

IRS Tries to Further Limit ERC Claims Under Governmental Order Test

by Hale E. Sheppard

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In this article, Sheppard examines the IRS's recent efforts to limit access to the employee retention credit based on governmental orders.

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I. Introduction

The stock market is on the rise, inflation is steady, and unemployment levels are low. One might say things are going well with the U.S. economy. It was not long ago, though, that the country was in peril because of COVID-19. Congress created the employee retention credit to protect American businesses and workers, then in rapid succession enacted laws to ease eligibility requirements and increase ERC amounts. Meanwhile, the IRS — tasked with publishing guidance for implementing the ERC — issued various pronouncements. The IRS's position is that it is just clarifying issues as they evolve, consistent with the congressional mandate. Many taxpayers, however, believe that the IRS is inappropriately, if not illegally, narrowing access to the ERC.

Whether the IRS's actions are proper remains unclear, but what is certain is that the IRS is relying on its own guidance in reviewing, and frequently denying, ERC claims. This is especially true when it comes to taxpayers seeking ERCs because their businesses were suspended under a governmental order.

This article focuses on how to treat ERC claims based on governmental orders, and it could serve as a desktop guide for affected taxpayers whose

positions have been ignored, rejected, or challenged by the IRS.

II. Congressional Guidance

Congress passed four laws regarding the ERC, with the first being the Coronavirus Aid, Relief, and Economic Security Act.¹ It generally provided that an “eligible employer” could get an ERC against employment taxes equal to 50 percent of the “qualified wages” it paid to each employee, subject to various limitations.² An eligible employer was one that was carrying on a trade or business and met *one* of the following two tests.

First, the operations of the employer were partially or fully suspended during a specific quarter because of an order from an appropriate governmental authority that limited commerce, travel, or group 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 during a specific quarter (reduced gross receipts test).⁴ The benefits under the CARES Act were capped. In particular, the amount of qualified wages for any one employee could not exceed \$10,000 for *all* applicable quarters combined. That meant the maximum ERC per employee for all of 2020 was \$5,000.⁵

¹ 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 *Id.*, section 2301(c)(2)(A)(ii)(I).

⁴ *Id.*, section 2301(c)(2)(A)(ii)(II). The period *started* with the quarter during which the gross receipts were less than 50 percent of the gross receipts during the same quarter the previous year, and *ended* the quarter after the gross receipts were greater than 80 percent of the gross receipts the previous year. *See* CARES Act, section 2301(c)(2)(B).

⁵ CARES Act, section 2301(b)(1); JCX-12R-20, *supra* note 1, at 38.

Coverage of the ERC changed several times, but it originally applied to the second, third, and fourth quarters of 2020.⁶

Congress next passed the Taxpayer Certainty and Disaster Tax Relief Act.⁷ Among other things, that legislation expanded the period during which eligible employers might benefit. They could claim ERCs not only for the second, third, and fourth quarters of 2020 (as under the CARES Act) but also for the first and second quarters of 2021.⁸

Eligible employers could get increased amounts of ERCs, as follows: Initially, under the CARES Act, an eligible employer could only claim ERCs for 50 percent of qualified wages, up to \$10,000 per employee for all of 2020. The relief act changed two things: First, the qualified wages on which the ERC could be claimed increased from 50 percent to 70 percent; and second, the amount was calculated per quarter, not per year. The following example demonstrates how those two modifications favored taxpayers. If an eligible employer paid an employee \$10,000 in qualified wages in each of the first and second quarters of 2021, the ERCs would total \$14,000 (that is, \$7,000 per quarter).⁹

Congress next enacted the American Rescue Plan Act.¹⁰ That legislation “codified” the ERC for the first time, making it section 3134 of the Internal Revenue Code. The ARPA further expanded the ERC, allowing benefits for the third and fourth quarters of 2021, too.¹¹ It also inserted a new type of eligible employer, the so-called recovery start-up business, defined as an employer that began operating a trade or business after February 15, 2020; had average annual gross receipts of \$1 million or less during the relevant period; and did not otherwise qualify as an eligible employer.¹²

Congress then introduced the Infrastructure Investment and Jobs Act.¹³ That law *retroactively* shortened the period for which eligible employers could claim benefits. Except for recovery start-up businesses, eligible employers could no longer solicit ERCs for the fourth quarter of 2021.

