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In this article, Sheppard examines recent IRS actions regarding employee retention credits in the broader context of ERC events over the past three years and into the future.

I. Introduction

Deadlines for seeking employee retention credits are fast approaching, large numbers of claims are being filed, and fears of widespread fraud abound. What is the solution? Well, according to the IRS, pumping the proverbial brakes is the way to go. It recently imposed a moratorium of at least three months on processing new ERC claims. The IRS made several other important announcements, too. These include the start of enhanced compliance reviews on all ERC claims, an upcoming special withdrawal option for taxpayers with pending yet unpaid claims, and a future settlement program for taxpayers that previously received ERCs but did not really deserve them. This article, the latest in a series, examines recent IRS actions and fits them into the broader context of ERC events over the past three years and into the future.[1] More precisely, it looks at what the IRS didn't, did, and might do.

II. Main Congressional and IRS Guidance

Congress passed four laws in less than two years, and the IRS supplemented this by issuing multiple types of ERC guidance. An overview follows.

A. First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act in March 2020.[2] It generally provided that an eligible employer could claim ERCs 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.[3]

An eligible employer meant one that was carrying on a trade or business in 2020 and met one of the following two tests. First, the employer's operations were partially or fully suspended during a quarter because of an order

[1]Readers seeking details about the ERC rules and their evolution should see the following articles by this author: Hale E. Sheppard, "ERC Disputes: Mastery of Procedural and Substantive Rules Required," *Tax Notes Federal* (coming Nov. 6, 2023); Sheppard, "Employee Retention Credits: Reasons for Prolonged Claims," *Tax Notes Federal*, Oct. 16, 2023, p. 431; Sheppard, "Employee Retention Credits: Issues Arise as Finger-Pointing Begins," *Tax Notes Federal*, Sept. 11, 2023, p. 1843; Sheppard, "IRS Clarifies Limited Eligibility of Federal Credit Unions for ERCs," *Tax Notes Federal*, Sept. 4, 2023, p. 1615; Sheppard, "New ERC Guidance About Suspended Operations and Supply Chains," *Tax Notes Federal*, Aug. 28, 2023, p. 1413; Sheppard, "Employee Retention Credits: Analyzing Key Issues for Promoters and Other Enablers," *J. Tax'n* (coming 2023); Sheppard, "Employee Retention Credits: Analyzing Key Issues for Taxpayers Facing IRS Audits," *J. Tax'n* (coming 2023); Sheppard, "Employee Retention Credits: Analyzing Congressional and IRS Guidance From Start to Finish," *J. Tax'n* (coming 2023).

[2]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.

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

from an appropriate governmental authority that limited commerce, travel, or group meetings for commercial, social, religious, or other purposes because of COVID-19 (the governmental order test).[4] Second, the employer suffered a significant decline in gross receipts during a particular quarter (the reduced gross receipts test).[5]

The term "applicable employment taxes" in this context generally meant an employer's share of amounts due under the Federal Insurance Contributions Act.[6]

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. There were two categories: large and small. When an eligible employer had an average of more than 100 full-time employees (large eligible employer), qualified wages meant those paid to any employee who was not providing services as a result of the governmental order test or the reduced gross receipts test.[7] Alternatively, when an eligible employer had an average of 100 or fewer full-time employees (small eligible employer), qualified wages meant all wages paid during a quarter, whether or not the employees were actually working.[8] In addition to the amounts described above, qualified wages included the qualified health plan expenses paid by the eligible employer, which were allocable to the qualified wages.[9]

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 applicable quarters combined in 2020. This meant that, after applying the 50 percent limit, the maximum ERC per employee for 2020 in its entirety was $5,000.[10] If the ERCs surpassed this threshold, then the excess would be treated as an employment tax overpayment and refunded to the eligible employer.[11]

Congress instructed the IRS to issue the forms, instructions, regulations, and other guidance necessary to allow for advance payments of ERCs to eligible employers and to require reconciliation of those payments when the employers later filed the relevant returns.[12] To implement this legislative mandate, the IRS revised various returns, including Form 941, "Employer's Quarterly Federal Tax Return," and Form 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund." Within just a few days of Congress enacting the CARES Act, the IRS also published Form 7200, "Advance Payment of Employer Credits Due to COVID-19."[13] It instructed eligible employers to retain employment taxes equal to their ERCs instead of depositing them with the IRS. If there were insufficient applicable employment taxes to fully cover the ERCs claimed, taxpayers were told to complete and file a Form 7200 to seek advance payment from the IRS.[14]

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.[15]

B. Second Law

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act in December 2020.[16]

As explained, whether amounts paid by an eligible employer constitute qualified wages depends in part on the average number of full-time employees. The relief act 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

[4] *Id.* at section 2301(c)(2)(A)(ii)(I).

[5] *Id.* at section 2301(c)(2)(A)(ii)(II).

[6] *Id.* at section 2301(c)(1). These consist of Social Security and Medicare taxes.

[7] *Id.* at section 2301(c)(3)(A)(i).

