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In this article, Sheppard analyzes recent developments concerning the employee retention credit that might have escaped the attention of many taxpayers and their advisers.

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I. Introduction

Battles over employee retention credit claims are turning more serious now, with many audits, administrative appeals, and cases getting underway. Taxpayers hoping to emerge victorious from a fight with the IRS or the Justice Department must have a deep understanding of legislative, substantive, procedural, and strategic matters surrounding the ERC. Reliance on speculation and personal opinions from bloggers, social media personalities, podcasters, and the like will not suffice. Understandably, loads of taxpayers have trouble separating legitimate guidance from hype, and they find it even more challenging to keep up with rapidly evolving matters in the ERC world. This article, the latest in a multipart series by the author, discusses five new, important items that might have escaped the attention of taxpayers.

II. Overview of ERC Legislation

Before getting into what has occurred lately in the ERC arena, readers first need some background.

Congress passed the Coronavirus Aid, Relief, and Economic Security Act in early 2020.[1] Under the CARES Act, an eligible employer could get an ERC against certain employment taxes equal to 50 percent of the qualified wages it paid to each employee, subject to various limitations.[2] An eligible employer was one carrying on a business that also met one of the following two tests: (1) The business's operations were partially or fully suspended because of a governmental order that limited commerce, travel, or group meetings for commercial, social, religious, or other purposes because of COVID-19 (the governmental order test);[3] or (2) the business suffered a significant decline in gross receipts (the reduced gross receipts test).[4] Coverage under the CARES Act was limited; it applied only to the second, third, and fourth quarters of 2020.[5] Qualified wages for any one employee could not exceed $10,000 for all quarters in 2020 combined. Taking into account the 50 percent limitation, the maximum ERC per employee was merely $5,000.[6]

The U.S. economy continued to struggle. Congress, therefore, quickly passed three additional laws focused on the ERC. They made the tax benefit more accessible and favorable to taxpayers in several ways. For example, Congress

[1] Joint Committee on Taxation, "Description of the Tax Provisions of P.L. 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(a).

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

[4] *Id.* at section 2301(c)(2)(A)(ii)(II) and (c)(2)(B).

[5] *Id.* at section 2301(m).

[6] *Id.* at section 2301(b)(1); JCT, *supra* note 1, at 38.

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enlarged the time frame, allowing most eligible employers to claim ERCs for the second quarter of 2020 through the third quarter of 2021. Further, the percentage of qualified wages on which they could make ERC claims increased from 50 percent to 70 percent. Another modification was calculating the maximum amount of qualified wages per quarter, not per year. The effect was that the ERC cap for 2020 was $5,000 per employee, while the ceiling for 2021 was $21,000 per employee. Congress also lowered the standards for meeting the reduced gross receipts test; instead of having to fall by more than 50 percent, gross receipts only had to drop by more than 20 percent. Several other changes, which are beyond the scope of this article, also came into play.[7]

III. Analyzing Five Recent Events

With so many things happening, and so quickly, it is difficult for diligent tax professionals to stay updated about ERC issues. For normal people, including decision-makers at companies that already made or might make ERC claims, staying abreast of emerging ERC issues might seem impossible. Below is some recent information that might help.

A. Disclosure Program for Third-Party Payers

The IRS has introduced various programs in the past year trying to convince employers to change course, abandon their earlier ERC claims, and return the money before being audited or otherwise challenged. The IRS introduced the first procedure in October 2023 (the withdrawal program).[8] Its official objectives were to "help small business owners and others who were pressured or misled by ERC marketers or promoters into filing ineligible claims" and "to help honest taxpayers" who "mistakenly claimed the ERC."[9] In terms of eligibility, an employer can apply for the withdrawal program if it made an ERC claim on an amended employment tax return, it filed that return solely to claim the ERC, it wants to retract the entire claim, and it has not yet gotten the benefits.[10] Acceptance into the withdrawal program is not a given; the IRS indicates that it will send applicants letters indicating yea or nay. While not spelled out by the IRS, one assumes that rejection might happen if it has prior indications of intentional misconduct, civil fraud, or criminality.[11]

