taxnotes federal

Volume 182, Number 8 ■ February 19, 2024

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by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, February 19, 2024, p. 1457

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ERC Challenges by the IRS, to the IRS, and Among Various Parties

by Hale E. Sheppard

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In this article, Sheppard examines some of the current developments with the employee retention credit, noting that employers, sponsors, accountants, and others should be aware of them to effectively defend themselves.

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I. Introduction

There has been lots of talk about the employee retention credit over the past few years, and it is bound to increase. This is a polarizing tax benefit, for sure, with different perspectives espoused by many factions. There are a few things on which everyone can seem to agree, though. First, guidance regarding the ERC is dense and complicated. Congress passed four laws in rapid succession, and the IRS tried to keep pace by issuing various notices, revenue procedures, chief counsel advisories, generic legal advice memos, frequently asked questions, forms, fact sheets, and more. This barrage of information, some of it untimely and inconsistent, has resulted in confusion. Second, ERCs often involve big money for employers who obtain them, professionals who assist in the procurement process, and others. Third, parties working toward the mutual goal of submitting proper ERC claims and maximizing benefits sign agreements, the terms of which are sometimes subject to different interpretations. These three realities have converged to trigger disputes — both with the IRS and among various parties. This article, the latest in a long list of articles about the ERC by the same author, examines these early clashes.[1]

II. Disputes Involving the IRS

ERC battles will be plentiful because the IRS has promised lots of taxpayer audits, which will be followed by administrative appeals and litigation. The IRS announced that it had already referred "thousands of ERC cases for audit" as of September 2023.[2] This figure is bound to increase for two reasons. First, in response to rising concerns about questionable Forms 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," seeking ERCs, the IRS also declared in September 2023 that it was placing an "immediate moratorium" on the processing of any "new" ERC claims.[3] Second, pending and future ERC claims will be subjected to "enhanced compliance reviews" by the IRS.

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[1] Hale E. Sheppard, "ERC Enforcement Tactics: The IRS's Carrots and Sticks So Far," *Tax Notes Federal*, Feb. 5, 2024, p. 1017; Sheppard, "IRS Tries to Further Limit ERC Claims Under Governmental Order Test," *Tax Notes Federal*, Jan. 29, 2024, p. 819; Sheppard, "ERC Disputes: Mastery of Procedural and Substantive Rules Required," *Tax Notes Federal*, Nov. 6, 2023, p. 977; Sheppard, "Employee Retention Credits: What the IRS Didn't, Did, and Might Do," *Tax Notes Federal*, Oct. 23, 2023, p. 619; Sheppard, "Employee Retention Credits: Reasons for Prolonged Claims," *Tax Notes Federal*, Oct. 16, 2023, p. 431; Sheppard, "Employee Retention Credits: Analyzing Key Issues for 'Promoters' and Other 'Enablers,'" 139 *J. Tax'n* 15 (2023); Sheppard, "Employee Retention Credits: Analyzing Key Issues for Taxpayers Facing IRS Audits," 139 *J. Tax'n* 32 (2023).

[2] IR-2023-169.

[3] IR-2023-169; Nathan J. Richman, "ERC Moratorium Seemingly Directed at Taxpayer Awareness," *Tax Notes Federal*, Oct. 30, 2023, p. 905; Richman, "Tax Pros Are Reading Further and Further Into ERC Moratorium," *Tax Notes Federal*, Dec. 18, 2023, p. 2235; Lauren Loricchio and Richman, "IRS Moratorium Jolts Employee Retention Credit Industry," *Tax Notes Federal*, Nov. 27, 2023, p. 1670.

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Logic dictates that this additional scrutiny will significantly delay processing times, increase the probability of audit, and lead to more ERC clashes between employers and the IRS.[4]

The IRS also announced that its Criminal Investigation division had initiated over 300 investigations by October 2023, involving approximately $3.5 billion in claims.[5] The IRS clarified that it was focused on those that were "knowingly attempting to help taxpayers or employers evade tax, in other words, commit acts of fraud."[6] These efforts might trigger criminal charges, indictments, and prosecutions.

Finally, the IRS indicated in December 2023 that it had already started various "promoter investigations" under section 6700.[7] These investigations might result in refund litigation by many alleged promoters that are facing stiff penalties.

For the preceding three reasons and others, clashes with the IRS will be on the uptick soon. Several are underway already, as seen below.[8]

A. Employer Sues for Refund

In *Lightning Oilfield Services*,[9] the employer filed ERC claims on Forms 941-X for the first, second, and third quarters of 2021. It alleged that it met all the criteria necessary to obtain approximately $3.6 million in ERCs. The IRS neither sent the refunds nor issued notices of disallowance during the following six months; therefore, the employer filed a suit for refund in district court. The employer asked the court to rule that it was entitled to all ERC amounts, penalties, interest, and costs.

