

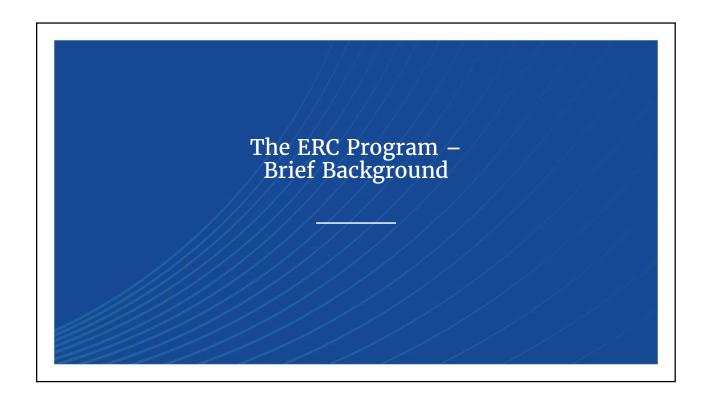
Agenda

- The ERC Program Brief Background
- Widespread Abuse of the ERC and Recent Events
- IRS Scrutiny
- ERC Audits What to Expect & Best Practices
- ERC Litigation
- ERC Best Practices for M&A





 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$



ERC Basics

- Employee Retention Credit ("ERC") was created by the CARES Act in March of 2020, and provides eligible employers with a refundable tax credit. Expanded by the Consolidated Appropriations Act.
- Can generally be claimed for Q2-Q4 of 2020 and Q1-Q3 of 2021.
 - Focus will typically be on 2021 quarters because the 2021 ERC offers a larger credit for each quarter, and vastly expands the number of employers that can qualify for the credit for all wages paid to employees.
- If a company claims the ERC, they are required to amend their income tax return to reduce their payroll tax deduction attributable to the ERC period.

Reinhart

© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

Who is Eligible for the ERC?

Two tests – satisfaction of either gives rise to eligibility (discussion of RSBs excluded).

1. <u>Decline in Gross Receipts Test</u>

- Black and white test, generally based purely on receipts for the tested quarter compared to the receipts for the same quarter in 2019.
- Certain exceptions (alternative quarter election), and be wary of misinformation (projected receipts)

2. Partial Suspension Due to Governmental Order Test

- Much more grey test, more room for gameplaying. Generally requires that the operations of the business were partially or fully suspended due to an appropriate governmental order.
- Be wary of supply chain/port closure arguments, misunderstandings about remote work and mask mandates, etc.



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

5

Calculating the ERC Refund - Qualifying Wages

- First hurdle large vs. small employers
 - Importantly, certain wages (productive time) are excluded for "large" employers.
 - For the 2020 ERC, a "large" employer has an average of more than 100 full-time employees (based on 2019 figures). For the 2021 ERC, this figure was raised to 500.
- Generally, qualifying wages are defined as "wages" under Code section 3121(a) and "compensation" as defined in Code section 3231(e) paid by an eligible employer during a covered calendar quarter.
 - Certain healthcare costs borne by the employer can be included.
- Also, note that PPP double dipping is not permitted. Wages paid with forgiven PPP funds are not ERC-eligible.



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

How the ERC is Claimed

- 2020 SoL closed, 2021 claims may still be filed (until April 15, 2025).
- Credit is claimed by amendment of the business's Forms 941 (i.e., via a Form 941-X).
 - Must be paper filed.
- IRS used to publish the number of unprocessed Forms 941 and 941-X.
 - They have stopped this practice, and now exclude ERC claims from the count.
- On October 10, 2024, IRS announced they were processing about 400,000 claims (~\$10 billion in claims).
 - Reports of 1.4 million unprocessed claims as of June 17, 2024.



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

7

Widespread Abuse of the ERC and Recent Events

Widespread Attention - Some Legit, Others Not

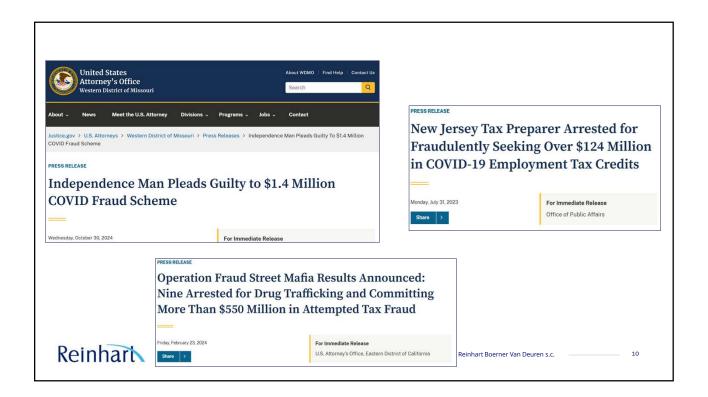
Inside a Sales Army Turning a Tax Break Into a Modern-Day Gold Rush