The next maneuver by the IRS was announcing the voluntary disclosure program (VDP) in December 2023.[12] The official rationale for the first VDP was the IRS's "concern about scams and potential fraud regarding ERC claims" in light of the "false and misleading public advertisements and scams taking advantage of taxpayers."[13] The IRS explained that an employer could apply for the first VDP only if it was not currently under IRS investigation or examination, the IRS had not already received information from any source about ERC violations by the employer, and the IRS had not sent a demand for repayment of an ERC.[14] What carrots was the IRS offering to induce participation in the first VDP? If the employer repaid 80 percent of the ERC amount, the IRS would (1) waive all penalties and interest on the amount returned, (2) not characterize as income the 20 percent that the employer retained, and (3) permit the employer to take a wages-paid deduction for income tax purposes for 100 percent of the relevant wages, even though it was paying only 80 percent.[15] The first VDP ended March 22.[16]

Participation in the first VDP was not stellar, so the IRS tried again in August,[17] when it

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[7] These laws consisted of the Taxpayer Certainty and Disaster Tax Relief Act (Consolidated Appropriations Act, 2021, division EE, section 207); the American Rescue Plan Act of 2021, section 9651; and the Infrastructure Investment and Jobs Act.

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

[9] IR-2023-193; FS-2023-24.

[10] FS-2023-24.

[11] *Id.*

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

[13] Announcement 2024-3, section 1.

[14] *Id.* at section 2.

[15] *Id.* at section 3.

[16] *Id.*

[17] Treasury Inspector General for Tax Administration, "Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed," No. 2024-400-068, at 12 (Sept. 20, 2024) (stating that the IRS received only 2,609 applications for the first VDP).

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announced the next round of the earlier initiative (second VDP).[18] There are three major distinctions between the first and second VDPs. First, the deadline for applying for the first VDP was March 22, while the deadline for the second VDP is November 22. Second, the employer had to repay 80 percent of the ERC amount under the first VDP, while this figure rose to 85 percent under the second VDP. Third, the employer could rectify ERC claims for any quarter in 2020 or 2021 under the first VDP, but the second VDP is limited to claims for 2021.[19]

The latest effort by the IRS, introduced in September, is designed to permit a third-party payer (TPP) to withdraw incorrect ERC claims that it made for its employer-clients (supplemental claim process).[20] Common TPPs include professional employer organizations, certified professional employer organizations, and so-called section 3504 agents. The IRS explained that a TPP might have filed ERC claims for multiple employer-clients under its own employer identification number, only to discover later that some of those claims were improper. The supplemental claim process allows a TPP to withdraw the ERC claims for problematic clients while maintaining claims for others. The IRS explained that by filing the supplemental claim, the TPP is essentially asking the IRS not to process the outstanding Forms 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," and the IRS will treat them "as if they were never filed."[21]

The supplemental claim process is not for everyone, of course. The IRS cautioned that it is unavailable to employers that filed their ERC claims directly (and not through a TPP) using their own EIN. The IRS further clarified that a TPP that already received the full amount of the ERC claimed on behalf of an employer-client, either as a refund or as a credit against future taxes, cannot avail itself of the supplemental claim process. The IRS also emphasized that a TPP cannot use the supplemental claim process to address any ERC claims filed after January 31, 2024. It underscored that any TPP that plans to use the supplemental claim process must submit replacement Forms 941-X by November 22. If the IRS accepts a Form 941-X, it becomes "the sole adjusted employment tax return for the tax period." Conversely, if the IRS rejects a Form 941-X, it will send the TPP a letter and audit or otherwise review the first Form 941-X filed.[22] Finally, the IRS indicated that any TPP behaving badly will not find the supplemental claim process enticing. Why? According to the IRS, filing a replacement Form 941-X under the supplemental claim process will not exempt a TPP from potential criminal investigation and prosecution if the TPP "willfully filed a fraudulent ERC claim, or if [the TPP] assisted or conspired in such conduct."[23]

Interestingly, unlike earlier disclosure programs, the IRS seems to allow a TPP that is already under audit to participate in the supplemental claim process. If the IRS has not notified a TPP about an audit for a particular period, the TPP can file replacement Forms 941-X through the "Supplemental Claim for ERC Fax Line." On the other hand, if the IRS has already communicated with a TPP about an audit, the TPP should agree with the revenue agent about how to file the replacement Forms 941-X or simply supply them in response to the audit notice, as appropriate.[24]

B. TIGTA Report

Several government watchdogs have directed lots of attention to how the IRS has handled ERC matters over time. One such group is the Treasury Inspector General for Tax Administration. TIGTA has published three major ERC reports analyzing the good, the bad, and the ugly.[25] It published a fourth report in September that provides lots of

[18] Announcement 2024-30, 2024-36 IRB 581.

