Employee Retention Credits: Analyzing Key Issues for "Promoters" and Other "Enablers"

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This article, the third in a series, summarizes the main ERC rules introduced by Congress and the IRS, clarifies the period during which ERC claims will continue, identifies several clues of imminent enforcement actions, and explores a long list of weapons that the IRS likely will utilize, some common, others obscure.

Introduction

It is obvious that the Internal Revenue Service ("IRS") has been scrutinizing, and will continue to pursue, those that it considers "promoters" or "enablers" of improper employee retention credit ("ERC") claims. What is not apparent to many, though, is the wide range of tools at the IRS's disposal and how their use might affect not only the targets, but also the taxpayers who relied on them. This article, the third in a series, summarizes the main ERC rules introduced by Congress and the IRS, clarifies the period during which ERC claims will continue, identifies several clues of imminent enforcement actions, and explores a long list of weapons that the IRS likely will utilize, some common, others obscure.[1]

Congressional and IRS Guidance

Congress passed four laws in less than two years regarding the ERC, and the IRS topped this by issuing multiple Notices, Revenue Procedures, and other guidance to implement the legislative mandates. This abundance of direction, released in a short timeframe, resulted in complexity, of course. Below is a mere glimpse at the big picture.[2]

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First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") in March 2020.[3] This was a complicated piece of legislation, which introduced key aspects that evolved over time.

General Rule

The CARES Act generally provided that an "Eligible Employer" could get an ERC against "Applicable Employment Taxes" equal to 50 percent of the "Qualified Wages" that it paid to each employee for each quarter, subject to a maximum.[4] The three key terms are defined below.

Eligible Employer

An Eligible Employer meant an employer that was carrying on a trade or business, which also met *one* of the following two tests. First, the employer's operations were partially or fully suspended during a quarter because of an order from an "appropriate governmental authority" limiting commerce, travel, or group meetings for commercial, social, religious, or other purposes due to COVID ("Governmental Order Test").[5] Second, the employer suffered a significant decline in gross receipts during a particular quarter ("Reduced Gross Receipts Test").[6] 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.[7]

Applicable Employment Taxes

The term "employment taxes" ordinarily refers to three items, namely, (i) federal income taxes paid solely by employees through mandatory withholding by their employers, (ii) amounts under the Federal Insurance Contributions Act ("FICA"), which are paid partly by employees and partly by employers, and (iii) amounts under the Federal Unemployment Tax Act ("FUTA"), which are paid entirely by employers.[8] The term Applicable Employment Taxes initially meant FICA amounts for ERC purposes.[9]

Qualified Wages

The notion of Qualified Wages under the CARES Act depended on the number of full-time employees working for an Eligible Employer before things went downhill. Where 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 Government Order Test or the Reduced Gross Receipts Test.[10] The CARES Act placed a limit on Qualified Wages when it came to Large Eligible Employers. They could not exceed the amount that an employee would have been paid for actually working an equivalent duration during the 30 days immediately preceding the relevant period.[11] This cap was designed to avoid pay-rate manipulation. For example, if a Large Eligible Employer normally paid an employee $15 per hour, but during the period that it met the Governmental Order Test or the Reduced Gross Receipts Test it paid the same employee $20 per hour (regardless of whether he was actually providing services or not), then only $15 per hour of wages paid, and only for those hours when the employee was not providing services, were considered Qualified Wages.[12]

The tax treatment was more favorable when it came to more modest businesses. Specifically, where an Eligible Employer had an average of 100 or less full-time employees ("Small Eligible Employer"), Qualified Wages meant *all wages* paid during a quarter, regardless of whether the employees were actually working.[13]

In addition to the amounts described above, Qualified Wages included certain "Qualified Health Plan Expenses" of the Eligible Employer.[14]

Limitations

The sky was *not* the limit under the CARES Act. Indeed, the amount of Qualified Wages for any one employee could not be more than $10,000 for *all* applicable quarters combined. This meant that the maximum ERC per employee for all of 2020 was $5,000.[15]

Applicability

Coverage of the ERC changed several times later, but it originally applied to wages paid after March 12, 2020, and before January 1, 2021. In other words, the CARES Act had the ERC benefitting Eligible Employers during the second, third, and fourth quarters of 2020.[16]

IRS Guidance for First Law

The IRS released Notice 2021-20 in March 2021. It only applied to the periods contemplated by the CARES Act; that is, second, third and fourth quarters of 2020.[17] The IRS guidance in Notice 2021-20 was *massive*, with much of it far exceeding the express language of the CARES Act.[18] The first article in this series described the IRS guidance in detail.

Second Law

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 ("Relief Act") in December 2020.[19] It extended and modified the existing ERC law in several ways.[20]

IRS Guidance for Second Law

The IRS needed to provide yet more administrative direction after Congress enacted the Relief Act. This time it came in the form of Notice 2021-23. The new guidance generally did *not* change what the IRS had previously supplied in Notice 2021-20. Rather, Notice 2021-23 "amplified" its earlier guidance, taking into account changes that Congress made in the Relief Act.[21]

Expansion of ERC

Notice 2021-23 starts with scope, confirming that an Eligible Employer might be able to claim ERCs not only for second, third and fourth quarters of 2020 (as it could under the CARES Act), but also for first and second quarters of 2021.[22]

Increasing Maximum ERCs

For second, third and fourth quarters of 2020, an Eligible Employer could only claim ERCs for 50 percent of Qualified Wages, up to a maximum of $10,000 per employee for all of 2020. Simple math shows that, under the

original CARES Act, Eligible Employers could get no more than $5,000 per employee that year.

Things changed in two ways for first and second quarters of 2021 thanks to the Relief Act. The percentage increased from 50 to 70, *and* the amount was calculated per quarter, not per year. As a result, if an Eligible Employer were to pay an employee $10,000 in Qualified Wages in each of the first and second quarters of 2021, then the ERCs would total $14,000 (*i.e.*, $7,000 per quarter).[23]

New Small and Large Eligible Employer Standards

Notice 2021-23 explained that whether amounts paid by an Eligible Employer will constitute Qualified Wages depends, in part, on the average number of full-time employees. It began by summarizing the original rules, as follows.

For purposes of the ERC for 2020, for an Eligible Employer with an average of more than 100 full-time employees in 2019 ("2020 Large Eligible Employer"), Qualified Wages were those paid to employees for the time that they were not providing services because of the Governmental Order Test or the Reduced Gross Receipts Test. By contrast, for an Eligible Employer with 100 or fewer full-time employees in 2019 ("2020 Small Eligible Employer"), Qualified Wages were those paid to any employee (regardless of whether they were providing services or not) during any quarter that business operations were partially or fully suspended because of the Governmental Order Test or when the employer met the Reduced Gross Receipts Test.[24]

The Relief Act modified the figures. In particular, Large Eligible Employers became those whose average number of full-time employees was more than 500 ("2021 Large Eligible Employer"), while Small Eligible Employers were those with an average of 500 or less ("2021 Small Eligible Employer").[25] In other words, the threshold went from 100 to 500 full-time employees, the result of which was that more taxpayers qualified as Small Eligible Employers.

Abolishing Limit for Large Eligible Employers

Notice 2021-23 explained that, under the CARES Act, the Qualified Wages for 2020 Large Eligible Employers could not exceed what an employee would have been paid for actually working an equivalent amount during the 30 days immediately preceding the start of the suspension because of the Governmental Order Test or when the employer met the Reduced Gross Receipts Test. The Relief Act abolished that limit, such that it did *not* apply when determining Qualified Wages for first and second quarters of 2021.[26]

Reduced Gross Receipts Test Easier to Meet

Notice 2021-23 explained that, under the CARES Act, the period during which an employer met the Reduced Gross Receipts Test was generally determined by identifying the first quarter in 2020, if any, in which its gross receipts were less than 50 percent of its gross receipts for the same quarter in 2019. Moreover, the period ended the quarter after which the employer's gross receipts in 2020 exceeded 80 percent of its gross receipts for the same quarter in 2019, or at end of 2020, whichever occurred first.

The Relief Act introduced changes. Specifically, that legislation provided that an employer would be an Eligible Employer for any quarter during which its gross receipts were less than 80 percent of its gross receipts for the same quarter in 2019. Thus, when it came to the ERC for first and second quarters of 2021, the determination of Eligible Employer status was made separately for each quarter and was based on a threshold of 80 percent.[27] To put it another way, a less significant drop in revenue still qualified a taxpayer as an Eligible Employer.

