A Comprehensive Look at ERC Enforcement Tactics So Far

by Hale E. Sheppard

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In this article, Sheppard identifies and explores the major enforcement tactics used by the IRS thus far in challenging employee retention credit claims.

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I. Introduction

Many people fancy themselves employee retention credit experts, claiming to know everything under the sun about this complex tax benefit and its related procedures. That might be true in limited cases, but most people are somewhat confused. This is logical given the massive amount of information — much of it inaccurate — released by various sources since the ERC was introduced in March 2020. Among the aspects that escape most people are the enforcement actions taken by the IRS. Why are they important? Well, taxpayers, along with other parties that might end up in the IRS's crosshairs, cannot adequately defend themselves if they do not understand what their adversary is doing.

This article, another in a long series by the author, identifies and explores the major enforcement tactics used by the IRS thus far in challenging what it considers improper ERC claims. Readers might already be familiar with some of the items addressed in this article, but seeing them together, in chronological order, with commentary and context, should be helpful.

II. Overview of Four Relevant Laws

Congress passed four laws regarding the ERC in less than two years. These are complicated, of course, and matters got even more complex when the IRS issued detailed notices to elaborate on each new law.

Congress kicked things off with the Coronavirus Aid, Relief, and Economic Security Act.[1] Coverage of the ERC changed several times, but under the CARES Act, it initially applied to the second, third, and fourth quarters of 2020.[2] The CARES Act generally provided that an eligible employer could get an ERC against certain employment taxes equal to 50 percent of the qualified wages it paid to each employee.[3]

An eligible employer was one that was carrying on a trade or business and met one of the following two tests. First, the operations of the employer were partially or fully suspended during a particular quarter because of an order from an appropriate governmental authority that limited commerce, travel, or group meetings for commercial, social, religious, or other purposes because of COVID-19 (governmental order test).[4] Second, the employer suffered a significant decline in gross receipts during a particular quarter (reduced gross receipts test).[5]

The concept of qualified wages under the CARES Act depended on the number of full-time employees. When an eligible employer had an average of more than 100 full-time employees (large eligible employer), qualified wages were

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[1] Joint Committee on Taxation, "Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security Act," JCX-12R-20 (Apr. 23, 2020); *see also* Notice 2021-20, 2021-11 IRB 922.

[2] CARES Act, section 2301(m).

[3] *Id.* at section 2301(a).

[4] *Id.* at section 2301(c)(2)(A)(ii)(I).

[5] *Id.* at section 2301(c)(2)(A)(ii)(II).

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those paid to any employee who was not providing services either as a result of the government order test or the reduced gross receipts test.[6] On the other hand, when an eligible employer had an average of 100 or fewer full-time employees (small eligible employer), qualified wages were all wages paid during a quarter, whether or not the employees were actually working.[7] The benefits under the CARES Act were capped; qualified wages for any one employee could not exceed $10,000 for all applicable quarters combined. Consequently, the maximum ERC per employee for all of 2020 was $5,000.[8]

Congress next passed the Taxpayer Certainty and Disaster Tax Relief Act.[9] Among other things, that law expanded the period during which eligible employers might benefit. They could claim ERCs not only for the second, third, and fourth quarters of 2020 but also for the first and second quarters of 2021.[10] Eligible employers could also get more ERCs since the relief act changed a few things. In particular, the percentage of qualified wages on which the ERC could be claimed increased from 50 percent to 70 percent, and the amount was calculated per quarter, not per year.[11]

The American Rescue Plan Act followed.[12] It codified the ERC, making it section 3134 of the IRC. ARPA further expanded the ERC, allowing benefits for the third and fourth quarters of 2021.[13] It also created a third category of eligible employer, the so-called recovery start-up business. That was an employer that began operating its business after February 15, 2020, had average annual gross receipts of $1 million or less during the relevant period, and did not otherwise qualify as an eligible employer.[14]

Congress ended matters with the Infrastructure Investment and Jobs Act.[15] It retroactively shortened the periods for which eligible employers could claim benefits. Except for recovery start-up businesses, eligible employers could not solicit ERCs for the fourth quarter of 2021.

III. Evolving Enforcement Actions

The IRS has introduced a long list of ERC-related enforcement mechanisms over the past few years. However, with all the information and misinformation about ERCs circulating, many taxpayers are unclear about what is actually happening in this area. Taxpayers at an informational disadvantage are just that — disadvantaged, at least when it comes to defending themselves against the IRS. Thus, to help taxpayers understand what has occurred and what is likely to happen in the future, the IRS's enforcement actions follow in chronological order to best show their evolution.

A. Warning of Wrongdoing

The IRS published a significant number of news releases, fact sheets, and the like warning about potential ERC abuse. IRS officials, demonstrating some serious chest-thumping, declared that they would "not cease until every fraudulently obtained dollar is accounted for and the individuals behind the schemes are prosecuted to the fullest extent of the law."[16] The IRS continued with similar rhetoric, disparaging the "aggressive marketing" of improper ERCs and calling it "a barrage of aggressive broadcast advertising, direct mail solicitations, and online promotions." The IRS also described some "tell-tale signs of misleading claims," which it later labeled "seven suspicious warning signs." Among these were unsolicited calls or advertisements mentioning an "easy application process," assurances that someone could determine ERC eligibility within minutes,

[6] *Id.* at section 2301(c)(3)(A)(i).