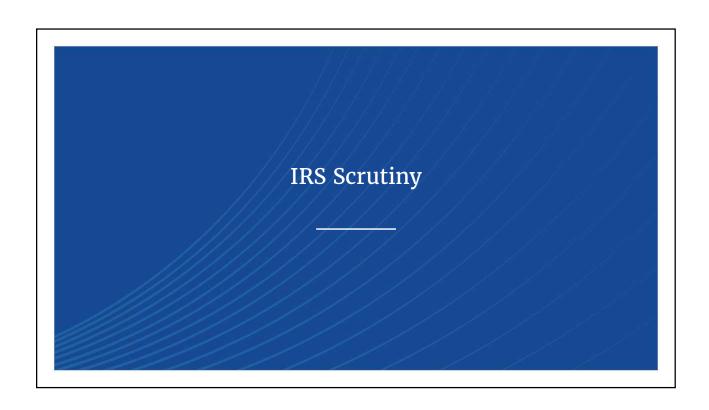














IRS Shares "Warning Signs" of Incorrect Claims (August 26, 2024)

- Essential businesses during the pandemic that could fully operate and didn't have a decline in gross receipts
- Businesses using wages already used for Paycheck Protection Program loan forgiveness
- · Too many quarters being claimed
- Too many employees and wrong calculations
- · Businesses citing supply chain issues
- Businesses didn't pay wages or didn't exist during eligibility period

- Businesses unable to support how a government order fully or partially suspended business operations
- Businesses reporting family members' wages as qualified wages
- Large employers claiming wages for employees who provided services
- Government orders that don't qualify
- Businesses claiming ERC for too much of a tax period
- Promoter says there's nothing to lose

© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

12

Reinhart

Available Options for Forfeiting or Amending Claims

- First Round Voluntary Disclosure Program (Closed)
 - IRS received more than 2,600 applications involving more than \$1.09 billion
- Second Round Voluntary Disclosure Program (Open until Nov. 22, 2024)
 - Available if ERC refund has been paid/credited and you are willing to return 100% of the refund
 - Only 2021 quarters permitted
 - Requires repayment of 85% of refund amount (i.e., 15% windfall)
 - No penalties or interest (absent fraud)
- Withdrawal of Entire Claim
 - Available only if refund not paid/cashed
 - Must withdraw the **entire amount** of the ERC claim
 - No penalties or interest (absent fraud)
- Amended Forms 941-X
 - · Useful if claim is partially valid

Reinhart

* Note also the consolidated claim process for third-party payers promulgated in Sept.

 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$

ERC Audits – What is Happening and What to Expect

IRS ERC Enforcement Activity

- Various avenues, including the following:
 - 105C Recapture Letters
 - Field Audits
 - Criminal Promoter Prosecution
 - Whistleblowers (Promoters, Circ. 230, etc.)
 - Report a promoter or advisor outside of the VDP application with Form 14242, Report Suspected Abusive Tax Promotions or Preparers

 PPF

 POF

Reinhart

105C Letters – Generally

- IR-24-169
 - Issuance began in July 2024
- Various reasons for disallowance, including:
 - No record of prior employment tax deposits
 - No signs of operating a trade or business
 - Failure to qualify for credit (under either test)
- Significance
 - Opportunity to protest to the IRS Independent Office of Appeals
 - Typically 30 days, but IRS has indicated that they won't enforce this for these ERC 105C letters
 - · Check with IRS if waiting for 86-C (referring you to Appeals) letter for extended period of time
 - Formal disallowance that starts the 2-year refund suit timeline



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

1

105C Letters - Another IRS Mistake

- Many 105C letters have contained incorrect information, or omitted language regarding taxpayer rights
 - "The IRS learned that some of the recent early mailings have inadvertently omitted a paragraph highlighting the process for filing an appeal to the IRS or district court, and the agency is taking steps to ensure this language is mailed to all relevant taxpayers."
- IRS says more than 90% were "validly issued"
 - 10% sent in error...
 - National Taxpayer Advocate: "This doesn't mean they didn't contain errors rather, it only means the IRS believes the errors did not invalidate the notices. Thus, I suspect it's possible – if not likely – that many of the notices, even if valid, contained errors."