Election of Measurable Quarters

Notice 2021-23 pointed out that the Relief Act permitted an employer to elect to use an alternative/different quarter to calculate gross receipts. With this election, an employer gen-

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1 Earlier articles in the series are as follows: Hale E. Sheppard, "Employee Retention Credits: Analyzing Congressional and IRS Guidance from Start to Finish," 139 JTAX 3 (September 2023); Hale E. Sheppard, "Employee Retention Credits: Analyzing Key Issues for Taxpayers under IRS Audit," 139 JTAX __ (October 2023).

2 Like the first two articles, this one does *not* address special rules related to deferral of employment tax payments, tax-exempt organizations, government instrumentalities, tribal governments, employers in U.S. territories, aggregated entities treated as a single employer, and qualified health plan expenses.

3 Public Law 116-126; U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020).

4 Public Law 116-126, Section 2301(a).

5 Public Law 116-126, Section 2301(c)(2)(A)(ii)(I).

6 Public Law 116-126, Section 2301(c)(2)(A)(ii)(II).

7 Public Law 116-126, Section 2301(c)(2)(B).

8 Section 3101, Section 3111, Section 3301, and Section 3401. When dealing with compensation paid to railroad employees and representatives, the term "employment taxes" also encompasses amounts imposed by the Railroad Retirement Tax Act. *See* Section 3221.

9 Public Law 116-126, Section 2301(c)(1). These consist of Social Security and Medicare taxes.

10 Public Law 116-126, Section 2301(c)(3)(A)(i).

11 Public Law 116-126, Section 2301(c)(3)(B).

12 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 41.

13 Public Law 116-126, Section 2301(c)(3)(A)(ii)(I) and (II).

14 Public Law 116-126, Section 2301(c)(3)(C)(i).

15 Public Law 116-126, Section 2301(b)(1); U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 38.

16 Public Law 116-126, Section 2301(m).

17 Notice 2021-20, Section I.

18 Notice 2021-20, Section III.

19 Public Law 116-260, Division EE, Section 207 (Dec. 27, 2020). The Relief Act was one portion of the larger Consolidated Appropriations Act of 2021.

20 *See, generally*, U.S. Joint Committee on Taxation. Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security. JCX-3-21 (Feb. 8, 2021), pgs. 66-70.

21 Notice 2021-23, Section II. This article does not explore all new data provided in Notice 2021-23; it focuses on the most relevant aspects

22 Notice 2021-23, Section III, A.

23 Notice 2021-23, Section III, D.

24 Notice 2021-23, Section III, E.

25 *Id.*

26 *Id.*

27 Notice 2021-23, Section III, C.

28 *Id.*

29 Public Law 117-2, Section 9651 (March 11, 2021).

30 Notice 2021-20 continues to apply to second, third and fourth quarters 2020, and Notice 2021-23 continues to apply to first and second quarters 2021. *See* Notice 2021-49, Section I.

erally determined whether the Reduced Gross Receipts Test was met for a particular quarter in 2021 by comparing its gross receipts from the immediately-preceding quarter with those for the corresponding quarter in 2019 (and by substituting 2020 for 2019 if the employer did not exist at the start of that quarter in 2019). For instance, for first quarter 2021, an employer could elect to use its gross receipts from fourth quarter 2020 and compare them to those from fourth quarter 2019.[28]

Third Law

Congress passed the American Rescue Plan Act of 2021 ("ARP Act") in March 2021.[29] Importantly, the ARP Act "codified" the ERC for the first time, making it Section 3134 of the Internal Revenue Code.

IRS Guidance for Third Law

Notice 2021-49 was the next in the series of IRS guidance. It retained and expanded the earlier information in Notice 2021-20 (relating to the CARES Act) and Notice 2021-23 (relating to the Relief Act).[30] It also supplied new data concerning the ARP Act, its expansion of the ERC to third and fourth quarters of 2021, and its introduction of Section 3134.[31] Certain aspects of Notice 2021-49 are explored below.

Expansion of ERC

Notice 2021-49 confirmed that, under Section 3134, an Eligible Employer could claim ERCs for third and fourth quarters of 2021.[32] Thus, at that point, the ERC was available with respect to second, third, and fourth quarters of 2020 (under the CARES Act), first and second quarters of 2021 (under the Relief Act), and third and fourth quarters of 2021 (under the ARP Act).

Recovery Startup Businesses

Notice 2021-49 explained that the ARP Act inserted a new type of Eligible Employer, the so-called Recovery Startup Business. That was an employer (i) that began operating a trade or business after February 15, 2020, (ii) had average annual gross receipts of not more than $1 million during the relevant period, and (iii) did not otherwise qualify as an Eligible Employer under the Governmental Order Test or the Reduced Gross Receipts Test.[33] The ARP Act imposed a cap on the ERCs that a Recovery Startup Business could claim; they could not exceed $50,000 for each of third and fourth quarter 2021. Notice 2021-49 explained that the analysis of whether an employer was a Recovery Startup Business had to be done separately for each quarter.[34]

Severely Financially Distressed Employers

The ARP Act introduced the notion of Severely Financially Distressed Employers. According to Notice 2021-49, for purposes of the ERC for third and fourth quarters of 2021, an Eligible Employer was a Severely Financially Distressed Employer if its gross receipts were less than 10 percent for the same quarter in 2019 (or in 2020, if the employer did not exist in 2019). The earlier restriction on Qualified Wages for Large Eligible Employer disappeared in these instances. Thus, for third and fourth quarters of 2021, a Severely Financially Distressed Employer, which was also a Large Eligible Employer, could treat *all* wages paid to its employees as Qualified Wages, not just wages for those employees who were not providing services.[35]

Expanded Assessment Period

Notice 2021-49 clarified the special, extended assessment-period in the context of the ERC. It said that the assessment-period for any amount attributable to an ERC would not expire before the date that is five years (instead of the normal three years) after the date on which the pertinent Form 941 was filed, or the date on which such Form 941 is deemed to have been filed, whichever is later.[36] For instance, if an Eligible Employer filed a timely Form 941 for third quarter 2021 claiming ERCs, such Form 941 was deemed to have been filed on April 15, 2022, and the assessment-period would stay open until April 15, 2027.

Importantly, Notice 2021-49 indicated that the extended assessment-period applied to ERC claims for third and fourth quarters of 2021 under the ARP Act, but did *not* affect claims for earlier quarters in 2020 or 2021 under the CARES Act or Relief Act, respectively.[37]

Comprehensive Clean Up

Notice 2021-49 also contained some general clean up, if you will, offering supplemental guidance on different issues that had arisen since Congress first introduced the ERC and the IRS began implementing it.[38] Specifically, Notice 2021-49 answered questions about the definition of full-time employees, treatment of tips, special rules for related parties, inconsistent elections for comparing gross receipts, and unique rules in cases where employers acquire a business.[39]

Revenue Procedure 2021-33

Revenue Procedure 2021-33 created a "safe harbor" that allowed taxpayers to exclude certain items from gross receipts when calculating that figure for ERC purposes, including loans forgiven under the Paycheck Protection Program ("PPP").[40] Revenue Procedure 2021-33 said that an employer can omit various things, among them any PPP loan forgiveness, when analyzing its eligibility to claim ERCs for a particular quarter, as long as the employer "consistently applies" the safe harbor.[41] This means that the employer must disregard the loans for *all* relevant quarters, and not include and exclude amounts at its whim with the goal of satisfying a particular standard or percentage.[42] Making the election to apply this safe harbor was rather easy; an employer simply needed to ignore the forgiven PPP loan when calculating amounts for the Reduced Gross Receipts Test.[43] The safe harbor applied to *all* periods relevant to the ERC, namely, second quarter 2020 through fourth quarter 2021.[44]

Fourth Law

Things came to an unexpected close when Congress enacted the Infrastructure Investment and Jobs Act

("IIJA") in November 2021.[45] That legislation announced the end of the ERC, and to the surprise of many, *retroactively* shortened the periods for which Eligible Employers could claim benefits. Just nine months earlier, Congress underscored several lofty reasons for expanding the ERC to cover 2021 in its entirety. It drastically changed course with the IIJA, generally eliminating fourth quarter 2021. As a result, most ERC claims were limited to second, third and fourth quarters of 2020, and first, second and third quarters of 2021.[46]

Recovery Startup Businesses were spared. They, and only they, could continue claiming ERCs for fourth quarter 2021.[47] Congress made it easier for taxpayers to be Recovery Startup Businesses, too. It removed the requirement that an employer could not otherwise qualify as an Eligible Employer pursuant to the Governmental Order Test or Reduced Gross Receipts Test.[48]

IRS Guidance for Fourth Law

The IRS issued Notice 2021-65 to clarify the IIJA. It started, of course, with confirmation that Eligible Employers, other than Recovery Startup Businesses, could *not* claim ERCs for fourth quarter 2021.[49] The next logical step for the IRS was recouping funds. It did so by explaining that advance ERC payments received by most Eligible Employers for fourth quarter 2021 constituted "erroneous refunds," they had to be timely repaid, and delinquencies would be penalized.[50]

