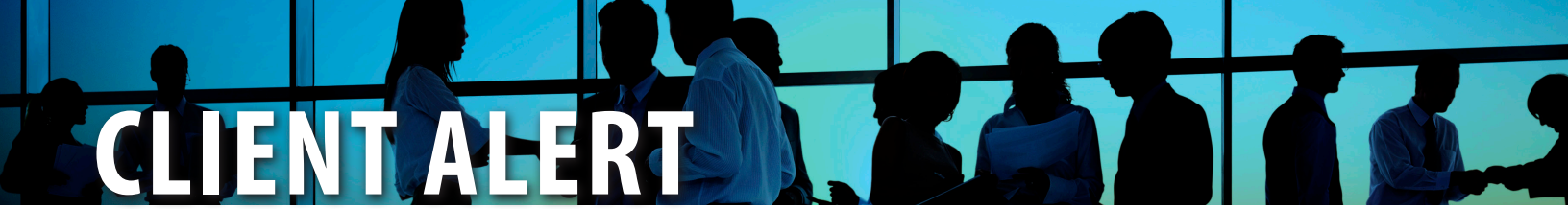


IRS ISSUES ALERTS AND BEGINS AUDIT ACTIVITY RELATED TO THE EMPLOYEE RETENTION TAX CREDIT

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, up to $26,000 per eligible employee. Because of the potentially significant value of the ERC to employers, the Internal Revenue Service ("IRS") has warned of "blatant" attempts by promoters 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 is stepping up enforcement action involving ERC claims.

Employers considering making an ERC claim, or those that have already made an ERC claim, should carefully consider whether the claim is justified under the guidance issued by the IRS on the ERC. Employers may consider consulting with an experienced tax professional, especially if significant diligence was not done on an ERC claim.

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 that "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 that 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 factually 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:

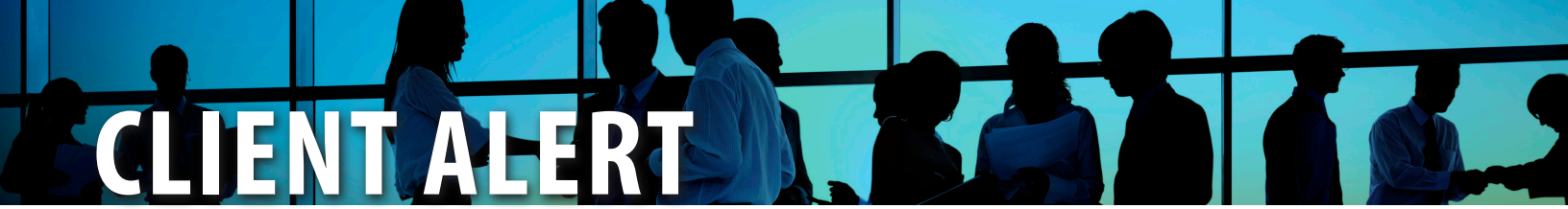
1. Sustained a "full or partial suspension" of operations due to an order from an appropriate governmental authority limiting commerce, travel, or group meetings because of COVID-19 during 2020 or the first three quarters of 2021;
2. Experienced a "significant decline in gross receipts" during 2020 or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

Improper claims for the ERC tend to be based on promoters taking an aggressive position on "full or partial suspensions" without thoroughly 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 declarations of emergency 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 because that guidance is not mandatory.

- Increases in costs to successfully maintain pre-pandemic levels of operations are not a factor in IRS guidance.

- Shutdown orders do not apply to the employer itself (i.e., shutdown orders applicable to employer customers), 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 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 that closed an employer's workplace, but the employer could continue operations comparable to 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 ceased to be effective during a quarter.

Issues Raised on Audit

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:

1. A list of employees who were paid wages for which the ERC was claimed.

2. Whether any of the employer's employees who received wages under the ERC are related to owners.

3. The amount of wages paid to each employee for which the ERC was claimed.

4. Documentation that operations were fully or partially suspended due to an appropriate governmental authority due to COVID, including copies of each governmental order.

5. 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.

6. 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.

Five-Year Limit on Civil Actions for Recovery of Erroneous Refunds

Internal Revenue Code ("Code") Section 7405(b) allows the government to bring a civil action to recover any portion of a tax imposed that was erroneously refunded. Under Code Sections 7405(d) and 6532(b), the statute of limitations for bringing such an action is two years from making the refund, and extends for five years for any cause of fraud or misrepresentation of a material fact. Therefore, the statute of limitations for the IRS to bring an action to reclaim an ERC refund will not end until at least two years after the refund is made.

The Payment of a Claim Is Not IRS Acquiescence

The fact that 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. Only when the relevant statute of limitations has expired, and the IRS' ability to bring a civil suit has expired can an employer feel comfortable knowing that the government will not challenge the claim.

Consequences of Taking Aggressive Positions

The Code provides for 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%), penalties for erroneous claim for a refund (20%), penalties attributable to fraud (75%), or evasion of employment taxes (100%). 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 that 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 voluntarily amends a Form 941-X and repays an ERC claim to the IRS before an audit, 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 on the facts and analysis, and will enhance 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.

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