taxnotes federal

Volume 182, Number 11 ■ March 11, 2024

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by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, March 11, 2024, p. 1981

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ERCs: Probing the Strength of IRS Penalty Threats

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In this article, Sheppard examines the evolving employee retention credit guidance from Congress and the IRS and explains that taxpayers pondering their next move need to determine how much weight they should give IRS penalty threats, considering the unique circumstances.

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I. Introduction

The IRS is trying various methods to halt what it considers improper employee retention credit claims. Among other things, it has threatened to assert penalties against taxpayers with the goal of stopping aggressive ERC submissions, strong-arming concessions during audits, deterring the filing of refund suits in court, and encouraging the return of ERC amounts through recent settlement programs. Browbeating taxpayers with potential penalties is standard stuff, but it becomes particularly interesting in the ERC context when the IRS's ability to carry out its warnings is questionable.

This article, the latest in a long list by the author, describes the evolving ERC guidance from Congress and the IRS, explains its significance, highlights the recurrent themes of ERC complexity and taxpayer victimization, reviews relevant penalty-mitigation standards, and suggests that taxpayers pondering their next move need to determine how much weight they should give IRS penalty threats.

II. Evolving ERC Guidance

Information about the ERC, primarily from Congress and the IRS, is a work in progress. Lots of guidance has been released over time. Below is an overview of the main items.

A. First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act in March 2020.[1] It generally provided that an eligible employer could claim ERCs against certain employment taxes equal to 50 percent of the qualified wages paid to each employee for each quarter.[2]

An eligible employer meant one that was carrying on a trade or business in 2020 and met one of the following two tests. First, the employer's operations were partially or fully suspended because of an order from an appropriate governmental authority that limited commerce, travel, or meetings for commercial, social, religious, or other purposes because of COVID-19 (governmental order test).[3] Second, the employer suffered a significant decline in gross receipts (reduced gross receipts test).[4]

The notion of qualified wages depended on the number of full-time employees working for an eligible employer before things went downhill. There were two categories of eligible employers. When an eligible employer had an average of more than 100 full-time employees (large eligible

[1] *See* Joint 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.

[2] CARES Act, section 2301(a).

[3] CARES Act, section 2301(c)(2)(A)(ii)(I).

[4] CARES Act, section 2301(c)(2)(A)(ii)(II).

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employer), qualified wages meant those paid to any employee who was not providing services.[5] Conversely, when an eligible employer had an average of 100 or fewer full-time employees (small eligible employer), qualified wages meant all wages paid during a quarter, regardless of whether the employees were actually working.[6] In addition to the amounts described above, qualified wages included the qualified health plan expenses paid by the eligible employer that were allocable to the qualified wages.[7]

Benefits were limited under the CARES Act. In particular, the amount of qualified wages for any one employee could not exceed $10,000 for all quarters combined in 2020. Thus, after applying the 50 percent limit, the maximum ERC per employee for all of 2020 was $5,000.[8]

Coverage of the ERC changed several times but it originally applied to qualified wages paid by eligible employers during the second, third, and fourth quarters of 2020.[9]

Congress instructed the IRS to issue "such forms, instructions, regulations and guidance as are necessary" to accomplish a long list of things related to the ERC.[10]

B. Notice 2021-20

The IRS released its first major guidance in March 2021. Notice 2021-20, 2021-11 IRB 922, was massive. It filled more than 50 pages, replete with rules, terminology, examples, and more.[11]

C. Second Law

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 in December 2020.[12] That legislation modified the existing ERC law in several ways, some of which are explored below.[13]

Eligible employers originally could claim ERCs only for the second, third, and fourth quarters of 2020. The relief act broadened the scope, adding the first and second quarters of 2021.[14]

The relief act made several changes related to qualified wages, too. For example, it increased the relevant percentage. The CARES Act contemplated an eligible employer getting an ERC equal to 50 percent of the qualified wages paid to each employee for each quarter. The relief act raised that to 70 percent.[15] Moreover, the relief act favorably adjusted the cap on qualified wages. The amount was initially $10,000 per employee for all quarters, creating a maximum ERC of $5,000 per employee. The relief act increased this to $10,000 for each employee, for each quarter.[16]

The relief act also modified the standards for being a small eligible employer and a large eligible employer, thereby making it easier to claim ERCs for all wages paid to employees during certain quarters, not just to those who were not providing services. Large eligible employers became those whose average number of full-time employees during the relevant period was more than 500 (instead of more than 100), while small eligible employers were those with an average of 500 or fewer.[17]

The relief act also eliminated the earlier rule that the qualified wages paid by a large eligible employer to an employee cannot surpass the amount that the employee would have been paid for actually working the same amount of time during the 30 days immediately before the period

[5] CARES Act, section 2301(c)(3)(A)(i).

[6] CARES Act, section 2301(c)(3)(A)(ii)(I) and (II). These standards later changed from 100 to 500 full-time employees. *See* Consolidated Appropriations Act, 2021, division EE, section 207; and Notice 2021-23, 2021-16 IRB 113, Section III.E.

[7] CARES Act, section 2301(c)(3)(C)(i).

[8] CARES Act, section 2301(b)(1); JCT, JCX-12R-20, *supra* note 1, at 38.

[9] CARES Act, section 2301(m); *see also* Notice 2021-20.

[10] CARES Act, section 2301(1).