ERC Claims Continuing

Eligible Employers could have solicited ERCs on *timely* Forms 941 for each relevant quarter in 2020 and/or 2021. Alternatively, they could, and in many instances still can, seek ERCs after the fact by filing Forms 941-X (Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund). A taxpayer normally must file a refund claim, including a Form 941-X seeking ERCs, within three years after filing the relevant Form 941, or within two years after paying the relevant taxes, whichever period expires later.[51] Forms 941 for all four quarters of a particular year are deemed filed on April 15 of the next year.[52] For example, Form 941 for second quarter 2020 had to be filed by July 31, 2020 (*i.e.*, the last day of the month following the end of the second quarter), but is deemed to have been filed nearly nine months later, on April 15, 2021.[53]

ERCs were available for second, third and fourth quarter of 2020. Assuming that an Eligible Employer filed Forms 941 for these periods on time, the law would treat them as being filed on April 15, 2021. Thus, applying the three-year limit described above, the Eligible Employer could file Forms 941-X making ERC claims *until April 15, 2024.* ERCs were also available for first, second, third and fourth quarter of 2021, though the last quarter was ultimately restricted to Recovery Startup Businesses. Again, assuming that an Eligible Employer filed Forms 941 on time, the IRS would deem them filed on April 15, 2022. Taking into account the three-year restriction an Eligible Employer could file Forms 941-X claiming ERCs, or more of them, *until April 15, 2025.*

Clues of Imminent Enforcement

Several things indicate that the IRS is beginning to engage in serious enforcement actions against advisors, attorneys, accountants and others who supposedly "promoted" or otherwise "enabled" taxpayers to make unjustified ERC claims.

Watchdog Reports

The Treasury Inspector General for Tax Administration ("TIGTA") pub-

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31 Notice 2021-49, Section I.

32 Notice 2021-49, Section III, A.

33 Notice 2021-49, Section III, D.

34 *Id.*

35 *Id.*

36 Notice 2021-49, Section III, G; Section 6501(b)(2).

37 Notice 2021-49, Section III, G.

38 Notice 2021-49, Section IV.

39 *Id.*

40 Revenue Procedure 2021-33, Section 1. *See* Paycheck Protection Program Flexibility Act of 2020, Public Law 116-142.

41 Revenue Procedure 2021-33, Section 3.03.

42 *Id.*

43 Revenue Procedure 2021-33, Section 3.04.

44 Revenue Procedure 2021-33, Section 6.

45 Public Law 117-58 (Nov. 15, 2021).

46 Public Law 117-58, Section 80604(a) (Nov. 15, 2021).

47 *Id.*

48 *Id.*

49 Notice 2021-65, Section III, A.

50 Notice 2021-65, Section III, B.

51 Section 6511(a); Treas. Reg. § 301.6511(a)-1(a); Section 6511(b)(1); Treas. Reg. § 301.6511(b)-1(a).

52 Section 6501(b)(2); Treas. Reg. § 301-6501(b)-1(b); Section 6513(c); Treas. Reg. § 301.6513-1(c).

53 Treas. Reg. § 301.6501(b)-1(b).

54 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. Reference Number 2020-46-041 (June 30, 2020), pgs. 18-19.

55 Treasury Inspector General for Tax Administration. Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic. Report No. 2021-46-043 (July 9, 2021), pgs. 7-8.

56 Treasury Inspector General for Tax Administration. Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic. Report No. 2021-46-043 (July 9, 2021), pg. 9.

57 Treasury Inspector General for Tax Administration. Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits. Report No. 2022-46-059 (August 31, 2022), pg. 4.

58 Treasury Inspector General for Tax Administration. Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits. Report No. 2022-46-059 (August 31, 2022), pg. 13.

59 *See, e.g.*, Government Accountability Office. COVID-19: Continued Attention Needed to Enhance Federal Preparedness, Response, Service Delivery, and Program Integrity. GAO-21-551 (July 10, 2021); Government Accountability Office. COVID-19: Sustained Federal Action is Crucial as Pandemic Enters its Second Year. GAO-21-387 (March 31, 2021).

60 Government Accountability Office. COVID-19: IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Compliance Efforts. GAO-22-104280 (May 2022), pgs. 33-35.

61 Government Accountability Office. COVID-19: IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Compliance Efforts. GAO-22-104280 (May 2022), pg. 36.

62 *Id.*

63 Government Accountability Office. COVID-19: IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Compliance Efforts. GAO-22-104280 (May 2022), pg. 66.

64 News Release 2021-65 (March 31, 2021).

65 IRS Tax Tip 2023-44 (April 4, 2023).

66 News Release 2022-183 (October 19, 2022).

67 Information Release IR-2023-49 (March 20, 2023); Information Release IR-2023-71 (April 5, 2023).

68 Information Release IR-2023-105 (May 25, 2023).

lished several reports describing what many predicted; that is, troubles with ERCs from the outset. TIGTA identified, among other things, many claims of dubious veracity. For instance, one report explained that within just two months of enacting the CARES Act, the IRS had already flagged over one million Forms 941 as erroneous or possibly fraudulent.[54] A second report, likewise, discovered that the IRS did not catch several hundred Forms 941 for 2020, claiming ERCs of more than $92 million, with strong indicators of fraud.[55] It also found that the IRS granted ERCs to over 500 governmental entities, which, by their very nature, could not qualify as Eligible Employers.[56] A third TIGTA report explained that the filing season was already underway when Congress enacted many of the COVID-related laws, such as the CARES Act, so the IRS did not have adequate time to make the necessary programming changes. This caused the IRS not to perform certain validations, and many erroneous or fraudulent ERC claims went undetected.[57] The third report also determined that hundreds of taxpayers that likely did not qualify as Recovery Startup Business received about $20 million in improper ERCs for fourth quarter 2021.[58]

The Government Accountability Office ("GAO") also released several reports regarding implementation by the IRS of various COVID-related tax benefits, including the ERC.[59] Like TIGTA, the GAO identified numerous problems. These included granting ERC claims submitted by fabricated or ineligible entities, conceding ERCs to taxpayers that never claimed them on their Forms 941 in the first place, failing to catch mismatches between the ERC claims actually received and those reported on Forms 941, miscalculations of amounts, and more.[60] The GAO was sympathetic to the IRS's plight, recognizing that it had to carry out laws that changed several times during 2020 and 2021, cope with its own staffing and capacity challenges caused by COVID, and limit internal controls before disbursing ERCs in order to help struggling employers and their workers receive financial help as quickly as possible. These circumstances, however, generated a "high level of risk of revenue loss" and "contributed to the issuance of some invalid tax credit funds."[61] The GAO underscored that the IRS still had a chance at redemption; it could aggressively audit ERCs, recoup improper disbursements, and punish wrongdoers. The GAO phrased it more diplomatically, of course. It said that the IRS "could use post-filing compliance or examination activities to address already-issued tax credit refunds that may have been in error or otherwise invalid."[62] In its response to the GAO report, the IRS agreed with the need for strong enforcement, and emphasized that it was already in the works. Specifically, the IRS explained that the "Emerging Threats Mitigation Team," which is part of the Office of Fraud Enforcement, was already operating a program that is (i) referring promoters and return preparers who engaged in "abusive tax schemes" involving ERCs to the Office of Professional Responsibility ("OPR"), (ii) coordinating with the Criminal Investigation Division about fabricated entities, (iii) preventing the issuance of improper ERC claims, and (iv) assigning cases to the Civil Examination Division.[63]

IRS Pronouncements

The IRS has issued a significant number of New Releases, Information Releases, Facts Sheets, and the like referencing the ERC. They started out positive, but swiftly turned negative as the IRS began detecting abuses. Below are some of the pronouncements centered on wrongdoing by alleged promoters.