[7] *Id.* at section 2301(c)(3)(A)(ii)(I) and (II). These standards later changed from 100 to 500 full-time employees. *See* Consolidated Appropriations Act, 2021, division EE, section 207; and Notice 2021-23, 2021-16 IRB 1113, Section III.E.

[8] CARES Act, section 2301(b)(1); JCX-12R-20, *supra* note 1, at 38.

[9] Consolidated Appropriations Act, 2021, division EE, section 207; JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021); *see also* Notice 2021-23.

[10] Notice 2021-23, Section III.A.

[11] *Id.* at Section III.D.

[12] ARPA, section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

[13] Notice 2021-49, Section III.A.

[14] *Id.* at Section III.D.

[15] *See also* Notice 2021-65, 2021-51 IRB 880.

[16] IR-2021-65.

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contingency fees based on a percentage of ERCs obtained, and statements to the effect that all taxpayers should apply for ERCs because there was nothing to lose.[17]

B. Placement on the 'Dirty Dozen' List

The IRS announced that improper ERC claims not only made the "Dirty Dozen" list for 2023 but topped it.[18] The IRS kept ERC claims on the list for 2024.[19]

C. Seeking Help From Financial Institutions

Treasury's Financial Crimes Enforcement Network and the IRS issued an alert to financial institutions.[20] It enumerated many red flags to assist those institutions in detecting, preventing, and disclosing suspicious transactions concerning possible ERC fraud. Indicators highlighted in the alert include when (1) a business account receives more than one ERC deposit over multiple days; (2) a small business account receives an ERC deposit that is not commensurate with its size, volume of transactions, or number of employees; (3) a large ERC deposit is quickly transferred to a peer-to-peer service or online bank, or it is withdrawn in cash from an ATM; (4) the only deposits into an account consist of ERCs; (5) the account did not exist in 2020 or 2021; (6) a completely dormant account suddenly receives an ERC deposit; (7) an active account with no payroll history gets an ERC deposit; and (8) the customer indicates that its ERC was procured by a third party whose credentials cannot be verified or that was the "subject of adverse media."[21] The alert ended by reminding financial institutions of their duties concerning potentially improper ERC claims, including the filing of suspicious activity reports, retaining related records for at least five years, and sharing pertinent data among financial institutions.[22]

[17]IR-2023-105; IR-2024-39.

[18]IR-2023-49; IR-2023-71.

[19]IR-2024-85.

[20]Treasury, "FinCEN Alert on COVID-19 Employee Retention Credit Fraud," FIN-2023-Alert007, (Nov. 22, 2023) (confirming that FinCEN issued the alert "in close coordination" with the IRS).

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

[22]*Id.* at 8-10.

D. Training Specialized Personnel

In addition to making external announcements, the IRS showed some internal focus. It trained several hundred revenue agents to conduct civil examinations of ERC claims.[23] In 2022, it published a training guide on ERC claims for revenue agents.[24] The IRS also produced more expansive training materials later that same year.[25]

E. Issuing Regulations Confirming Authority

The IRS issued regulations concerning its ability to reclaim ERCs.[26] They emphasize that a "refund, credit, or advance of any portion of [an ERC] to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund for which the IRS must seek repayment."[27]

The government has always enjoyed the right to recoup excess ERCs through litigation.[28] However, the CARES Act and ARPA specifically contemplate the "administrative recapture" of ERCs. The IRS implemented that congressional mandate by issuing the regulations.[29] They clarify that the "assessment and administrative collection procedures *do not replace* the existing recapture methods, but rather represent an *alternative method* available to the IRS" (emphasis added).[30]

The regulations establish the following rule:

> Any amount of [ERCs] for Qualified Wages . . . that is treated as an overpayment and refunded or credited to an employer [by the IRS] and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall be

[23]Nathan J. Richman, "IRS Readying Hard Look at Employee Retention Credit Claims," *Tax Notes Federal*, Oct. 31, 2022, p. 747; IRS, "Lesson 3 — Tax Credit for Employee Retention," COVID Credits & Deferrals for Employment Tax, Student Guide (revised July 2022).

[24]IRS, *supra* note 23.

[25]Lauren Loricchio, "Documents Shed Light on IRS Scrutiny of Employee Retention Credit," *Tax Notes Federal*, Dec. 12, 2022, p. 1584; IRS, "COVID Credits and Deferral Training for Employment Tax" (May 11, 2023).

[26]REG-111879-20; T.D. 9904; REG-109077-21; T.D. 9953, Background, Section V.

[27]T.D. 9904, Background, Section III.

[28]*Id.* at Background, Section IV.

[29]*Id.* at Explanation of Provisions.

