

ERC Enforcement Tactics: The IRS's Carrots and Sticks So Far

by Hale E. Sheppard

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In this article, Sheppard continues his discussion of employee retention credits with an overview of the various rewards and punishments that the IRS has used over the last two years.

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I. Introduction

Congress took action to help U.S. businesses and workers economically suffering because of the COVID-19 pandemic, which included creating the employee retention credit. The IRS was charged with implementing the ERC. The number of claims filed, the amounts sought, and the grounds for relief far surpassed what was expected. These and other factors led to problems, among them the IRS's struggle to adequately administer the ERC program.

The IRS has repeatedly acknowledged that many employers have submitted proper claims, complying with both the letter and spirit of the ERC. Other claims, suggests the IRS, are excessive or baseless, caused by good-faith misunderstandings of the law, lack of timely guidance on certain issues, or aggressive positions encouraged by some advisers. The reality is that the IRS has experienced significant challenges separating the wheat from the chaff. Therefore,

following its standard playbook, the IRS has introduced both carrots and sticks, the effectiveness of which is yet to be seen. This article, the latest in a long list by the author, summarizes the ERC laws and explores each of the IRS's enforcement methods so far.¹

II. Overview of Relevant Laws

Congress passed four laws regarding the ERC, the highlights of which are described below.

Congress first enacted the Coronavirus Aid, Relief, and Economic Security Act.² It generally provided that an eligible employer could get an ERC against some employment taxes equal to 50 percent of the qualified wages paid to each employee, subject to various limitations.³ An eligible employer meant one that was carrying on a trade or business in 2020 and met one of the following two tests. First, the operations of the employer were partially or fully suspended

¹Readers seeking more details about ERC rules and issues should see the following articles by the same author: Hale E. Sheppard, "IRS Tries to Further Limit ERC Claims Under Governmental Order Test," *Tax Notes Federal*, Jan. 29, 2024, p. 819; Sheppard, "Employee Retention Credits: What the IRS Didn't, Did, and Might Do," *Tax Notes Federal*, Oct. 23, 2023, p. 619; Sheppard, "Employee Retention Credits: Reasons for Prolonged Claims," *Tax Notes Federal*, Oct. 16, 2023, p. 431; Sheppard, "Employee Retention Credits: Analyzing Key Issues for Promoters and Other Enablers," 139 *J. Tax'n* 15 (2023); Sheppard, "Employee Retention Credits: Analyzing Key Issues for Taxpayers Facing IRS Audits," 139 *J. Tax'n* 32 (2023); Sheppard, "IRS Clarifies Limited Eligibility of Federal Credit Unions for ERCs," *Tax Notes Federal*, Sept. 2, 2023, p. 1615; Sheppard, "Employee Retention Credits: Issues Arise as Finger-Pointing Begins," *Tax Notes Federal*, Sept. 11, 2023, p. 1843; Sheppard, "New ERC Guidance About Suspended Operations and Supply Chains," *Tax Notes Federal*, Aug. 28, 2023, p. 1413; Sheppard, "Employee Retention Credits: Analyzing Congressional and IRS Guidance From Start to Finish," 139 *J. Tax'n* 3 (2023); Sheppard, "Comparing Consequences of Obtaining Improper PPP and ERC Benefits: Taxpayers Might Be Surprised," 139 *J. Tax'n* 17 (2023); Sheppard, "ERC Disputes: Mastery of Procedural and Substantive Rules Required," *Tax Notes Federal*, Nov. 6, 2023, p. 977.

²Joint 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.

³CARES Act, section 2301(a).

during a 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 before things went downhill. When an eligible employer had an average of more than 100 full-time employees (large eligible employer), qualified wages meant those paid to any employee who was not providing services as a result of the governmental 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 meant 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. This meant that the maximum ERC per employee for all of 2020 was \$5,000.⁸ Coverage of the ERC changed several times, but it originally applied to the second, third, and fourth quarters of 2020.⁹

Congress next passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020.¹⁰ It modified the standards for being a small eligible employer and a large eligible employer, thereby making it easier to claim ERCs for all wages paid to

employees during certain quarters, not just to those who were not providing services.¹¹ Specifically, large eligible employers became those whose average number of full-time employees was more than 500 (instead of more than 100), while small eligible employers were those with an average of 500 or fewer.¹² The relief act also 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 2021.¹³ Also, eligible employers could get increased amounts of ERCs, as two things changed: 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.¹⁴