Marking the one-year anniversary of the introduction of the ERC, the IRS explained that criminal investigations and civil examinations were underway. Regarding the former, the IRS indicated that the Criminal Division was "pledging its continued commitment to investigating COVID-19 fraud," including instances related to the ERC. The Head of the Criminal Investigation Division added 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."[64]

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 since Fall 2022, yet taxpayers that do not meet the Eligible Employer standard continue trying to claim ERCs in 2023.[65] The IRS again warned taxpayers to "be wary" of companies advising them to claim large ERCs because many of them are taking improper positions regarding eligibility and amounts. According to the IRS, unscrupulous companies were charging large upfront fees or contingent fees based on the size of the tax refund, instructing taxpayers to take unsupported positions with the IRS regarding the ERC, and then compounding the problem by failing to tell the taxpayers that they must have a corresponding decrease in the deduction that they claim on their federal income tax returns for wages paid. The IRS then told taxpayers to proactively fix that situation: "If the business filed an income tax return deducting qualified wages before it filed an employment tax return claiming the credit, the business should file an amended income tax return to correct any overstated wage deduction."[66]

The IRS continued down this path, announcing in March 2023 that improper ERC claims not only made it onto the Dirty Dozen list, they topped it.[67] 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 (i) unsolicited calls or advertisements mentioning an "easy application process," (ii) statements that the promoter can determine ERC eligibility within minutes, (iii) large upfront fees or a contingent fee based on a percentage of the refund obtained,

and (iv) statements to the effect that all taxpayers should apply for ERCs because there is nothing to lose. The IRS also reiterated that it was already conducting civil examinations and criminal investigations.[68]

High-ranking IRS enforcement officials recently acknowledged that the ERC constitutes a "substantial compliance issue" because of the huge number of claims and incidence of noncompliance, with "much of it bordering on fraud." They also called it a "case study on a program ripe for improper claims" as a result of IRS underfunding, quantity of taxpayers desperate for a post-COVID financial boost, paper-filing of returns, and complicated qualification rules.[69]

The IRS later announced that it had seen a "wave of summer scams relentlessly pounding taxpayers" with inaccurate offers about several tax items, including the ERC. The IRS explained that "unscrupulous promoters" were luring taxpayers into making improper ERC claims via offers in social media, on the radio, during phone solicitations, and through mailings that resemble official IRS correspondence. The IRS emphasized that promoters often do not frankly discuss with taxpayers eligibility factors, limitations, income tax implications, and other key matters. The IRS concluded with its standard warning that "anyone who improperly claims the ERC must pay it back, possibly with penalties and interest."[70]

Training the Troops

The IRS moved from words to actions, training its personnel to carry out the ERC mission. The IRS began by announcing that it had trained 300 Revenue Agents to conduct civil examinations of ERC claims, while Special Agents will focus on potential criminality by "promoters" and other "enablers" of such claims.[71] Consistent with those admonitions, the IRS released in late 2022 an initial training guide for Revenue Agents assigned to question all things ERC. Its main goal, unsurprisingly, was for personnel to be capable of (i) determining the specific quarters in 2020 and 2021 during which a taxpayer was an Eligible Employer, (ii) identifying what payments constituted Qualified Wages, (iii) calculating the correct amount of ERCs that a taxpayer could claim, (iv) applying any limitations on ERCs based on the size of the employer, and (v) understanding the interplay between ERCs and other tax benefits.[72] The IRS borrowed heavily from its earlier guidance, particularly Notice 2021-20, in crafting the training guide.[73]

Things did not end there. The IRS produced more expansive training materials, which were released at the end of 2022.[74] In the words of one IRS official, such materials explain how Revenue Agents "should scrutinize" all aspects of the ERC and confirm that it "is being abused by third parties with schemes targeting employers that are ineligible."[75] Among other things, the training materials address fraud in detail.[76] They also reminded Revenue Agents that auditing "refundable credits [like the ERC] requires extra scrutiny by the examiner *in detecting fraud committed by a taxpayer, promoter, and/or return preparer.*"[77]

Actions Facing Promoters and Other Enablers

An earlier article in this series explored IRS enforcement actions focused on taxpayers who filed improper ERC claims. This current article centers on another target of the IRS, the advisors, consultants, attorneys, accountants and others that it views as "promoters" or "enablers" of ERC abuse. The IRS has several arrows in its enforcement quiver, and nobody can be sure which ones it will extract. What is certain, though, is that the IRS enjoys several possibilities, as seen below.

Promoter Penalties

The IRS can assess sizable "promoter" penalties under Section 6700. A survey of the key issues follows.

NOTES

[69] Nathan J. Richman, "Employee Retention Credit Claimants May See Help from the IRS," Tax Notes Doc. 2023-16685 (June 9, 2023).

[70] Internal Revenue Service. IR-2023-131 (July 21, 2023); *See also* Internal Revenue Service. IR-2023-132 (July 21, 2023).

[71] Nathan J. Richman, "IRS Readying Hard Look at Employee Retention Credit Claims," 177 Tax Notes Federal 747 (Oct. 31, 2022); "IRS Releases Employee Retention Credit Training Guide," Tax Analysts Document No. 2022-38592 (providing a document called "Lesson 3 – Tax Credit for Employee Retention – Student Guide (Revised 7/2022)).

[72] "IRS Releases Employee Retention Credit Training Guide," Tax Analysts Document No. 2022-38592.

[73] *Id.*

[74] Lauren Lorrichio, "Documents Shed Light on IRS Scrutiny of Employee Retention Credit," 2022 Tax Notes Federal Today 232-7 (Dec. 5, 2022)' "IRS Slide Show Training on COVID Credits, Deferral," Tax Analysts Document No. 2023-13616.

[75] Lauren Lorrichio, "Documents Shed Light on IRS Scrutiny of Employee Retention Credit," 2022 Tax Notes Federal Today 232-7 (Dec. 5, 2022).

[76] "IRS Slide Show Training on COVID Credits, Deferral," Tax Analysts Doc. No. 2023-13616.

[77] "IRS Slide Show Training on COVID Credits, Deferral," Tax Analysts Doc. No. 2023-13616 (emphasis added).

[78] U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pgs. 210-211.

[79] Section 6700(a)(1)(A) and (B).

[80] Chief Counsel Advisory 200402008.

[81] *Id.*

[82] *Id.*

[83] Section 6700(a)(2)(A). Alternatively, the persons make or furnish, or they cause another to make or furnish, a "gross valuation overstatement" as to any material matter, but that is not relevant to this article. *See* Section 6700(a)(2)(B).

[84] U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 211.

[85] Section 6700(a) (Flush Language).

[86] Chief Counsel Advisory 202125008; Chief Counsel Advisory 202125009; U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 212.

[87] Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 40; Internal Revenue Manual § 4.32.2.12.5.2 (06-04-2018).

[88] U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 212; *See also Gardner v. Commissioner*, 145 TC 161 (2015, *aff'd* 120 AFTR 2d 2017-6699 (9th Cir. 2017).

[89] Internal Revenue Manual § 20.1.6.13 (08-25-2020); *In re Tax Refund Litigation*, 766 F. Supp. 1248 (E.D. N.Y. 1991); *Capozzi v. United States*, 980 F.2d 872 (2nd Cir. 1992).

[90] Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 5 (emphasis added); See also Internal Revenue Manual § 4.32.2.12.5.1 (06-08-2012).

[91] *Crim v. Commissioner*, TC Memo 2021-117; *Crim v. Commissioner*, 131 AFTR 2d 2023 (Court of Appeals for the District of Columbia May 2, 2023).

Prioritizing Promoters

Congress decided to center on promoters, prioritizing them over taxpayers, when introducing Section 6700. It recognized that, while the Securities and Exchange Commission has certain powers to challenge promoters, the IRS would be better situated to lead the charge for several reasons. For starters, Congress expected the IRS to carry out promoter investigations "with vigor" because prevention of shelters requires fewer enforcement resources than chasing numerous taxpayer-investors. Congress also noted that if the IRS can prove fraud by a promoter, this can "materially aid" taxpayer-investors in their efforts to rescind any contracts they executed with promoters. Lastly, Congress believed that promoter penalties are "particularly equitable" because promoters, professional advisors, and salesman of tax shelters generally are "more culpable" than taxpayer-investors, who rely on representations from these persons in deciding whether to participate.[78]

Criteria for Sanctions

The IRS can assess penalties against persons meeting specific criteria. They *either* organize, or assist in organizing, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, *or* they participate (directly or indirectly) in the sale of ownership interests in such entity, plan, or arrangement.[79] The IRS defines the preceding concepts broadly.