[30]T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

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treated as an underpayment . . . and may be assessed and collected by the [IRS] in the same manner as the taxes.[31]

Officials explained that, under the new regulations, the IRS can "treat what is normally an erroneous refund as an underpayment of tax subject to regular assessment and administrative collection practices."[32]

F. Involving the OPR

The IRS's Office of Professional Responsibility has jurisdiction over various tax professionals.[33] It issued an alert in early 2023 making three key points.[34] First, it reminded practitioners that they must make reasonable inquiries of taxpayers to confirm their eligibility for, and the correct amount of, ERCs. The alert said, "If the practitioner cannot reasonably conclude . . . that the client is or was eligible to claim the ERC, then the practitioner should not prepare an original or amended return that claims or perpetuates a potentially improper credit." Moreover, the alert explained that if a practitioner discovers that a current client violated the ERC requirements in a prior year, the practitioner has a duty to inform the client of the noncompliance and related penalties.

Second, the alert reminded practitioners that all tax positions must have at least a reasonable basis. Expanding on this notion, it recommended that practitioners advise clients that previously made unwarranted or excessive ERC claims of their option to file Form 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," to rectify the situation.

Third, the alert warned that practitioners might not be able to rely on opinions, reports, analyses, and similar documents prepared by entities outside the IRS when it comes to making ERC claims. It explained that if a previous adviser has a conflict of interest with a taxpayer because of the amount or type of the fee that was charged (for example, a prohibited contingent fee), a practitioner might not be able to reasonably rely on documents from that adviser.

G. Undermining Supply Chain Positions

The IRS periodically publishes guidance on contested issues, which it styles as educational or informational. The reality is that this guidance often has more of an enforcement slant because both the IRS and taxpayers often cite it during tax disputes. Indeed, by issuing specific guidance, the IRS is declaring its position and expects all personnel — including those auditing ERC claims — to follow suit. This is why generic legal advice memorandum AM 2023-005 and similar IRS pronouncements are addressed below.

AM 2023-005 summarized the IRS's view on whether an employer can demonstrate that its business operations were partially or fully suspended, and thus that it met the governmental order test, solely because of supply chain problems. The IRS conceded that an employer can "step into the shoes" of its supplier, but that is not easy. The employer must show that (1) the supplier was subject to an acceptable governmental order during the relevant period, (2) the order caused the supplier to suspend its operations, (3) the inability to obtain goods or materials from the supplier caused a partial or full suspension of the employer's operations, and (4) the employer was unable to procure goods or materials from an alternative source. The memorandum applied these standards to five scenarios.

H. Imposing a Processing Moratorium

In response to rising concerns about improper ERC claims, the IRS announced in September 2023 that it was placing an immediate moratorium on the processing of new ERC claims.[35] The IRS initially indicated that the freeze would remain in effect until the end of 2023.[36] The stoppage has

[31] T.D. 9978; reg. section 31.3111-6(b) and (c); reg. section 31.3134-1(a) and (b); reg. section 31.3221-5(b) and (c).

[32] Loricchio, "New ERC Withdrawal Process Coming From IRS," *Tax Notes Federal*, Oct. 23, 2023, p. 745.

[33] 31 U.S.C. section 10.2(a)(5); 31 U.S.C. section 10.3.

[34] OPR, "Professional Responsibility and the Employee Retention Credit," Issue No. 2023-02 (Mar. 7, 2023).

[35] IR-2023-169; 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.

[36] Loricchio and Richman, "IRS Moratorium Jolts Employee Retention Credit Industry," *Tax Notes Federal*, Nov. 27, 2023, p. 1670.

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surpassed that time frame already, and the IRS has yet to set a date for ending the moratorium.[37]

I. Using Computers to Identify Targets

The IRS gave assurances that it was not twiddling its thumbs, so to speak, during the moratorium. It was busy "transcribing and digitizing" pending ERC claims to identify types of high-risk cases, fortify fraud detection techniques, and deploy its enforcement personnel accordingly.[38]

J. Enhancing Pre-Payment Review

The IRS indicated that the need for patience would be paramount for pending ERC claims — that is, those filed before the IRS instituted the processing moratorium. This was because the IRS planned to conduct "enhanced compliance reviews" of all pending claims, thereby pushing the standard processing period from 90 days to 180 days, and "much longer if the claim faces further review or audit."[39]

K. Starting Civil Examinations

The IRS announced that it had already referred "thousands of ERC cases for audit" as of September 2023, and this was before it even started its "enhanced compliance review" of all pending and future ERC claims.[40]

L. Investigating Potential Criminals

The IRS broadcast that its Criminal Investigation division had initiated over 250 investigations of potentially fraudulent ERC claims as of July 2023.[41] By October of that year, that number had risen to 301 investigations, involving approximately $3.5 billion in claims.[42] The IRS clarified that its criminal focus is limited to those that were "knowingly attempting to help taxpayers or employers evade tax, in other words, commit acts of fraud."[43]

M. Narrowing Eligibility of Federal Credit Unions

The IRS issued a chief counsel advice memorandum in August 2023 regarding ERCs and federal credit unions (FCUs).[44] The IRS explained that it contemplates six primary factors when determining whether an entity is an "instrumentality" of a federal, state, or local government.[45] It concluded that FCUs are governmental instrumentalities for ERC purposes because they are created by federal statute, serve the governmental purpose of fomenting the economic well-being of underserved populations, perform governmental functions when they act as fiscal agents, and are controlled and supervised by a public authority — for example, the National Credit Union Administration Board.