Congress then enacted the American Rescue Plan Act of 2021.¹⁵ That legislation codified the ERC for the first time, making it section 3134 of the Internal Revenue Code. ARPA further expanded the ERC, allowing benefits for the third and fourth quarters of 2021.¹⁶ It also inserted a new type 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.¹⁷

Things ended when Congress introduced the Infrastructure Investment and Jobs Act.¹⁸ That law retroactively shortened the periods for which eligible employers could claim benefits. Except for recovery start-up businesses, eligible employers could no longer solicit ERCs for the fourth quarter of 2021.

III. Exploring IRS Enforcement Methods

The IRS, facing changing laws over a two-year period, a mandate to get money in the hands of

⁴ CARES Act, section 2301(c)(2)(A)(ii)(I).

⁵ CARES Act, section 2301(c)(2)(A)(ii)(II). The period started with the quarter during which the gross receipts were less than 50 percent of the gross receipts during the same quarter the previous year, and ended the quarter after the gross receipts of the employer were greater than 80 percent of the gross receipts the previous year. See CARES Act, section 2301(c)(2)(B).

⁶ CARES Act, section 2301(c)(3)(A)(i).

⁷ CARES Act, 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); JCT, *supra* note 2, at 38.

⁹ CARES Act, section 2301(m).

¹⁰ 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.

¹¹ Consolidated Appropriations Act, 2021, Division EE, section 207(e).

¹² Notice 2021-23, Section III.E.

¹³ *Id.*, Section III.A.

¹⁴ *Id.*, Section III.D.

¹⁵ ARPA, section 9651; see also Notice 2021-49, 2021-34 IRB 316.

¹⁶ Notice 2021-49, Section III.A.

¹⁷ Notice 2021-49, Section III.D.

¹⁸ See also IR-2021-65.

struggling businesses as quickly as possible, and a torrent of ERC claims, has attempted to control matters with various carrots and sticks, that is, rewards and punishments.

A. Warnings of Wrongdoing

The IRS disseminated a large number of new releases, fact sheets, and the like, warning about potential ERC abuse. For instance, marking the first anniversary of the introduction of the ERC, the IRS explained that criminal investigations and civil examinations were underway. High-ranking officials threatened that the IRS “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.”¹⁹ The IRS later disseminated a tax tip whose title was remarkably blunt: “Watch Out for Employee Retention Credit Schemes.” It explained that the IRS had been warning taxpayers about promoter scams for a long time, yet taxpayers that do not meet the standards continued trying to claim ERCs in 2023.²⁰ The IRS upped the rhetoric soon thereafter, declaring that “aggressive marketing” of ERCs persisted and there was “a barrage of aggressive broadcast advertising, direct mail solicitations, and online promotions.” The IRS then laid out some “tell-tale signs of misleading claims.” Among them were unsolicited calls or advertisements mentioning an “easy application process,” statements that the promoter can determine ERC eligibility within minutes, large upfront fees or a contingent fee based on a percentage of the refund obtained, and statements to the effect that all taxpayers should apply for ERCs because there is nothing to lose.²¹ Later, the IRS labeled the ERC a “case study on a program ripe for improper claims” because of IRS understaffing, taxpayers desperate for a financial lift, the paper filing of returns, and complicated qualification rules.²²

¹⁹ *Id.*

²⁰ IRS Tax Tip 2023-44.

²¹ IR-2023-105.

²² Nathan J. Richman, “Employee Retention Credit Claimants May See Help From IRS,” *Tax Notes Federal*, June 12, 2023, p. 1862.

B. ‘Dirty Dozen’ Designation

The IRS announced in March 2023 that improper ERC claims not only made the “Dirty Dozen” list, but they topped it.²³

C. Enlisting Help From Financial Institutions

The IRS, in addition to notifying the public about potential ERC issues, issued an alert to financial institutions.²⁴ It described common types of ERC fraud, identified various red flags suggesting violations, and reminded financial institutions of their reporting duties.