From the IRS's perspective, the notion of "organizing" includes discovering, planning, investigating or initiating an investment, devising a business or financial plan for the investment, or carrying out such investment through negotiations or transactions with others.[80] The idea of "assisting in organizing" is expansive, too. The IRS takes the position that it entails (i) preparing any document establishing an entity used in an abusive transaction (*e.g.*, articles of incorporation, partnership agreement, trust instrument, etc.), (ii) registering the entity with any federal, state or local government, (iii) creating a prospectus, private placement memorandum, or other document describing the transaction, (iv) drafting a tax or legal opinion, (v) issuing an appraisal, and/or (vi) negotiating or otherwise acting in connection with the purchase of any property utilized in the transaction.[81]

When it comes to "participating in the sale" of a supposed tax shelter, the IRS believes that this phrase reaches *any* marketing activities. These include, but are not limited to, direct contact with a prospective investor or his representative, solicitation of investors by mail, phone, or advertisements, and instructing salespersons about the tax shelter or sales presentations thereof.[82] In addition to organizing or participating in the sale of a tax shelter, persons must do something more in order to be punished. For instance, they personally make or furnish, or cause another person to make or furnish, a statement about the allowability of any tax deduction or credit, the excludability of any income, or the attainment of any other tax benefit by a taxpayer, *and* they actually know, or have reason to know, that such statement is materially false or fraudulent.[83]

In summary, persons might get hit with promoter penalties under Section 6700 if they organize, help with organizing, directly sell, and/or indirectly sell interests in an entity, plan or arrangement, *and* they either make or cause another person to make a false or fraudulent statement about the tax benefits that a taxpayer will obtain from participating. Congress crafted this standard with hopes of broad applicability. It stated that "persons subject to the penalty may include not only the promoter of a classic tax shelter partnership or tax avoidance scheme, but any other person who organizes or sells a plan or arrangement with respect to which there are material inaccuracies affecting the tax benefits to be derived from participation."[84]

Penalty Amounts

The size of the penalty depends on the behavior. In situations involving false or fraudulent statements, the penalty equals 50 percent of the income that the promoter has already derived, or will derive, from the activity.[85] Where the income amount is speculative, the formula is based on the money that the promoter was reasonably expected to realize. This covers, for example, fees that the promoter was scheduled to earn for ongoing management of the tax shelter after its initial implementation, as well as fees paid by taxpayers who ultimately decided not to claim the tax benefits.[86] Below is a simple example from the IRS:

> A promoter's scheme used limited liability companies ("LLCs") and trusts to divert income. The examiner can prove that the promoter created 40 LLCs, 25 of which were used by known participants in the scheme. The examiner can also prove that four of the 25 participants paid $1,000 each to the promoter. Gross income to be derived from the scheme is $40,000 (40 LLCs multiplied by $1,000 minimum), so the penalty is $20,000 (50% of the gross income).[87]

Unsuccessful Promotion Suffices

Congress clarified that the mere promotion of abusive transactions suffices to trigger penalties under Section 6700; it is *not* necessary that a taxpayer actually engage in the transaction or claim the tax benefits. Legislative history contains the following commentary on this point: "There need not be reliance by the purchasing taxpayer or actual underreporting of tax. These elements were not included because they would substantially impair the effectiveness of this [promoter] penalty. Thus, a penalty can be imposed based upon the offering materials of the arrangement without an audit of any purchaser of interests."[88]

Endless Assessment Periods

Importantly, there is no statute of limitations on assessment of promoter penalties. The IRS, in other words, is under no time pressure to identify potential wrongdoers, audit them, and impose sanctions.[89] The IRS explains to its personnel that the penalty "can

be assessed *at any time* [and] once an assessment is made, the 10-year statute of limitation on collection applies."[90] The endless assessment period has led to cases in which a taxpayer promoted a tax shelter from 1999 to 2003, he was criminally convicted, the IRS assessed promoter penalties in 2010 while he was still incarcerated, and the IRS initiated collection actions when he was released from prison in 2014.[91] The endless assessment period has also triggered cases where the IRS assessed penalties against a promoter *after* he died and then proceeded to collect them from his estate.[92]

Assessable Penalty Status

Promoter penalties are "assessable penalties." This essentially means that alleged promoters have no right to seek administrative or judicial review *before* the IRS assesses penalties, they cannot utilize the normal deficiency procedures applicable to income taxes and other items, and they must pay a portion of the disputed penalties first and then try to recoup them through a specialized, two-step refund process.[93] They begin by paying at least 15 percent of the penalties and filing a timely Form 6118 (Claim for Refund of Tax Return Preparer and Promoter Penalties). If the IRS either issues a Notice of Disallowance or simply ignores it for more than six months, then the alleged promoter can start a suit for refund in District Court.[94]

Potential Outcomes

The results of a promoter investigation vary. In theory, the IRS might conclude that nothing is awry, halt the procedure, and issue a so-called "Discontinuance Letter." This occurs in rare circumstances.[95] More often, the IRS decides to assess civil penalties, seek an injunction from a federal court, refer the matter to the Criminal Investigation Division, or take other steps.[96]

Coordination with Criminal Investigation Division

Revenue Agents are instructed to do several things at the start of a promoter investigation, one of which is checking to see whether the Criminal Investigation Division is already involved. If so, Revenue Agents are encouraged to conduct "parallel investigations" with their co-workers on the criminal side.[97] These consist of simultaneous, yet separate, actions by the Civil Examination Division (conducted by a Revenue Agent) and by the Criminal Investigation Division (led by a Special Agent). These are not joint investigations.[98] The Internal Revenue Manual tells IRS personnel that sharing information among Revenue Agents, Special Agents, and government attorneys "is the key ingredient in developing civil and criminal investigations simultaneously and efficiently."[99] The Internal Revenue Manual further tells Special Agents, who focus on criminal actions, to develop as much evidence as possible (using summonses, search warrants, undercover operations, and other tools) *before* resorting to the grand jury process. This is because the Criminal Investigation Division can only share non-grand-jury information with the Civil Examination Division.[100]

The IRS might allege various crimes in a tax shelter case. Examples from a pending case consist of tax fraud conspiracy, wire fraud, aiding the filing of false tax returns, executing false tax returns, and money laundering.[101]

Aiding-and-Abetting Penalties

The IRS can sanction a promoter under Section 6701 for aiding-and-abetting a tax understatement in certain instances. Penalties apply where a person assists in, procures, or advises with respect to the preparation of any portion of a return, affidavit, claim, or other document, *and* such person knows (or has reason to know) that such portion will be used in connection with a material tax matter, *and* knows that such portion will result in

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92 Chief Counsel Advisory 201235017; *Reiserer v. United States*, 479 F.3d 1160 (9th Cir. 2007).

93 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 5; Section 6703(b); Section 6703(c).

94 Section 6703(c).

95 Internal Revenue Manual § 4.32.2.12.10.3.2.2 (06-04-2018). Discontinuation might be appropriate where the IRS concludes that the alleged promoter was not involved in the relevant activity, the activity was not abusive in nature, or the promoter died and the operation is defunct. *See* Internal Revenue Manual § 4.32.2.9.3 (06-04-2018).

96 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 4.

97 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 10; Internal Revenue Manual § 4.32.4.5 (06-04-2018).

98 Internal Revenue Manual § 4.32.2.7 (09-23-2011).

99 Internal Revenue Manual § 4.32.2.7.7 (06-04-2018).

100 *Id.*

101 18 U.S.C. § 371, 18 U.S.C. § 1349, 18 U.S.C. § 1343; 26 U.S.C. § 7206(2); 26 U.S.C. § 7206(1); 18 U.S.C. § 1957. *See, e.g., United States v. Fisher et al*, First Superseding Criminal Indictment, District Court, Northern District of Georgia, Case No. 1:21-CR-00231, February 24, 2022.

102 Section 6701(a).

103 *Nielsen v. United States*, 976 F.2d 951, 955 (5th Cir. 1992); IRS Technical Advice Memorandum 200243057.

104 Section 6701(b)(1). The penalty increases to $10,000 when corporations are involved.

105 *Sansom v. United States*, 703 F.Supp. 1505, 1509 (N.D. Fla. 1988).

106 *Mullikin v. United States*, 952 F.2d 920, 928 (6th Cir. 1991); *Lamb v. United States*, 977 F.2d 1296, 1297 (8th Cir. 1992).

107 Section 6701(f)(3).

108 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 22.

109 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 22 (emphasis added).

110 Section 7408(c); Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 28.

111 Section 7408(a).

112 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 213 (emphasis added).

113 U.S. Joint Committee on Taxation. General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), pg. 213.

114 26 U.S.C. § 7402, 26 U.S.C. § 7406, 26 U.S.C. § 7408.

115 Internal Revenue Manual § 4.32.2.9.1 (06-04-2018).

116 Internal Revenue Manual § 4.32.2.9.1 (06-04-2018) (emphasis added).

117 31 U.S.C. § 10.2(a)(5); 31 U.S.C. § 10.3.