[8] *Id.* at section 2301(c)(3)(A)(ii)(I) and (II). These standards later changed from 100 to 500 full-time employees. *See* Consolidated Appropriations Act, 2021, Division EE, section 207; and Notice 2021-23, 2021-16 IRB 1113, Section III.E.

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

[10] *Id.* at section 2301(b)(1); JCT, *supra* note 2, at 38.

[11] CARES Act, section 2301(b)(3)(A); IRC section 6402(b); reg. section 301.6402-1; IRC section 6413(b).

[12] CARES Act, section 2301(i)(1) and (2).

[13] IRS, "Instructions for Form 7200," at 2 (Mar. 2020).

[14] *Id.*; *see also* Notice 2021-20, Section III, Question 50.

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

[16] Consolidated Appropriations Act, Division EE, section 207; JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021); *see also* Notice 2021-23.

were not providing services.[17] Large eligible employers became those whose average number of full-time employees was more than 500 (instead of more than 100), while small eligible employers were those with an average of 500 employees or fewer.[18]

The relief act also expanded the period during which eligible employers could benefit. They could claim ERCs not only for second, third, and fourth quarters of 2020 (as they could under the CARES Act), but also for first and second quarters of 2021.[19] Eligible employers could get increased amounts of ERCs, too. Under the CARES Act, an eligible employer could claim ERCs for only 50 percent of qualified wages, with a cap of $10,000 per employee for all of 2020. Things changed in two ways thanks to the relief act. The figure increased from 50 percent to 70 percent of the qualified wages paid, and the amount was calculated per quarter, not per year. Thus, if an eligible employer were to pay an employee $20,000 in qualified wages in each of the first and second quarters of 2021, the ERCs would total $28,000 (that is, $14,000 per quarter).[20]

The relief act modified the rules about advance payments of ERCs. It provided that only small eligible employers, using the newest definition, could seek them. It further said that those payments could not exceed 70 percent of the average quarterly wages paid by the eligible employer in 2019.[21] Also, the relief act established that if the advance payments received by small eligible employers were greater than the ERCs ultimately allowed for a quarter, then the applicable employment taxes would be increased by the excess.[22] These rules applied beginning first quarter 2021.[23]

C. Third Law

Congress introduced the American Rescue Plan Act of 2021 in March 2021.[24] That law codified the ERC rules, making them section 3134 of the IRC.

ARPA expanded the ERC, allowing eligible employers to claim benefits for the third and fourth quarters of 2021.[25] Thus, at that point, the ERC was available for qualified wages paid during 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 ARPA).[26]

New section 3134 confirmed that surplus ERCs would be treated as overpayments by eligible employers, and credited or refunded to them, as appropriate.[27] It also allowed for advance payments. It repeated that small eligible employers, according to the revised guidelines established by the relief act, could elect for any quarter to receive an advance payment of ERCs up to 70 percent of the average quarterly wages paid in 2019.[28] New section 3134 also corroborated that advance payments received by small eligible employers that surpassed the ERCs ultimately allowed would trigger an increase in applicable employment taxes.[29] Finally, it directed the IRS to issue forms, instructions, regulations, and other guidance necessary to allow for advance payments of ERCs and "to prevent the avoidance of the purposes of the limitations" of section 3134.[30]

D. Fourth Law

Things came to a close when Congress enacted the Infrastructure Investment and Jobs Act in November 2021.[31] That legislation announced the end of the ERC, and it retroactively shortened the periods for claiming

[17] Consolidated Appropriations Act, Division EE, section 207(e).

[18] Notice 2021-23, Section III.E.

[19] *Id.* at Section III.A.

[20] *Id.* at Section III.D.

[21] Consolidated Appropriations Act, Division EE, section 207(g)(1).

[22] *Id.*

[23] *Id.* at section 207(k).

[24] ARPA, section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

[25] ARPA, section 9651(a).

[26] *Id.*; *see also* IRC section 3134(n).

[27] ARPA, section 9651(a); *see also* IRC section 3134(b)(3).

[28] ARPA, section 9651(a); *see also* IRC section 3134(j)(2)(A).

[29] ARPA, section 9651(a); *see also* IRC section 3134(j)(3)(B).

[30] ARPA, section 9651(a); *see* also IRC section 3134(m).

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

benefits. Eligible employers, with one narrow exception, could no longer solicit ERCs for fourth quarter 2021. As a result, ERCs for most eligible employers could not surpass a grand total of $26,000, an amount consisting of $5,000 for 2020 in its entirety, plus $7,000 for each of the first, second, and third quarters of 2021. The IRS explained that advance ERC payments received by most small eligible employers for fourth quarter 2021 now constituted "erroneous refunds," which had to be repaid.[32]

III. What the IRS Did Not Do

The purpose of this article is not to disparage the IRS, but understanding what it did not accomplish is important. A few of the IRS's shortcomings follow.