III. Focus on the Governmental Order Test

As explained, the governmental order test is met when an employer’s operations were “partially or fully suspended” because of an “order” from an “appropriate governmental authority” that limited “commerce, travel, or group meetings for commercial, social, religious, or other purposes” because of COVID-19.¹⁴ The governmental order test, by its nature, is more subjective than the reduced gross receipts test, less reliant on objective facts and figures. It also requires employers to interpret complicated terms and concepts, often without clear direction.

The IRS has issued several types of ERC guidance, the authority of which is already being questioned in the courts.¹⁵ Putting aside that pending issue, this article examines the evolving indications from the IRS about the governmental order test. These systematic changes generally have not been helpful to taxpayers, as shown below.

A. Initial Questions and Answers

Soon after Congress enacted the CARES Act, the IRS posted a list of frequently asked questions on its website.¹⁶ Several of them concerned the governmental order test. They were later incorporated into Notice 2021-20, 2021-11 IRB 922.

B. Notice 2021-20

The IRS provided additional direction about the governmental order test generally, and partial or full suspension of business operations specifically, in Notice 2021-20.¹⁷ The IRS issued

⁶ CARES Act, section 2301(m).

⁷ P.L. 116-260, division EE, section 207 (Dec. 27, 2020); JCT, “Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security,” JCX-3-21, at 66-70 (Feb. 8, 2021); see also Notice 2021-23, 2021-16 IRB 1113.

⁸ Notice 2021-23, Section III.A.

⁹ *Id.* at Section III.D.

¹⁰ P.L. 117-2, section 9651 (Mar. 11, 2021); see also Notice 2021-49, 2021-34 IRB 316.

¹¹ Notice 2021-49, Section III.A.

¹² *Id.* at Section III.D.

¹³ ARPA; see also Notice 2021-65, 2021-51 IRB 880.

¹⁴ CARES Act, section 2301(c)(2)(A)(ii)(I).

¹⁵ See, e.g., Lauren Loricchio, “Lawsuit Seeks to Invalidate IRS’s ERC Guidance,” *Tax Notes Federal*, Dec. 11, 2023, p. 2068.

¹⁶ See IR-2020-62 (Apr. 1, 2020) (referencing the questions no longer accessible by internet).

¹⁷ Notice 2021-20, Section III.D.

that guidance about nine months after it released the initial FAQs. The author of this article has abbreviated, simplified, clarified, or otherwise modified the relevant portions of Notice 2021-20 to make them more understandable.

Question: What “orders” from an “appropriate governmental authority” can be considered when determining eligibility for the ERC?

Answer: Orders, proclamations, or decrees from the federal government, or any state or local government, may be taken into account only if they limit commerce, travel, or group meetings for commercial, social, religious, or other purposes because of COVID-19 and they relate to the suspension of operations. Also, if orders and the like come from a state or local government, as opposed to the federal government, that government must have jurisdiction over the relevant employer’s operations.

Whether something qualifies as a governmental order is determined without regard to its level of enforcement. Statements from a government official, including comments made during press conferences or interviews with the media, are not governmental orders for ERC purposes. Also, the declaration of a state of emergency by a governmental authority does not constitute a governmental order if it does not limit commerce, travel, or group meetings in any manner.

Examples of acceptable governmental orders include an order from a city’s mayor indicating that all nonessential businesses must close for a particular period of time, an emergency proclamation by a state mandating that all residents (except essential workers) must shelter in place, an order from a local official imposing a curfew that affects the operating hours of a business, and an order by a local health department requiring workplace closure for cleaning and disinfecting.

Whether the operations of a business are considered essential or nonessential might vary from jurisdiction to jurisdiction and depend on the terms of the relevant governmental order. For example, the governor issues an order that all nonessential businesses must close from March 20, 2020, until April 30, 2020. The order provides a list of nonessential businesses that includes gyms, spas, nightclubs, barber shops, hair salons, tattoo

parlors, physical therapy offices, waxing salons, fitness centers, bowling alleys, arcades, racetracks, indoor children’s play areas, theaters, chiropractors, planetariums, museums, and performing arts centers. The order is a governmental order limiting the operations of nonessential businesses, so employers with nonessential businesses to which the governmental order applies may be considered eligible employers.