118 Treasury Department, Circular 230, Title 31 of Code of Federal Regulations, Subtitle A, Part 10 (2014).

119 Internal Revenue Service - Office of Professional Responsibility. Professional Responsibility and the Em-

a tax understatement to the IRS.[102] The type of person on whom the IRS may impose this penalty is broad; it is not limited to traditional accountants, enrolled agents, and other return preparers.[103]

In terms of numbers, the aiding-and-abetting penalty generally equals $1,000 per person, per period, per taxpayer.[104] The courts have largely concluded that this penalty applies to cases characterized by false or fraudulent statements.[105] The courts have also confirmed that, like promoter penalties under Section 6700, there is no time limit on when the IRS may assess the aiding-and-abetting penalty.[106] On a positive note for alleged promoters, the IRS cannot double down, imposing both promoter penalties under Section 6700 and aiding-and-abetting penalties under Section 6701; it must select one or the other.[107]

Individual Income Tax Audits of Promoters

The IRS observes that many promoters generate significant income from their activities and they "often use their own promotions" to reduce or eliminate taxes on such income.[108] Consequently, a promoter penalty investigation under Section 6700 frequently leads to a federal income tax audit of a promoter's own Forms 1040 (U.S. Individual Income Tax Returns). The IRS does not see a major conflict for a Revenue Agent in wearing two hats, stating that "you may conduct *both* the promoter's income tax examination *and* the promoter investigation."[109]

Referral for Injunction Suit

In addition to the actions described above, the IRS, with assistance from the Department of Justice ("DOJ"), can take more urgent actions. Specifically, if the circumstances warrant it, the DOJ can file a lawsuit with the proper District Court seeking an injunction. This legal mechanism prohibits a person from engaging in any action that would trigger promoter penalties under Section 6700 or any violation of Circular 230.[110] Notably, although the behavior to be enjoined must be subject to certain penalties, it is *not* a prerequisite to filing an injunction suit that the IRS has actually assessed penalties yet.[111] The speediness of the procedure is one of the very reasons that Congress introduced it back in 1982:

> Congress believed that the most effective way to curtail promotion of abusive tax shelters, etc. is through injunctions issued against violators to prevent recurrence of the offense. The ability to seek injunctive relief will ensure that the [IRS] can attack tax shelter schemes years *before* such challenges would be possible if the [IRS] were first required to audit investor tax returns.[112]

District Courts have broad authority to impose equitable relief. They can, for instance, enjoin particular conduct of a promoter, all actions by a promoter that might violate Section 6700, or behavior that tends to impede the administration of tax laws.[113] They can also force promoters to "disgorge," or relinquish, all or a portion of the money they made from improper activities.[114]

The IRS explains to its personnel that injunction suits constitute just one weapon to combat tax shelter activities; they are "separate and apart from other civil or criminal actions" against promoters."[115] The IRS recommends that injunction actions proceed, even *after* a promoter has been criminally prosecuted and sentenced to incarceration, fines, probation, etc. This is because, from the IRS's perspective, "a criminal sentence is punishment for *past* criminal behavior, while an injunction prohibits *future* behavior."[116]

Referrals to Office of Professional Responsibility

OPR has jurisdiction over various tax professionals.[117] The standards, rules and procedures used by OPR are found in a part of the regulations known as Circular 230.[118] OPR issued an "alert" in early 2023 addressing issues related to ERC claims.[119] Readers first need some background to appreciate the alert.

Individuals the OPR Governs

OPR has jurisdiction over attorneys, accountants, enrolled agents, actuaries, retirement plan agents, tax return preparers, and other professionals who "practice before the IRS."[120] The idea of "practice" in this context is expansive, encompassing "all matters connected with a presentation" to the IRS related to a taxpayer's rights, privileges, or liabilities.[121] Likewise, the notion of a "presentation" broadly covers, among other things, (i) preparing documents, filing documents, and/or communicating with the IRS, (ii) giving written advice with respect to any entity, transaction, plan or arrangement "having a potential for tax avoidance or evasion," and (iii) representing a client at conferences, hearings or meetings.[122]

Referrals to OPR

The IRS instructs its personnel to refer a potential promoter to OPR as soon as it appears that the individual has violated *any aspect* of Circular 230.[123] Moreover, the IRS dictates that referrals to OPR are mandatory, not discretionary, in cases where the IRS actually assesses promoter penalties. The IRS further clarifies that an OPR referral is not a substitute for sending a case to the DOJ for an injunction action, but rather a supplement thereto.[124]

Key Provisions

Summarized below are some of the key provisions in Circular 230 when it comes to the ERC.

Section 10.21 – Knowledge of a Client's Error or Omission

When a practitioner learns that a client has not complied with U.S. tax law or has made an error on, or omission from, any return, document, affidavit, or other item that the client previously filed or executed, the practitioner "must advise the client promptly" of the non-compliance, as well as the corresponding consequences.[125]

Section 10.22 – Diligence as to Accuracy

A practitioner must "exercise due diligence" in preparing, assisting in the

preparation of, approving, and filing of returns, documents, affidavits and other items relating to IRS matters.[126]

Section 10.27 - Fees Charged

Generally, a practitioner cannot charge an "unconscionable fee" in connection with any matter before the IRS.[127] This includes, but is not limited to, tax planning and advice, preparing or filing returns or claims for refund or credit, assisting in the preparation or filing of returns or claims, and all matters linked to a presentation to the IRS related to a taxpayer's rights, privileges, or liabilities.[128]

A practitioner ordinarily *cannot* charge a "contingent fee" for any services provided in connection with an IRS matter.[129] Why? The IRS believes that a rule against contingent fees "supports voluntary compliance with federal tax laws by discouraging return positions that exploit the audit-selection process."[130] There are a few exceptions to the general prohibition on contingent fees. First, a practitioner can charge such a fee for services related to the IRS's audit of, or other challenge to, (i) an original tax return, or (ii) an amended return or claim for refund or credit, but *only* if it was filed within 120 days after the taxpayer received a written notice from the IRS of audit or other challenge of the original tax return.[131] Second, a practitioner may charge a contingent fee for services related to a claim for refund or credit, provided that it was filed *solely* in connection with the determination of penalties or interest (not taxes) assessed by the IRS.[132] Third, a practitioner can propose a contingent fee for services related to any tax judicial/court proceeding.[133]

Circular 230 features an expansive definition of "contingent fee." It encompasses (i) any fee based, fully or partially, on whether a position on a tax return or other filing with the IRS is not challenged, or if it is challenged, it is ultimately sustained by the IRS or the court, (ii) any fee based on a percentage of a refund reported on a return, a percentage of taxes saved, or otherwise depends on specific results obtained, and (iii) any fee arrangement whereby the practitioner will reimburse the taxpayer for all or part of the fee paid if the position taken on a tax return or other filing is challenged by the IRS, or is not sustained by the IRS or a court, regardless of whether such reimbursement occurs pursuant to an indemnity agreement, guarantee, rescission right, or something similar.[134]

Section 10.29 – Conflict of Interest

Circular 230 logically prohibits practitioners from representing a client before the IRS if such representation involves a "conflict of interest."[135] For these purposes, an unacceptable conflict exists where representing one client will be directly adverse to another, or where there is a "significant risk" that a representation will be "materially limited" because of a practitioner's responsibilities to another client, a former client, a third person, or his own personal interests.[136] Even if a conflict exists, this might not be the end of it. Circular 230 indicates that a practitioner can still represent a client before the IRS if he "reasonably believes" that he can provide "competent and diligent" representation to the affected client, such representation is not illegal, and, most importantly, the affected client gives "informed consent" and waives the conflict in writing.[137]

Section 10.34 – Standards for Documents

A practitioner cannot sign a tax return or claim for refund that he knows, or should reasonably know, contains a position that lacks a reasonable basis, is "unreasonable," or constitutes either a willful attempt to understate taxes or a reckless or intentional disregard of the rules.[138]

When it comes to possible sanctions, a practitioner must inform a taxpayer of any penalties that are reasonably likely to apply with respect to

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ployee Retention Credit. Issue No. 2023-02 (March 7, 2023).

120 31 U.S.C. § 10.2(a)(5); 31 U.S.C. § 10.3.

121 31 U.S.C. § 10.2(a)(4).

122 31 U.S.C. § 10.2(a)(4); T.D. 9359, Summary of Comments and Explanation of Provisions, (Sept. 26, 2007), 72 Federal Register 54541.

123 Treasury Department, Circular 230, Title 31 of Code of Federal Regulations, Subtitle A, Part 10 (2014).

124 Internal Revenue Service. Tax Shelter Promoter Investigations under IRC 6700. LB&I Process Unit, Document Control Number PEN-P-005 (2021), pg. 39; Internal Revenue Manual § 4.32.2.13.2 (06-04-2018); Internal Revenue Manual § 4.32.2.13.2 (06-04-2018). IRS personnel make a referral by completing and submitting Form 8484 (Report of Suspected Practitioner Misconduct).

125 31 U.S.C. § 10.21.

126 31 U.S.C. § 10.22(a).

127 31 U.S.C. § 10.27(a).

128 31 U.S.C. § 10.27(c)(2).