A. Failure to Prevent Early Problems

The Treasury Inspector General for Tax Administration published several reports describing what many had predicted — that is, troubles with ERC processing from the outset. TIGTA identified 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 1 million Forms 941 as erroneous or possibly fraudulent.[33] A second report 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.[34] It also found that the IRS granted ERCs to over 500 governmental entities, which, by their very nature, could not initially qualify as eligible employers.[35] A third TIGTA report explained that many erroneous or fraudulent ERC claims went undetected.[36] It further determined that hundreds of taxpayers that likely did not qualify as recovery start-up businesses received about $20 million in improper ERCs for fourth quarter 2021.[37]

The Government Accountability Office also released several reports regarding the IRS's implementation of various COVID-19-related tax benefits, including the ERC.[38] Like TIGTA, the GAO identified many 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 ERC claims actually received and those reported on Forms 941, and more.[39]

B. No Shortening of Claims Period

Under the existing rules, eligible employers can file Forms 941-X making ERC claims for the relevant quarters of 2020 until April 15, 2024, and they can file Forms 941-X for quarters of 2021 for even longer, until April 15, 2025.[40] The current IRS Commissioner suggested on several occasions that, with the goal of halting a massive number of last-minute ERC claims of dubious validity, the period during which taxpayers can file Forms 941-X should be shortened.[41] He seems to have relinquished this pursuit, opting instead for the processing moratorium described later.

C. No Mechanism to Prevent Whipsaw

A term used in tax disputes is "whipsaw." It has several meanings, one of which is that the IRS takes two inconsistent positions, both unfavorable to a taxpayer, and only one can be correct. If the taxpayer does not recognize the threat and take

[32] *Id.* at Section III.B.

[33] TIGTA, "Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions," Report No. 2020-46-041, at 18-19 (June 30, 2020).

[34] TIGTA, "Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic," Report No. 2021-46-043, at 7-8 (July 9, 2021).

[35] *Id.* at 9.

[36] TIGTA, "Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits," Report No. 2022-46-059, at 4 (Aug. 31, 2022).

[37] *Id.* at 13.

[38] *See, e.g.*, GAO, "COVID-19: Continued Attention Needed to Enhance Federal Preparedness, Response, Service Delivery, and Program Integrity," GAO-21-551 (July 10, 2021); GAO, "COVID-19: Sustained Federal Action Is Crucial as Pandemic Enters Its Second Year," GAO-21-387 (Mar. 31, 2021).

[39] GAO, "COVID-19: IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Compliance Efforts," GAO-22-104280, at 33-35 (May 2022).

[40] Sections 6511(a), 6511(b)(1), 6501(b)(2), and 6513(c); reg. sections 301.6511(a)-1(a), 301.6511(b)-1(a), 301-6501(b)-1(b), and 301.6513-1(c).

[41] Lauren Loricchio and Nathan J. Richman, "Taxpayers Sold Bogus ERC Claims May Face Troubled Waters," *Tax Notes Federal*, Sept. 11, 2023, p. 1928 (saying that the IRS commissioner "has suggested closing the period to claim the ERC on amended returns as another way to contain fraud in the program"); Jonathan Curry and Loricchio, "IRS Halts ERC Claims Processing Amid 'Tsunami' of Fraud," *Tax Notes Federal*, Sept. 18, 2023, p. 2139 (saying that the IRS commissioner "previously suggested that Congress could also step in to end the ERC program early").

timely steps to counter it, then it can get whipsawed by the IRS.[42] This concept might apply in the ERC context.

The CARES Act said that an eligible employer's income tax deduction for the qualified wages it paid must be reduced by the amount of ERCs it receives.[43] A decrease in the wages-paid deduction might trigger an increase in federal income tax liability.

The IRS, clarifying congressional standards, explained the following: "An employer's deduction for Qualified Wages, including Qualified Health Plan Expenses, is reduced by the amount of" the ERC.[44] The IRS offered additional guidance on timing issues. It presented the following scenario in which an eligible employer filed Forms 941-X to claim ERCs for earlier quarters after it had already filed its income tax return covering the same quarters:

> When a taxpayer claims the employee retention credit because of the retroactive amendment of [the law] or otherwise files [a Form 941-X] to claim the employee retention credit, the taxpayer should file an amended federal income tax return or administrative adjustment request (AAR), if applicable, for the taxable year in which the Qualified Wages were paid or incurred to correct any overstated deduction taken with respect to those same wages on the original federal tax return.[45]

The IRS warned that the situation has been exacerbated by the fact that some companies aggressively promoting ERCs fail to tell eligible employers that benefits on the employment tax side (the receipt of credits) might cause detriments on the income tax side (increased liabilities) and that all the positions on related returns must be reconciled.[46]

This should have eligible employers and their advisers thinking about the interplay of employment taxes and income taxes in the ERC context, as well as whether filing protective amended income tax returns is appropriate.[47] The IRS has not addressed this key issue or floated any type of potential relief to affected taxpayers.

IV. What the IRS Did

Putting aside the snags described above, the IRS has taken significant actions to implement and enforce the ERC rules — a few of them follow.

