

ERC Update: Current Developments in Uncharted Waters

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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



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The ERC Program – Brief Background

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.

Who is Eligible for the ERC?

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

1. **Decline in Gross Receipts Test**

- 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.

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.

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.

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



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PRESS RELEASE

Independence Man Pleads Guilty to \$1.4 Million COVID Fraud Scheme

Wednesday, October 30, 2024

For Immediate Release

PRESS RELEASE

New Jersey Tax Preparer Arrested for Fraudulently Seeking Over \$124 Million in COVID-19 Employment Tax Credits

Monday, July 31, 2023

For Immediate Release
Office of Public Affairs

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PRESS RELEASE

Operation Fraud Street Mafia Results Announced: Nine Arrested for Drug Trafficking and Committing More Than \$550 Million in Attempted Tax Fraud

Friday, February 23, 2024

For Immediate Release
U.S. Attorney's Office, Eastern District of California

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IRS Scrutiny

IRS Dirty Dozen (2023 and 2024)

IRS
File Pay Refunds Credits & Deductions Forms & Instructions

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/ IRS opens 2023 Dirty Dozen with warning about Employee Retention Credit claims; increased scrutiny follows aggressive promoters making offers too good to be true

IRS opens 2023 Dirty Dozen with warning about Employee Retention Credit claims; increased scrutiny follows aggressive promoters making offers too good to be true

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IR-2023-45, March 20, 2023

WASHINGTON — In a further warning to people and businesses, the Internal Revenue Service added widely circulating promoter claims involving Employee Retention Credits as a new entry in the annual [Dirty Dozen](#) list of tax scams.

For the start of the annual Dirty Dozen list of tax scams, the IRS spotlighted Employee Retention Credits, following blatant attempts by promoters to con ineligible people to claim the credit. Renewing several earlier alerts, the IRS highlighted schemes from promoters who have been blasting ads on radio and the internet touting refunds involving Employee Retention Credits, also known as ERCs. These promotions can be based on inaccurate information related to eligibility for and computation of the credit.

"The aggressive marketing of these credits is deeply troubling and a major concern for the IRS," said IRS Commissioner Danny Werfel. "Businesses need to think twice before filing a claim for these credits. While the credit has provided a financial lifeline to millions of businesses, there are promoters misleading people and businesses into thinking they can claim these credits. There are very specific guidelines around these pandemic-era credits; they are not available to just anyone. People should remember the IRS is actively auditing and conducting criminal investigations related to these false claims. We urge honest taxpayers not to be caught up in these schemes."

Topics in the News
News Releases
News Releases for Frequently Asked Questions
Multimedia Center
Tax Relief in Disaster Situations
Inflation Reduction Act
Tax Reform
Taxpayer First Act

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Dirty Dozen: Beware of aggressive promoters who dupe taxpayers into making questionable Employee Retention Credit claims; risks continue for small businesses, special withdrawal program remains available

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IR-2024-05, March 29, 2024

Topics in the news

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

- Essential businesses during the pandemic that could not 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



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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

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



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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](#) [PDF](#)

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

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.”

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(l))
 - No SoL in the case of fraud



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	Varies quarterly. 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>



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

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.

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

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 Loper Bright, 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

ERC Litigation

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)

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. Ill., No 1:24-cv-09729 – filed 10.8.24)
 - Glass & architectural metal business
 - \$1.3M in ERC
 - Based on gross receipts test

Best Practices for M&A

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

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.

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

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).



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Questions?

THANK YOU!

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