

# How the IRS Can Recapture ERC Refunds and Interest

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In this article, Sheppard explores the relationship between employee retention credit statutes, two sets of recent regulations, and the expansion of assessment periods.

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## I. Introduction

Congress instructed the IRS to publish administrative guidance on specific, limited issues regarding the employee retention credit. The IRS did so, first issuing regulations about its ability to recapture “erroneous refunds,” followed by regulations touting its supposed authority to grab related interest payments. If these new rules withstand scrutiny, they will enhance the IRS’s enforcement capabilities, especially when one considers them in conjunction with the current and possibly expanding assessment periods. This article explores four major ERC laws, two sets of recent regulations, various assessment periods applicable to ERC claims, and how they all interrelate.

## II. Overview of Four ERC Laws

### A. First Law

Congress introduced the ERC in early 2020 when it enacted the Coronavirus Aid, Relief, and Economic Security Act.<sup>1</sup> That first law was applicable to the second, third, and fourth quarters of 2020.<sup>2</sup> It generally stated that an eligible employer could claim an ERC against employment taxes equal to 50 percent of the qualified wages it paid to employees.<sup>3</sup> The CARES Act had its limits — for example, the qualified wages for any one employee could not exceed \$10,000 for all three quarters combined. That meant the maximum ERC for all of 2020 was just \$5,000 per employee.<sup>4</sup>

ERCs for a specific quarter could not surpass the relevant employment taxes paid by an eligible employer for all employees for that quarter.<sup>5</sup> If the ERCs exceeded the threshold, the surplus would be treated as a tax overpayment and refunded.<sup>6</sup>

Through the CARES Act, Congress told the IRS that it “shall issue such forms, instructions, regulations, and guidance as are necessary” to accomplish four specific items: facilitating advance payments of ERCs; providing a mechanism for reconciling advance payments with the corresponding Forms 941, “Employer’s Quarterly Federal Tax Return,” filed later; permitting “recapture” of ERCs from taxpayers that later received small business loans; and

<sup>1</sup> P.L. 116-136; Joint Committee on Taxation, “Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security (‘CARES’) Act,” JCX-12R-20 (Apr. 23, 2020); *see also* Notice 2021-20, 2021-11 IRB 922.

<sup>2</sup> CARES Act, section 2301(m).

<sup>3</sup> *Id.*, section 2301(a).

<sup>4</sup> *Id.*, section 2301(b)(1); JCT, *supra* note 1, at 38.

<sup>5</sup> CARES Act, section 2301(b)(2).

<sup>6</sup> *Id.*, section 2301(b)(3)(A) (citing section 6402(a) and section 6413(b)).

allowing third-party payers to submit the documents necessary to substantiate that their clients meet the ERC criteria.<sup>7</sup>

## B. Second Law

The second piece of legislation was the Taxpayer Certainty and Disaster Tax Relief Act, which extended ERC benefits to the first and second quarters of 2021.<sup>8</sup> Eligible employers could get more ERCs under the relief act because it increased the percent of qualified wages on which they could claim ERCs from 50 to 70. It also provided that qualified wages would be calculated per quarter, not per year.<sup>9</sup>

## C. Third Law

Congress next introduced the American Rescue Plan Act of 2021.<sup>10</sup> That law codified the ERC rules into section 3134. ARPA extended the ERC, allowing eligible employers to claim benefits for the third and fourth quarters of 2021.<sup>11</sup> It also confirmed that surplus ERCs would be treated as overpayments by eligible employers and credited or refunded, as appropriate.<sup>12</sup> Finally, similar to the earlier CARES Act, ARPA instructed the IRS to issue forms, instructions, regulations, and necessary guidance. The specific purposes for such IRS direction differed, however. Under ARPA, the IRS was told to supply details to allow advance payments of ERCs, permit third-party payers to substantiate client eligibility, and “prevent the avoidance of the purposes of the limitations” of section 3134.<sup>13</sup>