A. Issued Administrative Guidance

The IRS, in an attempt to keep pace with recurrent congressional mandates issued a considerable amount of administrative guidance. This has come in various forms, such as notices, revenue procedures, chief counsel advisories, frequently asked questions, checklists, regulations, and more.[48] Among the notable items are IRS pronouncements addressing ERCs and federal credit unions, exploring the interplay between suspended operations and supply chain problems, and creating a safe harbor that allows taxpayers to exclude certain items from gross receipts when calculating that figure for ERC purposes, including loans forgiven by the government under the Paycheck Protection Program.[49]

B. Warned the World About Possible Abuse

The IRS disseminated a significant number of news releases, fact sheets, and the like warning anyone who would listen about potential ERC abuse. For instance, marking the one-year anniversary of the introduction of the ERC, the IRS explained that criminal investigations and civil examinations were underway. High-ranking officials threatened that the IRS "would not cease until every fraudulently obtained dollar is

[42] *See generally* Harvey S. Gilbert et al. "Whipsaw Revisited," 43(2) *Tax Law.* 343 (Winter 1990); Internal Revenue Manual 5.20.6; IRM 8.2.3.13.

[43] CARES Act, section 2301(e).

[44] Notice 2021-20, Section II.F.; Notice 2021-20, Section III.K., Question 60.

[45] Notice 2021-49, Section IV.C.

[46] IR-2022-183.

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

[48] *See, e.g.*, Notice 2020-22, 2020-17 IRB 664; Notice 2021-20; Notice 2021-23; Notice 2021-24, 2021-18 IRB 1122; Notice 2021-49; and T.D. 9978.

[49] ILM 202333001; Fred Stokeld, "IRS Clarifies Availability of Retention Credit for Credit Unions," *Tax Notes Federal*, Aug. 28, 2023, p. 1524; Rev. Proc. 2021-33, 2021-34 IRB 327, section 1.

accounted for and the individuals behind the schemes are prosecuted to the fullest extent of the law."[50]

The IRS later disseminated a tax tip whose title was remarkably blunt: "Watch Out for Employee Retention Credit Schemes." It explained that the IRS had been warning taxpayers about promoter scams for a long time but that taxpayers that do not meet the standards continue trying to claim ERCs in 2023.[51]

The IRS continued down this path, announcing in March that not only had improper ERC claims made it onto the "Dirty Dozen" list, they topped it.[52]

The IRS upped the rhetoric soon thereafter, declaring that aggressive marketing of ERCs persisted and that there was "a barrage of aggressive broadcast advertising, direct mail solicitations, and online promotions." The IRS then laid out some "tell-tale signs of misleading claims." Among them were unsolicited calls or advertisements mentioning an easy application process, statements that the promoter can determine ERC eligibility within minutes, large upfront fees or a contingent fee based on a percentage of the refund obtained, and statements to the effect that all taxpayers should apply for ERCs because there is nothing to lose.[53]

IRS enforcement officials later 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 understaffing, taxpayers desperate for a post-COVID-19 financial boost, paper filing of returns, and complicated qualification rules.[54]

C. Trained the Troops

In addition to making repeated external announcements, the IRS has exhibited some internal focus: It divulged that it had trained several hundred revenue agents to conduct civil examinations of ERC claims.[55] In late 2022 the IRS released an initial training guide for revenue agents. Its main goal, unsurprisingly, was for personnel to be capable of determining the quarters in 2020 and 2021 during which a taxpayer was an eligible employer, identifying what payments constituted qualified wages, calculating the correct ERC amounts, applying limitations on ERCs based on the size of the employer, and understanding the interplay between ERCs and other tax benefits.[56] Things did not end there. The IRS produced more expansive training materials, which were released at the end of 2022.[57]

D. Issued Regulations

The IRS issued temporary regulations about reclaiming excessive ERCs released to taxpayers.[58] The regulations began by reminding taxpayers that ERCs were initially limited in several ways, one of which was that they could not exceed the applicable employment taxes on the wages paid for all employees of the eligible employer for the relevant quarter. If the ERCs topped this threshold, the surplus would be treated as an overpayment and credited or refunded to the eligible employer, as appropriate. The temporary regulations emphasized that a "refund, credit, or advance of any portion of [ERCs] to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund for which the IRS must seek repayment."[59]

The temporary regulations, citing two decisions by the Supreme Court, clarified that the IRS has an unfettered right to engage in recoupment by trial.[60] However, the CARES Act and ARPA contemplate "administrative

[50] IR-2021-65.

[51] IRS Tax Tip 2023-44.

[52] IR-2023-49; IR-2023-71.

[53] IR-2023-105.

[54] Richman, "Employee Retention Credit Claimants May See Help From IRS," *Tax Notes Federal*, June 12, 2023, p. 1862.

[55] Richman, "IRS Readying Hard Look at Employee Retention Credit Claims," *Tax Notes Federal*, Oct. 31, 2022, p. 747; IRS, "Lesson 3: Tax Credit for Employee Retention," COVID Credits & Deferrals for Employment Tax, Student Guide (rev. July 2022).

[56] IRS, *supra* note 55.