[11] Notice 2021-20.

[12] Consolidated Appropriations Act, 2021, division EE, section 207.

[13] *See generally* JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021).

[14] Consolidated Appropriations Act, 2021, division EE, section 207(a).

[15] *Id.*

[16] *Id.*

[17] *Id.*

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when the governmental order test or reduced gross receipts test was met.[18]

The standards for meeting the reduced gross receipts test were lowered under the relief act, which made achieving eligible employer status easier. Instead of gross receipts having to fall below 50 percent of the previous mark, they only had to be less than 80 percent during the same quarter in 2019.[19]

The relief act also gave employers the power to elect, in determining whether they met the reduced gross receipts test, to compare the gross receipts of the immediately preceding quarter to those for the corresponding quarter in 2019, instead of using the quarter for which the ERC is claimed.[20]

D. Notice 2021-23

The IRS needed to provide yet more administrative direction after Congress released the relief act. This time, it came in the form of Notice 2021-23, 2021-16 IRB 1113. The new guidance was hefty again, occupying more than 10 pages with data specific to the relief act.[21]

E. Third Law

Congress passed the American Rescue Plan Act of 2021 in March 2021. That law further expanded the ERC, allowing eligible employers to claim benefits for the third and fourth quarters of 2021.[22] Thus, at that point, the ERC was available for the second, third, and fourth quarters of 2020 (under the CARES Act), the first and second quarters of 2021 (under the relief act), and the third and fourth quarters of 2021 (under ARPA).

ARPA also created a new type of eligible employer, the so-called recovery startup business. That was an employer that began carrying on a trade or business after February 15, 2020, and whose average annual gross receipts during the relevant period did not exceed $1 million.[23]

ARPA added new rules about "severely financially distressed employers," too. These are employers whose gross receipts during the relevant quarter were less than 10 percent of those in the previous comparable quarter. For this narrow category of struggling businesses, the term "qualified wages" means all wages paid to employees during all relevant quarters.[24]

In terms of enforcement, ARPA granted the IRS more time to audit taxpayers who might be misbehaving. In particular, the law created an exception to the general three-year rule on assessments; it allowed the IRS five years from the date on which the relevant employment tax return was filed or deemed filed to audit, propose taxes and penalties, and issue a final notice.[25]

F. Notice 2021-49

Notice 2021-49, 2021-34 IRB 316, was next in the series of IRS guidance.[26] It contained supplemental guidance on different issues that had arisen since Congress first introduced the ERC.[27] Like the earlier releases from the IRS, this one was substantial, consisting of nearly 20 pages. The information generally applied to all quarters covered by the ERC under all legislation to date. In other words, the guidance from the IRS, first released to the public in August 2021, was retroactive back to March 2020. That triggered the filing of many Forms 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund," to make changes to incorporate the IRS's new direction about the definition of full-time employees, treatment of tips, special rules for related parties, using inconsistent quarters for making gross receipt comparisons, and unique rules in cases in which employers acquire a business.[28]

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[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] Notice 2021-23.

[22] ARPA, section 9651(a).

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] Notice 2021-20 continues to apply to the second, third, and fourth quarters of 2020, and Notice 2021-23 continues to apply to the first and second quarters of 2021. *See* Notice 2021-49, 2021-34 IRB 316, Section I.

[27] Notice 2021-49, Section IV.

[28] *Id.*

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G. Rev. Proc. 2021-33

The IRS created a safe harbor that allows taxpayers to exclude certain items from gross receipts when calculating that figure for ERC purposes, including loans forgiven under the Paycheck Protection Program.[29]

Rev. Proc. 2021-33, 2021-34 IRB 327, says that an employer can ignore 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" this safe harbor.[30] This means that the employer must disregard the loans for all relevant quarters, and not include and exclude amounts at its whim to satisfy a particular standard or percentage.[31] The safe harbor applied to all periods relevant to the ERC, namely, the second quarter of 2020 forward.[32] This retroactive stance by the IRS obligated many eligible employers to file yet more Forms 941-X.

H. Fourth Law

Congress enacted the Infrastructure Investment and Jobs Act in November 2021.[33] That legislation announced the end of the ERC and it shortened the periods for claiming benefits. Eligible employers, except recovery startup businesses, could no longer solicit ERCs for the fourth quarter of 2021. As a result, ERCs for most eligible employers could not surpass a total of $26,000, an amount based on $5,000 for 2020 in its entirety, plus $7,000 for each of the first, second, and third quarters of 2021.[34]

I. Notice 2021-65

The IRS issued Notice 2021-65, 2021-51 IRB 880, to clarify the IIJA. It began, of course, with confirmation that most eligible employers could not claim ERCs for the fourth quarter of 2021.[35] 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 the fourth quarter of 2021 constituted "erroneous refunds" that must be repaid and that delinquencies would be penalized.[36]

J. 'Dirty Dozen' List

The next guidance from the IRS, loosely defined, was the placement of improper ERC claims atop the "Dirty Dozen" list in March 2023.[37]

K. Office of Professional Responsibility Alert

The IRS's Office of Professional Responsibility issued an alert in March 2023 underscoring that ERC claims implicate several aspects of Circular 230.[38] First, referencing due diligence and reliance 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 explained that if a practitioner discovers that a current client violated the ERC requirements in a prior period, the practitioner has a duty to inform the client of the noncompliance and related penalties.[39]

Second, again alluding to section 10.34 of Circular 230, the alert told practitioners that all tax positions must have at least a reasonable basis. Expanding on this notion, the alert recommended that practitioners with clients that previously made unwarranted or excessive ERC claims advise them of the option to file Forms 941-X.[40]

Third, the alert warned practitioners that they might not be able to rely on opinions, reports, analyses, and similar documents prepared by others when it comes to making ERC claims. It

[29] Rev. Proc. 2021-33, 2021-34 IRB 327, section 1. *See* Paycheck Protection Program Flexibility Act of 2020.