Another example involves a mayor who holds a press conference encouraging residents to practice social distancing to prevent the spread of COVID-19. That mayoral statement is not an order limiting commerce, travel, or group meetings, so it is not considered a governmental order for ERC purposes.

In yet another example, a local health department finds that a restaurant has several health code violations and orders it to close. Because the closure order is unrelated to COVID-19, it would not be considered a governmental order in the ERC context.¹⁸

Question: If a governmental order requires nonessential businesses to suspend operations but allows “essential businesses” to continue operations, have the essential businesses suffered a partial or full suspension of operations?

Answer: An employer that operates an essential business generally does *not* have a partial or full suspension of operations if a governmental order allows its operations to remain open. However, it might have a partial suspension if, under the circumstances, the governmental order suspends more than a “nominal portion” of its operations. For example, an employer that maintains both essential *and* nonessential business operations — each of which constitutes more than a nominal portion of its operations — might have a partial suspension if a governmental order restricts the operations of the nonessential portion, even if the essential portion is unaffected.

Also, an essential business that is permitted to continue its operations may nonetheless have a partial suspension if a governmental order requires it to close for a period during normal

¹⁸ *Id.* at Section III.D, Q&A 10.

working hours. For purposes of the ERC, part of an employer's business operations will constitute more than a "nominal portion" if either the gross receipts from that portion of the operations make up 10 percent or more of the total gross receipts, or the hours of service performed by employees in that portion of the business make up 10 percent or more of the total number of hours of service performed by all employees in the business.¹⁹

Question: If a governmental order causes suppliers to an essential business to suspend their operations, does the essential business have a suspension of operations?

Answer: An employer with an essential business might have a partial or full suspension of operations if its suppliers are unable to make deliveries of critical goods or materials under a governmental order that causes the supplier to suspend its operations. For example, an employer operates a manufacturing business that is considered essential. Its supplier of raw materials must shut down under a governmental order, and the employer is unable to procure the raw materials from an alternate supplier. The employer would be considered an eligible employer because its operations have been suspended as a result of the governmental order that suspended operations of its supplier.²⁰

Question: If a governmental order causes customers of an essential business to stay at home, does that business have a suspension of operations?

Answer: An employer that operates an essential business that is not required to close its physical locations or otherwise suspend its operations does not have a partial or full suspension of its operations solely because its customers are subject to a governmental order requiring them to stay at home. For instance, an automobile repair business is an essential business. Although its business has declined significantly because of a governmental order that limits travel, the employer does not have a partial or full suspension of operations under a governmental order.²¹

Question: If an employer voluntarily suspends operations or voluntarily reduces hours because of COVID-19, but these actions are not under a governmental order, is the employer an eligible employer?

Answer: An employer that voluntarily suspends operations or reduces hours is not eligible for the ERC on the basis of a partial or full suspension.²²

Question: If a governmental order requires an employer to close its workplace, but it is able to continue operations comparable with those before the closure by requiring employees to telework, does the employer have a suspension of operations?

Answer: If an employer's workplace is closed by a governmental order, but it is able to continue operations comparable with those beforehand by making employees telework, its operations are not partially or fully suspended. However, if the closure of the workplace causes the employer to suspend business operations for some purposes but not others, it might have a partial suspension of operations under the governmental order. For example, Employer A, a software development company, maintains an office in a city where the mayor ordered that only essential businesses may operate. Employer A's business is not essential. Before the governmental order, all employees teleworked once or twice per week, and business meetings were held at various locations. After the governmental order, Employer A requires all employees to telework full time and limits client meetings to telephone or video conferences. Employer A's business operations are not partially or fully suspended because they may continue in a comparable manner.

Another example involves Employer B, a physical therapy facility located in a city where the mayor ordered that only essential businesses may operate. Employer B's business is not essential. Before the governmental order, none of Employer B's employees teleworked, and all appointments, administration, and other duties were carried out at the workplace. After the governmental order, Employer B moves to an online format and can serve some clients

¹⁹ *Id.* at Section III.D, Q&A 11.

²⁰ *Id.* at Section III.D, Q&A 12.

²¹ *Id.* at Section III.D, Q&A 13.

²² *Id.* at Section III.D, Q&A 14.

remotely, but employees cannot access specific equipment or tools that they typically use in therapy, and not all clients can be served remotely. Employer B's business operations are partially suspended by the governmental order because its workplace, including access to physical therapy equipment, is central to its operations, and the business operations cannot continue in a comparable manner.