In terms of methods, the alert explained that some individuals filed fraudulent ERC claims using fabricated entities, as well as dormant ones (that is, legitimate entities that previously obtained an employer identification number but did not engage in any activities or pay any workers during the relevant periods).²⁵ Others filed ERC claims for which they did not meet the eligibility requirements. For instance, they used the same wages in receiving a loan under the Paycheck Protection Program, inflated the amount of wages paid during a quarter, or improperly stated that their businesses were suspended under the governmental order test.²⁶ The alert then criticized certain “ERC mills,” which supposedly neglected to fully inform employers of the applicable standards, gave employers insufficient information about how ERC eligibility and amounts were determined, refused to personally sign the Forms 941-X, “Adjusted Employer’s Quarterly Federal Return or Claim for Refund,” submitted to the IRS in an attempt to skirt liability, and encouraged inflated claims because they received large fees based on the amount of ERCs obtained.²⁷

The alert next enumerated many red flags for purposes of assisting financial institutions in detecting, preventing, and disclosing suspicious transactions related to possible ERC fraud.

²³ IR-2023-49; IR-2023-71.

²⁴ FIN-2023-Alert007, “FinCEN Alert on COVID-19 Employee Retention Credit Fraud” (Nov. 22, 2023) (the document confirms that the Financial Crimes Enforcement Network issued the alert “in close coordination” with the IRS).

²⁵ *Id.* at 4.

²⁶ *Id.* at 4-5.

²⁷ *Id.* at 5.

Among the indicators highlighted by the IRS were the following: (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 automated teller machine; (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.”²⁸

The alert ended with several reminders for financial institutions about their duties associated with potentially improper ERC claims. It urged institutions to file suspicious activity reports if they know or suspect that a transaction involves funds derived from illegal activity, is designed to avoid financial regulations, lacks a business or other apparent lawful purpose, or involves using the institution to facilitate illegal activity. The alert further reminded institutions of their obligation to retain a copy of all suspicious activity reports, business records, and other supporting documentation for at least five years after a filing.²⁹ Lastly, it explained that “information sharing among financial institutions is critical to identifying, reporting, and preventing” ERC fraud and that the IRS “strongly encourages such voluntary information sharing.”³⁰

D. Training 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.³¹ It

also published in late 2022 an initial training guide for revenue agents. Its main goal, unsurprisingly, was for IRS personnel to be capable of determining the quarters during which a taxpayer was an eligible employer, identifying what payments constituted qualified wages, calculating correct ERC amounts, applying limitations based on the size of the employer, and understanding the interplay between ERCs and other tax benefits.³² The IRS later produced more expansive training materials, which were released at the end of 2022.³³

E. Regulations Expanding IRS Authority

The IRS issued temporary regulations about reclaiming excessive ERCs.³⁴ They began by reminding taxpayers that ERCs were initially limited in several ways, one of which was that they could not exceed the applicable employment taxes on the wages paid for all employees of the eligible employer for the relevant quarter. If the ERCs topped this threshold, the surplus would be treated as an overpayment and credited or refunded to the eligible employer, as appropriate. The temporary regulations emphasized that a “refund, credit, or advance of any portion of [ERCs] 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” (emphasis added).³⁵

The temporary regulations, citing two decisions by the Supreme Court, clarified that the IRS has an unfettered right to engage in recoupment by trial.³⁶ However, the CARES Act and ARPA specifically contemplate “administrative recapture” of excess ERCs. The IRS carried out these congressional directives by issuing the temporary regulations, granting itself authority to assess and collect improper ERCs.³⁷ The temporary regulations said that they fortify,

³² IRS, *supra* note 31.

³³ 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).

³⁴ REG-111879-20; T.D. 9904; REG-109077-21; T.D. 9953, Section V.

³⁵ T.D. 9904, Section III.

³⁶ T.D. 9904, Section IV.

³⁷ T.D. 9904, Explanation of Provisions.

²⁸ *Id.* at 7-8.

²⁹ *Id.* at 8.

³⁰ *Id.* at 10.