 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$

ERC Audits, Generally

- "Thousands" have been initiated and are underway, per the IRS
- Wide scope of issues
 - Eligibility, particularly under the partial suspension test
 - Focus on supply chain arguments (see GLAM 2023-005)
 - FTE Counts
 - Qualified wage calculation (owner wages, PPP double dipping, etc.)
 - Aggregation
- Statute of Limitations
 - Note the special 5-year SoL for Q3 and Q4 of 2021 (IRC § 3134(I))
 - · No SoL in the case of fraud

Reinhart

🗓 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c

10

ERC Audits - The Stakes

- Penalties
 - Underpayment (IRC §§ 6662 and 6663)
 - Accuracy
 - Reasonable cause?
 - IRC § 6676 misinformation
- Interest
- Criminal Exposure
 - Fraudulent/willful misconduct

Type of interest or penalty	Code section that provides authority to assess	Interest or penalty rate
Interest	IRC 6601	<u>Varies quarterly</u> . 1st quarter 2024 rate is 8%-10%
Failure-to-pay penalties	IRC 6651(a)(2) IRC 6651(a)(3)	.5-25% Or 1/4% or 1%
Failure-to-file penalties	IRC 6651(a)(1)	5-25%
Failure-to-deposit penalties	IRC 6656(a)	2-15%
Accuracy-related penalties	IRC 6662(a)	20%
Civil fraud penalties	IRC 6663	75%
Fraudulent failure-to-file penalties combined with the failure-to-file penalties	IRC 6651(f)	15-75%
Trust fund recovery penalties	IRC 6672	Equal to total amount of the tax evaded, or not collected, or not accounted for and paid over.

Criminal charges related to taxes can include, but are not limited to, tax evasion (IRC 7201), filing a false return (IRC 7206(1)), false claims (18 USC 287) and false statements (18 USC 1001). A person convicted of tax evasion is subject to a prison term of up to five years and a fine of up to \$250,000. Filing a false return subjects a person to a prison term of up to three years and a fine of up to \$250,000.

https://www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit-voluntary-disclosure-program

Reinhart

 $\hbox{@ 2023 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$

How to Prepare for Audits/Lessons from the Front

- Re-examine eligibility and recalculate wages yourself
- Looks for common pressure points
 - Aggregation
 - Owner wages
 - FTE count
 - Be wary of M&A activity
- Bolster the record
 - Reach out to past advisors
 - · Create documentation where necessary



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

2.

Documenting ERC Claims to Protect Against Penalties/Interest

- At a bare minimum, any business that claimed the ERC should have an audit file consisting of:
 - Detailed memo/email chain specifically identifying the quarters for which the company is eligible and identifying the method of qualification with specificity.
 - If based on partial suspension, be sure to detail governmental orders, document more than nominal interruption, etc.
 - Excel spreadsheet showing payroll and other "wage" expenses for each eligible quarter and backing out any PPP-funded payroll.
 - List of advisors used when claiming the credit and what advice came from each.
 - Retain all correspondence (i.e., emails), consultant presentation materials, etc

Reinhart

 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$

IRS Criminal Investigations

- According to the IRS, 460 criminal cases have been initiated (as of July 1, 2024)
 - Potentially fraudulent claims worth nearly \$7 billion
 - As of August 8, 37 investigations had resulted in federal charges, with 17 investigations resulting in convictions and nine sentencings with an average sentence of 20 months
- Your clients may be asked to help (interviews, etc.)
 - · Think this through
 - We have seen clients who participate in the VDP be asked to assist with this process



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c

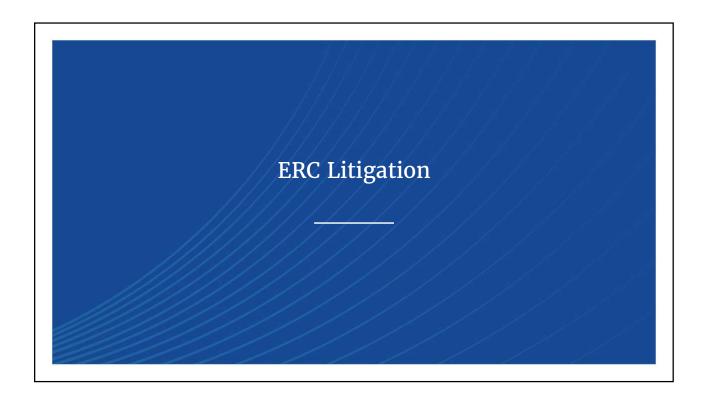
23

Loper Bright Implications?