B. Employer Sues to Invalidate IRS Guidance

In *Southern California Emergency Medicine*,[10] the employer, an urgent care center, filed Forms 941-X seeking ERCs for six quarters in 2020 and 2021. It took the position that it qualified because its operations suffered a partial suspension as a result of an appropriate governmental order. The IRS issued notices of disallowance for all quarters, denying refunds based primarily on the terms of Notice 2021-20, 2021-11 IRB 922. The employer did not file a suit for refund with the district court. Instead, it launched a suit seeking to halt (that is, enjoin) the IRS from relying on Notice 2021-20 in making ERC determinations because the IRS allegedly violated the Administrative Procedure Act in issuing it.

Some context is necessary here. The Tax Court recently explained in *Green Valley Investors*[11] that the APA involves a three-step procedure, dictating that agencies, like the IRS, must (1) issue a general notice to the public about proposed rulemaking, (2) allow interested persons to provide input, by submitting comments or participating in hearings, and (3) feature in the final rule a "concise general statement" of its "basis and purpose." The Tax Court acknowledged the existence of certain exceptions, including that the APA applies only to "legislative rules," not "interpretive rules." Finally, the Tax Court recognized that Congress reserved the right to modify the APA requirements, but warned that a statute enacted after the APA cannot be interpreted as superseding the APA unless "it does so expressly."[12] The Tax Court held that Notice 2017-10, 2017-4 IRB 544, which identified certain activities as "syndicated conservation easement transactions," was invalid because it did not comport with the APA.[13]

That recent Tax Court case constitutes just one of a growing list of APA-related problems for the IRS. Here are some others. A district court held that the IRS violated the APA when it issued

[4] IR-2023-169.

[5] IR-2023-201; Richman, "IRS Has Hundreds of Criminal ERC Cases Open," *Tax Notes Federal*, Nov. 6, 2023, p. 1102.

[6] Loricchio, "Sunset for ERC Withdrawal Initiative to Be Determined," *Tax Notes Federal*, Nov. 6, 2023, p. 1093.

[7] Richman, "Civil Examinations of ERC Promoters Are Underway," *Tax Notes Federal*, Dec. 11, 2023, p. 2048; *see also* Loricchio, *supra* note 6.

[8] Loricchio and Richman, "Lawsuits Target Business Practices of ERC Firms," *Tax Notes Federal*, Oct. 30, 2023, p. 924.

[9] Complaint, *Lightning Oilfield Services Inc. v. United States*, No. 4:23-cv-01246 (N.D. Tex. Dec. 15, 2023).

[10] Complaint, *Southern California Emergency Medicine Inc. v. Werfel*, No. 5:23-cv-02450 (C.D. Cal. Dec. 1, 2023); Loricchio, "Lawsuit Seeks to Invalidate IRS's ERC Guidance," *Tax Notes Federal*, Dec. 11, 2023, p. 2068.

[11] *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5, at 7-8 (2022).

[12] *Id.* at 7-8.

[13] *Id.* at nn.5 and 22.

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Notice 2016-66, 2016-47 IRB 745, which identified certain microcaptive insurance arrangements as "transactions of interest."[14] Likewise, the Sixth Circuit ruled that the IRS improperly ignored the APA when it published Notice 2007-83, 2007-45 IRB 960, which called trusts using cash life insurance policies listed transactions.[15] Another district court determined that the IRS failed to comply with the APA in issuing temporary regulations for the dividends received deduction under section 245A.[16] Finally, the IRS issued a chief counsel advisory indicating that it cannot argue that taxpayers must file both Forms 8275, "Disclosure Statement," and Forms 8886, "Reportable Transaction Disclosure Statement," to avoid the economic substance penalty for undisclosed transactions because the sole source of this double duty, Notice 2010-62, 2010-40 IRB 411, contravenes the APA and the IRS's own policy statement.[17]

In *Southern California Emergency Medicine*, the employer primarily argues that (1) Notice 2021-20 creates material changes to the ERC rules created by Congress, including significantly narrowing eligibility standards and imposing new requirements; (2) those changes are legislative in nature; (3) the ERC laws enacted by Congress do not expressly exempt the IRS from complying with the APA; (4) the IRS violated the APA by issuing Notice 2021-20 without the requisite public notice and participation; and (5) the IRS acted contrary to its own policy statement, issued in 2019 and still in effect today, stating that the "best practice" for the IRS is the notice and comment process established by the APA, the IRS will use the notice and comment process for both legislative and interpretive rules, and subregulatory guidance, including a notice, "does not have the force and effect of law."[18]

C. Employer Sues to Stop Jeopardy Assessment

In *Finland Financial*,[19] two officers of the employer were indicted for obtaining millions of dollars in improper financial benefits under the Paycheck Protection Program and Economic Injury Disaster Loan Program. The employer later opened a bank account, into which several checks from the government were deposited, and from which several withdrawals were made. The indicted officers were listed among the account holders. Based on this and other "suspicious circumstances," the bank placed a hold, or freeze, on the account to further investigate. The employer then filed suit against the bank, seeking release of the funds. It indicated to the court, among other things, that the funds were needed to finance the defense against the indictment. The employer later withdrew the suit.

