

ERCs and Protective Amended Income Tax Returns

by Hale E. Sheppard

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In this article, Sheppard explains the relationship between employee retention credits and income taxes, timing issues, and the filing of protective amended returns.

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I. Introduction

Many taxpayers are thinking about employee retention credit matters these days. Most are focused on employment tax issues, namely how much of the tax benefit they will obtain. The answers are far from clear for many taxpayers, especially those with pending ERC claims subject to the “enhanced review process” and those already under audit by the IRS.

Taxpayers in these circumstances and others should consider related tax issues too. They should analyze how the potential reduction or elimination of ERC amounts will affect income tax returns, when those events will occur, and what should be done in the meantime.

II. Glimpse at Relevant Legislation

Congress first enacted the Coronavirus Aid, Relief, and Economic Security Act in 2020.¹ That law generally provided that an eligible employer could get an ERC against employment taxes equal to 50 percent of the qualified wages it paid to each employee.² The benefits under the CARES Act were capped; qualified wages for any one employee could not exceed \$10,000 for all applicable quarters combined. That meant the maximum ERC per employee for all of 2020 was \$5,000.³ Coverage of the ERC changed several times, but it originally applied to second, third, and fourth quarters of 2020.⁴

Congress next passed the Taxpayer Certainty and Disaster Tax Relief Act.⁵ It expanded the period during which eligible employers might benefit. They could claim ERCs not only for second, third, and fourth quarters of 2020 but also for first and second quarters of 2021.⁶ Also, eligible employers could get increased amounts of ERCs, as two things changed under the relief act. The percentage of qualified wages on which ERC could be claimed increased from 50 percent to 70 percent, and the amount was calculated per quarter, not per year.⁷

Next Congress enacted the American Rescue Plan Act, which codified the ERC for the first time,

¹Joint 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.

²CARES Act, section 2301(a).

³CARES Act, section 2301(b)(1); JCX-12R-20, *supra* note 2, at 38.

⁴CARES Act, section 2301(m).

⁵P.L. 116-260, division EE, section 207 (Dec. 27, 2020); JCT, “Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security,” JCX-3-21 (Feb. 8, 2021), at 66-70; *See also* Notice 2021-23, 2021-16 IRB 1113.

⁶Notice 2021-23, Section III.A.

⁷*Id.* at section III.D.

making it section 3134.⁸ ARPA further expanded the ERC, allowing benefits for the third and fourth quarters of 2021.⁹

The ERC legislative saga finally ended when Congress introduced the Infrastructure Investment and Jobs Act.¹⁰ That law retroactively shortened the periods for which eligible employers could claim benefits. With one narrow exception, eligible employers could no longer solicit ERCs for the fourth quarter of 2021.

III. Interplay of Employment and Income Taxes

The CARES Act stated that an eligible employer's income tax deduction for the qualified wages paid must be reduced by the amount of ERCs it receives.¹¹ The IRS explained the interrelationship: "An employer's deduction for Qualified Wages, including Qualified Health Plan Expenses, is reduced by the amount of" ERCs.¹² The IRS later offered additional guidance on timing issues. It presented the following scenario featuring an eligible employer that filed Forms 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," to claim ERCs for earlier quarters after it had already filed its income tax return covering those same quarters:

When a taxpayer claims the [ERC] because of the retroactive amendment of [the ERC laws] or otherwise files [Form 941-X] to claim the [ERC], the taxpayer should file an amended federal income tax return or administrative adjustment request (AAR), if applicable, for the taxable year in which the Qualified Wages were paid or incurred, to correct any overstated deduction taken with respect to those same wages on the original federal income tax return. [The CARES Act] generally provides, in relevant part, that rules similar to the rules of Section 280C shall apply [and they] require tracing to the

specific wages generating the applicable credit. To satisfy this tracing requirement, the taxpayer must file an amended return or AAR, as applicable.¹³

Why is understanding the interrelationship between employment tax returns and income tax returns important? Because a decrease in the wages-paid deduction might trigger an increase in federal income tax liability. The IRS warned that generalized unawareness or confusion on this issue has been exacerbated by ERC-promoting companies failing to tell eligible employers that benefits on the employment tax side (that is, receipt of credits) might cause detriments on the income tax side (that is, decreased deductions) and that all positions on related returns must be reconciled.¹⁴