The IRS arrived at the following four determinations based on that reasoning: FCUs cannot claim ERCs for the second, third, and fourth quarters of 2020 because the CARES Act explicitly prohibits instrumentalities of the federal government from doing so; FCUs can claim ERCs for the first and second quarters of 2021 because, although they are instrumentalities, they meet the exception introduced by the relief act; FCUs can claim ERCs for the third quarter of 2021 in accordance with ARPA because they are excepted instrumentalities under that law, too; and FCUs can claim ERCs for the fourth quarter of 2021 only if they are recovery start-up businesses.

N. Excluding OSHA Communications

The IRS later issued generic legal advice memorandum AM 2023-007, addressing the relationship between the governmental order test, partial or full suspension of business operations, and communications by the Occupational Safety and Health Administration. The specific issue was

[37] IR-2024-72 (stating that a "specific resumption date hasn't been determined"); IR-2024-78 (explaining that a "specific resumption date hasn't been determined, but at this point, the IRS anticipates it will be sometime in the late spring").

[38] Richman, "IRS Hasn't Been Idle During ERC Moratorium," *Tax Notes Federal*, Jan. 29, 2024, p. 924.

[39] IR-2023-169.

[40] *Id.*

[41] *Id.*

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

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

[44] ILM 202333001; Fred Stokeld, "IRS Clarifies Availability of Retention Credit for Credit Unions," *Tax Notes Federal*, Aug. 28, 2023, p. 1524.

[45] *See* Notice 2021-20, Section III, question 2 (citing Rev. Rul. 57-128, 1957-1 C.B. 311).

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whether an employer could rely on OSHA communications about preventing the spread of COVID-19 in the workplace to meet the definition of eligible employer for ERC purposes.

AM 2023-007 described three documents that OSHA issued in connection with COVID-19. The first was the "Interim Enforcement Response Plan," which recommended multiple safety controls, including social distancing, maintaining ventilation systems, and using masks. The second was called "Protecting Workers Guidance," which explained that, although the document referenced "mandatory OSHA standards," it merely contained recommendations that were "advisory in nature and informational in content" and did not constitute a law, standard, or regulation. The third item was an OSHA "directive" that provided personnel with policies and procedures for home-based worksites.

AM 2023-007 pointed out that the applicable law requires a governmental order and never mentions "recommendations, guidelines, or other information standards." Moreover, because the law does not specifically define the term "order," the IRS must use general principles of statutory interpretation. The memorandum thus turned to the ordinary meaning of the word as found in the dictionary. According to that source, an order in this context normally means a command or mandate given by a government official, and the three OSHA communications described above do not command or mandate any employer to take any action. The memorandum then got more specific, looking to the legislation that created OSHA — the Occupational Safety and Health Act of 1970. It explained that nonbinding guidance, such as that in the Interim Enforcement Response Plan and the Protecting Workers Guidance, is not considered an order under that formative legislation.

The memorandum further suggested that the OSHA communications probably would not support ERC claims even if they were considered orders. Why? The pertinent law requires that an employer be subject to a governmental order and that that order cause a partial or full suspension of operations. The memorandum predicted that the recommendations by OSHA to wear masks, offer sanitation supplies, and encourage social distancing likely would not have more than a "nominal effect" on business operations.

O. Scrutinizing Improper Promotion

The IRS indicated in late 2023 that it had already started so-called promoter investigations under section 6700. Notably, in doing so, the IRS recognized that "some promoters pitched valid claims" and it "is not interested in all promoters."[46]

P. Offering Claim Withdrawal

In October 2023 the IRS unveiled a program for employers that had previously filed ERC claims and then changed their minds (the withdrawal option).[47] The official objective was to "help small business owners and others who were pressured or misled by ERC marketers or promoters into filing ineligible claims."[48] It was also designed, the IRS suggested, "to help honest taxpayers" that "mistakenly claimed the ERC."[49]

The withdrawal option, which is still in effect, functions as follows. An employer can apply for the withdrawal option if (1) it made an ERC claim on an amended employment tax return, such as a Form 941-X; (2) it filed that return solely for purposes of claiming the ERC; (3) it wants to retract the entire ERC claim, not just reduce it; and (4) the IRS has not yet issued the ERC, or the employer has not yet cashed or deposited the check.[50] The IRS warned, though, that an employer that filed fraudulent ERC claims, assisted another in doing so, or conspired to do so will not be exempt from criminal charges simply by applying for the withdrawal option.[51] The IRS also stressed that it will send applicants a letter "about whether their withdrawal request was accepted or rejected," and employers have not officially participated in, or benefitted from, the

[46] Richman, "Civil Examinations of ERC Promoters Are Underway," *Tax Notes Federal*, Dec. 4, 2023, p. 2048; *see also* Loricchio, *supra* note 43.

[47] IR-2023-193; Joseph DiSciullo, "Fact Sheet Explains How to Withdraw Claims for Employee Retention Credit," *Tax Notes Federal*, Oct. 30, 2023, p. 883; IR-2023-169.