The IRS then made a recapture assessment for improper ERCs obtained by the employer, followed by a jeopardy levy to collect the liability from the account. The IRS justified its actions on two facts. First, the Forms 944, "Employer's Annual Federal Tax Returns," seeking ERCs showed that the employer had supposedly paid wages of about $2.6 million, whereas the Forms W-2, "Wage and Tax Statement," issued to employees reported only $710,000. Second, the forms 944 and W-2 indicated that the employer remitted to the IRS significant tax withholdings, but it had done no such thing.

The employer filed another suit with the court, this time asking it to conclude that the IRS's expedited seizure of the account to repay ERCs was unreasonable. Relevant law dictates that those seizures are acceptable if the taxpayer is "or appears to be" planning to place money or other property beyond the IRS's reach by removing it from the country, concealing it, dissipating it, or transferring it to other persons. The court said the emptying of the account by the IRS was copacetic for three reasons: the employer's earlier admission in the case involving the bank that it intended to exhaust the funds to fight the criminal charges against its officers, the inconsistencies in the employment tax returns and withholdings,

[14] *CIC Services LLC v. IRS*, No. 3:17-cv-00110 (E.D. Tenn. 2022).

[15] *Mann Construction Inc. v. United States*, 27 F. 4th 1138 (6th Cir. 2022).

[16] *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 (D. Colo. 2022).

[17] ILM 202244010; Treasury, "Policy Statement on the Tax Regulatory Process" (Mar. 5, 2019).

[18] Treasury, *supra* note 17.

[19] *Finland Financial Inc. v. United States*, No. 8:23-cv-01707 (C.D. Cal. 2023).

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and the prior ERC recapture assessment by the IRS. The court ultimately held that the IRS had a "reasonable belief" that the funds were in jeopardy and that that belief was not "arbitrary or capricious."

III. Disputes Not Involving the IRS

ERC claims can involve big numbers, that is, significant tax savings for employers and significant fees for those assisting them. When serious money is at issue, fighting often ensues. The ERC arena is no exception to this reality. Various court battles between diverse parties have already started — before the deadlines for submitting ERC claims for 2020 and 2021 have even closed. One would expect many more to follow as additional claims are filed, IRS enforcement activities continue, some employers decide to resolve matters with the IRS through its "withdrawal option" or "voluntary disclosure program," notices of disallowance are issued and challenged, refund litigation decisions are rendered, and so on.[20]

What follows is a survey of various cases entailing different parties and issues, the details of which are derived from documents filed with the courts and available to the public. Some of the descriptions are based solely on allegations made by the parties, which means that they might not be comprehensive or entirely accurate; allegations tend to contain lots of rhetoric. Moreover, only the beginning of each case is discussed — not its ultimate resolution. Thus, some cases might have been dismissed, settled, or otherwise concluded without any legal rulings. In short, the inclusion of a party in any of the cases discussed should not be interpreted negatively, as they did not necessarily do anything wrong. Following in this vein, the names of the parties have been replaced with more general terms, such as "employer," "sponsor," "accountants," "specialty firm," and more.

A. Employers Sue Sponsors

Many cases involve employers airing grievances with sponsors. Below are just a few.

1. First example.

The accountants supposedly approached the employer, which agreed to supply its business information to ascertain whether, or to what extent, it was entitled to ERCs.[21] The engagement letter contemplated a contingency fee to the accountants equal to 20 percent of any tax reduction or refund. The accountants gave the employer a questionnaire whose express purpose was to "document a full or partial suspension of operations as a result of a governmental order restricting commerce, travel, or group meetings." The employer completed the questionnaire. The accountants did not engage in further discussions, seek additional data, or ask if certain supply chain interruptions noted by the employer triggered a suspension of its business operations. Based solely on the responses to the questionnaire, the accountants reasoned that the employer had suffered a qualifying suspension and was entitled to about $1.5 million in ERCs. The accountants prepared and filed Forms 941-X on behalf of the employer seeking that amount.

After filing Forms 941-X, the employer consulted different accountants, who explained that it was not eligible for ERCs. Heeding this second opinion, the employer plans to return the $1.5 million to the IRS, and it wants the first accountants to give back the fee of about $300,000. The employer sent a termination letter to this effect, in response to which the accountants asserted that the employer still owed the contingency fee, despite the fact that the employer refused to accept the IRS refund.

The employer asked the court to rule that the accountants are not entitled to the fee of about $300,000 because they supposedly violated the state's Consumer Protection Act, breached the contract by not performing services "with reasonable care and in a diligent and competent manner," and committed professional negligence in performing its accounting and return preparation services.

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[20] For more information about the withdrawal option and voluntary disclosure program, see IR-2023-193; Joseph DiSciullo, "Fact Sheet Explains How to Withdraw Claims for Employee Retention Credit," *Tax Notes Federal*, Oct. 30, 2023, p. 883; Announcement 2024-3, 2024-2 IRB 364; Loricchio, "IRS Launches ERC Voluntary Disclosure Program," *Tax Notes Federal*, Jan. 1, 2024, p. 188.