³¹ 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).

not substitute, the IRS's normal tools. They explained that "these assessment and administrative collection procedures *do not replace* the existing recapture methods, but rather represent an *alternative method* available to the IRS" (emphasis added).³⁸

The final regulations establish the following rule:

Any amount of credits 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 treated as an underpayment of [applicable employment taxes] and may be assessed and collected by the [IRS] in the same manner as the taxes.* [Emphasis added.]³⁹

IRS officials explained that, under the final regulations, the IRS can "treat what is normally an erroneous refund as an underpayment of tax subject to regular assessment and administrative collection practices."⁴⁰

F. Dissuading Return Preparers

The IRS's Office of Professional Responsibility has jurisdiction over various tax professionals.⁴¹ The standards, rules, and procedures used by the OPR are found in a part of the regulations known as Circular 230.⁴²

The OPR issued an alert in early 2023 addressing issues related to ERC claims.⁴³ It underscored that ERC claims implicate several aspects of Circular 230. First, the alert reminds practitioners that they must make reasonable inquiries of a taxpayer to confirm its eligibility for, and the correct amount of, ERCs. The alert stated the following in this regard: "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, it explained that if practitioners discover that a current client violated the ERC requirements in a prior year, they have a duty to inform the client of the noncompliance and related penalties.⁴⁴

Second, the alert told practitioners that all tax positions must have at least a reasonable basis. Expanding on this notion, it recommended that practitioners who have clients that claimed unwarranted or excessive ERC claims in the past advise them of the option to file Forms 941-X.⁴⁵

Third, the alert warned practitioners that they might not be able to rely on opinions, reports, analyses, and similar documents prepared by others when it comes to making ERC claims. It explained that if the previous adviser has a conflict of interest with the taxpayer because of the amount or type of fee the adviser charged (for example, a prohibited contingent fee), then the practitioner might not be able to reasonably rely on the documents from the adviser.⁴⁶

The alert came to the following conclusion, which arguably was designed to dissuade return preparers from assisting those making ERC claims:

When a practitioner enters into an engagement with a client who has claimed the ERC, wants to claim it, or asks about the possibility, the practitioner needs to have or gain an in-depth knowledge of the credit, especially its eligibility criteria. The practitioner must also follow Circular 230's requirements of (1) due diligence in the practitioner's advice and in preparing and filing returns; (2) full disclosure to a client of its tax situation; and (3) reasonable reliance on client-provided information and on any advice provided by another tax professional.⁴⁷

³⁸ T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

³⁹ 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).

⁴⁰ Loricchio, "New ERC Withdrawal Process Coming From IRS," *Tax Notes Federal*, Oct. 23, 2023, p. 745.

⁴¹ 31 U.S.C. section 10.2(a)(5); 31 U.S.C. section 10.3.

⁴² Treasury, Circular 230, 31 C.F.R. Subtitle A, Part 10 (2014).

⁴³ OPR, "Professional Responsibility and the Employee Retention Credit," Issue No. 2023-02 (Mar. 7, 2023).

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

G. Processing Moratorium

In response to rising concerns about a large number of questionable Forms 941-X seeking ERCs, the IRS announced in September 2023 that it was placing an immediate moratorium on the processing of any new ERC claims.⁴⁸ This processing freeze would remain in effect until at least the end of 2023.⁴⁹ Some companies have banded together to demand an end to the moratorium.⁵⁰ Others have adopted a different approach, seemingly converting the moratorium into something positive, turning lemons into lemonade. For example, some companies have started offering loans to employers awaiting ERC payments, second opinions regarding ERC eligibility and amounts, or insurance products.⁵¹

H. Enhanced Prepayment Review

The IRS clarified that, when it comes to pending ERC claims (that is, those filed before the IRS instituted the moratorium), patience is paramount. This is because the IRS plans to conduct “enhanced compliance reviews,” thereby pushing the standard processing period from 90 days to 180 days, and “much longer if the claim faces further review or audit.”⁵² Logic dictates that these deeper reviews will lead to more disallowances of ERC claims before payment by the IRS.

I. Massive Refund Disallowances

In December 2023, the IRS disallowed more than 20,000 ERC claims that were facially false because the employers did not exist or they did not pay any employees during the relevant quarters.⁵³ The IRS, in other words, jettisoned the

low-hanging fruit, the “claims that fell outside the legal requirements.”⁵⁴ The IRS warned that this initial mass rejection represented just the beginning, as it planned to soon send “disallowance letters and letters seeking the return of funds erroneously claimed and received.”⁵⁵

J. Civil Examinations

The IRS announced that it had already referred “thousands of ERC cases for audit” as of September 2023, and this all occurred before the IRS started its “enhanced compliance review” of all pending and future ERC claims.⁵⁶

K. Criminal Investigations

The IRS broadcast that Criminal Investigation had initiated over 250 investigations of potentially fraudulent ERC claims as of July 2023.⁵⁷ By the following October, this number had risen to 301 investigations, involving approximately \$3.5 billion in claims.⁵⁸ The IRS clarified, though, 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.”⁵⁹

L. Promoter Investigations

The IRS indicated in December 2023 that it had already started so-called promoter investigations under section 6700, which entail communicating with affected employers. In doing so, the IRS recognized that “some promoters pitched valid claims” and the IRS “is not interested in all promoters.”⁶⁰

⁴⁸ 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.