[48] IR-2023-193.

[49] FS-2023-24.

[50] *Id.*

[51] *Id.*

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withdrawal option unless and until they receive an approval letter.[52]

The IRS commissioner acknowledged that early interest in the withdrawal option was low, but he expected it to gain traction over time.[53]

Q. Encouraging Voluntary Disclosure

The IRS announced the ERC voluntary disclosure program (VDP) in December 2023.[54] The official rationale for this move was the IRS's "concerns about scams and potential fraud regarding ERC claims given false and misleading public advertisements and scams taking advantage of taxpayers."[55]

Not all employers were eligible for the VDP. The IRS explained that an employer could apply only if it met all the following criteria: (1) the employer was not under IRS criminal investigation, (2) the employer had not been notified already that the IRS intended to start a criminal investigation, (3) the IRS had not received information from a third party alerting it to the employer's noncompliance, (4) the IRS had not acquired information directly of noncompliance from an enforcement action, (5) the employer was not under an employment tax audit by the IRS for any tax period for which it was applying for the VDP, and (6) the employer had not previously received a notice and demand from the IRS for repayment for all or a portion of an ERC claim.[56]

What did the IRS offer to induce participation by employers? If an employer repaid 80 percent of the ERC it erroneously received, the IRS would waive all penalties and interest on the amount returned. Moreover, the IRS would not characterize as income the 20 percent that the employer got to retain. Lastly, an employer could claim a wages-paid deduction for income tax purposes for 100 percent of the relevant wages, even though it was only paying 80 percent (not 100 percent) thanks to the VDP.[57]

The IRS expressly stated that applying to the VDP would not be a panacea. Indeed, it indicated that executing a closing agreement under the VDP "does not preclude the IRS from investigating any associated criminal conduct or recommending prosecution for violation of any criminal statute, and does not provide immunity from prosecution."[58] Additionally, the IRS clarified that participation by any employer in the VDP was at its sole discretion; it stated that denial of a VDP application was "not subject to judicial review or administrative appeal."[59]

The deadline for applying for the VDP was March 22.

R. Disallowing the Defective

In December 2023 the IRS disallowed more than 20,000 ERC claims that were facially false because the employers did not exist or did not pay any employees during the relevant quarters. The IRS, in other words, jettisoned the low-hanging fruit, the "claims that clearly fell outside the legal requirements."[60]

S. Threatening Mass Disallowances

The IRS warned that the mass rejection of groundless ERC claims represented just the beginning of its efforts, as it planned to soon send "disallowance letters and letters seeking the return of funds erroneously claimed and received."[61] Specifically, the IRS announced that it would direct "a different set of letters to thousands of ERC recipients," notifying them that the IRS would recoup their unwarranted ERCs through normal tax assessment and collection procedures.[62] True to its word, the IRS indicated in March that it had recently sent more than 12,000

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[52] *Id.*

[53] Jonathan Curry, "IRS Expects Interest in ERC Withdrawal to Pick Up Soon," *Tax Notes Federal*, Dec. 18, 2023, p. 2231.

[54] Announcement 2024-3, 2024-2 IRB 364; Loricchio, "IRS Launches ERC Voluntary Disclosure Program," *Tax Notes Federal*, Jan. 1, 2024, p. 188.

[55] Announcement 2024-3, section 1.

[56] *Id.* at section 2.

[57] *Id.* at section 3.

[58] *Id.* at section 4.

[59] *Id.*

[60] IR-2023-230; Curry, "ERC Compliance Campaign Gets Underway With First Wave of Letters," *Tax Notes Federal*, Dec. 11, 2023, p. 2046.

[61] IR-2023-230; Curry, *supra* note 60.

[62] IR-2024-21.

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letters to employers recapturing all ERCs claimed, plus imposing penalties and interest.[63]

T. Using Tax Professionals as Proxies

The IRS announced in January that CI was beginning a series of "educational sessions" for tax professionals in their offices throughout the country.[64] It apparently sent invitations to approximately 220 companies that were "doing significant ERC filings," and slightly more than half responded. The goal of these events, according to the IRS, was "for tax professionals to encourage their clients to consider withdrawing fraudulent ERC claims or voluntarily disclosing improper claims."[65] A cynic might suggest that the real purpose was for CI to put companies on notice that they are on the IRS's radar.

U. Urging Enforcement Legislation

It is true that Congress, not the IRS, enacts legislation. However, certain legislation might be attributed to the IRS because its leaders were the ones urging Congress to take various actions.[66] A recently proposed law, discussed below, was introduced shortly after the IRS commissioner "met with members of the Senate Finance Committee to ask for additional tools for enforcement efforts related to the credit."[67] The commissioner also testified before the House Ways and Means Committee, again emphasizing the need for legislative changes to assist the IRS in combating improper ERC claims and those endorsing them.[68]

Before getting to the legislation in question, readers need some foundation on the types of penalties that the IRS can impose in situations involving what it deems to be abusive transactions. The IRS frequently threatens promoter penalties under section 6700. Persons might get hit with promoter penalties if they organize, help with organizing, directly sell, or indirectly sell interests in an entity, plan, or arrangement, and if they either personally make or cause another person to make (1) a false or fraudulent statement about the tax benefits that a taxpayer will obtain from participating, or (2) a "gross valuation understatement."