[21] Complaint, *Acer Landscape Services LLC v. Lasiter & Lasiter P.C.*, No. 3:23-cv-00531 (M.D. Tenn. May 24, 2023).

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2. Second example.

The university and the sponsor executed an agreement, under which the sponsor would determine eligibility for the ERC, calculate the proper ERC amount, prepare a "tax credit package," and provide defense services in case of an IRS audit.[22] In exchange, the university agreed to pay the sponsor a contingency fee equal to 15 percent. The dispute seems to center on when, exactly, the university must make that payment. The agreement stated that the university's obligation was "not contingent" upon it filing the ERC claims prepared by the sponsor or receiving them. Nonetheless, the university alleged that the sponsor otherwise represented, and the university understood, that it would be obligated to pay only to the extent that it actually received ERCs.

The court filings indicate the following chain of events: The university and the sponsor signed the agreement, the sponsor concluded that the university was entitled to about $6 million in ERCs, independent accountants and auditors working for the university later reviewed the proposed ERC claims by the sponsor and concluded that they were not supportable, the university informed the sponsor that it did not intend to file the ERC claims or pay the contingency fee of about $900,000, and the sponsor threatened to sue the university for nonpayment.

The court filings also point out that the agreement contained a provision stating that the sponsor does not provide tax or accounting advice and is not an accountant or return preparer, and thus is not responsible for preparing the university's federal or state tax returns, including the ERC claims. The court filings further indicate that the agreement said that the sponsor's team consists of attorneys, or they work closely with tax attorneys at a major international law firm to properly interpret the relevant laws and keep clients fully compliant.

The university asked the court to issue a declaratory judgment ruling that (i) the agreement was void from the outset because it was an illegal contract, it violates public policy, the sponsor provided no consideration, and it was obtained by fraud, and (ii) the university is relieved of any obligation to file the ERC claims that it now believes are inaccurate or to pay the contingency fee to the sponsor.

3. Third example.

An agent of the sponsor marketed services at a conference for home healthcare providers.[23] A person referred to here as John Jones, served as an "independent consultant" to the employer and attended that conference. He was never an owner, officer, or representative of the employer, and he never had authority to enter into contracts on behalf of the employer. He had access to payroll and financial data of the employer because of his role as a consultant, but he was not permitted to share that data with third parties.

Jones agreed to work as a "referral source" for the sponsor, focused on finding clients in the healthcare industry. Jones worked unilaterally with the sponsor to prepare and submit ERC claims for the employer, presumably to earn a referral fee or other compensation. As part of this process, Jones forged an electronic signature for the owner of the employer on a contract with the sponsor and on the relevant IRS forms. The employer later received notices from the IRS indicating that it would be getting ERCs for the first, second, and third quarters of 2021. The employer received checks from the IRS for those three quarters, which it deposited and then left untouched. The sponsor then sent the employer an invoice seeking about $540,000, which represented the contingency fee associated with the ERCs. The employer repudiated any contract with the sponsor, demanded copies of all related documents and communications, and initiated the lawsuit.

The employer is asking the court to rule that the contract with the sponsor was void because it was forged and unauthorized, the employer does not owe the sponsor $540,000, the sponsor must turn over all materials related to the ERC claims, and the sponsor must pay all costs and expenses

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[22]Complaint, *Marywood University v. Synergi Partners Inc.*, No. 3:22-cv-00991 (M.D. Pa. June 22, 2022).

[23]Complaint, *Nurturing Direct Homecare Inc. v. ERC Specialists LLC*, No. 1:23-cv-04331 (E.D.N.Y. June 13, 2023).

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that the employer will incur in rectifying ERC matters with the IRS.

4. Fourth example.

Representatives of the employer spoke with a well-known businessman in its area, who informed the employer of the existence of ERCs and recommended that it hire the sponsor to help procure them.[24] The businessman did not disclose any financial relationship between himself and the sponsor. After reviewing informational and promotional material, the employer signed an agreement with the sponsor. It indicated that the employer would pay a 15 percent contingency fee for the services provided by the sponsor, including determining eligibility for the ERC, calculating the amount, delivering a "tax credit package" containing all necessary supporting documentation, and providing audit support in the case of any IRS audit. The agreement stated that the contingency fee was due upon receipt of the tax credit package and was not contingent upon the employer filing the ERC claims or receiving any benefits.

After experiencing delays and learning more about the sponsor's business practices, the employer submitted a notice of termination. The employer had not received the tax credit package when it terminated the agreement. That arrived a week later, and the eligibility analysis was never supplied at all. Also, the tax credit package covered ERCs for the second quarter of 2021, even though the employer supposedly never provided any data to the sponsor about that period.