## D. Fourth Law

The passage of the Infrastructure Investment and Jobs Act ended matters.<sup>14</sup> That law

retroactively shortened the relevant periods, prohibiting ERC claims for the fourth quarter of 2021 for all eligible employers, other than so-called recovery startup businesses. The IRS explained that under the Infrastructure Investment and Jobs Act, advance payments received by most eligible employers for the fourth quarter of 2021 became “erroneous refunds,” which had to be repaid.<sup>15</sup>

## III. Final Regulations on Recouping Taxes

The IRS issued two sets of temporary regulations about how it could administratively challenge and possibly recover excessive ERC amounts.<sup>16</sup> The first set addressed recapture of improper ERC refunds issued to eligible employers in accordance with the CARES Act or the relief act.<sup>17</sup> The second set was necessary because ARPA created a new tax provision, section 3134, instead of simply expanding and amending the earlier laws.<sup>18</sup> The IRS ultimately combined both into just one set of final regulations (tax recapture regulations).<sup>19</sup>

The tax recapture 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.”<sup>20</sup> Also, they stated that “a refund or credit of any portion of [ERCs], regardless of whether they are advanced, to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund that the employer must repay.”<sup>21</sup>

The tax recapture regulations further explained that section 6201 grants the IRS its general assessment authority. That tax provision broadly states that the IRS “is authorized and required to make the inquiries, determinations, and assessments of all taxes (including interest, additional amounts, additions to tax, and

<sup>7</sup> *Id.*, section 2301(l)(1) and (2).

<sup>8</sup> Consolidated Appropriations Act, 2021, division EE, section 207; JCT, “Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security,” JCX-3-21, at 66-70 (Feb. 8, 2021); *see also* Notice 2021-23, 2021-15 IRB 1113, Section III.A.

<sup>9</sup> Notice 2021-23, at Section III.D.

<sup>10</sup> ARPA section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

<sup>11</sup> ARPA section 9651(a).

<sup>12</sup> *Id.* (*see* section 3134(b)(3)).

<sup>13</sup> *Id.* (*see* section 3134(m)).

<sup>14</sup> *See also* Notice 2021-65, 2021-51 IRB 880.

<sup>15</sup> *Id.* at Section III.B.

<sup>16</sup> The text of the temporary regulations also served as the text of the proposed regulations. *See* T.D. 9978.

<sup>17</sup> REG-111879-20; T.D. 9904.

<sup>18</sup> REG-109077-21; T.D. 9953, Background, Section V.

<sup>19</sup> T.D. 9978; reg. section 31.3111-6; reg. section 31.3131-1; reg. section 31.3132-1; reg. section 31.3134-1; reg. section 31.3221-5.

<sup>20</sup> T.D. 9904.

<sup>21</sup> T.D. 9953, Background, Section IV.

assessable penalties) imposed by” the Internal Revenue Code.<sup>22</sup> However, section 6201 does *not* expressly allow the IRS to assess and collect any non-rebate portion of an erroneous refund of a refundable credit, like the ERC.<sup>23</sup> That is why the tax recapture regulations were necessary.

Citing two decisions by the Supreme Court, the IRS clarified that the government has an unfettered right to engage in recoupment by litigation. It said that “the government can bring civil litigation to recover funds which its agents [including the IRS] have wrongfully, erroneously, or illegally paid, and no statute is necessary to authorize the government to sue in such a case, since the right to sue is independent of a statute.”<sup>24</sup>

The IRS claimed in the tax recapture regulations that Congress authorized it to go further, arguing the following: The CARES Act instructed the IRS to issue “such forms, instructions, regulations, and guidance as are necessary” to accomplish several things, including allowing advance payments; permitting reconciliation of those payments with the ERCs reflected on the corresponding Forms 941 filed later; and providing for recapture of ERCs if distributed to taxpayers that later received small business loans.<sup>25</sup>