The IRS also punishes persons under section 6701 for aiding and abetting tax understatements. This penalty applies when three criteria are met: a person assists in, procures, or advises regarding the preparation of any portion of a return, affidavit, claim, or other document; the person knows (or has reason to know) that the document will be used in connection with a material tax matter; and the person knows that it will result in a tax understatement to the IRS.[69] The aiding and abetting penalty generally equals $1,000 per person, per period, per taxpayer.[70]

With that background under their belts, readers are ready to turn to the proposed legislation. Congress recently mulled over a law that could have serious consequences in the ERC world.[71] The legislation, called the Tax Relief for American Families and Workers Act of 2024 (H.R. 7024), was approved by the House in January. The Senate has not yet done the same.

The act would create a special penalty for so-called ERC promoters. This is a misnomer, really, because it does not involve promoter penalties under section 6700, but rather aiding and abetting penalties under section 6701. If the act were to pass, the existing sanctions would increase when it comes to ERC promoters. The current penalty is essentially $1,000 per violation. This figure would swell under the act to the larger of $200,000 or 75 percent of the gross income derived from

[63] IR-2024-78.

[64] IR-2024-21.

[65] Loricchio, "ERC Abuse Revives Debate Over Contingency Fees," *Tax Notes Federal*, Mar. 18, 2024, p. 2268.

[66] Doug Sword and Cady Stanton, "Mixed Reviews for Werfel on ERC, 1099-K Reporting, and More," *Tax Notes Federal*, Feb. 19, 2024, p. 1498.

[67] Loricchio, "Tax Deal Would Bring ERC Claims to Earlier End and Curb Abuse," *Tax Notes Federal*, Jan. 22, 2024, p. 732; *See also* Sword and Stanton, "Werfel Pitches Senators on Three Legislative Fixes for ERC Fraud," *Tax Notes Federal*, Jan. 15, 2024, p. 527 (explaining that the IRS commissioner asked Congress to give the IRS authority to ban contingency fees for ERC claims, increase penalties for certain preparers of those claims, and extend the assessment period).

[68] Sword and Stanton, *supra* note 66.

[69] Section 6701(a).

[70] Section 6701(b)(1). The penalty increases to $10,000 when corporations are involved.

[71] Sword and Stanton, *supra* note 67; Loricchio, *supra* note 67.

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providing aid, assistance, or advice regarding any ERC document.[72] An "ERC document" is any return, affidavit, claim, or other document concerning any ERC claim.[73] These penalties have the potential of being mammoth when one considers the size of some ERC claims and the fact that some persons deemed to be ERC promoters charged hefty fees.

The term ERC promoter has three categories. First, it covers any person that provides aid, assistance, or advice regarding an ERC document, if that person charges or receives a contingency fee (that is, a fee based on the amount of the ERCs) and the aggregate gross receipts concerning those services constitute more than 20 percent of the gross receipts of that person for the year the services were provided or the preceding one.[74] It is interesting to note that the act, in its original form, did not contain language about a revenue threshold or percentage; simply doing ERC-related work in exchange for a contingent fee sufficed.[75] Second, an ERC promoter also includes any person that provides aid, assistance, or advice regarding an ERC document, if the aggregate gross receipts concerning those services constitute more than 50 percent of the gross receipts of that person for the year the services were provided or the preceding one.[76] Lastly, the definition of ERC promoter embraces any person that provides aid, assistance, or advice regarding an ERC document, if the aggregate gross receipts concerning those services exceed 20 percent of the gross receipts of that person for the year the services were provided or the preceding one, and those receipts exceed $500,000.[77]

[72] Tax Relief for American Families and Workers Act of 2024, section 602(a)(1). The figure decreases from $200,000 to $10,000 when the ERC promoter is an individual instead of an entity.

[73] *Id*. at section 602(f).

[74] *Id*. at section 602(e)(1)(A).

[75] JCT, "Description of H.R. 7024, the 'Tax Relief for American Families and Workers Act of 2024,'" JCX-2-24, at 69 (Jan. 17, 2024) (stating that a person could be an ERC promoter solely because that person "charges or receives a fee based on the amount of the ERTC refund or credit").

[76] Tax Relief for American Families and Workers Act of 2024, section 602(e)(1)(B)(i).

[77] *Id*. at section 602(e)(1)(B)(ii). What is particularly interesting is that the act expressly carves out certified professional employer organizations from the definition of ERC promoter. *See id*. at section 602(e)(2).

The act, in addition to hitting ERC promoters with heightened aiding and abetting penalties under section 6701, would obligate them to comply with particular due diligence requirements. The act states that any ERC promoter that fails to meet the applicable due diligence standards regarding eligibility for, or the amount of, any ERC claim will face a penalty of $1,000 for each violation.[78]

Moreover, the act provides that in situations involving ERC promoters, the ERC claim generally would be treated as a listed transaction and the ERC promoter would be considered a material adviser thereto.[79] These characterizations could trigger many negative things for ERC promoters, such as the need to file Forms 8918, "Material Advisor Disclosure Statement," recordkeeping duties, and penalties for transgressions.