[57] Loricchio, "Documents Shed Light on IRS Scrutiny of Employee Retention Credit," *Tax Notes Federal*, Dec. 12, 2022, p. 1584; IRS, "COVID Credits and Deferral Training for Employment Tax" (May 11, 2023).

[58] REG-111879-20; T.D. 9904; REG-109077-21; T.D. 9953, Background, Section V.

[59] T.D. 9904, Section III.

[60] *Id.* at Section IV.

recapture" of excess ERCs. The IRS carried out these congressional instructions by issuing the temporary regulations, granting itself authority to assess and collect improper ERCs.[61]

The temporary regulations said that they fortify, not substitute, the IRS's normal tools. They explained that "these assessment and administrative collection procedures *do not replace* the existing recapture methods, but rather represent an *alternative method* available to the IRS."[62] (Emphasis added.)

The final regulations establish the following rule:

> Any amount of credits for Qualified Wages . . . that is treated as an overpayment and refunded or credited to an employer [by the IRS] and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall be treated as an underpayment of [Applicable Employment Taxes] and may be assessed and collected by the [IRS] in the same manner as the taxes.[63]

E. Placed a Moratorium on Processing

In response to rising concerns about the large number of questionable Forms 941-X seeking ERCs, the IRS announced on September 14 that it was placing an immediate moratorium on the processing of any new ERC claims.[64] This processing freeze will remain in effect until at least the end of 2023. There is no payment of tax benefits, of course, without prior processing. This means that taxpayers filing Forms 941-X going forward will not be getting financial relief any time soon, if ever.

The IRS clarified that, when it comes to pending ERC claims, patience is paramount. This is because the IRS plans to conduct enhanced compliance reviews, thereby pushing the standard processing period from 90 days to 180 days, and "much longer if the claim faces further review or audit."[65]

F. Started Civil Examinations

The IRS announced that it had already referred thousands of ERC cases for audit as of September, which occurred before the IRS even started its enhanced compliance review of all pending and future ERC claims.[66]

As explained earlier, the final regulations indicate that improper ERCs that were credited or refunded to eligible employers will be treated as underpayments and assessed and collected by the IRS in the same manner as employment taxes.[67] Thus, one assumes that the IRS will use the following procedure, or a variation thereof. The IRS will initiate an audit of questionable Forms 941 and Forms 941-X. In light of the time limitations, revenue agents likely will ask eligible employers early in the process to voluntarily extend the applicable assessment periods by executing a Form SS-10, "Consent to Extend the Time to Assess Employment Taxes." Whether eligible employers do so will depend on the circumstances. To the extent that revenue agents identify what they believe are undeserved ERCs, they will issue examination reports proposing tax liabilities and perhaps penalties. Eligible employers might challenge the examination reports by filing protest letters and seeking reconsideration by the Independent Office of Appeals. Assuming that eligible employers cannot reach an agreement with Appeals, the IRS will assess the taxes and penalties. This means that the IRS essentially records a tax debt on its books, and collection actions can commence.

Eligible employers have a few potential remedies at this juncture. They can, for instance, wait for the IRS to issue a post-lien notice or pre-levy notice, file a request for a collection due process hearing, participate in a conference with Appeals, and then lodge a petition with the Tax

[61] *Id.* at Explanation of Provisions.

[62] T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

[63] T.D. 9978; reg. sections 31.3111-6(b) and (c), 31.3134-1(a) and (b), and 31.3221-5(b) and (c).

[64] IR-2023-169.

[65] *Id.*

[66] *Id.*

[67] Reg. sections 31.3111-6(b) and (c), 31.3134-1(a) and (b), and 31.3221-5(b) and (c).

Court to challenge an unfavorable notice of determination.[68] Alternatively, eligible employers can pay the required amount and then file a refund suit with the proper district court or Court of Federal Claims.[69]

G. Initiated Criminal Investigations

The IRS announced that the Criminal Investigation division had initiated over 250 investigations of potentially fraudulent ERC claims as of July.[70] It is unclear whether those actions were directed at taxpayers, returns preparers, or what the IRS labels "promoters." Regardless of the current IRS focus, the reality is that, in extreme cases, when evidence exists that a taxpayer made false ERC claims, the IRS might pursue criminal sanctions. Convictions could trigger fines, jail time, or both. Tax crimes commonly raised by the IRS include tax evasion, making false statements, submitting false documents, and conspiracy to defraud the U.S. government.[71]

V. What the IRS Might Do

This section of the article is predictive, identifying actions that the IRS might take in the future. The list is not exhaustive because maneuvers by the IRS, taxpayers, and others involved with ERC claims surely will morph as circumstances change over time.

