

LETTERS TO THE EDITOR

tax notes federal

ERC Audits and the IRS's \$80 Billion Cash Infusion

To the Editor:

One of the most popular relief measures that was implemented in response to the COVID-19 pandemic and that has recently been the source of significant confusion among employers is the employee retention credit. The ERC is a refundable credit against payroll taxes available to employers that experienced substantial declines in gross receipts or suspended business operations due to governmental orders from March 13, 2020, to December 31, 2021. With a potential credit of up to \$5,000 per employee in 2020 and up to \$7,000 per employee per quarter in 2021, the ERC is a valuable resource for those employers who claimed the credit on their Forms 941 for the second quarter of 2020 to the fourth quarter of 2021. Even for those employers that did not claim the credit on a Form 941, the ERC remains a relevant and valuable resource because they can still claim the credit by filing amended payroll tax returns before the expiration of the applicable statute of limitations.

While valuable, the ERC has been a source of confusion for many employers. Specifically, the various changes made to the legislation behind the ERC have resulted in unclear eligibility rules and retroactive changes. For instance, the ERC was initially unavailable to employers who had received a Paycheck Protection Program loan. However, the Taxpayer Certainty and Disaster Tax Relief Act subsequently eliminated this restriction at the end of 2020, retroactively permitting PPP loan borrowers to claim the ERC, subject to the satisfaction of eligibility requirements and other considerations. Consequently, PPP loan borrowers that had determined they were ineligible for the ERC needed to reexamine their eligibility in light of this change. Additionally, the American Rescue Plan Act had made the ERC available to employers through the fourth quarter of 2021. However, on November 15, 2021, the Infrastructure Investment and Jobs Act (P.L. 117-58) retroactively terminated the fourth-quarter

ERC for most employers. At the time, many employers had received advance payments of the ERC or had reduced their employment tax deposits in reliance on the law and guidance effective to that point. This change caused a multitude of issues, as employers had to repay the advance payments or adjust their payroll tax deposits to offset the retained amounts.

Some third-party advisers may have taken advantage of this confusion to encourage employers to take improper positions related to eligibility and the amount of available ERC. On October 19 the IRS published a warning to employers to be wary of third parties who advise an employer to claim the ERC when the employer may not qualify. According to the IRS, "Businesses are encouraged to be cautious of advertised schemes and direct solicitations promising tax savings that are too good to be true. Taxpayers are always responsible for the information reported on their tax returns. Improperly claiming the ERC could result in taxpayers being required to repay the credit along with penalties and interest."

The IRS is poised to step up enforcement measures to address improper ERC claims. In this regard, a report published on August 31 by the Treasury Inspector General for Tax Administration identified the allowance of \$45 million in potentially erroneous nonrefundable ERCS, in part due to procedural failures to refer amended returns to Examination that met the IRS's referral criteria. The IRS will also receive an additional \$80 billion in funding from the Inflation Reduction Act (P.L. 117-169), over \$45 billion of which will be allocated to enforcement.

Given this perfect storm of employer confusion over the ever-changing ERC rules and looming IRS audits, employers should take proactive measures to ensure that they are eligible for the ERC and have properly calculated the credit amount. While only two of the most prominent measures employers should take are discussed below, the ERC's complexity means that there are many additional actions available to employers.

Regarding ERC eligibility, employers relying on governmental orders should make certain that they have copies of the relevant governmental orders, can identify the specific provisions that imposed restrictions on their business operations, and have supporting opinions if available. These restrictions must have caused a full or partial suspension of the employer's business operations. Typical restrictions include direct prohibitions on the performance of certain business operations, occupancy restrictions that affect employees' ability to perform their duties, significant COVID-19-related cleaning obligations that result in the closure of the business while the cleaning is performed, and delays of critical goods by suppliers that were subject to governmental orders. Employers should also compare the effective dates of each governmental order against the claimed eligibility period to ensure they align. If they don't, it's possible a portion of qualified wages include wages paid during periods when the employer's business operations were not fully or partially suspended.

Regarding the calculation of the ERC amount, employers should verify whether they are a small employer or large employer in 2020 and 2021. The different size classifications have the potential to result in significantly different ERC amounts. A small employer may treat all wages during the eligibility period as qualified wages up to the corresponding maximum. To be treated as a small employer in 2020, an employer must have averaged 100 or fewer full-time employees in 2019. To be treated as a small employer in 2021, an employer must have averaged 500 or fewer full-time employees in 2019. On the other hand, a large employer may treat only wages to employees for not providing services during the eligibility period as qualified wages up to the corresponding maximum. To be treated as a large employer in 2020, an employer must have averaged more than 100 full-time employees in 2019. To be treated as a large employer in 2021, an employer must have averaged more than 500 full-time employees in 2019. If an employer is classified as a large employer but only paid wages to employees when they provided services, the ERC amount should be negligible to nothing because no wages would count as qualified wages. If this same employer was instead classified as a small employer, the

ERC amount could be significant, depending on the number of employees and the amounts paid to each employee.

While the ERC has afforded millions of employers the opportunity to retain their employees throughout the COVID-19 pandemic, it has also been a significant source of confusion. Because the IRS is poised to increase its enforcement of ERC claims, now is the time for those that have already claimed the ERC or that intend to claim it to evaluate their eligibility and credit amount. Employers that don't will be vulnerable to extensive audits and potential litigation.

Juan F. Vasquez Jr.

Victor Viser

Tania Albuja

Chamberlain, Hrdlicka, White, Williams &

Aughtry

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