[19] *Id.*; IR-2024-213; IR-2024-212; Benjamin Valdez, "ERC Voluntary Disclosure Program Reopens," *Tax Notes Federal*, Aug. 19, 2024, p. 1576.

[20] IR-2024-246.

[21] *Id.*

[22] *Id.*

[23] *Id.* (see the IRS webpage cited therein, "Filing a Supplemental Claim for the Employee Retention Credit").

[24] *Id.*

[25] TIGTA, "Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions," 2020-46-041 (June 30, 2020); TIGTA, "Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic," 2021-46-043 (July 9, 2021); TIGTA, "Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits," 2022-46-059 (Aug. 31, 2022).

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hindsight, along with some suggestions for present and future operations.[26] This article discusses those suggestions.

The September TIGTA report acknowledged that the IRS took numerous steps to increase awareness, both internally and externally, about ERC eligibility requirements, and that those efforts likely prevented payment of erroneous claims. However, TIGTA identified approximately 1,000 paid claims with signs of impropriety, which the IRS had processed under former criteria. TIGTA recommended that the IRS subject those claims and others to "post-refund compliance review to recover potentially erroneous ERCs paid." The IRS agreed.[27]

The IRS changed its referral criteria in late 2022 to include only returns that met specific scenarios and higher dollar thresholds. The IRS explained that it implemented these changes to cope with the influx of ERC claims and expedite their processing. According to the TIGTA report, these modifications "led to hundreds of thousands of returns with billions of dollars in ERC claims not being considered for possible pre-refund examination."[28] TIGTA said that about 185,000 claims that avoided prior scrutiny "present a significant risk to tax administration because the IRS now has to try and recover the funds that were already paid." It recommended that the IRS review all relevant claims, consider them for post-refund compliance, and prioritize the claims whose general assessment periods remain open.[29]

The TIGTA report recognized that the IRS implemented various actions that prevented payment of some improper ERC claims. For instance, the IRS identified thousands of companies that were not formed until 2022, after the periods for which an ERC can be claimed. It also found companies that existed during the relevant periods but did not pay any employees. The IRS sent these unqualified companies notices of disallowance, which prevented about $1.3 billion leaving the government coffers inappropriately. However, the TIGTA report said that, based on its review of unprocessed claims, the IRS missed over 920 entities that clearly had no grounds for making ERC claims. TIGTA suggested additional review, and the IRS capitulated.[30]

Another interesting aspect of the TIGTA report is its explanation of the financial calculation made by the IRS. Apparently, the IRS compared the financial damage of swiftly paying improper ERC claims and then trying to claw them back with the damage of slowly paying proper ERC claims. The TIGTA report reveals that the second option prevailed:

> Delays in processing ERC claims may impact legitimate businesses that are eligible for the ERC and could result in increased interest paid by the IRS to these businesses, if a determination is made that the ERC claim is legitimate. The ERC team is working . . . to calculate the amount of estimated credit interest that could potentially be paid because of the delayed processing of ERC claims. The ERC team is using these estimates to compare the risk of paying potentially erroneous ERC claims to the potential amounts of interest paid as it moves forward with its decisions on how to work the inventory. According to the IRS's estimates, the moratorium and additional time taken to analyze and process ERC claims will be a cost savings to the Government, *i.e.*, the IRS will pay less in interest on the legitimate claims when compared to the claims identified as high risk and likely erroneous.[31]

In summary, TIGTA seems to indicate that the IRS plans to conduct significant amounts of pre-refund and post-refund review of ERC claims, with measured concern about how long these compliance actions might take.

[26] TIGTA, *supra* note 17.

[27] *Id.* at 6-7.

[28] *Id.* at 7.

[29] *Id.* at 8.

[30] *Id.* at 9-10.

[31] *Id.* at 14.

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C. More Time to Respond to Disallowance Notices

The first step to recouping cash or credits from the IRS is for a taxpayer to file a timely claim for refund, which usually is done on a Form 941-X in the ERC context.[32] A taxpayer must file a refund claim within three years of the time that it filed the relevant tax return or within two years of the time that it paid the relevant taxes, whichever period expires later.[33]

If the IRS fully or partially denies a refund claim by issuing a notice of disallowance, or if it fails to respond to the refund claim for more than six months, the taxpayer has two main options. First, the taxpayer can seek immediate help from the courts by initiating a refund suit in the proper federal district court or the Court of Federal Claims.[34] Second, the taxpayer can file a protest letter and seek reconsideration by the IRS Appeals Office, keeping in mind that doing so does *not* stop the clock from running. Normal IRS procedure is to grant a taxpayer 30 days from the date of the notice of disallowance to submit the protest letter. In situations where the Appeals Office upholds the earlier notice of disallowance or fails to make a decision within two years, the taxpayer can file a refund suit, as described above.