[30] Rev. Proc. 2021-33, section 3.03.

[31] *Id.*

[32] Rev. Proc. 2021-33, section 6.

[33] *See also* Notice 2021-65, 2021-51 IRB 880.

[34] Notice 2021-65, Section III.B.

[35] Notice 2021-65, Section III.A.

[36] Notice 2021-65, Section III.B.

[37] IR-2023-49.

[38] Office of Professional Responsibility, "Professional Responsibility and the Employee Retention Credit," Issue No. 2023-02 (Mar. 7, 2023).

[39] *Id.*

[40] *Id.*

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explained that, if the previous adviser has a conflict of interest with the taxpayer because of the amount or type of fee he charged (for example, a prohibited contingent fee), then the practitioner might not be able to reasonably rely on the documents from the adviser.[41]

L. Legal Memo About Supply Chain Issues

The IRS supplied additional guidance in July 2023. This time it came as a generic legal advice memorandum (GLAM) centering on the interplay between the governmental order test and supply chain problems.[42]

The GLAM summarized the IRS's position as follows. An employer can "step into the shoes" of its supplier. However, this is not easy, since an employer must show that (1) the supplier was subject to an acceptable governmental order during the relevant period, (2) that order caused the supplier to suspend its operations, (3) the inability to obtain goods or materials from the supplier caused a full or partial suspension of the employer's operations, and (4) it was unable to procure goods or materials from an alternative source.[43] The IRS examined five scenarios in the GLAM against that backdrop.

In Scenario 1, Employer A was not subject to a governmental order at any time. However, during 2020 and 2021, Employer A experienced several delays in receiving critical goods from Supplier 1. At all times during 2020 and 2021, Employer A continued to operate because it had a surplus of the critical goods normally provided by Supplier 1. Employer A assumed that Supplier 1's delay in delivering critical goods was caused by COVID-19. Employer A inquired in this regard, and Supplier 1 vaguely confirmed that the delay was because of COVID-19, but it did not provide a copy of any governmental order, and Employer A was unable to locate one independently. The IRS ruled that Employer A was not an eligible employer because it could not demonstrate that a government order applicable to Supplier 1 partially or fully suspended Supplier 1's operations. Moreover, even if Employer A received or could locate a governmental order applicable to Supplier 1, Employer A was not forced to cease operations because it had a reserve of critical goods. Consequently, Employer A did not experience a suspension of operations because of an inability to obtain Supplier 1's critical goods. The relevant inquiry, emphasized the IRS, is whether Employer A's operations could continue. Because Employer A was able to continue its own business operations despite the supply chain disruption, it was not subject to a suspension.

In Scenario 2, Employer B was not subject to a governmental order at any time. However, certain critical goods from Supplier 2 were stuck at port. Employer B assumed that the bottleneck was a result of COVID-19, but it could not identify any specific governmental order to that effect. Some news sources stated that COVID-19 was the reason for the bottleneck, while others cited different causes, such as increases in consumer spending and aging infrastructure. Also, Supplier 2 mentioned to Employer B that other critical goods that were not stuck at port also would be delayed because of a shortage of truck drivers. Employer B saw discussions on social media indicating that the truck driver shortage was caused by drivers being out sick with COVID-19. The IRS concluded that Employer B was not an eligible employer because it could not demonstrate that a governmental order applicable to Supplier 2 partially or fully suspended Supplier 2's operations. Also, while COVID-19 may have been a contributing factor to the bottleneck at the port or to the truck driver shortage, Employer B could not substantiate that any specific governmental order caused these problems.

In Scenario 3, Employer C and Supplier 3 were located in a jurisdiction that issued governmental orders suspending both of their business operations during April 2020. The orders were lifted in May 2020. For the remainder of 2020 and 2021, Employer C experienced a delay in receiving critical goods from Supplier 3. Supplier 3 did not provide a reason for the delay, but Employer C assumed that it was because of the governmental order in place back in April 2020. The IRS determined that Employer C was an eligible employer in the second quarter of 2020 because its business operations were partially or

[41] *Id.*

[42] AM 2023-005 (July 21, 2023).

[43] *Id.*

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fully suspended because of a governmental order. However, only those wages paid during the second quarter of 2020, when Employer C's operations were actually suspended, were qualified wages. The IRS further explained that Employer C was not an eligible employer for any other quarter in 2020 or 2021 because it cannot show that a governmental order applicable to Supplier 3 partially or fully suspended Supplier 3's operations. The residual delays caused by a governmental order in place during a prior quarter will not constitute a governmental order in subsequent quarters once the order has been lifted.