⁴⁹ Loricchio and Richman, “IRS Moratorium Jolts Employee Retention Credit Industry,” *Tax Notes Federal*, Nov. 27, 2023, p. 1670.

⁵⁰ Loricchio, “Business Coalition Seeks End to ERC Moratorium,” *Tax Notes Federal*, Jan. 1, 2024, p. 196.

⁵¹ IR-2023-193; Loricchio, “IRS Earns Praise for ERC Claim Withdrawal Initiative,” *Tax Notes Federal*, Oct. 23, 2023, p. 715; Loricchio and Richman, *supra* note 49.

⁵² IR-2023-169.

⁵³ IR-2023-230; Jonathan Curry, “ERC Compliance Campaign Gets Underway With First Wave of Letters,” *Tax Notes Federal*, Dec. 11, 2023, p. 2046.

⁵⁴ IR-2023-230; Curry, *supra* note 53.

⁵⁵ IR-2023-230; Curry, *supra* note 53.

⁵⁶ IR-2023-169.

⁵⁷ *Id.*

⁵⁸ IR-2023-201; Richman, “IRS Has Hundreds of Criminal ERC Cases Open,” *Tax Notes Federal*, Nov. 6, 2023, p. 1102.

⁵⁹ Loricchio, “Sunset for ERC Withdrawal Initiative to Be Determined,” *Tax Notes Federal*, Nov. 6, 2023, p. 1093.

⁶⁰ Richman, “Civil Examinations of ERC Promoters Are Underway,” *Tax Notes Federal*, Dec. 11, 2023, p. 2048; *see also* Loricchio, *supra* note 59.

M. Claim Withdrawal Option

The IRS announced in September 2023 that it would soon introduce a “special withdrawal option” for taxpayers with cold feet — that is, those who previously filed ERC claims, did not yet receive the tax benefits, reflected on the matter, and want to reverse course with the IRS on the most favorable terms possible.⁶¹ According to the IRS, the option would be available to approximately 600,000 taxpayers whose ERC claims were pending review.⁶² The IRS offered the following teaser:

The IRS is finalizing details that will be available soon for a special withdrawal option for those who have filed an ERC claim but the claim has not been processed. This option — which can be used by taxpayers whose claim hasn’t yet been paid — will allow the taxpayers, many of them small businesses who were misled by promoters, to avoid possible repayment issues and paying promoters contingency fees.⁶³

After considerable buildup, the IRS unveiled the program in October 2023 (withdrawal option).⁶⁴ Its official objective was to “help small business owners and others who were pressured or misled by ERC marketers or promoters into filing ineligible claims.”⁶⁵ It was also designed, says the IRS, “to help honest taxpayers” who “mistakenly claimed the ERC.”⁶⁶

Moving from rhetoric to reality, the withdrawal option functions as follows. In terms of eligibility, 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.⁶⁷ The IRS warned, though, that an employer that filed fraudulent ERC claims, assisted in doing so, or conspired to do so will not be exempt from criminal investigation and prosecution simply by applying for the withdrawal option.⁶⁸

The withdrawal option features three different methods, depending on the circumstances. Employers that have not received ERC refunds and have not been notified by the IRS of an audit are instructed to do the following for each quarter for which they are participating: Make a copy of the Form 941-X or other appropriate return; write “withdrawn” in the left margin of the first page; have an authorized person sign, date, and write their title in the right margin; and fax the document to a special number or mail it.⁶⁹