The employer never filed the ERC claims with the IRS, but the sponsor still demanded payment equal to 15 percent of the amount calculated. The employer therefore filed a lawsuit alleging that the businessman, as an agent of the sponsor, and the sponsor itself fraudulently induced the employer into signing the agreement; the fee structure of the agreement was unconscionable; the employer terminated the agreement before the sponsor did any work or the employer received any benefit; the sponsor violated its duty of good faith and fair dealing; and the businessman assured the employer that the sponsor would not be charging it any fees. The employer asked the court to relieve it of any payment obligation based on these grounds and others.

5. Fifth example.

The employer is a wholesale distributor of products, primarily to convenience stores.[25] It signed an agreement with the sponsor for ERC services, under which the sponsor sent a one-page questionnaire to the employer. The sponsor, based solely on the responses to the questionnaire, indicated that the employer was entitled to ERCs for several quarters because it had supposedly suffered a partial suspension as a result of a governmental order related to COVID-19. More specifically, the sponsor concluded that certain "supply chain" issues sufficed to support the ERC claims. The employer filed Forms 941-X seeking a refund of about $3 million. The IRS honored the claims in full, and the sponsor then demanded payment of 15 percent. Before paying the sponsor, the employer (likely with outside assistance) further examined the situation. It realized that it did not meet the eligibility standards for the ERC after considering the guidance from the IRS about supply chain issues in Notice 2021-20 and AM 2023-005. The employer explained to the sponsor that it planned to return the refund to the IRS and thus owed the sponsor nothing. Because the sponsor insisted on payment, the employer filed suit seeking a ruling from the court that it was not obligated to pay because the sponsor failed to perform the services outlined in the agreement, illegally engaged in the practice of law without a license, violated various laws by improperly sharing fees and preparing tax returns, and induced the employer to sign an agreement that was procedurally and substantively unconscionable.

B. Employer Sues Sponsors and Related Parties

Other cases feature allegations against sponsors, as well as affiliated professionals.

[24] Complaint, *Dynamic Integrated Services LLC v. Synergi Partners Inc.*, No. 4:22-cv-02537 (D.S.C. Aug. 2, 2022), and Amended Complaint (Oct. 4, 2022).

[25] Complaint, *Colonial Wholesale Distributing LLC v. ERC Specialists LLC*, No. 187023909 (Fla. Cir. Ct. Nov. 29, 2023).

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1. Employer sues sponsor and attorneys.

The employer manufactures wholesale food products for sale to retailers.[26] The sponsor approached the employer about potential ERC claims, portraying itself as an expert in the field, with the ability to expedite the process. The employer executed an agreement with the sponsor, which contemplated a contingency fee of 15 percent.

The agreement further authorized an attorney affiliated with the sponsor to serve as its representative before the IRS. The employer alleged that, based on the terms of the agreement, the actions of the parties, and the designation of the attorney as "general counsel" for the sponsor, the attorney was an employee of, or an agent for, the sponsor. Also, the employer further maintained that it had an attorney-client relationship with the attorney, as shown by the agreement and Form 2848, "Power of Attorney and Declaration of Representative." The employer alleged that the attorney had a conflict of interest in representing it because of the desire of the sponsor and attorney to "procure highly lucrative contingent fee cases for legal representation that yielded unreasonable monetary payments in their favor." Moreover, the attorney supposedly failed to disclose the conflict of interest or supply a written waiver for that conflict. The employer claimed that these actions and inactions violated Circular 230.

It appears that the employer filed the ERC claims, received the benefits from the IRS, and paid the sponsor a contingency fee of about $170,000. The employer later reconsidered matters. It then filed suit asking the court to rule that the attorney and sponsor were negligent in providing tax and legal advice regarding the ERC, committed professional malpractice, violated state deceptive trade practices law, breached their fiduciary duty, and must repay the employer $170,000, plus other appropriate costs and damages.

2. Employer sues sponsor and accountants.

The taxpayer, who is over 75 years old, owned several companies.[27] He had health problems throughout the relevant period, including surgeries, followed by lengthy recoveries during which he took strong pain medications that prevented him from actively engaging in business activities. The controller for the companies was elderly, too, and he started having trouble performing his professional duties. Things worsened when the controller began suffering cognitive decline after getting COVID-19. The controller was also not computer-literate or otherwise tech savvy. Given the circumstances, the taxpayer hired his long-standing outside accountants to oversee the work of the controller and to provide additional in-house services. The accountants supposedly knew that the controller had health problems, was not an owner or officer of any of the companies, and did not have authority to execute agreements on behalf of the taxpayer or the companies.

The facts are not altogether clear from the court filings, but it appears that the accountants collaborated with the sponsor to have the controller execute an agreement for ERC services. Among other things, the agreement indicated that payment of 17 percent would be due when the sponsor delivered a "calculation and support package," regardless of whether the IRS ever granted the ERCs. When the taxpayer later discovered the existence of the agreement and received the related invoice from the sponsor, he consulted independent tax professionals. They concluded that the companies did not qualify for ERCs and that filing the claims could lead to IRS audits, tax liabilities, penalties, and interest. Accordingly, the taxpayer did not file the ERC claims, yet the sponsor demanded payment of approximately $800,000 anyway.

