim was justified upon audit from the IRS.
- Statements that the promoter or company can determine ERC eligibility within minutes. An actual interview process should generally be conducted to understand how a business operated before the COVID-19 pandemic and then during each quarter.
- Aggressive claims from the promoter that the employer qualifies before discussing the employer's specific situation. In reality, the ERC is a complex credit that requires careful review.
- Lack of a written narrative to comprehensively explain to an IRS examiner which provisions in a governmental order applied to the operations, and how those provisions caused the business to be suspended.
- Wildly aggressive suggestions from marketers urging employers to submit claims because there is "nothing to lose" or "before funds run out." In reality, improperly claiming and receiving the credit may amount to tax fraud with substantial penalties and interest due. Additionally, there is no "set amount of funds" set aside for ERC claims that is liable to run out. Employers have until April 15, 2024, to file a 941-X return to claim the ERC for any quarter in 2020, and until April 15, 2025, to file a claim for any quarter in 2021. Aggressive promoters are erroneously attempting to generate a false sense of urgency.

Additionally, promoters sometimes claim to be familiar with members of Congress who drafted the statute, suggesting that "all employers are eligible" without evaluating an employer's individual circumstances. This is simply not true, as eligibility for the ERC is a highly fact-intensive analysis, and many employers do not meet the eligibility requirements.

Properly Claiming the ERC

Eligible taxpayers can claim the ERC on an original or amended employment tax return for qualifying wages. To be eligible, an employer must have:

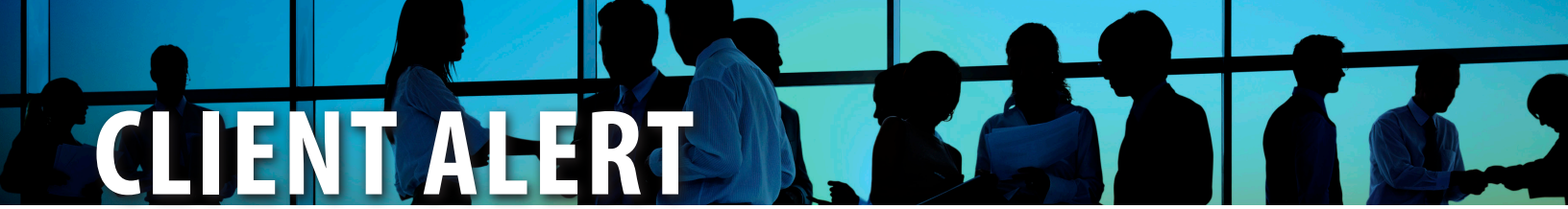
1. Sustained a "full or partial suspension" of operations due to an order from an appropriate governmental authority limiting commerce, travel, or group meetings because of COVID-19 during 2020 or the first three quarters of 2021;
2. Experienced a "significant decline in gross receipts" during 2020 or during the first three quarters of 2021; or
3. Qualified as a "recovery startup business" for the third or fourth quarter of 2021.

Improper claims for the ERC tend to be based on promoters taking an aggressive position on "full or partial suspensions" without fully analyzing the taxpayer's situation.

Under IRS Notice 2021-20, an employer that experiences a "full" or "partial" suspension due to orders from an appropriate governmental authority is eligible to claim the ERC during the suspension dates.
The suspension test is a two-part test in which an employer must establish:

1. The employer is subject to a "governmental order" in effect; and
2. The order has a "more than a nominal impact" on the business operations, either due to fully suspending them or requiring modifications to them.

A "governmental order" requires a federal, state, or local government order, proclamation, or decree that limits commerce, travel, or group meetings due to COVID-19. A government must issue the order with jurisdiction over the employer's operations. The order must also be mandatory to qualify—statements by government officials or mere emergency declarations do not suffice.



For a suspension, an employer must show that "more than a nominal portion" of business operations were affected. There are two available safe harbors for demonstrating this under Notice 2021-20:

1. The gross receipts from that portion of the business suspended make up at least ten percent of the employer's total gross receipts (both determined using the gross receipts from the same calendar quarter in 2019); or
2. The hours of service performed by employees in that portion of the business make up at least ten percent of the employer's total employee service hours (both determined using the service hours performed by employees in the same calendar quarter in 2019).

For a modification, employers must show that the modification caused "more than a nominal effect" on business operations. Under Notice 2021-20, a modification will have a "more than nominal effect" if it results in a ten percent or more reduction in an employer's ability to provide goods or services in its normal course of business.

Improper "Full or Partial Suspension" Positions

Many ERC promoters have advanced similar unjustified positions for claiming the ERC. This includes citing:

- Guidance and recommendations from federal bodies such as the Centers for Disease Control and Prevention ("CDC") do not qualify as suspension orders when that guidance is not mandatory.
- Increases in costs in order to successfully maintain pre-pandemic levels of operations, which is not a factor in IRS guidance.
- Shutdown orders not applicable to the employer itself (i.e., shutdown orders applicable to customers of the employer), which do not qualify under Notice 2021-20.
- A voluntary shutdown of an employer that was not required to close due to a governmental order. Many "critical infrastructure" or "essential" businesses that were exempted from most or many state and local governmental orders chose to close offices or branches during the height of the pandemic, but unless they were ordered to do so by a governmental order, this alone would not justify an ERC claim.
- A governmental order closed an employer's workplace, but the employer could continue operations comparable to operations before the closure via telework.
- Modifications to operations that do not rise to the level of a "partial suspension" because the modification did not have a "more than nominal effect" on the employer's business operations, meaning that it did not result in a reduction in an employer's ability to provide goods or services in the normal course of business of not less than ten percent.
- Reliance on broadly applicable "supply chain issues" without specific citation to a governmental order that, under the facts and circumstances, led to a lack of supply of critical goods or materials that caused the inability of the employer to operate.