A third example centers on Employer C, a scientific research company that conducts research in a laboratory and through the use of computer modeling. Employer C is located in a state where the governor ordered that only essential businesses may operate, and it is not one of those. Before the governmental order, Employer C's laboratory research operations could not be conducted remotely, and employees worked on-site, whereas its computer-modeling operations could be done remotely, and relevant employees often teleworked. After the governmental order, employees focusing on laboratory research cannot perform their work while the facility is closed, yet employees doing computer modeling telework, and those operations continue in a comparable manner. Employer C's operations are partially suspended by the governmental order because the laboratory research cannot continue in a comparable manner.²³

Question: What factors will the IRS consider in determining whether an employer was able to continue operations comparable with those before a closure, such that the employer did not suffer a partial or full suspension?

Answer: The IRS will consider a non-exhaustive list of factors in deciding if an employer was able to continue comparable operations. It will further assess whether the employer had adequate information technology and other support to continue operations from another location. Moreover, the IRS will gauge the amount of work that was portable or otherwise susceptible to being performed remotely. The IRS will also analyze the role that an employer's workspace plays in its business: Is it necessary, beneficial but not necessary, or just convenient? If

the workspace is so critical that operations cannot be performed remotely, "this factor alone indicates that the employer is not able to continue comparable operations." That might be true in situations involving laboratories or manufacturing using special equipment. Finally, the IRS will check the extent to which an employer allowed teleworking before the governmental order was issued. If it prohibited or permitted only minimal teleworking, the business might be deemed partially suspended during a reasonable period required to implement new policies, obtain and provide employees with appropriate equipment, and otherwise transition to remote work.²⁴

Question: If a governmental order requires an employer to close its workplace for some purposes, but it remains operational for limited purposes, does the employer have a suspension of operations?

Answer: If an employer's workplace is closed by a governmental order for some purposes, but it can remain open for other purposes or it can continue some operations remotely, the operations are partially suspended. However, if *all* an employer's business operations may continue subject to modification (for example, to satisfy social distancing requirements), that modification is not a partial suspension unless it has more than a nominal effect on the business operations. The IRS offered several examples on this point. First, a restaurant, Employer A, must cease on-site dining under a governmental order closing all restaurants, bars, and similar establishments. However, Employer A is allowed to continue food and beverage sales on a carryout, drive-through, and delivery basis. Employer A's business operations are partially suspended because a portion of its business operations (that is, its indoor and outdoor dining services) are closed under the governmental order.

The second example also involves Employer A, with a few changes. After two months, the government issues another order, this time allowing Employer A to offer sit-down service in its outdoor space, yet its indoor dining service remains closed. During this period, Employer A's

²³ *Id.* at Section III.D, Q&A 15.

²⁴ *Id.* at Section III.D, Q&A 16.

business operations are partially suspended because more than a “nominal portion” of its business operations (that is, its indoor dining service) are halted under a governmental order.

Employer A is featured in the third example, too. The government issues yet another order the following month, under which Employer A can offer indoor dining service as long as all tables in the dining room are placed at least six feet apart. The restriction on the spacing of tables limits capacity and has more than a nominal effect on business operations, such that Employer A’s operations are partially suspended.

The fourth example centers on Employer B, a retail business that must close its storefront locations under a governmental order. Employer B also maintains a website through which it continues to fulfill online orders unaffected. Employer B’s business operations are partially suspended.

Employer C, a hospital, is the focus of the fifth example. It is considered an essential business regarding its emergency room, intensive care unit, and other services involving urgent medical care. However, the governmental order prevents Employer C from conducting any elective or non-urgent medical procedures because they are nonessential. Although Employer C is an essential business, it has a partial suspension of operations under the governmental order.

The sixth example involves Employer D, a grocery store. It is an essential business under a government order, meaning that it can continue selling prepared or prepackaged food, but it must cease self-serve options, like salad bars. This stoppage does not have more than a nominal effect on business operations; therefore, Employer D does not suffer a partial suspension.