The taxpayer filed suit asking the court to void the agreement and award damages for unfair business practices, accountancy malpractice, breach of fiduciary duty, and financial elder abuse.

[26] Complaint, *Yayas Kitchen LLC v. ERC Specialists LLC*, No. 2:23-cv-01558 (D. Nev. Sept. 29, 2023).

[27] Complaint, *Nelson v. CTI III*, No. 34-2022-00316535 (Cal. Super. Ct. Mar. 8, 2022).

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C. Employer Sues Payroll Company

It appears that a couple, individually or jointly, owned several companies that operated casual food franchises.[28] These companies, here called the employer, entered into several contracts with a professional employer organization (PEO), according to which the PEO was in charge of preparing and filing Forms 941 for 2020. Before executing the contracts, the employer allegedly had multiple conversations during which it clarified that it would hire the PEO only if it would be entitled to ERCs. Officers of the PEO supposedly assured the employer that this was the case. The PEO filed Forms 941 for various quarters in 2020 without seeking ERCs.

Later, the employer hired a separate tax adviser to assist in seeking ERCs. That adviser estimated that the employer could get about $2.3 million. Based on this new information, the employer asked the PEO to file Forms 941-X for the relevant quarters in 2020 requesting ERCs. The PEO responded that the employer was unable to claim ERCs because it used a third-party payer (that is, the PEO), and it refused to submit Forms 941-X. The employer claimed that the PEO's position was contrary to the clear guidance issued by Congress and the IRS. Therefore, it filed a suit against the PEO alleging breach of contract, negligence, and intentional misrepresentation, and seeking $2.3 million in damages, penalties, and attorney fees.

There are many other disputes over entitlements and duties involving employers, staffing agencies, payroll companies, and ERC claims.[29]

D. Employer Sues for Consumer Protection Violations

After receiving unsolicited advertisements by fax regarding assistance in claiming ERCs, the employer filed a class action lawsuit against the sponsor, alleging violations of the Telephone Consumer Protection Act and the Junk Fax Prevention Act.[30] The employer sought an injunction against the sponsor preventing it from sending further faxes, as well as monetary damages for all members of the class. This is just one of a long list of cases alleging violations of laws designed to stop unsolicited faxes, calls, and text messages from sponsors or their referral agents.[31]

E. Employer Sues Its Own Employee

The employer hired the worker to serve as the controller. This position allowed him access to computer, financial, and bookkeeping systems.[32] The next month, the worker attended a webinar hosted by the sponsor regarding the ERC program. He then posed as an independent accountant and pretended to refer the employer to the sponsor in hopes of obtaining a referral fee. The employer later discovered this conduct, terminated the worker, and sued him under various legal theories, including breach of duty of loyalty by improperly entering into an agreement with the sponsor for the purposes of getting a referral fee.

F. Sponsors Sue Employers

Employers are not the only ones seeking judicial intervention; many sponsors have also filed suits, generally seeking payment of disputed

[28] Second Amended Complaint, *Golden West Wings LLC v. Shiftpixy Inc.*, No. 8:22-cv-01834 (C.D. Cal. Oct. 6, 2022).

[29] *See, e.g.*, Complaint, *Capistrano Catering Inc. v. Shiftpixy Inc.*, No. 30-2022-01264583 (Cal. Super. Ct. June 13, 2022).

[30] Complaint, *Prairie Pointe Orthodontics P.A. v. Jorns and Associates LLC*, No. 2:22-cv-2451 (D. Kan. Nov. 4, 2022).

[31] *See, e.g.*, Class Action Complaint, *Costa v. Millennia Tax Relief LLC*, No. 2:23-cv-09232 (C.D. Cal. Nov. 2, 2023); First Amended Class Action Complaint, *Harris v. Allied Capital Services LLC*, No. 1:23-cv-08284 (E.D.N.Y Nov. 7, 2023); Complaint, *Julian v. Bottom Line Concepts LLC*, No. 2:2-cv-02493 (D. Kan. Nov. 7, 2023); First Amended Complaint, *Ewing v. Gitre and Relief Consultants LLC*, No. 3:23-cv-002250 (S.D. Cal. Dec. 8, 2023).

[32] Amended Complaint, *Mikhail Education Corporation v. Naessens*, No. 2:22-cv-01698 (D. Nev. Feb. 14, 2023).

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fees. Several cases are introduced below, and many others are pending.[33]

1. First example.

The sponsor and employer executed an agreement regarding ERC services.[34] The agreement contemplated a payment of $1,000 per employee for each quarter of eligibility, with a maximum of 15 percent of the total ERCs. The sponsor provided the services, the employer filed the claims, and the IRS granted approximately $300,000 in ERCs. The employer supposedly failed to inform the sponsor of receipt of the ERCs, as required, and refused to pay the related fees of about $45,000. Therefore, the sponsor sued for breach of contract.

