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## How to Prepare for IRS Scrutiny of the Employee Retention Credit

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*Prompted by rampant dubious and misguided claims for ERC refunds, the IRS has amped up audits of filings for the credit, warns Caitlin Tharp of Step toe.*

Unlike most other provisions of the tax code, the employee retention credit (ERC) has reached mainstream consciousness. Robocalls and television ads promise up to \$26,000 per employee for businesses that were affected by COVID-19. Perhaps you are an employer who claimed an ERC refund based on one of these ads or after consulting with a tax professional. Whether you anticipated it or not, you are now in the IRS's sights.

The IRS took the extraordinary step on September 14 of announcing in [IR-2023-169](#) an immediate moratorium on processing new ERC claims, in order “to protect against fraud and revenue loss.” In March, in [IR-2023-49](#), the IRS designated abusive ERC claims on its “Dirty Dozen” list of tax scams. The situation has even drawn the attention of Commissioner Danny Werfel, who explained that “[w]hile the credit has provided a financial lifeline to millions of businesses, there are promoters misleading people and businesses into thinking they can claim these credits.” To target dubious claims, the IRS has referred thousands of ERC claims for audit. (IR-2023-169.)

Maybe you were careful and made your claim only after consulting with a reputable adviser. This might mean that you will ultimately get the refund, but it may not save you from an audit—the IRS cannot readily separate questionable ERC claims from those based on professional advice. As it often does, the IRS is taking a one-size-fits-all approach and has further slowed down processing of ERC claims received prior to the moratorium start date so that it can engage in “detailed compliance reviews.” (IR-2023-169.) I have worked with eligible employers who have been waiting more than two years to receive their employee re-

tionment credit refunds—funds that were intended to be a lifeline to help businesses through the pandemic but have been delayed while the IRS struggles to ascertain eligibility.

With the IRS aggressively targeting fraud and underlying rules that are fact-bound and ambiguous, the conditions are ripe for a glut of contentious disputes. Because the rules for eligibility are unclear, the IRS may end up disallowing arguably meritorious claims. Even when the IRS has paid out a taxpayer's ERC claim, the taxpayer is not necessarily in the clear. The IRS can sue taxpayers to recover what it later deems to be an erroneous refund.

ERC claimants will need to ready themselves for the reality that audit is likely and that they might be facing a difficult and fact-intensive dispute with an incredulous and aggressive IRS. It is therefore worth reviewing the relevant law and grounds that the IRS may cite for disallowing ERC refund claims.

### ***Fact-Intensive Eligibility Questions***

The purpose of the ERC was broad; Congress enacted the ERC to support businesses hit hard during the pandemic. The IRS explained in [IR-2022-183](#) that “[t]he ERC is a refundable tax credit designed for businesses who continued paying employees while shutdown due to the COVID-19 pandemic or had significant declines in gross receipts from March 13, 2020” to September 30, 2021. Like with all such broadly beneficial credits, the devil is in the details.

There are two main paths by which an employer is eligible for the ERC.

(1) The employer's business operations were fully or partially suspended during the calendar quarter due to orders from a governmental authority due to COVID-19 (the “Partial Suspension Test”).

(2) The employer had gross receipts in that quarter that were less than 80% of the gross receipts for the corresponding calendar quarter in 2019 (the “Gross Receipts Test”).

While the Gross Receipts Test appears to be an objective, bright-line test, it is nevertheless the subject of some disputes. The IRS has raised issues with employers about what revenue is included in gross receipts and whether the employers used correct method

to determine if there was a 20% decline. And in selecting ERC claims for audit, the IRS is often unable to distinguish between Gross Receipts Test and Partial Suspension Test claims. An employer with a claim based on the Gross Receipts Test should ensure that it has documentation that demonstrates the requisite 20% decline.

That said, most of the eligibility disputes involve employers whose claims ride on meeting the Partial Suspension Test. This is because the statutory language makes it so non-obvious as to who qualifies. Most businesses were adversely impacted by COVID-19-related government action, but does that mean they are all eligible for the ERC?