In Scenario 4, Employer D was not subject to a governmental order at any time. During 2020 and 2021, Employer D could not obtain critical goods from Supplier 4, but it managed to get them from an alternative supplier. The alternative supplier charged 35 percent more than Supplier 4. This meant that Employer D could continue operating its business, but it was not as profitable as it had been in 2019. The IRS indicated that Employer D was not an eligible employer because it was not prevented from operating at any point during 2020 or 2021, and incurring a higher cost for critical goods, alone, does not constitute a partial or full suspension of operations.

In Scenario 5, Employer E operated a large retail business selling a variety of products. It was not subject to a governmental order in 2021. Because of several supply chain disruptions, Employer E was not able to stock a limited number of products, and it was obligated to raise prices on other products that were in short supply. However, the product shortage did not prevent Employer E from continuing to fully operate during 2021. The IRS explained in the GLAM that Employer E was not an eligible employer during 2021 because it could not demonstrate that (1) a governmental order applicable to a supplier of critical goods or materials caused the supplier to suspend operations, and (2) it was unable to obtain critical goods and materials elsewhere. The IRS observed that Employer E was able to operate its business at all times in 2021. While certain products were unavailable, Employer E was still able to offer a wide variety of products to its customers and it was not forced to partially suspend operations.

M. Guidance on Governmental Employers

The IRS later turned its attention to those working at a federal credit union (FCU).

The CARES Act, which pertained to the second, third, and fourth quarters of 2020, prohibited governmental employers from benefitting from ERCs. That initial law said that the incentives will not apply to "the Government of the United States, the government of any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing."[44]

Notice 2021-20 also made that restriction quite clear. It first underscored that the ERC "does not apply to the Government of the United States, the government of any State or political subdivision thereof, or any agency or instrumentality of those governments, [such that] these entities are not Eligible Employers."[45] Next, Notice 2021-10, 2021-7 IRB 888, pondered how an organization can determine whether the IRS will consider it an "instrumentality" of the federal, state, or local government for ERC purposes. It explained that the IRS generally considers six factors, none of which is determinative by itself.[46]

The second round of ERC standards, derived primarily from the relief act, dramatically changed things. The relief act preserved the original ban on governmental employers but created a notable exception. It provided that the existing restriction will not apply to (1) any organization described in section 501(c)(1) and exempt from tax under section 501(a), or (2) any governmental employer that is a college or university, or whose principal purpose or function is providing medical or hospital care.[47] The corresponding guidance from the IRS, found in Notice 2021-23, contained much of the same information, with a few extra touches. Among other things, it said that governmental employers

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[44]CARES Act, section 2301(f).

[45]Notice 2021-20, Section II(B), Background.

[46]Notice 2021-20, Section III, Question 2 (citing Rev. Rul. 57-128, 1957-1 C.B. 311).

[47]Consolidated Appropriations Act 2021, division EE, section 207(d)(3); JCT, JCX-3-21, *supra* note 13, at 69.

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could only be eligible employers, and thus apply for ERCs, from the first quarter of 2021 forward. They did not enjoy retroactive eligibility for the second, third, and fourth quarters of 2020.[48]

Talk about governmental employers fell silent, but it returned in August 2023 when the IRS published a chief counsel advice memorandum.[49] It began by summarizing the relevant portions of the ERC legislation and related IRS guidance. It then turned to FCUs. The IRS explained that the Federal Credit Union Act, introduced nearly a century ago, allowed the creation of FCUs to combat limited credit availability and high interest rates by encouraging average citizens to pool their resources. It further indicated that each FCU acts as a "fiscal agent" of the U.S. government, performing various services associated with collecting, lending, borrowing, and repaying money. The IRS went on to note that the National Credit Union Administration Board has authority to investigate FCUs, suspend or revoke their charters, and even place them into involuntary liquidation. Finally, the IRS underscored that FCUs are exempt from all income taxes.

Consistent with its earlier guidance in Notice 2021-10, the IRS said that it contemplates six primary factors when determining whether an entity is an instrumentality of a federal, state, or local government.[50] The IRS concluded that FCUs are instrumentalities for ERC purposes because they are created by federal statute, serve the governmental purpose of fomenting the economic well-being of underserved populations, perform governmental functions when they act as fiscal agents, and are controlled and supervised by a public authority. The IRS explained that, because FCUs are instrumentalities of the federal government, and because they are tax exempt, they might qualify as eligible entities in the context of ERCs.

The chief counsel advice came to the following four conclusions. FCUs cannot claim ERCs for the second, third, and fourth quarters of 2020 because the CARES Act explicitly prohibits instrumentalities of the federal government from doing so. FCUs can claim ERCs for the first and second quarters of 2021 because, although they are instrumentalities, they meet the exception introduced by the relief act. FCUs can claim ERCs for the third quarter of 2021 in accordance with ARPA because they are excepted instrumentalities. Finally, FCUs can claim ERCs for the fourth quarter of 2021 for the same reason, as long as they are also recovery startup businesses.

N. Legal Memo About OSHA Communications

The IRS issued a GLAM in October 2023 addressing the relationship between the governmental order test, partial or full suspension of business operations, and "communications" by the Occupational Safety and Health Administration.[51] Notably, the GLAM was published more than three-and-a-half years after Congress created the CARES Act, more than two-and-a-half years after the IRS published Notice 2021-20, and some time after many taxpayers had already filed ERC claims with the IRS.

The specific issue addressed in the GLAM was whether an employer can rely on OSHA communications about preventing the spread of COVID-19 in the workplace in order to meet the definition of eligible employer for ERC purposes.