Historically, the notices of disallowance from the IRS involving the ERC came in the form of Letters 105C. They explained to taxpayers their right to file a protest letter, followed by a reminder: "If we don't hear from you within 30 days from the date of this letter, we will process your case with the information we have now."[35] Put another way, Letters 105C meant that taxpayers would get an ERC of $0, unless they filed a protest letter or something else compelling during the 30-day window.

The IRS modified the procedures in September.[36] It explained that a taxpayer can file a protest letter "at any time within two years" of the notice of disallowance, but it cautioned that it is preferable to challenge the IRS as soon as possible because "the timeline to resolve the claim and receive payment from the IRS is two years" from the date of the disallowance notice. The IRS then expanded its warning:

> Generally, you have two years from the date of [the notice of disallowance] to file suit. Requesting an appeal doesn't extend this time. By law, we can't issue a refund or allow a credit after the two-year period, unless you file suit during that period. If the end of the two-year period is approaching and a decision hasn't been made on your appeal (or if a favorable decision was made but the refund hasn't been paid yet), you can file suit or discuss extending the two-year period with us to protect your ability to receive a refund. If you don't file suit within the two-year period or sign an agreement with us extending the two-year period to file suit, you may lose your ability to receive a refund, even if Appeals has already made a favorable decision about your claim.

D. Rebranding ERC Legislation

Congress previously considered enacting a law designed to halt perceived ERC abuse. The proposed legislation, called the Tax Relief for American Families and Workers Act (H.R. 7024), garnered approval by the House of Representatives in January but failed to get a similar nod from the Senate.[37] Other politicians

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[32] Sections 6511(a) and 7422(a); reg. section 301.6402-2(a)(1).

[33] Section 6511(a); reg. section 301.6511(a)-1(a).

[34] Sections 6532(a)(1) and 7422(a); reg. section 301.6532-1(a).

[35] The author has many Letters 105C on file.

[36] Valdez, "IRS Extends Employee Retention Credit Appeal Window," *Tax Notes Federal*, Sept. 30, 2024, p. 2787 (see IRS webpage referenced in the article); Valdez, "IRS Clarifies Request for Employee Retention Credit Documents," *Tax Notes Federal*, Sept. 30, 2024, p. 2807 (stating that the IRS webpage "specified that taxpayers have two years to appeal a denial, up from the typical 30-day administrative deadline").

[37] Doug Sword and Cady Stanton, "Werfel Pitches Senators on Three Legislative Fixes for ERC Fraud," *Tax Notes Federal*, Jan. 15, 2024, p. 527; Loricchio, "Tax Deal Would Bring ERC Claims to Earlier End and Curb Abuse," *Tax Notes Federal*, Jan. 22, 2024, p. 732; Sword and Stanton, "Mixed Reviews for Werfel on ERC, 1099-K Reporting, and More," *Tax Notes Federal*, Feb. 19, 2024, p. 1498.

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took up the effort in September, rebranding the bill the ERTC Repeal Act of 2024 (S. 5079).[38] The name has changed, but the terms remain the same.

The ERTC Repeal Act would create a special penalty for ERC "promoters." The existing sanction for aiding and abetting tax understatements is $1,000 per violation.[39] Under the act, that figure would increase to the larger of $200,000 or 75 percent of the gross income derived from providing aid, assistance, or advice regarding any "ERC document."[40] Predictably, the term "ERC document" is defined broadly to encompass returns, affidavits, claims, or other documents related to any ERC claim.[41]

The concept of ERC promoter is also expansive under the act, featuring three categories:

1. Any person that provides aid, assistance, or advice regarding an ERC document, if that person charges or receives a contingency fee, *and* the aggregate gross receipts related to those services constitute more than 20 percent of the gross receipts of that person for the year the services were provided or for the preceding year.
2. Any person that provides aid, assistance, or advice regarding an ERC document, if the aggregate gross receipts related to those services constitute more than 50 percent of the gross receipts of that person for the year the services were provided or for the preceding year.
3. Any person that provides aid, assistance, or advice regarding an ERC document, if the aggregate gross receipts related to those services exceeds 20 percent of the gross receipts of that person for the year the services were provided or for the preceding year, *and* those receipts surpass $500,000.[42]

The ERTC Repeal Act would also obligate ERC promoters to comply with certain due diligence requirements. Those that fail to meet the applicable duties regarding eligibility for, and the amount of, any ERC claim would face a penalty of $1,000 per violation.[43] More importantly perhaps, noncompliance would constitute a determination that the ERC promoter knew that the relevant ERC claim would result in a tax understatement.[44]

The act further provides that when ERC promoters are involved, the IRS generally would treat ERC claims as listed transactions, and the ERC promoters would be considered material advisers thereto.[45] This classification would trigger information return requirements, recordkeeping obligations, potential penalties, and more.