Fast forward several years to after Congress introduced the ERC. The IRS introduced two programs in late 2023 designed to resolve ERC claims before disputes occur: the withdrawal option and the voluntary disclosure program (VDP). Both mention the overlap of employment tax and income tax issues. Under the withdrawal option, employers essentially must void prior Forms 941-X to eliminate pending ERC claims.¹⁵ The IRS reminded employers accepted into the withdrawal option that they 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.¹⁶ Things are a little different under the VDP because participating employers need to return to the IRS only 80 percent of the ERC amount obtained, and they are allowed to claim a wages-paid deduction for income tax purposes for 100 percent of the relevant wages. The IRS generally confirmed that participating in the VDP would fix employment tax issues as well as the related income tax issues:

This [VDP] includes the settlement of the ERC for purposes of a participant's employment tax obligations by

⁸ P.L. 117-2, section 9651 (Mar. 11, 2021); *see also* Notice 2021-49, 2021-34 IRB 316.

⁹ Notice 2021-49, Section III.A.

¹⁰ P.L. 117-58; *see also* Notice 2021-65, 2021-51 IRB 880.

¹¹ CARES Act, Section 2301(e).

¹² Notice 2021-20, Section II.F; Notice 2021-20, Section III.K, Question 60.

¹³ Notice 2021-49, Section IV.C.

¹⁴ IR-2022-183.

¹⁵ IR-2023-169; IR-2023-193; and FS-2023-24.

¹⁶ FS-2023-24.

eliminating their eligibility for the ERC while allowing a participant to retain 20 percent of the claimed ERC amount. Additionally, because the ERC reduces the income tax expense for qualified wages under rules similar to Section 280C of the Internal Revenue Code, this [VDP] also resolves the issue of the corresponding adjustment to income tax expense for participants, which include common law employers who used a third-party payer to claim the ERC on their behalf.¹⁷

The IRS has notified employers about the interrelationship between ERCs and income taxes at various points; whether they paid attention is another matter altogether.

IV. Timing Issues

Many ERC issues will not be settled for a long time. Indeed, in light of the assessment periods, collection methods, and dispute mechanisms described below, one can anticipate that many ERC matters will remain unresolved for years.

A. Overview of Assessment Periods

Forms 941, “Employer’s Quarterly Federal Tax Return,” for all four quarters of a specific year are deemed filed on April 15 of the next year.¹⁸ For example, Forms 941 for second quarter 2020 had to be filed by July 31, 2020, but were deemed filed nearly nine months later, on April 15, 2021.¹⁹ Likewise, Forms 941 for all quarters 2021 were deemed filed on April 15, 2022.

The IRS generally has three years from the date on which a tax return is filed (or deemed filed) to identify it as problematic, conduct an audit, and propose changes.²⁰ Thus, the normal assessment period for Forms 941 for 2020 will expire on April 15, 2024, while the standard

period for Forms 941 for 2021 will end April 15, 2025.²¹ The IRS has more time to challenge ERC claims for the third and fourth quarters of 2021.²² ARPA granted the IRS five years (instead of three years) to complete its work.²³ If an employer filed a Form 941 for third quarter 2021 claiming ERCs, it is deemed to have been filed on April 15, 2022, and the assessment period would stay open until April 15, 2027. Finally, the IRS can assess taxes “at any time” in situations involving a false or fraudulent return.²⁴

The time frames during which the IRS might audit and disallow ERC claims can be summarized as follows: (1) For ERC claims relating to second, third, and fourth quarters of 2020, the normal assessment period expires April 15, 2024; (2) for ERC claims relating to first and second quarters of 2021, the normal period expires April 15, 2025; (3) for ERC claims relating to third and fourth quarters of 2021, the special five-year period expires April 15, 2027; and (4) for ERC claims relating to any quarter in 2020 or 2021 that involves fraud or materially false statements, the period never expires.

B. Administrative Offsets by the IRS

Reports by governmental watchdogs indicate that the IRS issued many “erroneous refunds” in the early days of the ERC because of insufficient staffing, unclear rules, and pressure to get funds into the hands of struggling businesses as quickly as possible.²⁵ The good news for the IRS is that it might be able to exercise self-help in recouping amounts that it should not have released in the first place. As long as it makes a timely assessment, the IRS does not necessarily have to track down the taxpayer for payment. Rather, it can “offset” the liability by automatically

²¹ Reg. section 301.6501(b)-1(b).

²² Notice 2021-49, Section III.G.