### ***How Much Is a Nominal Portion?***

Eligibility under the Partial Suspension Test hinges on a facts-and-circumstances analysis of how one or more COVID-19 governmental orders affected the taxpayer's operations. If some of your business's operations were suspended due to COVID-19, the difficult question is whether the suspension was material enough to qualify as a partial suspension.

There at least is a safe harbor under IRS guidance, but that safe harbor requires parsing some facts about operations during the suspension. According to Q/A-11 of [Notice 2021-20](#), that safe harbor kicks in when:

“either (i) the gross receipts from that portion of the business operations is not less than 10 percent of the total gross receipts . . . , or (ii) the hours of service performed by employees in that portion of the business is not less than 10 percent of the total number of hours of service performed by all employees in the employer's business. . . .”

This safe harbor raises a host of questions. What constitutes a portion of a business? How does this safe harbor work with the aggregation rules (described below)? Does this safe harbor apply at the trade or business level or the employer level? How does this safe harbor apply where multiple factors or governmental orders affected the employer's business (possibly in different ways)? These are hard and fact-specific questions; eligibility for the credit could hinge on the answers to any one of them.

### ***Identifying Specific Governmental Orders***

Another common threshold issue in applying the Partial Suspension Test is identifying the relevant COVID-19 governmental order. In the same Notice at Q/A-20, the IRS explained that qualifying governmental orders must be mandatory in nature and not recommendations, such as those issued by the CDC or DHS for social distancing. To qualify, the governmental order must be in effect and cause a suspension of operations for the entire period during which the em-

ployer paid the wages that undergird the employer's ERC claim, as explained at Q/A-22. It is unclear whether the indirect impacts of governmental orders can qualify, such as where the relevant the order discouraged, but did not strictly prohibit, in-person activities.

Employers can at least argue that Congress intended the ERC to provide broad relief. With the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Congress expanded the ERC's availability for 2021 by increasing the threshold for an eligible small employer from businesses with 100 full-time employees to businesses with 500 full-time employees. That law also raised the maximum amount of the credit from \$5,000 per employee per year to \$7,000 per quarter.

While the ERC offered a greater incentive in 2021, the other requirements remained the same, including that the employer experience a partial suspension of operations due to a COVID-19 governmental order. At the same time, COVID-19 governmental restrictions decreased after 2020, making it harder to qualify under the Partial Suspension Test in 2021. As governmental orders waned, it may be difficult for a business to identify governmental orders that were in effect through the end of the third quarter of 2021.

### ***Aggregation Rules***

The ERC was intended to benefit *small* businesses affected by COVID-19. Accordingly, the aggregation rules treat businesses under common ownership as a single employer so that large business conglomerates split into many distinct entities do not qualify as small employers. These aggregation rules also apply in determining whether the employer experienced a partial suspension. In other words, in analyzing whether more than a nominal portion of the business experienced a partial suspension, the employer must look at the business of the entire aggregated group and not a discrete subpart. *Id.* at Q/A-7.

Then there is one further unexpected wrinkle—it is unclear whether the aggregation rules require an employer to include foreign entities. The statutory aggregation rules in [§3134\(d\)](#) of the Internal Revenue Code and [§2301\(c\)\(2\)\(A\)](#) of the Coronavirus Aid, Relief, and Economic Security ([CARES Act](#)) require employers to aggregate “[a]ll persons treated as a single employer under subsection (a) or (b) of section 52.” In turn, [Treas. Reg. §1.52-1](#) does not expressly exclude foreign entities—but see [§30B\(f\)\(4\)\(B\)](#), [§59A\(e\)\(3\)](#), and [§199A\(g\)\(3\)\(D\)\(ii\)\(II\)](#), which state that determinations under [§52\(a\)](#) shall be made without regard to [§1563\(b\)](#), which excludes foreign corporations, suggesting that foreign corporations would otherwise be excluded from an affiliated group under [§52\(a\)](#).

