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Employee Retention Credits Prompt IRS Audits

By Robert W. Wood

Have you heard all those TV and radio ads about getting $26,000 per employee from the federal government? In the early and middle stages of the pandemic, the PPP, the Paycheck Protection Program, was probably the most discussed business bailout provision that Congress offered. But later—including now—it is the Employee Retention Credit that is getting the most hype. Like the ads say, the ERC can net you up to $26,000 per employee, even if you got a PPP loan that was forgiven.

The ERC is a refundable tax credit designed for businesses that continued paying employees while shut down due to the COVID-19 pandemic or who had significant declines in gross receipts from March 13, 2020, to Dec. 31, 2021. That's a limited period, but businesses can typically file claims for the credit until April 15, 2025.

Eligible taxpayers can claim the ERC on an original or amended employment tax return, and to be eligible, employers must have:

- sustained a full or partial suspension of operations due to orders from an appropriate governmental authority limiting commerce, travel or group meetings due to COVID-19 during 2020 or the first three quarters of 2021,
- experienced a significant decline in gross receipts during 2020 or a decline in gross receipts during the first three quarters of 2021, or
- qualified as a recovery startup business for the third or fourth quarters of 2021.

There are two eligibility tests for the 2020 ERC and for the first three calendar quarters of 2021 – the gross receipts test and the suspension of operations test. The gross receipts test is simpler. You need to show a decline in gross receipts of more than 50% in any calendar quarter in 2020, or more than 20% in any of the first three calendar quarters in 2021.

The suspension of operations test is a subjective test. It is the test that is used when a taxpayer does not meet the gross receipts test. It generally requires the taxpayer to establish the following:

- The taxpayer suffered a full or partial suspension of business operations due to a governmental order that limited commerce, travel, or group meetings due to COVID-19.
- The taxpayer's employees were not able to work comparably through telework.
- The full or partial suspension of operations had more than a nominal effect on the taxpayer's business operations.

The tax law says you have until April 15, 2025 to claim your ERC. But reports say the IRS Commissioner and Treasury Department are exploring legislation to have Congress end the program early and to give the IRS greater powers. Some reports say that instead, the IRS statute of limitations on audit for ERC claims might be stretched from 3 to 10 years.

In July 2023, the IRS announced in AM-2023-005 that under Notice 2021-20, 2021-11 IRB 922, only employers that had to suspend their business operations because their suppliers were unable to provide critical goods or materials under a government order are eligible for the ERC. The scope of supply chain difficulties and what can qualify is likely to be an issue for many and we may see tax cases in court about it.

IRS audits of businesses claiming the Employee Retention Credit (ERC) are in full swing. The IRS is looking at companies who may be unfairly claiming it, and also at firms promoting assistance to them who the IRS thinks may be bending the rules. Congress provided vast pandemic tax relief in various forms. One of the most popular and enduring ones that is still drawing fire is the ERC.

It would be nice if when you got your refund, you could know that you were out of the woods. Unfortunately, though, you might get your refund, still get audited thereafter, and be then asked to repay the money. Not only that, but you can be asked to pay interest and penalties too. Even if your tax adviser or ERC refund company handled all the paperwork for you, the taxpayer—the employer that claimed the credit—is the one on the hook to the IRS.

This can make the worry of an audit very real. Most ERC companies charge a contingent fee based on the amount of the credit. So that $26,000 per employee can get whittled down by some fees. Contingent fees sounds a little like a personal injury suit, where the injured person pays nothing unless they recover. The American Institute of CPAs code of professional conduct appears to prohibit its CPAs from charging contingent fees for most services.

But some accountants are charging contingent fees, and most ERC companies do. Given the state of the law on contingent fees, it's not clear the IRS can do anything about it, at least now. Some years ago, the IRS hoped to stem the tide of contingent fee tax work, but litigation in the courts mostly went against the government and in favor of contingent fees.

As to the substance of the ERC, there are plenty of legitimate ERC claims being made. But the IRS is on high alert and is finding some that are purely fraudulent. Some involve fake business entities, identity theft of real businesses, etc. Some of these cases are going to involve criminal prosecution. Because of all the fake claims and fraud, some businesses that legitimately claimed the ERC are being audited too. In that sense, it is an unsettling time.

The IRS has been warning about schemes since last fall, but the credit claims continue to pour in. The IRS is even hoping to get help from the public, calling on people to report ERC fraud where they see it. Be careful out there.

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