²³ ARPA, section 9651(a); Notice 2021-49, Section III.G.

²⁴ Section 6501(c)(1); reg. section 301.6501(c)-1(a).

²⁵ See Treasury Inspector General for Tax Administration, “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,” Report No. 2020-46-041 (June 30, 2020); TIGTA, “Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic,” Report No. 2021-46-043 (July 9, 2021); TIGTA, “Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits,” Report No. 2022-46-059 (Aug. 31, 2022).

¹⁷ Announcement 2024-3, 2024-2 IRB 364, section 1.

¹⁸ Section 6501(b)(2); reg. section 301-6501(b)-1(b); section 6513(c); and reg. section 301.6513-1(c).

¹⁹ Reg. section 301.6501(b)-1(b).

²⁰ Section 6501(a).

grabbing tax payments made by the taxpayer in other contexts and applying those to reduce or satisfy the ERC-related liability.²⁶

C. Erroneous Refund Suits by the Government

An erroneous refund of “any portion of a tax imposed by” the IRC, including employment taxes, can be recovered by a civil action by the government.²⁷ In terms of timing, the government generally must initiate the lawsuit within two years after making the refund. That period extends from two years to five years “if it appears that any part of the refund was induced by fraud or misrepresentation of material fact.”²⁸

Here’s an example: If an eligible employer timely filed Forms 941 for all four quarters of 2021, the law would treat them as being filed on April 15, 2022. That means that the eligible employer could file Forms 941-X claiming ERCs until April 15, 2025. Assume that the IRS issued the refund on May 15, 2025, and it later determined that the Forms 941-X were fraudulent. In that scenario, the IRS would have five years from the payment date, until May 15, 2030, to file suit against the employer. The litigation might last for years after that.

D. Refund Suits by Taxpayers

The first step to recouping amounts from the IRS is for a taxpayer to file a timely refund claim.²⁹ When it comes to ERCs, Forms 941-X filed by eligible employers normally constitute refund claims. The IRS has no legal duty to respond to those claims, which often shocks taxpayers. Practitioners have described the reality as follows: “If a refund claim is filed within the applicable statute of limitations, the IRS has the discretion to accept and pay the claim, to deny part or all of it, or to simply ignore it.”³⁰

Taxpayers are not without remedies, though. They can file a refund suit if the IRS fails to

respond to the refund claim within six months.³¹ Moreover, if the IRS formally denies a refund claim by issuing a notice of disallowance, the taxpayer can seek help from the courts by initiating a refund suit.³² It’s common for these types of cases to drag on for years, with lots of discovery, motions, and trial time.

V. Illustrating Possible Problems

The following example incorporates some of the timing issues described above and underscores the potential conundrum for taxpayers.

Suppose that a calendar year corporation filed a Form 1120, “U.S. Corporation Income Tax Return,” for 2021. It later filed a timely Form 941-X for third quarter 2021 claiming significant ERCs, which would be deemed filed on April 15, 2022. The corporation subsequently received the refund triggered by the ERC claims. Soon thereafter, the corporation filed a Form 1120-X, “Amended U.S. Corporation Income Tax Return,” to reduce its wages-paid deduction for 2021. This triggered an additional income tax liability, which the corporation paid.

Years pass with no contact by the IRS. Eventually, the IRS starts an audit of the ERC claim, concludes that it was unjustified, and assesses employment taxes on June 1, 2026. The IRS is able to assess on that date thanks to the extended five-year period applicable to the third and fourth quarters of 2021. The corporation further analyzes its earlier ERC claim and concedes that it was wrong. Things are not all bad, thinks the corporation, because it should be able to file another Form 1120-X in 2026 to increase the wages-paid deduction for 2021 to reflect the disallowed ERCs from the third quarter of 2021. The problem is that, unless the corporation filed a timely “protective” Form 1120-X contemplating the potential ERC disallowance, it might be out of time — and out of luck.

VI. Potential Solution

The preceding example should have eligible employers and their advisers thinking about the

²⁶ Section 6402(b); reg. section 301.6402-1; reg. section 301.6402-3(a)(6). The IRS takes the position that the common law right of setoff applies to non-rebate erroneous refunds. See ILM 200014033.

²⁷ Section 7405(b).

²⁸ Section 6532(b); reg. section 301.6532-2.

²⁹ Section 6511(a); reg. section 301.6511(a)-1(a).