The GLAM described three documents that OSHA issued in connection with COVID-19. The first was the Interim Enforcement Response Plan, which recommended multiple safety controls, including social distancing, maintaining ventilation systems, and using masks. The GLAM emphasized that OSHA's website features a disclaimer, stating that OSHA rules are set by statute, standards, and regulations, and interpretations of these sources, including those in the Interim Enforcement Response Plan, "cannot create additional employer obligations." The GLAM went on to explain that the Interim Enforcement Response Plan is not addressed to any specific employer, does not establish a blanket mandate or new requirements for all

[48] Notice 2021-23, Section III(B) and Section IV; *see also* Consolidated Appropriations Act 2021, division EE, section 207(k).

[49] ILM 202333001; Fred Stokeld, "IRS Clarifies Availability of Retention Credit for Credit Unions," *Tax Notes Federal*, Aug. 28, 2023, p. 1524.

[50] *See* Notice 2021-20, Section III, Question 2 (citing Rev. Rul. 57-128).

[51] AM 2023-007 (Oct. 18, 2023).

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workplaces, and represents nothing more than instructions to field personnel about evaluating workplace hazards triggered by COVID-19.

The second OSHA communication was called Protecting Workers Guidance. The GLAM explained that, although this document references "mandatory OSHA standards," it merely contains recommendations that are "advisory in nature and informational in content," and does not constitute a law, standard, or regulation.

The third item mentioned in the GLAM was an OSHA directive, providing personnel guidance regarding policies and procedures for home-based worksites. The GLAM explained that the directive underscores that "OSHA respects the privacy of the home and has never conducted inspections of home offices."

The GLAM then began its analysis. It pointed out that the CARES Act, later codified with certain changes as section 3134, requires a governmental order, and never mentions "recommendations, guidelines, or other information standards." Moreover, because the CARES Act does not specifically define the term "order," the IRS must use principles of statutory interpretation. The GLAM thus turned to the ordinary meaning of the word, as found in the dictionary. According to that source, an "order" normally means a command or mandate given by a government official, and the OSHA communications described above do not command or mandate an employer to take any action. The GLAM then got more specific, looking at the law that created OSHA, the Occupational Safety and Health Act. It explained that nonbinding guidance, such as that in the Interim Enforcement Response Plan and the Protecting Workers Guidance, is not considered an "order" under that legislation.

The IRS was not finished yet, though. The GLAM further explained that the OSHA communications probably would not support an ERC claim, even if they were to be considered governmental orders. Why? The rules require that an employer be subject to a governmental order and that the order cause a partial or full suspension of operations. The GLAM suggests that the recommendations by OSHA to wear masks, offer sanitation supplies, and encourage social distancing likely would not have more than a "nominal effect" on an employer's ability to operate its business.

The GLAM concluded by applying its reasoning to two scenarios. In the first one, the employer is located in a jurisdiction that lifted all COVID-related orders in the first quarter of 2021. At that time, the employer ceased all mitigation measures, other than encouraging employees to wear masks and use routine hygiene practices. The employer claimed ERCs for the second and third quarters of 2021 on the grounds that its business operations were partially suspended because of the OSHA communications. The IRS concluded that (1) the OSHA communications did not constitute an order for ERC purposes, and (2) even if they did, the employer could not demonstrate that the limited measures in place during the second and third quarters of 2021 had more than a nominal effect on its business operations.

The second scenario was the same as the first, except that, before 2020, the employees had teleworked two or three times per week. Starting the first quarter of 2020 and continuing through the third quarter of 2021, the employer allowed the employees to telework on a full-time basis. The IRS concluded that (1) the OSHA communications did not constitute an order for ERC purposes; (2) even if they did, the employer could not demonstrate that the limited measures in effect during the second and third quarters of 2021 had more than a nominal effect on its business operations; (3) the employer was able to continue operations in a comparable manner, as its employees were already equipped to telework before COVID-19 hit; and (4) as stated in its directive, OSHA does not inspect home offices.

O. Frequently Asked Questions

Approximately one month after Congress enacted the CARES Act, the IRS first posted frequently asked questions about ERC issues on its website in April 2020.[52] The IRS has added,

[52]IR-2020-62 (referencing the questions no longer accessible by internet).

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deleted, and otherwise changed those FAQs over the years. For instance, it made major changes in July, September, and November 2023.[53]

III. Significance of IRS Guidance

The IRS has issued a considerable amount of guidance about ERC issues. That seems positive in theory, but it has created problems in practice, largely because it is unclear who, if anyone, can rely on what the IRS says. For example, the IRS issued two GLAMs and a chief counsel advice analyzing distinct ERC matters. Each of them expressly states that the advice provided by the IRS "may not be used or cited as precedent."