The act also contains a few important rules that are not specific to ERC promoters. For instance, it would significantly extend the assessment period from three years to six years. This gets worse when one reads the language closely: The act specifies that the six-year clock does not even start ticking against the IRS until the date on which the relevant Form 941, "Employer's Quarterly Federal Tax Return," is actually filed, when the Form 941 is deemed to have been filed, or when the credit or refund regarding the ERC is made, whichever occurs latest.[80] Given the ultra-slow manner in which the IRS has processed ERC claims, which has been exacerbated by the moratorium and enhanced review process, employers might be susceptible to IRS audits for many years under the act.

Another critical rule in the act, not directed just toward ERC promoters, is that the IRS would not allow any ERC credit or refund unless the claim was filed on or before January 31.[81]

[78] *Id*. at section 602(c)(1) and (2) (referencing due diligence requirements found in section 6695(g)). Noncompliance with the due diligence standards would also constitute a determination that the ERC promoter knew that the ERC claim would result in a tax understatement by another person for purposes of the third prong of section 6701(a). *See* Tax Relief for American Families and Workers Act of 2024, section 602(b).

[79] *Id*. at section 602(d)(1) and (2).

[80] *Id*. at section 602(i).

[81] *Id*. at section 602(h).

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V. Launching Correspondence Audits

The IRS, likely recognizing the limited resources available for ERC enforcement and the massive number of claims filed, quietly added another tool in late 2023. The IRS started performing correspondence audits, meaning audits conducted solely through the mail, with no personal interaction between the taxpayer and the IRS. These types of audits have long been a target of criticism from IRS watchdogs.[82] The national taxpayer advocate, for instance, labeled correspondence audits among the "most serious problems" with the IRS. She explained the situation as follows:

> Many taxpayers experience difficulties with correspondence audits. Once a return is selected for examination, the IRS notifies the taxpayer by letter. Correspondence audit letters fail to provide a point of contact — the taxpayer is not given a direct phone number or the name of an IRS employee to contact. If no response to the initial contact letter is received, the IRS generally makes no effort to contact the taxpayer before making an adjustment, issuing a notice of deficiency, and closing the case. Taxpayers wishing to speak with someone regarding an audit are limited to calling a representative on a toll-free line. This process creates significant challenges for taxpayers and practitioners who need to reach the IRS to discuss their cases. Getting through on the IRS's toll-free lines is difficult and time-consuming. If the IRS initiates a call to the taxpayer or practitioner in response to correspondence, the taxpayer or practitioner is often unavailable. Getting back in touch with the IRS can be nearly impossible due to the IRS's inability to leave detailed phone messages.[83]

In the context of ERC claims, the IRS began sending Letters 6612 to various taxpayers in late 2023.[84] These letters confirm that the IRS is auditing the ERC claimed, instruct the taxpayer to fully respond to the enclosed information document request, indicate that the deadline is 30 days from the date on the letter, and enumerate four outcomes. First, if the materials provided in response to the IDR support ERC eligibility and amounts, the IRS will accept the Form 941 or Form 941-X. Second, in situations in which the materials fail to offer full support, the IRS will send an examination report explaining proposed adjustments, and the taxpayer can then dispute matters in various ways. Third, if a taxpayer decides to ignore a Letter 6612, the IRS will completely disallow the ERC claimed and not release any refunds. Finally, the IRS contemplates a fourth scenario in which taxpayers prepare their responses to the IDRs, suddenly realize they are not entitled to the ERCs previously sought, and want to withdraw their claims. When taxpayers experience this type of epiphany, they are supposed to "let the IRS know" and then get their "specific instructions" on how to give back their tax benefits.

Letters 6612 do not contain the name, title, or phone number of a revenue agent, tax compliance officer, or other IRS employee with whom the taxpayers under audit can communicate directly. The taxpayers must send all materials — including a potentially massive number of documents, questions, and anything else — to a generic IRS fax number or office.

The amount of data demanded by the IDRs is vast, of course. Among other things, they demand details about (1) whether the taxpayer was engaged in a trade or business; (2) how the taxpayer qualified under the governmental order test, with particular focus on the concepts of partial or full suspension of operations, as well as "nominal portions" of, and "nominal effects" on, a business; (3) how the taxpayer qualified under the gross reduced receipts test; (4) whether the taxpayer met the recovery start-up business standards during the third or fourth quarter of 2021; (5) how the ERC amounts were calculated;

[82] *See*, *e.g.*, Government Accountability Office, "IRS Correspondence Audits: Better Management Could Improve Tax Compliance and Reduce Taxpayer Burden," GAO-14-479 (June 5, 2014).

[83] National Taxpayer Advocate, "Annual Report to Congress 2021," at 149 (2022).

[84] IRS, "Understanding Your Letter 6612" (updated Dec. 18, 2023); Richman, "IRS ERC Audits Undergo Changes as They Get Older," *Tax Notes Federal*, Mar. 11, 2024, p. 2080. The author has on file several letters 6612 sent to clients.