129 31 U.S.C. § 10.27(b)(1).

130 T.D. 9359, Summary of Comments and Explanation of Provisions, (Sept. 26, 2007), 72 Federal Register 54541-54542.

131 31 U.S.C. § 10.27(b)(2); IRS Notice 2008-43.

132 31 U.S.C. § 10.27(b)(3).

133 31 U.S.C. § 10.27(b)(4).

134 31 U.S.C. § 10.27(c)(1).

135 31 U.S.C. § 10.29(a).

136 *Id.*

137 31 U.S.C. § 10.29(b).

138 31 U.S.C. § 10.34(a)(1). *See* Section 6694(a)(2).

139 31 U.S.C. § 10.34(c)(1).

140 31 U.S.C. § 10.34(c)(2).

141 31 U.S.C. § 10.34(d).

142 31 U.S.C. § 10.37(b).

143 *Id.*

144 Internal Revenue Service - Office of Professional Responsibility. Professional Responsibility and the Employee Retention Credit. Issue No. 2023-02 (March 7, 2023).

145 *Id.*

146 *Id.*

147 *Id.*

148 *Id.*

149 *Id.*

150 31 U.S.C. § 330(b); 31 U.S.C. § 10.50.

151 *Id.*

152 31 U.S.C. § 330(b); 31 U.S.C. § 10.50; Notice 2007-39.

153 Section 7701(a)(36)(A).

154 Treas. Reg. § 301.7701-15(b)(1) and (2).

155 Section 6694(a)(1); Section 6694(a)(2).

156 Section 6694(a)(1).

157 Section 6694(b)(1) and (2).

158 Section 6694(a)(3).

159 1.6694-2(e)(1).

160 Treas. Reg. § 1.6694-2(b)(1); Treas. Reg. § 1.6694-1(e)(1).

161 Treas. Reg. § 1.6694-1(e)(1); Treas. Reg. § 1.6694-1(e)(3), Example 3.

162 Treas. Reg. § 1.6694-2(e)(5).

163 Section 7525(a)(1).

164 Section 7525(a)(1), Section 77525(a)(2), Section 7525(a)(3); Section 7525(b); 31 U.S.C. § 330; and 31 C.F.R. § 10.3.

165 Section 7525(a)(2).

166 U.S. Senate, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-174 (April 22, 1998). Pgs. 70-71.

a position taken on his tax return, if the practitioner advised the taxpayer with respect to such position and/or he prepared or signed the return.[139] Additionally, the practitioner must tell the taxpayer of any opportunity to avoid penalties by disclosure to the IRS, if relevant.[140]

Lastly, with respect to tax-related information furnished by the taxpayer in connection with preparation of a return, a practitioner generally may rely on it in good faith, and without independent verification. With that said, a practitioner cannot "ignore the implication of information furnished to, or actually known by, the practitioner." Additionally, the practitioner "must make reasonable inquiries" where the information supplied by the taxpayer appears to be "incorrect, inconsistent with an important fact or another factual assumption, or incomplete."[141]

Section 10.37 – Reliance of Written Advice from Others

A practitioner may only rely on the advice of another person if such advice was "reasonable" and the reliance was "in good faith considering all the facts and circumstances."[142] Circular 230 cautions that reliance will *not* meet this standard when the practitioner knows, or reasonably should know, that the advice is not reliable, the person giving the advice is not competent or lacks the qualifications necessary to do so, or the person has a conflict of interest.[143]

New OPR Alert

This article now turns back to the new "alert" from OPR to practitioners involved with ERC claims.[144] Why did OPR take this unusual step? Well, many practitioners approached OPR seeking guidance on how to avoid problems when preparing and/or signing "original tax returns, amended returns, or claims for refund relating to these credits."[145] The alert underscored that ERC claims implicate several aspects of Circular 230. First, referencing due diligence and potential reliance on others under Section 10.22 and Section 10.34, the alert reminds practitioners that they must make reasonable inquiries of the taxpayer to confirm its eligibility for, and the correct amount of, ERCs. It 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, the alert explains that if a practitioner discovers that a current client violated the ERC requirements in a prior year, the practitioner has a duty to inform the client of the noncompliance and related penalties.[146]

Second, again alluding to Section 10.34 of Circular 230, the alert tells practitioners that all tax positions must have at least a reasonable basis. Expanding on this notion, the alert recommends 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.[147]

Third, the alert warns 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 explains that, if the previous advisor has a conflict of interest with the taxpayer because of the amount or type of fee he charged (*e.g.*, prohibited contingent fee), then the practitioner might not be able to reasonably rely on the documents from the advisor.[148]

The alert came on stronger it its conclusion, as follows:

> 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 terms of giving advice and preparing 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.[149]

Potential Penalties

OPR has the power to punish any practitioner who is incompetent, disreputable, violates any part of Circular 230, or willfully and knowingly misleads a person he is currently or potentially representing.[150] Punishments vary depending on the conduct, but they can consist of a temporary suspension, permanent disbarment, public censure, and/or monetary penalty.[151] With respect to the last item on the list, OPR has latitude to impose a financial toll reaching the gross income that the person derived, or will derive, from the conduct giving rise to the penalty.[152]

Return Preparer Penalties

The IRS might pursue "tax return preparer" penalties as part of its ERC enforcement, and readers should be aware that this term means far more than just the individual (*e.g.*, accountant or enrolled agent) who actually prepares and/or signs a Form 941 or Form 941-X claiming ERCs.

General Standards

Starting with the basics, the concept of "tax return preparer" is broad when it comes to penalties under Section 6694. It generally means any person who prepares for compensation, or who employs one or more other persons to prepare for compensation, any tax return or claim for refund, or a "substantial portion" of any return or claim.[153] It encompasses both "signing preparers" (*i.e.*, individuals who are primarily responsible for the overall substantive accuracy of a return or claim) and "non-signing preparers" (*i.e.*, individuals, other than signing preparers, who prepare all or a substantial portion of a return or claim).[154]

The IRS normally can penalize a return preparer in situations where (i) he prepared a tax return or a refund claim, (ii) the return or claim included a position, (iii) the position results in an understatement of the taxpayer's tax liability, (iv) he knew (or reasonably should have known) about the position, *and* (v) one of the following three standards is met. First, the position relates to a tax shelter or a re-

portable transaction, and it was not reasonable for the preparer to believe that the position would "more likely than not" be sustained if the IRS were to challenge it. Second, the position does not involve a tax shelter or reportable transaction, but it was not properly disclosed to the IRS and it lacked "substantial authority." Third, the position does not implicate a tax shelter or reportable transaction and it was correctly disclosed, but there was no "reasonable basis" for the position.[155]

Penalty Amount

The penalty equals $1,000 or 50 percent of the income that the preparer derived (or will derive) with respect to the relevant tax return or refund claim, whichever amount is larger.[156] The penalty increases to $5,000 or 75 percent of the income in cases where the preparer willfully attempts to understate the tax liability on the return or claim, and where the preparer recklessly or intentionally disregards the rules and regulations.[157]

Penalty Defenses

The IRS cannot assert a preparer penalty under Section 6694 if the preparer can demonstrate that there was reasonable cause for the tax understatement and he acted in good faith.[158] The IRS considers a number of factors in gauging whether to sanction a particular preparer, including the nature of the error that caused the tax understatement, if the error was isolated or recurrent, the materiality of the error, the normal office practice used by the preparer to ensure accuracy and consistency in preparing returns or claims, and whether the preparer followed generally accepted industry practice in taking the position in question.[159]

Similar to the OPR standards described above, Section 6694 indicates that a preparer ordinarily is allowed to rely in good faith on information provided by the taxpayer, as well as information and advice provided by another advisor, preparer, or party, without independently verifying it.[160] Reliance has its limits, though. For instance, a preparer cannot ignore the implications of the items furnished, he must make "reasonable inquiries" if any item appears to be incorrect or incomplete, and he has a duty to determine whether all the facts and circumstances required by the Internal Revenue Code, regulations, and other guidance as a condition to claiming a deduction or credit have been met.[161] A preparer normally can rely on advice given by, or documents prepared by, another advisor, preparer, or some other person. Such reliance is prohibited, however, where the advice or a document is unreasonable on its face or the preparer knew (or should have known) that the prior individual was incompetent or unaware of all the facts.[162]

Challenges to Privilege

The IRS has become more aggressive in its efforts to gather all potentially relevant data, despite the fact some might be confidential. This scenario often arises when taxpayers engage in aggressive actions, including making large ERC claims, and then decline to provide copies of related communications with advisors on grounds that they are protected by the federally authorized tax professional ("FATP") privilege.