2. Second example.

The sponsor solicited the employer, recommending that the employer consider looking into the ERC program and indicating that it had previously achieved good results for similar companies.[35] The employer eventually signed an agreement with the sponsor for ERC services. The employer later came to believe that the sponsor had made material misrepresentations regarding its understanding of the employer's operations, its capabilities, and the type of benefits to which the employer would be entitled. The employer also believed that the proposed ERC claims prepared by the sponsor were inconsistent with the IRS guidance and would place the employer at risk of tax fraud charges. Therefore, the employer terminated the agreement before the sponsor had completed its work or filed the ERC claims. The sponsor demanded full payment under the agreement anyway and argued that the employer must resolve matters through arbitration, not litigation, in accordance with a dispute-resolution clause in the agreement.

3. Third example.

The sponsor provided tax consulting services to the employer under various agreements.[36] Among other things, the sponsor committed to assisting the employer in applying for ERCs in exchange for 12 percent of "all ERCs calculated." The sponsor figured that the employer was entitled to $5.6 million in ERCs and sent an invoice demanding approximately $670,000 in fees. One week before payment was due, the employer sent a termination notice to the sponsor, refusing to pay because the sponsor supposedly "failed to accurately calculate the ERC." The sponsor argued that the notice was ineffective because it was too late, the services had already been provided, and it violated the agreements expressly stating that the employer must either accept the sponsor's calculation or allow it to revise and submit all ERC claims to the IRS. The sponsor asked the court to rule that the employer breached the agreements and must pay 12 percent of the ERCs calculated by the sponsor.

4. Fourth example.

An employer that provides home healthcare services hired the sponsor to assist in obtaining ERCs.[37] The sponsor determined that the employer was entitled to approximately $4.7 million in ERCs. The contract between the parties indicated that the employer would pay 12 percent of the ERC amount, or $560,000. It appears from the court documents that the employer decided not to file the ERC claims for some reason, meaning it received no tax benefits. Therefore, the employer refused to pay the sponsor anything. This nonpayment triggered a lawsuit by the sponsor alleging breach of contract by the employer, with the employer countering that the sponsor engaged in fraudulent inducement and deceptive business practices under state law.

[33] *See, e.g.*, Complaint, *ERC Specialists LLC v. Worldwide Labz LLC* (D. Utah Sept. 29, 2023); Complaint, *Welsh Advisors Inc. v. Mission Bay Car Wash LLC*, No. 37-2023-00048241 (Cal. Super. Ct. Nov. 3, 2023); Complaint, *Nettax LLC v. Pollo West Corp.*, No. 4:23-cv-0019 (W.D. Va. Aug. 2, 2023); Complaint, *Incentax LLC v. RKJ Hotel Management LLC*, No. 23-ec-01622 (Cal. Super. Ct. 2023); Complaint, *Careful Consulting LLC v. Allied Collision Center Inc.*, No. N23C-10-003 (Del. Super. Ct. 2023); Complaint, *Omnibus Accounting & Tax Solutions PC v. Prime Pacific Grill SD Inc.*, No. 37-2022-00001093 (Cal. Super. Ct. Jan. 10, 2022); First Amended Complaint, *SumIt Credits LLC v. Chazanas*, No. 23STLC06050 (Cal. Super. Ct. 2023).

[34] Complaint, *WRUSA LLC v. ALA Turk Inc.*, No. 653005 (N.Y. Sup. Ct. Nov. 4, 2022).

[35] Memorandum of Law in Support of Motion to Dismiss, *Leyton USA Inc. v. YMCA of Columbia-Willamette*, No. 1:22-cv-10594-WY, (D. Mass. 2022).

[36] Complaint, *First Advantage Enterprise Screening Corporation v. International Golden Foods LLC*, No. 22-255 (D.D.C. June 29, 2022).

[37] *TC Services USA Inc. v. Ideal Home Health Inc.*, No. 509272 (N.Y. Sup. Ct. 2023).

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G. Sponsor Sues Business Associates

Cases show various scenarios of infighting among sponsors. A few samples follow.

1. First example.

The sponsor entered into separate partnerships with a specialty firm and accountants in connection with ERC services.[38] In essence, the sponsor was responsible for marketing, developing referral partners, determining ERC eligibility, and producing tax opinions for the employers. The specialty firm and accountants, for their part, calculated the ERC amounts and prepared and filed the Forms 941 or Forms 941-X. Under this initial arrangement, the sponsor received 50 percent of net proceeds, with the other 50 percent going to the specialty firm or accounting firm, depending on the partnership involved.

The parties later decided to change the division of proceeds. They formed a new partnership under which the sponsor, specialty firm, and accountants would each receive 33 percent of the net proceeds. Two months later, the specialty firm and accountants purportedly terminated the new partnership. This resulted in the sponsor being removed from the partnership, prevented from communicating with the employers, and excluded from any share of the net proceeds. The sponsor filed suit alleging breach of contract, breach of fiduciary duty, and defamation.