- Beyond the scope of this presentation, but there is an informal rule since the decision that every presentation must mention the case.
- Per <u>Loper Bright</u>, courts are required to exercise their own independent judgment when engaging in statutory interpretation and reviewing IRS interpretation of statutes
- IRC § 3134 (the codification of the ERC) leaves room for interpretation on various issues
 - Some commenters have focused in on the "more than nominal" suspension standard



 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$



ERC Litigation, Generally

- Can be filed in federal district court (where business is located) or in the Court of Federal Claims in Washington, D.C.
 - Either way, US DoJ will represent the IRS
- In many cases, not going to be advisable, but that calculus is slowly shifting.
 - Cost can be a factor, especially if the business is in desperate need of the refund (contingent or alternative fees?)
 - Consider alternate sources of funding
- If filing suit makes sense:
 Be cognizant of the 6-month waiting period after filing of refund claim not usually an issue
 - Heavily scrutinize the claim (and give preference to decline in gross receipts)

Reinhart

© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

ERC Litigation – Recent Examples

- The Job Center LLC (S.D. Ohio, No 1:24-cv-00510 filed 9.17.24)
 - Ohio industrial staffing company
 - \$5.1M in ERC
 - Based on partial suspension test
 - Claim filed in June 2023
- MTH Industries (N.D. III., No 1:24-cv-09729 filed 10.8.24)
 - Glass & architectural metal business
 - \$1.3M in ERC
 - Based on gross receipts test



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c



If ERC Claim Has Not Been Filed - Who is Entitled to the ERC?

- Targets are often in the process of claiming or reconsidering the ERC when the terms of the deal are being worked out.
- Who does the ERC belong to?
 - Generally, there is a good argument that the target should enjoy the benefit of the ERC since it relates to 2020/2021 quarters.
 - If the risk associated with the ERC is large, equity buyers may argue that a portion of the credit should stay with them
 - Many possible factors depending on deal structure increased income/employment tax audit risk, use of EIN, handling of refund check, possible penalties and interest, etc.
- Be wary of long timelines with respect to ERC refund issuance and review



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

21

If ERC Claim Has Been Filed – Diligence and Impact on Financials

- If it is determined that a target has taken the ERC, a number of questions should be asked:
 - Request a description of (i) the target company's rationale for qualifying for the credit, and (ii) the calculation of the qualified wage amounts being claimed.
 - Confirm that the target has not received a PPP loan, or that such loan was accounted for in the ERC calculation.
- Be wary of companies booking receipt of the ERC as "income" or an increase in revenue if this impacts valuation.

Reinhart

 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$

If ERC Claim Has Been Filed - Reps and Warranties

- Amended Returns
 - Who controls the amendment of income tax and payroll tax returns?
 - The filing of amended payroll or income tax returns could be required for a variety of ERC-related reasons (even in some cases, to take the credit after the deal is done).
- Possible Escrow of ERC Funds
 - For ERC claims not under the decline in gross receipts test, we should contemplate requesting an escrow of the full ERC amount (including contingent fees, etc.)
- R&W Insurance
 - The ERC is often excluded, and tax insurance typically isn't palatable
 - Depending on the size of the deal, this may be necessary, but I have seen deals die due to questionable ERC claims



© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.

2.

If ERC Claim Has Been Filed - Mitigating Audit Risk

- Tax Contests
 - Who will answer questions/substantiation requests from the IRS?
 - Who will control in the event of an ERC audit?
 - NOTE: Recall the extended audit period for Q3/Q4 of 2021... 5 years!
- Voluntary Disclosure Program
 - Forced participation is becoming common
 - If the claim is suspect, the buyer should contemplate including language permitting voluntary disclosure of the ERC claim (similar to common sales tax voluntary disclosure language).

Reinhart

 $\hbox{@ 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.}$



Joe Rekrut Reinhart Boerner Van Deuren jrekrut@reinhartlaw.com 414.298.8538

Questions?

THANK YOU!

This presentation provides information of a general nature. None of the information contained herein is intended as legal advice or opinion relative to specific matters, facts, situations or issues. Additional facts and information or future developments may affect the subjects addressed in this presentation. You should consult with a lawyer about your particular circumstances before acting on any of this information because it may not be applicable to you or your situation.

Reinhart

© 2024 All Rights Reserved. Reinhart Boerner Van Deuren s.c.