For its part, ARPA mandated that the IRS issue “such forms, instructions, regulations, and guidance as are necessary” for specific purposes, among them “preventing the avoidance of the purposes of the limitations” in the ERC rules.<sup>26</sup> The IRS interpreted the preceding two mandates in the CARES Act and ARPA to mean that Congress had empowered it “to issue guidance for the administrative reconciliation and recapture of erroneous refunds.”<sup>27</sup> The IRS carried that out by issuing the tax recapture regulations, giving the IRS authority to assess and collect improper ERCs, as follows:

These [tax recapture regulations] provide that erroneous refunds of [ERCs] are

treated as *underpayments* of [relevant employment taxes] and authorize the IRS to assess any portion of the [ERCs] erroneously credited, paid, or refunded in excess of the amount allowed as if those amounts were tax liabilities . . . subject to assessment and administrative collection procedures.

Any amount of the [ERC] for Qualified Wages . . . that are erroneously refunded or credited to an employer shall be treated as *underpayments* of [the relevant employment taxes] by the employer and may be administratively assessed and collected in the same manner as taxes.

The tax recapture regulations explained that the administrative procedures would apply in the normal course of processing Forms 941 and Forms 941-X, or while auditing them later to determine if the ERC claims were excessive.

The IRS offered several justifications for the tax recapture regulations. For example, the special procedures supposedly allow the IRS to efficiently recover undeserved amounts and avoid the costs and burdens of litigation, while at the same time safeguarding administrative protections for taxpayers that desire to dispute their tax liabilities.<sup>28</sup> The IRS also suggested that, “without these [tax recapture regulations], in some instances the IRS may not be able to avoid bringing costly and burdensome litigation to recover such reported erroneous refunds.”<sup>29</sup>

The tax recapture regulations clarified that they fortify, not substitute, the IRS’s normal tools. In that vein, the IRS said that “these assessment and administrative collection procedures *do not replace* the existing recapture methods, but rather represent an *alternative method* available to the IRS” (emphasis added).<sup>30</sup>

Nobody requested a hearing on the temporary version of the tax recapture regulations, and the IRS only received two written comments, both of

<sup>22</sup> Section 6201(a).

<sup>23</sup> T.D. 9953, Background, Section V.

<sup>24</sup> T.D. 9904, Background, Section IV.

<sup>25</sup> CARES Act, section 2301(l)(1) and (2).

<sup>26</sup> ARPA, section 9651(a) (see section 3134(m)).

<sup>27</sup> T.D. 9904, Background, Section IV.

<sup>28</sup> T.D. 9904, Explanation of Provisions; T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

<sup>29</sup> T.D. 9904, Special Analyses.

<sup>30</sup> T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

which addressed issues off topic.<sup>31</sup> Thus, the IRS published the final version essentially without changes, establishing 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 the [relevant employment taxes] and may be assessed and collected by the [IRS] in the same manner as the taxes.<sup>32</sup>

#### IV. Proposed Regulations on Recouping Interest

The tax recapture regulations analyzed above deal with IRS procedures for administratively challenging ERC claims, assessing liabilities, and collecting excessive amounts.<sup>33</sup> In other words, the tax recapture regulations address taxes, but not related interest. The IRS put it yet another way, explaining that “while the [tax recapture regulations] provide for the assessment of erroneous refunds of [ERCs] as an underpayment of certain employment taxes, they do *not* address overpayment *interest* paid to a taxpayer on an erroneous refund” (emphasis added).<sup>34</sup>

The proposed version of the interest recapture regulations, recently issued by the IRS in July, copes with interest issues.<sup>35</sup> They start with basics, which are that if the IRS allows a taxpayer ERCs that it later determines are unwarranted, the taxpayer must pay the resulting tax liability, plus the interest it received from the IRS on the erroneous refund.<sup>36</sup> The interest recapture regulations then attempt to justify their existence, leaning heavily on the supposed congressional mandate for the IRS to “prevent the avoidance [by taxpayers] of the purposes of the limitations” in the ERC rules. The interest recapture regulations state:

[The CARES Act and ARPA] authorize and require the [IRS] to issue regulations to prevent the *avoidance of the limitations* placed on the [ERCs] by these statutes. When a taxpayer is issued an erroneous refund of [ERCs] for which the taxpayer is not eligible, the taxpayer incurs a liability to repay that refund. The taxpayer also incurs a liability to repay any overpayment interest paid on the erroneous refund. In pursuing collection of these liabilities, *the IRS is enforcing the statutory limitations* on [ERCs] that made the taxpayer’s refund, and any accompanying overpayment interest, erroneous. Regulations providing for the administrative recapture of overpayment interest paid on refunds subsequently determined to be erroneous assist in resolving taxpayers’ repayment liabilities while also preserving administrative protections afforded to these taxpayers with respect to contesting their tax liabilities under the [Internal Revenue Code] and avoiding unnecessary costs and burdens associated with litigation.<sup>37</sup>

If the IRS were to finalize the interest recapture regulations in their current form, they would read as follows:

Any *overpayment interest* paid under Section 6611 [by the IRS] to an employer, or any third party payor . . . with respect to an erroneous refund . . . shall also be treated as an underpayment of taxes imposed by the [relevant employment tax provision] and may be assessed and collected by the [IRS] in the same manner as taxes.<sup>38</sup>

#### V. Periods to Recapture Tax and Interest

As noted, the recent tax recapture regulations authorize the IRS to use its normal procedures to audit ERC claims and recover erroneous refunds as taxes. On a related note, the interest recapture

<sup>31</sup>T.D. 9978, Summary of Comments and Explanations of Provisions.

<sup>32</sup>Reg. section 31.3111-6(b) and (c); reg. section 31.3134-1(a) and (b); reg. section 31.3221-5(b) and (c).

<sup>33</sup>REG-109032-23.

<sup>34</sup>*Id.* at Section IV.

<sup>35</sup>*Id.*

<sup>36</sup>Section 6611; section 6621.

<sup>37</sup>REG-109032-23, Section IV.

<sup>38</sup>REG-109032-23; prop. reg. section 31.3111-6(e); prop. reg. section 31.3131-1(d); prop. reg. section 31.3132-1(d); prop. reg. section 31.3134-1(d); prop. reg. section 31.3221-5(e).

regulations, if finalized in their current form, will permit the IRS to administratively recoup interest paid on erroneous refunds. Those are noteworthy rules by themselves, but they acquire even more importance when one considers the expanding periods during which the IRS can exercise its powers.

The IRS ordinarily has three years from the date on which a tax return is actually filed (or deemed filed) to identify it, conduct an audit, and propose changes.<sup>39</sup> Thus, when it comes to ERC claims, the *normal* assessment period for Forms 941 for any quarter of 2020 expired on April 15, while the period for Forms 941 for 2021 will lapse on April 15, 2025.<sup>40</sup>

ARPA granted the IRS more time to audit taxpayers for the third and fourth quarters of 2021. Specifically, it gives the IRS five years (instead of three years) from the date on which the relevant Form 941 was actually filed or deemed filed to challenge a taxpayer.<sup>41</sup> For instance, if a taxpayer filed a timely Form 941 for the third quarter of 2021 claiming ERCs, such tax return is deemed filed on April 15, 2022, and the assessment period remains open until April 15, 2027.

When a tax return is intentionally false or fraudulent, the IRS may assess *at any time*.<sup>42</sup> A few cases have concluded that the IRS warrants an indefinite period if the applicable return is fraudulent, regardless of whether caused by the taxpayer, return preparer, or another person.<sup>43</sup>

The Tax Relief for American Families and Workers Act, introduced in early 2024, is still pending in Congress.<sup>44</sup> If passed someday, the act

would expand the assessment period from three years to six years. Importantly, the six-year clock would not start ticking against the IRS until the date on which the relevant Form 941 was actually filed, when the Form 941 was deemed filed, or when the credit or refund regarding the ERC “is made,” whichever occurs later.<sup>45</sup>

The current administration has advocated for expanding the five-year period, which affects only the third and fourth quarters of 2021, to cover all possible quarters. One of the recommendations in its most recent budget proposal was to prolong the assessment period for all ERC claims (for both 2020 and 2021) from three years to five years.<sup>46</sup>

In summary, for ERC claims involving the second, third, and fourth quarters of 2020, the three-year period expired April 15; for claims involving the first and second quarters of 2021, the three-year period will end April 15, 2025; for claims relating to the third and fourth quarters of 2021, the five-year period will close April 15, 2027, and the assessment period never ceases if the ERC claim is fraudulent. Moreover, depending on the actions of Congress, the assessment period might extend to five years or six years for all ERC claims. The long periods lend significance to the new powers the tax recapture regulations and interest recapture regulations provide the IRS in its battles against improper ERC claims.