The IRS also offered guidance in the form of FAQs. That information reached the public quickly, of course, but its effect has been questioned by many. For example, the national taxpayer advocate explained the following in her recent report to Congress: "Informal guidance, like FAQs and online [IRS] tools, project the appearance of certainty, but taxpayers can't actually rely on such informal guidance to defend the merits of their positions in an audit or litigation."[54] The IRS, likewise, has recognized the limitations of disseminating information through FAQs. It indicates that "FAQs that have not been published in the [Internal Revenue] Bulletin will not be relied on, used, or cited as precedents by [IRS] personnel in the disposition of cases" and that "only guidance that is published in the [Internal Revenue] Bulletin has precedential value."[55]

Finally, the IRS produced its most substantive ERC guidance in four notices, issued soon after each of the four major laws enacted by Congress. Those notices were published in the Internal Revenue Bulletin, which normally creates legitimacy. However, uncertainty regarding the effect of the notices exists because taxpayers are asking the courts to invalidate them on the ground that the IRS failed to comply with the Administrative Procedure Act in issuing them.[56]

IV. Complexity and Victimization

The IRS has issued a considerable amount of data about ERC issues as they evolve, often as information releases, news releases, tax tips, and the like. The content varies, but two recurrent themes predominate. First, the ERC rules are complex and fluid. Second, many taxpayers have been victimized by companies encouraging aggressive or unsupportable positions. Below is just a sample of this messaging from the IRS.

The IRS warned in October 2022 that some parties "are taking improper positions related to taxpayer eligibility for, and computation of, the credit."[57]

The IRS indicated in March 2023 that parties continued to aggressively advertise improper ERC "schemes" using various outlets and they often neglected to inform taxpayers that they must reduce the wages-paid deduction on their federal income tax returns.[58]

When placing improper ERC claims atop its Dirty Dozen list later that month, the IRS cautioned taxpayers to "be aware of aggressive pitches from scammers," which constituted "blatant attempts by promoters to con ineligible people to claim the credit," and which were frequently grounded in "inaccurate information related to eligibility for, and computation of, the credit." The IRS also indicated that "there are promoters misleading people and businesses into thinking they can claim these credits," that the Dirty Dozen list is "aimed at helping raise awareness to protect honest taxpayers from aggressive promoters and con artists," and that "the increased prevalence of websites touting how easy it is to qualify for the ERC lend an air of legitimacy to abusive claims for refund." The IRS further stated that some companies marketing ERC claims inaccurately explained eligibility requirements, failed to tell employers that only recovery startup businesses could seek ERCs for

[53] IRS, "Frequently Asked Questions About the Employee Retention Credit" (July 27, 2023); *see also* Caitlin Mullaney, "IRS Hard Line on ERC Eligibility Earns Kudos From Tax Pros," *Tax Notes Federal*, July 31, 2023, p. 851.

[54] National Taxpayer Advocate, Annual Report to Congress, 2023, at 43-44 (Jan. 10, 2024).

[55] IRS, "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs" (Jan. 30, 2024).

[56] *Southern California Emergency Medicine Inc. v. Werfel*, No. 5:23-cv-02450 (C.D. Cal. 2023); Lauren Loricchio, "Lawsuit Seeks to Invalidate IRS's ERC Guidance," *Tax Notes Federal*, Dec. 11, 2023, p. 2068.

[57] IR-2022-183.

[58] IR-2023-40.

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the fourth quarter of 2021, and buried the fact that employers cannot solicit ERCs on the wages previously used as payroll costs in obtaining Paycheck Protection Program loans.[59]

In May 2023, the IRS announced that it continued to see "a barrage of aggressive broadcast advertising, direct mail solicitations and online promotions involving the Employee Retention Credit [by] aggressive promoters [that] are wildly misrepresenting and exaggerating who can qualify for the credits." It also underscored that the aggressive marketing was "preying on innocent businesses and others." The IRS then identified "a variety of ways that promoters can lure businesses, tax-exempt groups, and others into applying for the credit." It emphasized complexity, too, observing that the ERC "is a complex credit that requires careful reviewing before applying" and that the eligibility requirements "are technical areas that require review."[60]

Later, in July 2023, when discussing the "flood of schemes" involving ERCs, the IRS reiterated that "scam promoters are luring people to improperly claim the ERC," often by making "false claims about their company's legitimacy."[61]

That same month, the IRS announced that it continued "to warn businesses not to fall for aggressive marketing or scams related to the ERC" and offered a webinar in this regard. It reaffirmed its ongoing mantra that "unscrupulous promoters make false claims about their company's legitimacy and often don't discuss some key eligibility factors, limitations, and income tax implications that affect an employer's tax return."[62]

A tax tip issued soon thereafter contained some of the IRS classics, including that it continues discovering different ways that "promoters can lure businesses, non-profit groups, and others into applying for the credit."[63]

The IRS then issued another document emphasizing that the ERC has "very specific eligibility requirements" and "technical areas that require review."[64]

In announcing the ERC processing moratorium in September 2023, the IRS indicated that it was "increasingly alarmed about honest small business owners being scammed by unscrupulous actors," described the moratorium as a "safety net to focus on fraudulent claims and scammers taking advantage of honest taxpayers," and hinted at new initiatives in the future "to help businesses who found themselves victims of aggressive promoters." The IRS also acknowledged how challenging ERC claims can be, urging taxpayers to hire a trusted tax professional "who actually understands the complex ERC rules," and characterizing the ERC as "an incredibly complex credit" with "specific" and "precise" eligibility standards.[65]

The IRS introduced its withdrawal option in October 2023. Its objective was "to help small business owners and others who were pressured or misled by ERC marketers or promoters into filing ineligible claims." The IRS recognized that aggressive marketing of questionable ERC claims "has harmed well-meaning businesses and organizations," that some promoters "have misled employers and harmed honest employers by misrepresenting and exaggerating" pivotal standards, and that the ERC is a "complex credit with precise requirements."[66]

The IRS left little room for misunderstanding when it issued Publication 5887 in November 2023. It was titled "Employee Retention Credit Eligibility Checklist: Help Understanding This Complex Credit." That document contained a chart summarizing the eligibility criteria, admonishing taxpayers that "this is a very technical area of law."[67]

In December 2023, the IRS announced that it was issuing approximately 20,000 notices of disallowance to two categories of ERC claims that clearly failed to meet the eligibility requirements. In doing so, the IRS commissioner indicated that

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[59] IR-2023-49; *see also* IR-2023-71.