The final example discusses a couple situations with Employer E, a large retailer that must close its storefront location because of a governmental order. Employer E is allowed to continue offering curbside service to customers who purchase items online or by phone. During this period, business operations have been partially suspended. Two months later, the government issues another order, under which Employer E can reopen its storefront under some conditions. In particular, it can allow only a set number of customers inside at one time because

of social distancing mandates. That results in some customers being forced to wait in line outside for a short period during busy times. These conditions do not have more than a nominal effect on business operations. Therefore, during this second period, Employer E does not have a partial suspension.²⁵

Question: What factors will the IRS consider in determining whether a modification required by a governmental order had more than a nominal effect on business operations?

Answer: The types of modifications contemplated are those mandated by a governmental order as a condition of reopening a workplace to the public. Examples include limiting occupancy to create social distancing; requiring that services be performed on an appointment-only basis by businesses that previously allowed walk-ins; making employees and customers wear face masks; and changing the format of service, such as allowing the sale of carryout or prepacked food, but not sit-down dining. The fact that an employer must modify its operations because of a governmental order does not result in a partial suspension unless it has more than a nominal effect on operations.²⁶

Question: Are the operations of an employer partially suspended if it must reduce its operating hours because of a governmental order?

Answer: An employer that reduces its hours under a governmental order has partially suspended its operations because its operations have been limited. For example, an employer runs a food processing facility that normally operates 24 hours a day. A governmental order requires all food processing businesses to deep clean their workplaces daily to reduce the risk of spreading COVID-19. The employer reduces its daily operating hours by five to comply with the order. It has partially suspended its operations.²⁷

Question: Does an employer that operates in multiple locations and that is subject to a governmental order requiring partial or full suspension only in some locations have a suspension for ERC purposes?

²⁵ *Id.* at Section III.D, Q&A 17.

²⁶ *Id.* at Section III.D, Q&A 18.

²⁷ *Id.* at Section III.D, Q&A 19.

Answer: Employers that operate in multiple locations and that are subject to governmental orders limiting operations in some, but not all, jurisdictions have a partial suspension of operations. This discrepancy might be attributable to the employers being considered essential businesses in only some jurisdictions. To operate in a consistent manner in all jurisdictions, employers might establish a policy that complies with local governmental orders as well as guidance from the Centers for Disease Control and Prevention and the Department of Homeland Security. Thus, even though the employer may not be subject to a governmental order to suspend operations in some jurisdictions and may merely be following CDC or DHS guidance, the employer would still have partially suspended operations. The employer, therefore, would be an eligible employer regarding all its operations in all locations.

Consider the following example. The employer is a national retail store chain with operations in multiple states. In some jurisdictions, the employer is subject to a governmental order to close its stores, but it may offer curbside service whereby customers can order items online or by phone and personally pick them up. In other jurisdictions, the employer is not subject to any governmental order, or it is considered an essential business, thereby permitting its stores to remain open. The employer establishes a companywide policy that adheres to the local governmental orders *and* CDC and DHS guidance, requiring closure of all stores and continuance of only curbside service. Under those circumstances, the employer would have a partial suspension, making it an eligible employer nationwide.²⁸

Question: If the business operations of one member of an aggregated group are suspended by a governmental order, are those of the other members of the group also suspended?

Answer: All members of an aggregated group are treated as a single employer for ERC purposes. Thus, if a business is operated by multiple members of an aggregated group, and if the operations of one member of that group are

suspended by a governmental order, all members have a partial suspension, even if another member is located in a jurisdiction that is not subject to a governmental order. For example, the employer is a restaurant chain that operates through multiple subsidiary corporations located in various jurisdictions. The operations of some members of the group are stopped by governmental orders, while those of other members proceed. Because of the governmental order affecting some members, operations of all members of the employer's group are partially suspended.²⁹

Question: If an employer was subject to a governmental order to partially or fully suspend its business operations and that order was later lifted, did the employer have a suspension?

Answer: The employer had a suspension, but only during the periods when its operations were actually affected. If the governmental order was effective for a portion of a quarter, the employer is an eligible employer for the entire quarter, but it can claim ERCs for the qualified wages paid only while the governmental order was in effect. For example, the state issued an order for all nonessential businesses to close from March 10, 2020, through April 30, 2020. The employer, which operates a nonessential business, closes during that period in accordance with the governmental order. The employer is an eligible employer during the first and second quarters of 2020, but it can claim ERCs only for qualified wages paid from March 13, 2020 (that is, the date on which the CARES Act took effect) through April 30, 2020 (that is, the date on which the governmental order expired).³⁰

C. Internal Training Materials

The IRS released its internal ERC training guide in December 2022.³¹ The information about achieving eligible employer status thanks to the governmental order test was similar — and often identical — to that previously contained in Notice 2021-20. In other words, the IRS supplied nothing new here.