If an employer must aggregate its foreign entities with its domestic entities, does the employer then

need to consider whether there was a partial suspension of its *non-U.S.* operations because of *foreign* COVID-19 governmental orders? If it does, then such a foreign aggregation rule would arguably contradict IRS guidance in Notice 2021-20, wherein Q/A-10 defines an “order from an appropriate governmental authority” as any order from federal, state, or local government. There is not yet any IRS guidance about how to treat foreign entities for the aggregation rules.

### ***The IRS Guidance Is Susceptible to Challenge***

Aside from the statute, most of the details on ERC eligibility come from IRS Notices. And because the statutory language is fairly brief and open to various interpretations, it may be possible for employers to challenge the validity of rules announced through IRS guidance.

Suppose that the IRS argues that employers must aggregate foreign entities, but following Notice 2021-20, it also maintains that foreign governmental orders do not qualify to cause a partial suspension. The ERC statute (I.R.C. [§3134\(c\)\(2\)\(A\)](#) and [CARES Act §2301\(c\)\(2\)\(A\)](#)) does not exclude foreign governmental orders from the phrase “orders from an appropriate governmental authority.” To the extent IRS guidance is inconsistent with the statute, it is subject to challenge under the *Chevron* deference standard.

Further, the main piece of guidance, Notice 2021-20, was not issued in a formal regulation; thus, a court is not required to give it deference but defer only to the extent it is persuasive, an almost *de novo* review. See *United States v. Mead Corp.*, 533 U.S. 218 (2001). Finally, to implement the ERC, the IRS tried to quickly create rules to fill gaps that had not been addressed by Congress. Because Notice 2021-20 was not issued with the opportunity for public comment, its rules may be invalid for noncompliance with the Administrative Procedure Act. The Sixth Circuit Court of Appeals in *Mann Construction, Inc. v. United States* gave that rationale in setting aside a similar IRS Notice. In the event a court invalidates Notice 2021-20, many more ERC claims could qualify under the broad language of the statute.

### ***ERC ‘Mills’ Falsely Promise Easy Qualification***

Notwithstanding all of this complexity, there are firms advertising they can determine ERC eligibility in minutes, as the IRS warned in [IR-2023-135](#). A representative of one ERC firm stated in a marketing video that almost 80% to 90% of businesses qualify for the credit, as the Wall Street Journal reported. This may be savvy marketing but it is untrue no matter how many firms say it. The IRS Commissioner commented in [IR-2023-135](#): “The amount of misleading marketing around this credit is staggering, and it is creating an array of problems for tax professionals

and the IRS while adding risk for businesses improperly claiming the credit.”

The IRS has warned employers about the risks of using ERC “mills”—third-party promoters that use marketing ploys to charge heavy, upfront contingency fees (usually based on a percentage of the credit) with the promise of helping businesses compute and claim the credit. These “mills” have every incentive to claim the maximum possible ERC for every employer who comes to them, even if the business is not ultimately eligible, the IRS points out in [IR-2022-183](#). The IRS is investigating these promoters but it has not been able to stop the aggressive advertising or entry of new ERC mills into the market, resorting instead to a blanket moratorium. ([IR-2023-135](#).)

### ***IRS Review of ERC Claims***

In sorting legitimate claims from those that come from ERC mills, the IRS has little information to work with. Because Congress sought to deliver generous relief to lots of small businesses quickly (figuratively dropping money out of helicopters to help businesses through the pandemic), the IRS tacked the new credit on to an existing tax form that was historically used for much less complex items, like payroll tax withholding. The IRS hardly had the time to develop the infrastructure or reporting needed to determine eligibility. Most ERC claims have been made on Forms 941 or 941-X. These Forms were not designed to elicit the detailed information needed to answer the fact-bound eligibility questions discussed above. Indeed, Form 941 does not provide *any* space for a narrative justification. And Form 941-X asks only for the employer to explain the corrections made on the amended form.