A. Introduce a Claim Withdrawal Process

In September, the IRS announced that it would soon introduce a special withdrawal option for taxpayers with cold feet — that is, those that filed ERC claims but have not yet received the tax benefits and now want to reverse course on the most favorable terms possible.[72] According to the IRS, this option will be available to approximately 600,000 taxpayers whose ERC claims are pending review.[73] The IRS has not yet released details, offering only the following teaser:

> The IRS is finalizing details that will be available soon for a special withdrawal option for those who have filed an ERC claim but the claim has not been processed. This option — which can be used by taxpayers whose claim hasn't yet been paid — will allow the taxpayers, many of them small businesses who were misled by promoters, to avoid possible repayment issues and paying promoters contingency fees.[74]

B. Offer a Settlement Initiative

Also, in September, the IRS indicated that it plans to introduce a settlement program later in the year for taxpayers that filed ERC claims, got paid, became nervous, and want to repay the IRS with minimal financial downsides. The IRS has not yet revealed specifics, saying only that:

> If a business has already received an ERC that they now believe is in error, the IRS will be providing additional details on the settlement program in the fall that will allow businesses to repay ERC claims. The settlement program will allow the businesses to avoid penalties and future compliance action.[75]

C. Provide Guidance on Fees Paid

As indicated earlier, many companies assisting taxpayers with ERC claims charge a hefty upfront fee or contingency fee. The IRS is well aware of this. Indeed, enforcement officials described harsh outcomes for susceptible taxpayers: The ERC "mills are selling the idea that nearly anyone can qualify for the ERC in

[68] Section 6330(c)(2)(B) (a taxpayer "may also raise at the hearing challenges to the existence or amount of the underlying tax liability for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability"); reg. section 301.6330-1(e)(1); section 6330(d)(1); *Salazar v. Commissioner*, T.C. Memo. 2008-38.

[69] *See* IRS, "Employment Tax Returns — Examination and Appeals Rights," Publication 5146 (Rev. Mar. 2017); IRM 4.23.4; American Bar Association Section of Taxation, *Effectively Representing Your Client Before the IRS*, Vol. 1, Ch. 8 (2009); David M. Richardson et al., *Civil Tax Procedure*, Ch. 5 (2005).

[70] IR-2023-169.

[71] IRC sections 7201, 7206, 7207; 18 U.S.C. section 286; 18 U.S.C. section 287; see Justice Department release announcing arrest of tax return preparer for fraudulently seeking over $124 million in COVID-19 employment tax credits (July 31, 2023); criminal complaint, *United States v. Leon Haynes*, No. 23-MJ-11127 (D.N.J. 2023).

[72] IR-2023-169.

[73] *Id.*

[74] *Id.*

[75] *Id.*

exchange for 25 percent of the refund, and then absconding with their share [which] leaves taxpayers potentially subject to full repayment, penalties, and interest without access to the facilitators and their 25 percent."[76]

An interesting question, which the IRS has not yet addressed, is how eligible employers that claimed ERCs, received them, and decide to return the money to the IRS should treat any fees that they cannot recoup from their advisers. This issue was raised at a recent congressional hearing:

> There have and will continue to be situations where a tax professional, relying on [Office of Professional Responsibility] guidance, will decide not to file a [Form 941-X] out of fear that it would perpetuate an improper credit, and will advise the client to return the original ERC. The question then arises, that if the client returns the ERC received, can the fee paid to the third-party mills be claimed as a business deduction? One of the problems tax practitioners will confront in correcting an erroneous ERC claim is that the taxpayer is asked to return 100 percent of the ERC claimed when they only received a portion of the money because of the fees paid to the third-party mills. Not allowing the deduction only penalizes the small business owner who is trying to do the right thing and return an improper ERC that they might have been initially misled to take. Additional guidance or clarification from the IRS on this deductibility issue is needed to help both tax practitioners as well as taxpayers.[77]

The IRS acknowledged in its recent announcement about the upcoming special withdrawal option and settlement program that the fee issue remains a conundrum. The IRS left the question hanging, vaguely explaining that it "is continuing to assess options on how to deal with businesses that had a promoter contingency fee paid for out of the ERC payment."[78]

D. File Erroneous Refund Suits

The final regulations expressly say that the special ERC procedures supplement, not usurp, existing methods for recouping improper refunds issued to taxpayers.[79] This means that the government might opt for a traditional method — civil litigation. An erroneous refund of "any portion of a tax imposed by" the IRC, including employment taxes, can be recovered in a civil action by the government.[80] In terms of timing, the government generally must initiate a lawsuit within two years after making a refund. This time period extends from two years to five years, "if it appears that any part of the refund was induced by fraud or misrepresentation of material fact."[81] As mentioned above, the IRS believes that many ERC claims are false or fraudulent, which means that the Justice Department might rely on the five-year period in bringing erroneous refund cases.

Here is an example. If an eligible employer timely filed Forms 941 for all four quarters of 2021, the law would treat them as being filed on April 15, 2022. That means that the eligible employer could file Forms 941-X claiming ERCs until April 15, 2025. Assume it did just that. Further assume that the IRS issued the refund on May 15, 2025, after only a cursory review. Finally, suppose that the IRS, after taking additional time to reflect, determined that the Forms 941-X filed by the eligible employer were fraudulent. In that case, the IRS would have five years from the payment date, until May 15, 2030, to file suit against the eligible employer to reclaim the erroneous refund.