The act also contains rules that are *not* specific to ERC promoters. For instance, it would significantly extend the assessment period for ERC claims in favor of the IRS, enlarging it from three years to six years.[46] Moreover, the IRS would not allow any ERC claims unless they had been filed by January 31, 2024.[47]

E. New Task Force Report

Few are aware of it, but there is a COVID-19 Fraud Enforcement Task Force composed of the inspectors general of various governmental agencies. It publishes annual reports, most recently in April.[48] That report explained that the Justice Department's Tax Division has focused its efforts on combatting ERC abuse. In this regard, it has trained federal prosecutors throughout the country and published a detailed article regarding criminal charges, strategies, and procedural issues relevant to ERC infractions. The report also noted that Tax Division attorneys are directly involved in fraud cases involving the ERC. Indeed, trial attorneys have been assigned to each "fraud strike force" to help develop

[38] Introduced September 18 by Sen. Mitt Romney, R-Utah, the ERTC Repeal Act of 2024 would increase penalties on ERC fraud.

[39] Section 6701.

[40] ERTC Repeal Act, section 2(a). The figure decreases from $200,000 to $10,000 when the ERC promoter is an individual instead of an entity.

[41] *Id.* at section 2(f).

[42] *Id.* at section 2(e).

[43] *Id.* at section 2(c) (referencing due diligence requirements found in section 6695(g)).

[44] *Id.* at section 2(b).

[45] *Id.* at section 2(d).

[46] *Id.* at section 2(i).

[47] *Id.* at section 2(j).

[48] Council of the Inspectors General on Integrity and Efficiency, "COVID-19 Fraud Enforcement Task Force Report" (Apr. 2024).

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investigations into ERC schemes. They have also added many ERC cases to their regular litigation dockets. The report warns that ERC actions are far from over:

> Because the ERC was available for relatively recent years (2020 and 2021) and given the complexity of identifying and prosecuting these offenses, the Tax Division expects that prosecuting ERC-related crimes will continue to be a priority for the foreseeable future.[49]

The article referenced by the task force was written by the assistant chief of the criminal enforcement section of the Tax Division.[50] He takes the position that prosecuting ERC abuse does not require prosecutors to use "novel" criminal charges because "falsely claiming tax credits fits comfortably into a variety of statutes commonly used to prosecute tax crimes."[51] As examples, he points to the possible crimes of willfully filing false tax returns, submitting false claims, making false statements, evading taxes, and aiding and assisting in the preparation and presentation of false returns.[52] His article, like the report by the task force, predicts significant amounts of ERC-related actions for years to come, and he encourages his colleagues to rise to the task:

> Due to the magnitude of the fraud, prosecutions of tax-related COVID crime will likely occupy a substantial portion of the [Justice Department's] attention for years. Federal prosecutors, however, should not be intimidated when handling such cases. While COVID tax credits are new, the longstanding statutes available to address tax fraud are just as effective as ever. In fact, after one gets past the novelty of the COVID tax credits, prosecutions of those who abuse such credits are fundamentally the same as typical tax cases.[53]

IV. Conclusion

This article has highlighted the supplemental claim process, the latest TIGTA report, new timing issues applicable to disputing notices of disallowance, potential legislative changes under the ERTC Repeal Act, and the most recent task force report about future criminal actions. These constitute only a few of the recent events in the ERC arena, and many more are sure to materialize soon. As noted, battles against the IRS and the Justice Department promise to be complicated, and taxpayers determined to win will need to have a comprehensive understanding of all things ERC. ■

[49] *Id.* at 15.

[50] David Zisserson, "Tax Fraud Involving COVID-Relief Provisions," 73 *Dep't Just. J. Fed. L. & Prac.* 63 (Dec. 2023).

[51] *Id.* at 70.

[52] *Id.* at 71-73.

[53] *Id.* at 63.

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