2. Second example.

The first sponsor, to expand its existing tax credit services, began exploring potential partnerships in connection with the ERC.[39] It communicated with the second sponsor as part of this process but ultimately decided not to proceed. The first sponsor later learned that one of its officers, who had full access to general client data and specific data about ERC projects because of his position, had secretly signed a "strategic alliance agreement" with the second sponsor. The result was that the officer, while still employed by the first sponsor, allegedly was directing ERC clients to the second sponsor in exchange for a healthy referral fee or other compensation. The first sponsor filed suit, arguing that the second sponsor misappropriated trade secrets, aided and abetted the officer in breaching his fiduciary duties, intentionally interfered with current and potential client relationships, violated state business laws, and caused serious economic damage.

3. Third example.

The sponsor assists employers in obtaining ERCs and takes a percentage of the tax benefits for its efforts.[40] If the referral agent introduces an employer, it gets 3 percent of the total ERC amount as compensation. The sponsor wanted to expedite the process through automation; therefore, it entered into a consulting agreement with the referral agent, which was later supplemented by an addendum. Among other things, these documents discussed the initial development and ongoing maintenance of specialized software by the referral agent to accomplish the desired ERC calculations. The documents indicate that the referral agent would receive a fee increase from 3 percent to 10 percent in exchange for the work. Things proceeded according to plan — until they did not. At some point, disagreements about the appropriateness and amounts of payments to the referral agent arose. The referral agent then terminated the consulting agreement and demanded that the sponsor halt all use of the specialized software. In response, the sponsor filed suit and asked the court to make several rulings, including that the referral agent violated the contract, that the sponsor owns the software, and that the referral agent cannot use any confidential information it obtained as a result of the prior business arrangement.

H. Former Owner Sues Current Owner

In 2020 the first shareholder owned 50 percent of the employer, which was a subchapter S

[38] Complaint, *Wildflower Legacy and Wealth Planning LLC v. Level 8 Management Inc.*, No. 22-CA-006026 (Fla. Cir. Ct. Aug. 9, 2022).

[39] Complaint, *First Capitol Consulting Inc. v. Nettax LLC*, No. 2:23-cv-07837 (C.D. Cal. Sept. 19, 2023).

[40] Complaint, *Jorns & Associates LLC v. WCMS Media LLC*, No. 1:23-cv-00247 (D. Wyo. Dec. 30, 2023).

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corporation, a passthrough entity for tax purposes.[41] The employer received a loan under the PPP in 2020, which was later forgiven. In December 2020 the first shareholder sold all his stock in the employer to the second shareholder, thereby giving the second shareholder 100 percent ownership from that point forward. Companies that received loans under the PPP originally were ineligible to claim ERCs; therefore, the stock purchase agreement did not address them.

The law later changed, which the second shareholder apparently discovered in December 2021. He then filed Forms 941-X for all relevant quarters of 2020 (that is, quarters during which the first shareholder still owned 50 percent), without notifying the first shareholder, getting his authorization, or sharing any of the tax benefits. The day after filing the Forms 941-X, the second shareholder entered into an agreement with a financial company for it to purchase the ERC receivables for about $1.4 million. The second shareholder did not share this amount with the first shareholder, so the latter filed suit seeking 50 percent of the spoils.

I. Financial Company Sues Employer

Many cases center on unpaid loans by employers receiving ERCs.[42] The normal scenario goes something like this: The employer applied for ERCs, but it anticipated having to wait many months for the IRS to process the claims, and it needed funds quickly to pay workers and otherwise continue its business operations. Therefore, it entered into an agreement with a financial company that would purchase the employer's ERC receivables at a discounted price. The effect was that the financial company would essentially make a short-term loan, supplying the employer $80 immediately in exchange for $100 when the IRS released the ERCs to the employer. The loan was supposed to be secured by the future ERCs, for which a special account was established. The employer took the loan, later received the ERCs, but never repaid the financial company for one reason or another.

IV. Conclusion

This article touches on just a few of the ERC-related actions occurring now, including challenges by the IRS, to the IRS, and among employers and various professionals. The number and variety of disputes are sure to increase. Employers, sponsors, accountants, specialty firms, and others in the ERC space should be following these developments closely because effectively defending themselves — regardless of their roles — will require comprehensive and updated information about multiple battles on multiple fronts. ■

[41] First Amended Verified Complaint, *Baugh v. Daljaco Inc.*, No. 1:23-cv-00156, (D. Md. Jan. 24, 2023).

[42] Amended Complaint, *FCS Advisors LLC d/b/a Brevet Capital Advisors v. Island Fabrication LLC*, No. 23-cv-7341 (S.D.N.Y. Aug. 18, 2023). *See also* Complaint, *Omega Funding Solutions LLC v. Reifman Law Firm PLLC*, No. 1:23-cv-08975 (S.D.N.Y Oct. 12, 2023); Complaint, *FCS Advisors d/b/a Brevet Capital Advisors v. Smokin Joes BBQ*, No. 1:23-cv-07345 (S.D.N.Y Aug. 18, 2023); Complaint, *ERC Advance Funding LLC v. Union Institute & University*, No. 2023-0534 (Del. Ch. 2023).

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