### ***ERC Clawback***

Even when the IRS pays an ERC claim, the IRS has two years to bring suit against a taxpayer to recover an erroneous refund. See [§7405\(b\)](#). The ERC has additional provisions extending the normal statutes of limitations for the IRS to recover erroneous refunds. For third quarter 2021 claims, [§3134\(l\)](#) keeps the statute of limitations on assessment (*i.e.*, the period in which the IRS must act to assess tax against the employer) open for five years after the date the ERC is claimed. Final regulations at [Treas. Reg. §31.3134-1\(a\)](#), [§31.3111-6\(b\)](#), and [§31.3221-5\(b\)](#) allow the IRS to recover erroneously paid ERCs through the assessment process and to impose underpayment penalties on the ERC claim. An employer can take comfort in knowing that the IRS will not challenge or claw back its ERC claim only *after* these statutes of limitations have expired.

If the IRS denies an ERC claim before paying it, the employer is simply left without the claimed

amount (and may be out fees the employer paid to mills or advisors). If, however, the IRS denies the ERC claim *after* it has paid the refund, the employer must pay back the credit *along with* penalties and interest. The IRS currently charges interest in these circumstances at an 8% rate.

### ***How to Prepare***

Employers who claimed the ERC are likely to face IRS scrutiny, even if the IRS has already paid the refund. Because the relevant forms and submissions are typically inadequate for the IRS to judge the validity of the claim, the IRS will have to open an audit and request more information from employers. ERC claimants need to be armed with information that substantiates their eligibility when the IRS comes knocking.

As the IRS identifies problematic ERC mills, taxpayers who filed claims using those promoters are more likely to be audited. Employers who relied on a mill or some other contingency-fee firm should seek independent tax advice about their claims. In fact, the IRS Commissioner in IR-2023-169 urged businesses to “seek out a trusted tax professional who actually understands the complex ERC rules” to advise them as to ERC eligibility. Some employers who used an ERC mill may well qualify, but some may not. And employers who made ERC claims should take stock of their cash position—the only thing worse than paying the credit back to the IRS is being forced to do so long after you have spent the refund.

Even for an employer who received reputable advice on an ERC claim, the possibility of an IRS audit is daunting. As explained in Notice 2021-20, Q&A-70, the IRS requires employers to have documentation that substantiates their claims. For a claim based on a partial suspension, this means the employer must be able to point to a governmental order that was in effect and caused the suspension of operations during all periods for which the employer claimed the ERC. (*Id.* at Q&A-22.)

Employers will need to be able to effectively communicate why they are entitled to the ERC to the IRS. The IRS frequently begins an audit with an initial in-

terview at which the employer will need to explain to the IRS how and why it qualified for the credit. With the typical 30-day response window for IRS information requests, an employer will have little time to develop their argument for eligibility, gather documentation, and sharpen that narrative for the IRS. This is another good reason to engage a tax professional before audit.

During the audit, the IRS may take legally or procedurally dubious positions, especially given its aggressive posture toward ERC refund claims. Moreover, the ERC is new, the rules are unclear, and the IRS agent may not be sufficiently trained in them. Employers should assemble the legal theories for their claims and enlist the help of a tax advisor who can keep the IRS in line.

Another risk employers face is that when the IRS opens an audit in one area, it can spread to other areas. For instance, because the employer cannot deduct wages for which it claimed the ERC on its income tax return under §3134(e), the IRS will likely audit the employer’s wage reporting. Employers who filed claims through promoters are especially at risk; many ERC promoters did not inform their clients of this rule. Employers should also confirm that there is nothing else on their income tax return that may be of interest to the IRS.

ERC promoters advertise that the ERC is simple. It is not. ERC claimants should seek professional advice to understand and manage their risk from an ERC claim. Professional tax advisers can help mitigate these risks and navigate the perils of an IRS audit.

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### ***Author Information***

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