Additionally, employers are only permitted to claim the ERC for a "full or partial suspension" for the specific days a governmental order was in force. Employers may not claim the credit for an entire quarter, let alone the entire year, if a governmental order ceases to be effective during a quarter.

Substantiation Issues

Many promoters have filed claims that do not comply with the substantiation requirements that the IRS has provided in Notice 2021-20 and in its FAQs. These include maintaining:

- Copies of the specific governmental orders relied upon for the claim.
- Documentation on the decline in gross receipts.
- Documentation demonstrating the qualified wages and what amounts, including any qualified health plan expenses.
- Whether any of the employer's employees who received wages under the ERC are related to owners of the employer.
- The relationship of the employer to other businesses or entities and how required aggregation affects the ERC claim.
- Any completed Forms 7200 submitted to the IRS.
- Any completed federal employment and income tax returns to claim the ERC.

In its FAQs, the IRS warns specifically: "[d]on't accept a generic document about a government order from a third party. If they say you qualify for [the ERC] based on a government order, ask for a copy of the government order. Review it carefully to make sure it applied to your business or organization." Many promoters have produced one or two-page documents with simple conclusory statements that an order had a "more than nominal effect" or the company had been suspended for "more than a nominal portion" of a business without any documentation or analysis as to why. Lastly, many promoters fail to limit the claim of the ERC to the specific periods in which the orders applied, and, instead, claim the ERC for the entire quarter or even the entire year in which it applied.

Employers who are audited on their ERC claims should expect the IRS to demand the following, which have been raised on ERC audits thus far:

- A list of employees who were paid wages for which the ERC was claimed.
- Whether any of the employer's employees who received wages under the ERC are related to owners.
- The amount of wages paid to each employee for which the ERC was claimed.
- Documentation that operations were fully or partially suspended due to an appropriate governmental authority due to COVID, including copies of each governmental order.
- Documentation demonstrating how the employer determined that either "more than a nominal" portion of the business was suspended or that a required modification had a "more than nominal impact" on business.
- Copies of income tax returns, employer tax returns, and Form W-2s for all related entities if the employer is part of an aggregated group of employers.

Statute of Limitations

A three-year statute of limitations applies to ERC claims under Internal Revenue Code ("Code") Section 6051, as well as to FICA taxes assessable on Form 941 (the Form where the ERC is claimed). A particular five-year statute of limitations applies to the ERC claims for the third quarter of 2021. The IRS could bring a suit related to an ERC claim pursuant to the Tax Court deficiency procedures under Code Section 6212. The IRS could also file suit for an erroneous refund claim under Code Section 7405. While, generally, a deficiency proceeding must be initiated within the three-year statute of limitations under Code Section 6501, an IRS claim for an erroneous refund may be brought within two years of the date of the refund, or even five years of the date of the refund, if there is fraud or mistake of fact in making the refund claim.

Therefore, simply because the IRS pays an employer's claim for the ERC does not mean that the IRS actually agrees that the employer is entitled to the credit. The credit is not claimed on an "application" that is reviewed and approved by the IRS, it is simply claimed by amending Form 941 indicating that the employer is claiming the credit. It is only when the relevant statute of limitations has expired and the IRS' ability to bring a civil suit becomes time-barred, can an employer feel comfortable knowing that the government will not challenge the claim.

Consequences of Taking Aggressive Positions

The Code allows many different penalty provisions that could apply in the case of an erroneous ERC claim. Some of these include, but are not limited to, penalties for inaccuracy (20% of the unreported tax), penalties for erroneous claims for a refund (20% of the credit claimed), penalties attributable to fraud (75% of the underpayment), or evasion of employment taxes (100% civil penalty on employment taxes owed). Taxpayers always bear the burden of substantiating reasonable cause to avoid penalties and must exercise ordinary business care and prudence in reporting proper tax liability.

Therefore, potential penalties (as well as interest on the ERC credit) could total much more than the original ERC credit received in the first place.

Consider Engaging a Tax Professional Familiar with the ERC

Employers who have claimed the ERC but have concerns about the justification of the claim should consult a tax professional who is familiar with the ERC to examine the sufficiency of the claim. To the extent that an employer takes advantage of the announced ERC settlement program, the employer may be able to avoid interest and penalties, as well as the expense of an audit. Alternatively, a thorough review could reveal that the claim is justified based the facts and analysis, and will provide an enhancement to the taxpayer's demonstration of ordinary business care and prudence in making an appropriate claim.

Dickinson Wright PLLC is available to assist clients with the analysis of ERC claims and with IRS audits on ERC claims.

ABOUT THE AUTHOR

Eric W. Gregory is a Member in Dickinson Wright's Troy office. He can be reached at 248.433.7669 or egregory@dickinsonwright.com.