[60] IR-2023-105.

[61] IR-2023-131.

[62] IR-2023-132.

[63] IRS Tax Tip 2023-93.

[64] IR-2023-135.

[65] IR-2023-169; *see also* IR-2023-170.

[66] IR-2023-193; FS-2023-24; IR-2023-212.

[67] IRS Publication 5887, "Employee Retention Credit Eligibility Checklist: Help Understanding This Complex Credit" (Sept. 2023).

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it was "not surprising" to see claims of this nature given the "aggressive marketing" in the ERC arena.[68]

Later that month, the IRS introduced its Voluntary Disclosure Program (VDP), which it described as "part of a larger effort at the IRS to stop aggressive marketing around ERC that misled some employers into filing claims." The driving force for the VDP was concern over the number of fraudulent ERC claims resulting from the "false and misleading public advertisements and scams taking advantage of taxpayers."[69]

The IRS is not alone; several organizations have issued reports featuring similar conclusions.[70] Take, for example, the report by the National Taxpayer Advocate to Congress in 2021. It indicated that the ERC is a "complex" refundable tax credit whose tricky issues include determining when a business is partially or fully suspended because of an appropriate governmental order, the number of full-time employees, which wages qualify, how the business-aggregation rules affect the analysis, and whether business operations before and after a governmental order are "comparable."[71] The report also indicated that the ERC "is a significant tax benefit for employers, but its complexity presents opportunities for error" and that it "may appear straightforward, but there are many layers of complexity."[72]

Another report by the National Taxpayer Advocate to Congress, this time in 2023, made several pertinent observations.[73] First, it explained that "taxpayers have struggled to determine eligibility, and the IRS has likewise struggled to process these claims, because of both the volume and the complexity of the law." Second, the complexity of the ERC, combined with the lucrative nature of the credit, led to many companies providing "bad or misleading advice" to small businesses and encouraging them to make ERC claims "regardless of eligibility." Third, in mid-2023, the IRS essentially stopped processing claims "to handle the complexity and the increase in aggressive and misleading marketing that may have lured honest small businesses and organizations into erroneously claiming the credit." Fourth, the IRS imposed a processing moratorium in September 2023 because "it was concerned that business owners were being victimized." Fifth, the "continuing saga of ERC claims" should provide a lesson to the IRS about how to develop early public guidance, as well as internal processes to implement new legislation. While the IRS supplied some direction soon after Congress created the ERC in the CARES Act, "the guidance and rules for eligibility confused many small business owners [and] taxpayers and tax professionals were largely unable to reach knowledgeable IRS representatives who could clarify how the rules would apply in their situation." Sixth, the mix of "confusing rules," the absence of a duty for taxpayers to attach supporting documentation to their Forms 941-X claiming ERCs, and inefficient IRS processes "created fertile ground for ERC mills to lure business owners into filing fraudulent claims."[74]

V. Penalty Threats

A cornerstone of most tax compliance efforts is the threat of penalties. The IRS has not forgotten this when it comes to ERC claims. Case in point, the IRS has repeatedly warned that any taxpayer that "improperly claims the ERC must pay it back, possibly with penalties and interest," and a taxpayer "could find itself in a much worse cash position if it has to pay back the credit than if the credit were never claimed in the first place."[75] The IRS has also cautioned taxpayers that they will be held accountable if they fall prey to "advertised schemes and direct solicitations promising savings that are too good to be true" because

[68] IR-2023-230.

[69] IR-2023-247; Announcement 2024-3, 2024-2 IRB 364.

[70] *See*, *e.g.*, GAO, "IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Its Compliance Efforts," GA0-22-104280 (May 17, 2022); TIGTA, "Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits," Report No. 2022-46-059 (Aug. 31, 2022); Congressional Research Service, "CARES Act Assistance for Employers and Employees — The Paycheck Protection Program, Employee Retention Tax Credit, and Unemployment Insurance Benefits: An Overview (Part 1)," IN1324 (Apr. 21, 2020).

[71] NTA, "Objectives Report to Congress: Fiscal Year 2021," at 46 (June 29, 2020).

[72] *Id.*, at 59-60; *see also* IR-2020-132.

[73] NTA, *supra* note 54, at 9-11.

[74] *Id.* at 41-42.

[75] IR-2023-105.