E. Strategically Scrutinize Conflicts of Interest

The IRS has been issuing specialized information document requests as part of various compliance campaigns over the past few years.[82]

[76] Richman, *supra* note 55.

[77] Statement of Roger Harris, president of Padgett Business Services, at the July 27, 2023, House Ways and Means Oversight subcommittee hearing on the ERC.

[78] IR-2023-169.

[79] T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

[80] Section 7405(b).

[81] Section 6532(b); reg. section 301.6532-2.

[82] The author has a number of conflict of interest IDRs in his possession.

This trend has now reached those defending ERC claims and could have several consequences.

The IRS is not coy about its objective; the IDRs say that their purpose is "to identify conflicts with" the person representing the taxpayer during the audit. The IDRs then ask in-depth questions about the representative, his role, his relationship with the taxpayer, his affiliation with others advising on ERCs, the types of documents he prepared (for example, opinions, studies, analyses, reports, calculations, reviews, returns, etc.), the fees he charged for services, fees he received for making referrals, privilege claims, and the existence or absence of a written conflict of interest waiver from the taxpayer.

Some advisers, attorneys, accountants, and others who offer assistance in making ERC claims include "audit defense" as part of their package. Their participation on both the pre-claim and post-claim sides of the equation surely will trigger conflict of interest IDRs. The IRS will probably issue these IDRs for all ERC audits as a matter of course, consistent with its recent procedure for all compliance campaigns.

Why is this important to both representatives and taxpayers? Put differently, why is it advisable that taxpayers hire independent professionals, those with no connection whatsoever with the earlier ERC claim, to defend them during IRS disputes? First, the IRS uses conflict of interest IDRs to identify individuals for whom it will initiate promoter investigations under section 6700. Second, the IRS might attempt to undermine penalty defenses on grounds that the taxpayer cannot reasonably rely on anybody who has an inherent conflict of interest, is an insider or promoter, or lacks financial independence.[83] Third, the IRS might argue that a conflict of interest renders a representative ineligible to participate in the audit.[84] Fourth, based on the information provided in response to the IDRs, the IRS might contend that privilege related to the ERC issues never existed in the first place or it has been waived, so 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 litigation on grounds that an insurmountable conflict of interest exists or the representative "is likely to be a necessary witness."[85]

F. Pursue Promoters and Enablers

The IRS initially declared that it 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."[86] Building on that theme, IRS representatives said at more recent events that "there will be consequences for fraudsters and promoters of ERC-related schemes."[87] They did not specify what the repercussions might be, but the IRS has several tools at its disposal. Here are but a few.

The IRS can assess sizable promoter penalties under section 6700 against persons meeting certain criteria. Those persons either organize, or assist in organizing, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, or participate (directly or indirectly) in the sale of ownership interests in that entity, plan, or arrangement.[88] The IRS defines the preceding concepts broadly, of course. In addition to organizing or participating in the sale of tax shelters, persons must do something more to be punished. Specifically, they must personally make or furnish, or cause another person to make or furnish, a statement about the allowability of a tax deduction or credit, the excludability of any income, or the attainment of other tax benefits by a taxpayer. The persons also must know, or have reason to know, that the statement is materially false or fraudulent.[89] The size of the penalty

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

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

[85] Tax Court Rules and Procedures 24(g)(1); *see also* ABA Model Rules of Professional Conduct 1.7 and 1.8; *see also* Tax Court Rules and Procedures 201(b) (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 and Procedures 24(g)(2)(A).

[86] IR-2021-65.

[87] Loricchio, "IRS Zeroes In on Erroneous Employee Retention Credit Claims," *Tax Notes Federal*, July 31, 2023, p. 847.

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

[89] 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).

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.[90]

The IRS also can sanction persons under section 6701 for aiding and abetting a tax understatement related to ERCs. Penalties apply when a person assists, procures, or advises concerning the preparation of any portion of a return, affidavit, claim, or other document, and that person knows (or has reason to know) that it will be used in connection with a material tax matter, and knows that it will result in a tax understatement.[91] The type of person on whom the IRS may impose this penalty is quite broad; it is not limited to traditional accountants, enrolled agents, and other return preparers.[92]

The IRS, with assistance from the Justice Department, can take more urgent actions. If the circumstances warrant it, the Justice Department can file a lawsuit in federal 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, which governs practice before the IRS.[93] District courts have broad authority to impose equitable relief. They can, for instance, enjoin all actions by the promoter that might violate applicable law, or behavior that tends to impede the administration of tax laws.[94] They can also force promoters to disgorge, or relinquish, all or a portion of the money they made from their improper activities.[95]

The IRS's Office of Professional Responsibility has jurisdiction over attorneys, accountants, EAs, actuaries, retirement plan agents, registered tax return preparers, and other professionals who practice before the IRS.[96] The idea of practice in this context is liberal, encompassing all matters connected with a presentation to the IRS about the rights, privileges, or liabilities of a taxpayer.[97] Likewise, the notion of a presentation broadly covers, among other things, (1) preparing and filing documents with the IRS; (2) giving written advice regarding any entity, transaction, plan, or arrangement "having a potential for tax avoidance or evasion"; and (3) representing a client at conferences, hearings, or meetings.[98] OPR has the power to punish any practitioner who is incompetent or disreputable, violates any relevant standard, or willfully misleads a current or potential client.[99] Punishments vary depending on the conduct, but can consist of a temporary suspension, permanent disbarment, public censure, or a monetary penalty.[100] For the last item, 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.[101]