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(6) how the "qualified health plan expenses" were determined and allocated; (7) characterization of the taxpayer as a small eligible employer or a large eligible employer; (8) which employees receiving wages were actually performing services for the taxpayer; (9) all "related parties" to the taxpayer or its majority owners; (10) loans applied for, received, or forgiven under the Paycheck Protection Program; (11) wages taken into account by the taxpayer in obtaining benefits under the Restaurant Revitalization Fund, the Families First Coronavirus Response Act, and so on; and (12) amended income tax returns showing reduced deductions for wages paid by the amount of ERCs received. Things get worse when the IRS is scrutinizing multiple tax periods: The IDRs warn that "if multiple quarters are under audit, provide a response for each quarter [and] if you don't send a response for a quarter under audit, we'll disallow the ERC for that quarter."[85]

W. Confirming Third-Party Payer Liability

The IRS recently issued generic legal advice memorandum AM 2024-001, clarifying its position on the liability of various third-party payers for tax underpayments linked to faulty ERC claims.[86]

The memorandum described three types of third-party payer arrangements. First, it focused on section 3504 agents. In situations in which a third-party payer pays the wages of an employee or group of employees of one or more employer-clients, section 3504 provides that the third-party payer can be designated as an agent of the employer-clients for these purposes. The relevant regulation generally dictates that "all provisions of law (including penalties) and of the regulations applicable to an employer with respect to [the acts performed by the agent] shall be applicable to the agent."[87] According to the memorandum, this means that both the section 3504 agent and the employer "are liable for underpayments of employment tax related to such wages."

The second third-party payer arrangement addressed in the memorandum concerned a professional employer organization (PEO). The regulations say that if a third-party payer, such as a PEO, pays wages to individuals performing services for an employer-client under a service agreement, the third-party payer can be designated to perform acts of the employer, like filing employment tax returns and paying the corresponding taxes. The regulations also state that "all provisions of law (including penalties) and of the regulations applicable to an employer" are applicable to the PEO. The regulations add that the employer-client of the PEO remains subject to "all provisions of law (including penalties) and the regulations applicable to an employer with respect to these wages." The memorandum concluded that, in situations involving a PEO that performs tasks under a service agreement, both the PEO and the employer "are liable for underpayments of employment tax related to wages paid by the PEO to those employees."[88]

The third third-party payer arrangement concerned a certified professional employer organization (CPEO). A CPEO normally is treated as the only employer, and it assumes all employment tax liabilities and responsibilities for the wages it pays to worksite employees of its "customers" (that is, its employer-clients).[89]

The memorandum then turned to two relevant ERC laws, starting with the CARES Act. It examined some provisions dealing with third-party payers. One says any ERC "shall be treated as a credit described in Section 3511(d)(2)." This language ensures that, when it comes to ERC claims based on services performed by an employee of an employer-client of a CPEO, the employer-client can claim the ERC and the amount is determined using the wages paid by the CPEO. The memorandum emphasized that this provision "does not address liability for an improperly claimed ERC."

The second law, the Taxpayer Certainty and Disaster Tax Relief Act, added language to the effect that any forms, instructions, regulations, or

[85] Letters 6612 and accompanying IDRs. On file with author.

[86] Caitlin Mullaney, "Third-Party Payers Liable for ERC-Related Tax Underpayments," *Tax Notes Federal*, Feb. 19, 2024, p. 1495.

[87] AM 2024-001 (citing reg. section 31.3504-1(a)).

[88] *Id.* (citing reg. section 31.3504-2(c)).

[89] *Id.* (citing section 3511(a)(1) and (c)(1)).

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other IRS guidance will require the employer-client to be responsible for the accounting of ERCs and for any liability for improperly claimed ERCs, and will require the CPEO or other third-party payer to accurately report ERCs based on the information provided by the employer-client. As explained above, the general rules, which were in place before the relief act came into existence, provided that the CPEO was responsible for underpayments triggered by improperly claimed credits. The relief act ensured that the employer-client of a CPEO would also be liable for ERC-related underpayments.

The IRS summarized its position in the memorandum as follows: A third-party payer that is a section 3504 agent, PEO, or CPEO is liable for any underpayment resulting from any improper credit that the third-party payer claimed on behalf of the employer-client on the employment tax return filed under the third-party payer's own employer identification number when the credit is based on wages paid by the third-party payer to the employees of its employer-client. According to the IRS, "this rule applies to the ERC as it would any other employment tax credit."

IV. Conclusion

As we have seen, the IRS is rolling out many different enforcement techniques when it comes to ERC claims — some traditional, others less so. Labels are not important, though. What matters is awareness of key IRS movements. Can most taxpayers be expected to keep up with the 20-plus actions that the IRS has already taken, plus additional ones that will surely come in the future? No. Even if they were cognizant of what the IRS is doing, can most taxpayers appreciate how specific IRS maneuvers directly affect them, their strategies, their defenses, and more? Again, no. As disputes over ERC claims increase in the coming months and years, taxpayers — particularly those that sought large refunds or took aggressive positions — would be wise to seek the help of tax professionals at the forefront of ERC issues. ■

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