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taxpayers "are always responsible for the information reported on their tax returns."[76] More recently, the IRS referenced a long list of potential penalties, and its willingness to abate them, when announcing the withdrawal option in October 2023 and the VDP in December 2023.[77]

VI. Penalty Mitigation

The IRS has threatened to assert several penalties against taxpayers making improper ERC claims, with the specifics depending on the circumstances in each case.[78] Among them are federal tax deposit penalties under section 6656, late-payment penalties under section 6651, and accuracy-related penalties under section 6662. Applicable law provides that the IRS should not impose those sanctions, and courts should not uphold them if a taxpayer can demonstrate that the violation was because of "reasonable cause."[79]

This article is not a treatise on civil penalties; that would far exceed its scope. Set forth below is a mere summary of some key points about penalty mitigation that might be relevant in ERC cases. First, the most important factor in determining whether a taxpayer acted with reasonable cause is the extent of its efforts to ascertain the proper tax liability.[80] Second, a taxpayer may establish reasonable cause by presenting facts and circumstances showing that it exercised ordinary business care and prudence.[81] Third, a taxpayer's confusion might save the day. The regulations provide that "an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer," might reach the level of reasonable cause.[82]

Fourth, ignorance of the law might suffice. The IRS acknowledges that reasonable cause may exist "if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances," such as the level of complexity of a tax or compliance issue.[83] Fifth, the IRS generally must abate penalties in situations in which a taxpayer relies on erroneous advice (written or oral) by an IRS employee, the reliance was reasonable, the advice was given in response to the taxpayer's request, and the error was not the result of the taxpayer providing inadequate or inaccurate information to the IRS.[84]

The final point warrants a paragraph of its own. A taxpayer's reasonable reliance on an independent, informed, and qualified tax or legal professional often reaches the level of reasonable cause.[85] The regulations broadly define the concept of "advice" to cover "any communication" from a qualified adviser, and clarify that "advice does not have to be in any particular form."[86] The Tax Court has held that reasonable reliance exists when three elements are present: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser in a timely manner; and (3) the taxpayer actually relied in good faith on the adviser's advice.[87] It cautioned, however, that reliance might be unreasonable when "placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about."[88] For its part, the Supreme Court

[76] IR-2022-183; IR-2023-40.

[77] IR-2023-193; Joseph DiSciullo, "Fact Sheet Explains How to Withdraw Claims for Employee Retention Credit," *Tax Notes Federal*, Oct. 30, 2023, p. 883; Announcement 2024-3; Loricchio, "IRS Launches ERC Voluntary Disclosure Program," *Tax Notes Federal*, Jan. 1, 2024, p. 188.

[78] IRS, "Frequently Asked Questions About the Employee Retention Credit Voluntary Disclosure Program," at Q&A 5 (last updated Jan. 8, 2024).

[79] Section 6656(a); section 6651(a); section 6651(a)(2); reg. section 301.6651-1(a)(1); section 6662(a); section 6664(c); reg. section 1.6664-4(b)(1).

[80] Reg. section 1.6664-4(b)(1).

[81] IRM 20.1.1.3.2.1.

[82] Reg. section 1.6664-4(b)(1).

[83] IRM 20.1.1.3.2.2.6(2)(c).

[84] Section 6404(f); reg. section 301.6404-3(a); IRM 20.1.1.3.3.4.2.

[85] Reg. section 1.6664-4(c)(1); *United States v. Boyle*, 469 U.S. 241, 251 (1985).

[86] Reg. section 1.6664-4(c)(2).

[87] *Neonatology Associates v. Commissioner*, 115 T.C. 43, 99 (2000), *aff'd* 299 F.3d 221 (3d Cir. 2002).

[88] *Neonatology Associates*, 115 T.C. 43, 98 (citing *Goldman v. Commissioner*, 39 F.3d 402, 408 (2d Cir. 1994)); *see also Mortensen v. Commissioner*, 440 F.3d 375, 387 (6th Cir. 2006) (explaining that "in order for reliance on professional tax advice to be reasonable, however, the advice must generally be from a competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment"); *see also* Michele M. Kwon, "Dysfunction Junction: Reasonable Cause and Good Faith Reliance on Tax Advisors With Conflicts of Interest," 67 *Tax Law.* 403 (2014).

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has emphasized that the IRS must liberally construe the reasonable reliance defense:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[89]

VII. Conclusion

So, where are we? Congress issued four ERC laws in less than two years, and the IRS tried to keep pace, issuing guidance in the form of notices, revenue procedures, alerts, GLAMs, chief counsel advice, FAQs, and more. This administrative guidance was sometimes prospective, other times retroactive, and always dense. The complexities and timing issues created by the IRS obligated many employers to file Forms 941-X to make or adjust ERC claims, often more than once. The IRS has acknowledged that much of its guidance is not precedential; neither taxpayers nor the IRS can rely on it during ERC disputes. The validity of other IRS guidance is being challenged in court, too. Add to the mix repeated recognitions by the IRS that the ERC rules are far from straightforward. The IRS and governmental watchdogs have characterized the ERC as "complex" and "confusing," with "very specific eligibility requirements," creating many "opportunities for error," and involving "technical areas that require review" by professionals. The IRS has also underscored that many employers making ERC claims are not willing perpetrators of bad behavior, but rather victims of the situation. In this regard, the IRS has publicly stated on many occasions that employers were "conned," "lured," "misled," "taken advantage of," "preyed upon," or "victimized" by others. Finally, the regulations and cases establish a long list of justifications for penalty abatement.

The IRS has threatened taxpayers with various penalties to halt the filing of further ERC claims, encourage large concessions during audits, dissuade the filing of refund suits, and induce participation in the withdrawal option and VDP. One big question for taxpayers contemplating their next move is how much weight they should give those IRS threats in light of the unique circumstances addressed in this article. ■

[89] *Boyle*, 469 U.S. 241, 251.

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