The IRS might pursue return preparer penalties under section 6694 as part of ERC enforcement, and this category pertains to far more than just the individuals who actually sign forms 941 or 941-X. It generally means any person who prepares for compensation, or who employs other persons to prepare for compensation, any tax return or claim for refund, or a substantial portion thereof.[102] It encompasses both signing preparers (individuals who are primarily responsible for the overall substantive accuracy of a return or claim) and non-signing preparers (individuals, other than signing preparers, who prepare all or a substantial portion of a return or claim).[103] The IRS generally can penalize a return preparer in any one of the following circumstances. First, if the position on the return causing the tax understatement relates to a tax shelter or a reportable transaction, and it was not

[90] Section 6700(a) (flush language).

[91] Section 6701(a).

[92] *Nielsen v. United States*, 976 F.2d 951, 955 (5th Cir. 1992); TAM 200243057.

[93] Section 7408(c); IRS Large Business and International Division Process Unit, "Tax Shelter Promoter Investigations Under IRC 6700," PEN-P-005, at 28 (Dec. 14, 2021).

[94] JCT, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," JCS-38-82, at 213 (Dec. 31, 1982).

[95] Sections 7402, 7406, 7408.

[96] 31 U.S.C. section 10.2(a)(5); 31 U.S.C. section 10.3.

[97] 31 U.S.C. section 10.2(a)(4).

[98] *Id.*; T.D. 9359, Summary of Comments and Explanation of Provisions.

[99] 31 U.S.C. section 330(b); 31 U.S.C. section 10.50.

[100] 31 U.S.C. section 330(b); 31 U.S.C. section 10.50.

[101] 31 U.S.C. section 330(b); 31 U.S.C. section 10.50; Notice 2007-39, 2007-1 C.B. 1243.

[102] Section 7701(a)(36)(A).

[103] Reg. section 301.7701-15(b)(1) and (2).

reasonable for the preparer to believe that the position would "more likely than not" be upheld if the IRS were to challenge it. Second, if 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, if the position does not implicate a tax shelter or reportable transaction and it was correctly disclosed, but there was no reasonable basis for it.[104] The basic penalty equals $1,000 or 50 percent of the income that the preparer derived (or will derive) from the relevant tax return or refund claim, whichever amount is larger.[105] The penalty increases, of course, when the preparer willfully attempts to understate a liability or intentionally disregards applicable authorities.[106]

VI. Conclusion

All the items discussed here contribute to the broader ERC discourse, but the four most interesting are the immediate moratorium on processing future ERC claims, the threat of enhanced compliance reviews on pending and future claims, the announcement of a special withdrawal option for taxpayers with unpaid claims, and the promise of a settlement program for taxpayers that received ERCs and might not deserve them.

The first two items likely will end in a predictable and anticlimactic fashion — the IRS will uncover significant numbers of ERC claims that are unfounded, audits will follow, refund claims will be denied, and tax litigation of different varieties will ensue.

The outcome of the last two items is less clear. Why? The primary carrot dangled by the IRS for taxpayers that abandon their ERC claims, either by withdrawal or voluntary settlement, appears to be penalty waiver. This is a common bid by the IRS, and it works well in certain scenarios. The question is, will it function in situations involving ERCs when the IRS has not addressed the potential whipsaw issue involving interrelated employment tax and income tax issues, when the IRS has not determined the proper tax treatment of large upfront or contingency fees paid by taxpayers, and when the IRS has seemingly acknowledged that penalizing many taxpayers would be inappropriate, if not impossible, given the difficulty of the issues and the practices used by companies marketing ERC claims? If any doubt on this last point exists, one need look no further than the recent announcement by the IRS about its moratorium. There, the IRS says that the moratorium is designed to prevent "scammers taking advantage of honest taxpayers"; that it is creating the withdrawal and settlement procedures "to help businesses that found themselves victims of aggressive promoters"; that it sees "a variety of ways that promoters can lure businesses, tax-exempt groups and others into applying for the credit"; and that it recognizes that the ERC is "a complex claim with precise requirements," "an incredibly complex claim," and "a very technical area of the law."[107]

Uncertainty regarding some aspects of the ERC persists. One thing is clear, though: The IRS is now in enforcement mode, and taxpayers should be hiring qualified tax counsel without conflicts of interest, analyzing all their options, and otherwise preparing to defend themselves. ■

[104] Section 6694(a)(1); section 6694(a)(2).

[105] Section 6694(a)(1).

[106] Section 6694(b)(1) and (2).

[107] IR-2023-169; *see also* IRS, "Employee Retention Credit Eligibility Checklist: *Help Understanding This Complex Credit*" (last updated Sept. 19, 2023).