Overview

Section 7525 generally provides that the protections that apply to communications between taxpayers and their attorneys shall extend to communications between taxpayers and their FATPs.[163] This general rule faces several limitations. It *only* applies to (i) "tax advice," not return preparation and other services, (ii) provided by a person who qualifies as an FATP, such as a certified public accountant, enrolled agent, registered tax return preparer, and others, (iii) involving non-criminal matters, (iv) in connection with an administrative or judicial tax matter, where the IRS or DOJ is a party, and (v) not involving "tax shelters."[164]

Clarifications on Scope

Congress enacted Section 7525 more than two decades ago, in 1998, but the IRS never issued corresponding regulations. Therefore, one must turn to other sources, such as legislative history, to get more details about the magnitude of the FATP privilege.

Civil Federal Tax Matters Only

Section 7525 explains that the FATP privilege can only be asserted in "any non-criminal matter before the [IRS], and any non-criminal tax proceeding in federal court brought by or against the United States."[165] Stated another way, the FATP privilege does *not* apply to criminal actions, state tax skirmishes, civil disputes between private parties, and matters with non-tax gov-

NOTES

[167] *Chao v. Koresko*, 2005 WL 2521886 (3rd Cir. 2005).

[168] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (June 24, 1998), pg. 267.

[169] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (June 24, 1998), pg. 269.

[170] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (June 24, 1998), pgs. 268-269 (emphasis added).

[171] U.S. House of Representatives, Internal Revenue Restructuring and Reform Act of 1998, 105th Congress, 2d Session, Report 105-599 (June 24, 1998), pg. 269.

[172] Section 7525(b). This rule actually applies to any person, any director, officer, employee, agent, or representative of such person, or any other person holding an ownership interest in such person. *Id*.

[173] U.S. House of Representatives, American Jobs Creation Act of 2004, 108th Congress, 2d Session, Conference Report 108-755 (Oct. 7, 2004), pg. 605.

[174] Section 7525(b)(2); Section 6662(d)(2)(C)(ii); Treas. Reg. § 1.6662-4(g)(2)(i).

[175] *United States v. BDO Seidman, LLP*, 100 AFTR 2d 2007-5052, 492 F.3d 806 (DC CA 2007).

[176] The author of this article has number conflict-of-interest IDRs in his possession.

[177] *Neonatology Associates, P.A. et al v. Commissioner*, 115 T.C. 43 (2000), pgs. 88-94.

[178] Section 10.29(a) of Treasury Department Circular 230.

[179] Tax Court Rules & Procedures 24(g)(1); *See also* American Bar Associate Model Rules of Professional Conduct 1.7 and 1.8; *See also* Tax Court Rules & Procedures 201(b) (stating that the Tax Court can require a practitioner "to furnish a statement, under oath, of the terms and circumstances of his or her employment in any case."); Tax Court Rules & Procedures 24(g)(2)(A).

ernmental agencies.[166] This issue has been tested in at least one case, where the court ruled that the FATP privilege did not shield a taxpayer in a proceeding to challenge an administrative summons issued by the Department of Labor, despite the fact that the Department of Labor could later share the information that it obtained from the taxpayer with the IRS.[167]

The Privilege Can Be Waived

The FATP privilege, like others, is not absolute. It can be waived unintentionally when parties are not cautious. The legislative history states the privilege is inapplicable where a communication is made to one party, like an FATP, such that he can convey it to another party.[168] It also explains that the privilege can be relinquished when an FATP reveals an otherwise protected communication from a taxpayer to third parties, by copying them on an e-mail, for instance.[169]

No Expansion of Existing Protections

The legislative history clarifies that the FATP privilege does not enlarge any existing protections; its sole effect is to expand their applicability to non-attorneys. Notably, it confirms that data

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provided in connection with preparing a return does *not* become privileged, merely by supplying it to an attorney or FATP: "Information disclosed to an attorney *for the purpose of preparing a tax return* is not privileged under present law [and it] would not be privileged under [Section 7525], whether it was disclosed to an attorney, certified public accountant, enrolled agent, or enrolled actuary."[170]

Raising the Defense Might Backfire

The legislative history subtly warns that relying on the FATP privilege could potentially backfire, particularly if the "tax advice" provided was akin to legal advice, which only licensed *attorneys* can provide. Put another way, Congress cautioned advisors against inadvertently admitting that they engaged in the illegal practice of law.[171]

Tax Shelter Exception

The most important limitation on the FATP privilege, for purposes of this article, is the "tax shelter" exception. The FATP privilege does *not* apply to (i) any written communication, (ii) between an FATP and another person, (iii) in connection with the "promotion" of the participation by the person, either directly or indirectly, (iv) in any "tax shelter."[172] This restriction applies to all tax shelters, regardless of whether they were entered into by individuals, corporations, partnerships, tax-exempt entities, or any other entity.[173] The term "tax shelter" in this context is broadly defined to encompass any partnership, corporation, trust or other entity, investment plan or arrangement, or other plan or arrangement, "a significant purpose" of which is avoiding or evading federal income tax.[174] Importantly, the IRS must supply the court with enough evidence to satisfy each element of the tax shelter exception, but it does *not* have to demonstrate that a crime or fraud actually occurred.[175]

Scrutinizing Conflicts of Interest

The IRS has been issuing specialized Information Document Requests ("IDRs") as part of various "compliance campaigns" over the past few years.[176] This trend has now reached those defending ERC claims, and it could have several consequences. The IRS is not coy about its objective; the IDRs expressly state that their purpose is "to identify conflicts with" the person representing the taxpayer during the audit. It then proceeds to ask many questions about the audit representative, his role, his relationship with the taxpayer, and much more. A few examples follow:

1. Was the representative involved in any manner in promoting, marketing and/or providing advice regarding the tax position or transaction? If so, what was the specific nature of the involvement? If so, what materials did the representative provide to, and what communications (oral, written or electronic) did the representative have with, the taxpayer?
2. If somebody other than the representative promoted, marketed and/or provided advice to the taxpayer, what relation does the representative have with such person?
3. What fees, commissions, or other amounts did the taxpayer pay the representative in connection with the tax position or transaction?
4. What fees, commissions, or other amounts did the representative pay any other party in connection with the tax position or transaction involving the taxpayer, including, but not limited to, amounts for referring potential clients, conducting due diligence, providing advice, issuing opinions, or preparing studies, analyses, reports, calculations, or returns?
5. Has the representative in any way promoted, marketed and/or provided advice to the taxpayer about a similar tax position or transaction in any prior year?
6. Does the representative have a conflict of interest with the taxpayer, as defined by Section 10.29 of Circular 230? If so, has the taxpayer expressly waived such conflict and provided the representative written informed consent?
7. Did the representative or any other party provide a written tax or legal opinion to the taxpayer? If so, has the representative provided copies of all opinions to the IRS?
8. If the representative has withheld any documents from the IRS during the audit on grounds that they are privileged, confidential, or otherwise protected, has he supplied the IRS a complete privilege log?

Some advisors, attorneys, accountants, and others offering assistance in making ERC claims include "audit defense" as part of the package. Their participation on both the pre-claim and post-claim side of the equation surely will trigger conflict-of-interest IDRs by the IRS. The IRS likely will issue these IDRs in *all* ERC audits as a matter of course anyway, consistent with its recent procedure for all compliance campaigns. Why is this important, to both representatives and taxpayers? First, the IRS uses these IDRs to identify individuals on whom it will initiate a promoter investigation under Section 6700, impose various penalties, and/or subject to an OPR referral. Second, the IRS might attempt to undermine potential penalty defenses by taxpayers on grounds that they cannot "reasonably rely" on anybody who has an inherent conflict of interest, is an insider or promoter, or lacks financial independence.[177] Third, the IRS might argue that a conflict of interest renders a particular representative ineligible to participate in the audit.[178] Fourth, based on the information provided in response to the IDRs, the IRS might contend that the FATP never existed or it has been waived, such that the IRS can access otherwise confidential communications involving the taxpayer, representative, and others. Fifth, the IRS might play the long game, creating a record to support a Motion to Disqualify Opposing Counsel during Tax Court litigation on grounds that an insurmountable conflict of interest exists or the representative

"is likely to be a necessary witness."[179]

Conclusion

The IRS has been pursuing alleged "promoters" and other "enablers" of aggressive, questionable or downright fraudulent ERC claims for some time, and these efforts are intensifying. Those in the crosshairs usually know about *some* of the potential penalties and actions that the IRS might employ, and they might prepare for those. However, as this article demonstrates, the IRS also has more obscure tactics, which it might use given the magnitude of the perceived ERC problem. Those likely to be targeted by the IRS for alleged ERC infractions might be oblivious to, and thus blindsided by, these lesser known IRS approaches.