## VI. Conclusion

The IRS has recently lost several court cases for violating the Administrative Procedure Act in various contexts when it issued notices, regulations, and more.<sup>47</sup> Taxpayers, cognizant of this pattern, have already challenged some of the ERC guidance, which the IRS released without first seeking, obtaining, or contemplating public input.<sup>48</sup> As this article explains, Congress instructed the IRS in the CARES Act and ARPA to

<sup>39</sup> Section 6501(a).

<sup>40</sup> Reg. section 301.6501(b)-1(b). These deadlines also apply for Forms 941-X for 2020 or 2021.

<sup>41</sup> ARPA, section 9651(a); Notice 2021-49, Section III.G.

<sup>42</sup> Section 6501(c)(1); *Payne v. Commissioner*, 224 F.3d 415 (5th Cir. 2000), supplemented by T.C. Memo. 2001-231; *Neely v. Commissioner*, 116 T.C. 79 (2001).

<sup>43</sup> See, e.g., *Allen v. Commissioner*, 128 T.C. 37 (2007); *Eriksen v. Commissioner*, T.C. Memo. 2012-194; *Finnegan v. Commissioner*, 926 F.3d 1261 (11th Cir. 2019); *Ames-Mechelke v. Commissioner*, T.C. Memo. 2013-176; *Murrin v. Commissioner*, T.C. Memo. 2024-10.

<sup>44</sup> Tax Relief for American Families and Workers Act of 2024 (H.R. 7024); Doug Sword and Cady Stanton, “Werfel Pitches Senators on Three Legislative Fixes for ERC Fraud,” *Tax Notes Federal*, Jan. 15, 2024, p. 527; Lauren Loricchio, “Tax Deal Would Bring ERC Claims to Earlier End and Curb Abuse,” *Tax Notes Federal*, Jan. 22, 2024, p. 732; Stanton, “Wyden to File Tax Bill as Amendment to FAA Reauthorization,” *Tax Notes Federal*, May 13, 2024, p. 1273.

<sup>45</sup> Tax Relief for American Families and Workers Act, section 602(i).

<sup>46</sup> Treasury, “General Explanations of the Administration’s Fiscal Year 2025 Revenue Proposals,” at 203-204 (Mar. 11, 2024).

<sup>47</sup> See, e.g., Order on Cross-Motions for Summary Judgment, *Aroeste v. United States*, No. 3:22-cv-00682 (S.D. Cal. Nov. 20, 2023); *CIC Services LLC v. IRS*, No. 3:17-cv-00110 (E.D. Tenn. 2022); *Mann Construction Inc. v. United States*, 27 F. 4th 1138 (6th Cir. 2022); *Liberty Global Inc. v. United States*, No. 1:20-cv-03501 (D. Colo. 2022); ILM 202244010 (Nov. 4, 2022); and *Valley Park Ranch LLC v. Commissioner*, 162 T.C. No. 6 (2024).

<sup>48</sup> *Stenson Tamaddon LLC v. United States*, No. 2:24-cv-01123 (D. Ariz. 2024).

supply guidance for specific, narrow purposes, and taxpayers might argue that the tax recapture regulations and interest recapture regulations surpass those parameters. It would be no surprise to see more lawsuits alleging violations by the IRS of the APA. Until those loftier legal issues have been resolved, taxpayers facing IRS challenges to their ERC benefits should be aware of the new administrative powers, as well as the growing periods during which the IRS might be able to exert them. ■

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