Employers that have not received ERC refunds but have already been notified of an IRS audit have a different procedure. Taxpayers who are already under audit generally cannot proactively rectify matters with the IRS by filing qualified amended returns. The regulations prohibit this.⁷⁰ However, the IRS makes it clear that “employers facing an IRS audit, also referred to as an exam, can still withdraw their ERC claim.”⁷¹ Employers falling into this category are supposed to make a copy of the Form 941-X or other appropriate return; write “withdrawn” in the left margin of the first page; and have an authorized person sign, date, and write their title in the right margin. If a revenue agent has already been assigned to their case, employers should contact that individual to discuss how best to submit the application directly. Alternatively, if no revenue agent has been assigned to the case yet, employers should send their applications in response to the audit notice.⁷²

Finally, employers that have received ERC refund checks but are holding them have a

⁶¹ IR-2023-169.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ IR-2023-193; Joseph DiSciullo, “Fact Sheet Explains How to Withdraw Claims for Employee Retention Credit,” *Tax Notes Federal*, Oct. 30, 2023, p. 883.

⁶⁵ IR-2023-193.

⁶⁶ FS-2023-24.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ Reg. section 1.6664-2(c)(3)(i).

⁷¹ FS-2023-24.

⁷² *Id.*

slightly different path. They should make a copy of the Form 941-X or other appropriate return; write “withdrawn” in the left margin of the first page; have an authorized person sign, date, and write their title in the right margin; write “void” in the endorsement section on the backside of the check; draft a statement explaining the reasons for returning the check; and send all the materials to a designated group called the “Cincinnati Refund Inquiry Unit.”⁷³

The IRS indicates that it will send applicants a letter “about whether their withdrawal request was accepted or rejected.” It does not mention any reasons why employers would be rebuffed from the withdrawal option, but one assumes that this might occur if the IRS has prior indications of intentional misconduct, civil fraud, criminality, or the like.⁷⁴ The IRS also warns that employers have not officially participated in, or benefited from, the withdrawal option unless and until they receive an approval letter from the IRS.⁷⁵

The IRS also reminds taxpayers that those who are accepted into the withdrawal option might need to amend their federal income tax returns for the corresponding periods, likely to increase their wages-paid deductions to reflect the elimination of ERCs.⁷⁶

Some practitioners have predicted that participation by employers in the withdrawal option will be “underwhelming” because many are unaware of its existence or believe in good faith that their pending ERC claims are legitimate. The IRS commissioner acknowledged that early interest in the withdrawal option was low, but he expected it to gain traction after the IRS announced the settlement program, described next.⁷⁷

N. Voluntary Disclosure Program

In September 2023 the IRS indicated that it planned to introduce a settlement program later in the year for taxpayers who filed ERC claims, got paid, became nervous, and want to repay the IRS with minimal financial downsides. The IRS offered the following preview:

If a business has already received an ERC that they now believe is in error, the IRS will be providing additional details on the settlement program in the fall that will allow businesses to repay ERC claims. The settlement program will allow the businesses to avoid penalties and future compliance action.⁷⁸

The IRS, as promised, formally announced the ERC voluntary disclosure program (VDP) in December 2023.⁷⁹ Not all employers are eligible for the VDP, of course. The IRS had to draw the line somewhere. It explained that an employer can apply for the VDP only if it meets all the following criteria: (1) the employer is not under IRS criminal investigation; (2) the employer has not been notified that the IRS intends to start a criminal investigation; (3) the IRS has not received information from a third party alerting it to the employer’s noncompliance; (4) the IRS has not acquired information directly of noncompliance from an enforcement action; (5) the employer is not under an employment tax audit by the IRS for any tax period for which it is applying for the VDP; and (6) the employer has not received a notice and demand from the IRS for repayment for all or a portion of an ERC claim.⁸⁰

The IRS clarifies that an employer that uses a third-party payer, like a professional employer organization, can apply for the VDP. However, the third-party payer must submit the application on its behalf.⁸¹

Getting down to the nitty-gritty, the main terms of the VDP are as follows. Here is what an employer must do: (1) complete, sign under

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ Curry, “IRS Expects Interest in ERC Withdrawal to Pick Up Soon,” *Tax Notes Federal*, Dec. 15, 2023, p. 2231.

⁷⁸ IR-2023-169.

⁷⁹ Announcement 2024-3, 2024-2 IRB 364; Loricchio, “IRS Launches ERC Voluntary Disclosure Program,” *Tax Notes Federal*, Jan. 1, 2024, p. 188.

⁸⁰ Announcement 2024-3, section 2.