³⁰ David M. Richardson et al. *Civil Tax Procedure*, Ch. 9, at 218 (2005).

³¹ Section 6532(a)(1); reg. section 301.6532-1(a); section 7422(a).

³² Section 6532(a)(1); reg. section 301.6532-1(a); section 7422(a).

interplay of employment tax and income tax issues in the ERC context, as well as whether filing “protective” amended income tax returns is appropriate.³³ The concept of protective returns might be novel to some eligible employers or their advisers. Therefore, this article surveys several IRS sources explaining and supporting the notion of protective claims.

One IRS publication states the following about protective claims:

If your right to a refund is contingent on future events and may not be determinable until after the time period for filing a claim for refund expires, you can file a protective claim for refund. A protective claim can be either a formal claim or an amended return for credit or refund. Protective claims are often based on current litigation or expected changes in the tax law, other legislation, or regulations. A protective claim preserves your right to claim a refund when the contingency is resolved.³⁴

The Internal Revenue Manual provides similar guidance about protective claims:

The concept of a protective claim is well established in the case law, even though the term is not used in the statute or regulations. Protective claims are filed to preserve the taxpayer’s right to claim a refund when the taxpayer’s right to the refund is contingent on future events and may not be determinable until after the statute of limitations expires. . . . The [IRS] has discretion in deciding how to process protective claims. In general, it is in the best interests of the [IRS] and taxpayers to delay action on protective claims until the pending litigation or other contingency is resolved. Once the contingency is resolved, the [IRS] may obtain additional

information necessary in processing the claim and then allow or disallow the claim.³⁵

Finally, IRS legal memoranda offer additional color on the issue of protective claims:

When the results of pending litigation may significantly clarify whether a refund should be allowed, the interests of both the [IRS] and the taxpayer may be served by delaying action on the claim. If the [IRS] were instead to act quickly and disallow the claim, the taxpayer might be compelled to file a refund suit at an earlier time because Section 6532(a) provides for a limitations period of two years from the date the claim is disallowed. When there is a substantial possibility that the pending litigation will resolve whether the taxpayer is entitled to a refund, we see no reason why action on the claim should not be delayed as long as reasonably possible. Thus, we believe that such a “protective” claim may be held in abeyance until the pending litigation is resolved. We note, though, that if the [IRS] chooses to delay action on a refund claim, it is doing so because of the great discretion it has in deciding how to handle refund claims. There is no provision in the statute or regulations either requiring the [IRS] to expeditiously act on such a claim or prohibiting it from doing so. Because the [IRS] has no legal obligation to act on a refund claim within any specific period of time, it can legally delay action indefinitely. Of course, once six months has expired from the date the claim was filed, Section 6532(a) allows the taxpayer to bring a refund suit without waiting for the [IRS’s] response to the claim. However, when the taxpayer has filed a protective claim because the [IRS’s] position would be to disallow the claim but the resolution of pending litigation might cause the [IRS] to change its position and allow the claim instead, there is little likelihood that the

³³ See generally, ILM 200547011; Burgess J.W. Raby and William L. Raby, “Protecting the Protective Claim for Refund,” *Tax Notes*, Apr. 28, 2003, p. 529; IRM 21.5.3.4.7.3; Kristy M. Bowden, “Protective Claims for Refund: Protecting the Interests of Taxpayers and the IRS,” *56 Me. Law Rev.* 149 (2004); Brian T. Whitlock, “Protective Claims Abound as Supreme Court Reviews ACA,” *98(10) Taxes* 23 (2020).

³⁴ IRS Publication 556, “Examination of Returns, Appeals Rights, and Claims for Refund,” at 14 (Sept. 2013).

³⁵ IRM 25.6.6.5.5; see also IRM 4.90.7.1.

taxpayer will bring suit simply because the six month period specified in Section 6532(a) has expired.³⁶

VII. Conclusion

Many taxpayers that have filed or soon will file ERC claims are solely focused on employment tax issues. That's understandable but shortsighted. ERC claims involve employment and income tax issues, both of which must be adequately addressed. As this article demonstrates, timing is a major consideration, and knowledge of protective returns is fundamental. Taxpayers facing potential ERC audits, refund litigation, or participation in the withdrawal option or VDP would be wise to hire independent tax counsel with experience in the wide variety of issues that arise in analyzing and defending ERC claims. ■

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³⁶GCM 38786 (Aug. 13, 1981).