⁸¹ *Id.*

penalties of perjury, and electronically file Form 15434, “Application for Employee Retention Credit Voluntary Disclosure Program,” by March 22; (2) return to the IRS 80 percent of the ERCs it received; (3) execute a closing agreement; (4) make full payment electronically before signing the closing agreement, or apply for an installment agreement by enclosing a Form 433-B, “Collection Information Statement for Businesses,” with all supporting documentation; (5) if entering into an installment agreement, pay the taxes, applicable penalties, and interest charges; (6) if the ERC claims involve any quarters in 2020, grant the IRS additional time by executing a Form SS-10, “Consent to Extend the Time to Assess Employment Taxes”; and (7) supply detailed information to the IRS about any individual, business, or organization that assisted in making the ERC claims.⁸²

What is the IRS offering to induce participation by employers? If an employer repays the 80 percent in full, then the IRS will waive all penalties and interest on the amount returned. In addition, the IRS will not characterize as income the 20 percent that the employer gets to retain. Finally, an employer can claim a wages-paid deduction for income tax purposes for 100 percent of the relevant wages, even though it is paying only 80 percent thanks to the VDP.⁸³

The IRS expressly states that applying to the VDP is not the proverbial get-out-of-jail-free card. Indeed, it indicates 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.”⁸⁴ Moreover, the IRS makes it clear that participation by any employer in the VDP is at its sole discretion; it states that denial of a VDP application “is not subject to judicial review or administrative appeal.”⁸⁵

The IRS has posted some initial frequently asked questions dealing with the VDP.⁸⁶ A few of the more interesting ones are as follows:

- If an employer previously filed Forms 941-X to fully eliminate the ERC claims or if the IRS already disallowed those claims before the IRS announced the VDP, can the employer still obtain the 20 percent reduction? The FAQs say that an employer in either of these two positions generally is not eligible for the benefits of the VDP. However, in the case of the former, “the IRS will review your application on a case-by-case basis for eligibility” for the VDP.
- What happens if an employer that wants to apply for the VDP is unable to pay in full, and the IRS rejects its installment agreement application? The FAQs indicate that “no other IRS payment plans are an option” and recommend that the employer “consider financing the amount due from other sources so [it] can get the benefits” of the VDP.
- Can an employer submit an offer in compromise to satisfy the liability due under the VDP? The FAQs say that anything less than full payment, immediately or over time, is not possible.
- If the parent, subsidiary, or member of an employer’s consolidated group is under employment tax audit, can the employer still participate in the VDP? The FAQs explain that any such employment tax audit renders the employer ineligible, but the situation would be different if an income, excise, or some other type of tax audit were underway.
- Can an employer apply for the VDP if it is challenging the results of an earlier employment tax audit with the IRS Appeals Office or in Tax Court? The FAQs clarify that an employer is considered under audit for VDP purposes during any administrative or judicial appeal that involves the relevant tax periods.
- What happens if an employer does not cooperate with the IRS after filing the VDP

⁸² *Id.*, section 3.

⁸³ *Id.*

⁸⁴ *Id.*, section 4.

⁸⁵ *Id.*

⁸⁶ IRS, “Frequently Asked Questions About the Employee Retention Credit Voluntary Disclosure Program” (last updated Jan. 8, 2024).

application? The FAQs explain that the concept of “cooperation” includes timely and accurately responding to all requests by the IRS. They further warn that lack of cooperation will deprive an employer of all VDP benefits and might lead to “civil and criminal interest and penalties.”

- If an employer does not agree to the terms of the closing agreement after applying to the VDP, can it engage in mediation with the IRS? The FAQs emphasize that participation in the VDP requires execution of a closing agreement, the terms of which cannot be appealed in any manner.

IV. Conclusion

The IRS is coping with many things at once in the ERC context. For instance, it is processing a massive number of pending claims, preparing to address claims put on ice because of the moratorium, trying to distinguish between valid and invalid claims, attempting to halt what it deems bad actors, and introducing programs designed to entice employers into voluntarily retracting or settling earlier claims. The IRS, following protocol, has relied on a mix of carrots and sticks so far, many of which are described in this article. These methods are likely to morph over time, though. Employers that have already filed ERC claims, as well as those who plan to do so, should closely follow the enforcement trends as they evolve during the coming months and years. ■

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