²⁸ *Id.* at Section III.D, Q&A 20.

²⁹ *Id.* at Section III.D, Q&A 21.

³⁰ *Id.* at Section III.D, Q&A 22.

³¹ IRS, "Lesson 3: Tax Credit for Employee Retention" (Dec. 2020).

D. Memo About Supply Chain Issues

The IRS supplied additional guidance in July 2023 regarding its interpretation of partial or full suspension of operations. It came in the form of a generic legal advice memorandum on the interplay between suspended operations and supply chain problems.³²

The memo summarized the IRS's position as follows. An employer can "step into the shoes" of its supplier with suspended operations, but this is not easy. The employer must first 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 employer's inability to obtain goods or materials from the supplier caused a partial or full suspension of its operations; and (4) the employer was unable to procure goods or materials from an alternate source.³³ The memo applied those standards to five scenarios, as elaborated below.

1. 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. 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 the goods was caused by COVID-19. Employer A inquired, and Supplier 1 vaguely confirmed that the delay was caused by COVID-19, but it did not provide a copy of any governmental order, and Employer A was unable to locate one independently.

The memo indicated that Employer A was *not* an eligible employer because it could not demonstrate that a governmental order applicable to Supplier 1 partially or fully suspended Supplier 1's business 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. Thus, Employer A did not experience a

suspension of operations caused by an inability to obtain critical goods from Supplier 1. The relevant inquiry, the IRS emphasized, is whether Employer A's operations could continue. Because it was able to continue its business operations despite the supply chain disruption, it did not experience a partial or full suspension.

2. Scenario 2.

Employer B was not subject to a governmental order at any time. However, some critical goods from Supplier 2 were stuck at port. Employer B assumed that the bottleneck at the port 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 memo 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 might 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.

3. Scenario 3.

Employer C and Supplier 3 were located in a jurisdiction that issued governmental orders suspending both of their operations during April 2020. The orders were lifted in May 2020. For the remainder of 2020 and 2021, Employer C suffered 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 and May 2020.

The memo determined that Employer C was an eligible employer in the second quarter of 2020 because its operations were partially or fully suspended under a governmental order.

³² AM 2023-005 (July 21, 2023).

³³ *Id.*

However, only those wages paid during the second quarter of 2020, when Employer C's operations were actually suspended, were qualified wages. Employer C was not an eligible employer for any other quarter in 2020 or 2021 because it could not 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 do not constitute a governmental order in subsequent quarters once the order has been lifted.

4. 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 alternate supplier. The alternate supplier charged 35 percent more for the critical goods than Supplier 4. This meant that Employer D could continue operating its business, but it was not as profitable as before.

The memo concluded 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 does not on its own constitute a partial or full suspension of operations.

5. Scenario 5.

Employer E operated a large retail business selling a variety of products. It was not subject to a governmental order at any time. 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.

The memo reasoned that Employer E was not an eligible employer because it could not demonstrate that a governmental order applicable to a supplier of critical goods or materials caused the supplier to suspend operations and that Employer E was unable to obtain critical goods and materials elsewhere. The memo observed that while some 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.

E. Additional Questions and Answers

The IRS issued yet more guidance less than a week after it released the generic legal advice memo. This took the form of new FAQs posted on its website in July or September 2023.³⁴ Only those involving suspension of operations under the governmental order test are discussed below.³⁵

Question: Who is not eligible to claim the ERC?

Answer: An employer that is ineligible yet "often targeted by ERC scam promoters" is one that "experienced supply chain disruptions but did not experience a full or partial suspension of operations by a qualifying order."³⁶

Question: Is being subject to a governmental order enough for ERC eligibility?

Answer: No, employers must demonstrate that the governmental order was related to COVID-19 and that it resulted in a partial or full suspension of their trade or business.³⁷

Question: What does it mean for one's trade or business to be partially or fully suspended?

Answer: The answer depends on "your specific situation." However, an employer does not qualify if all its employees were able to telework during the pandemic, its customers were affected by a stay-at-home order but no governmental order applied directly to its business operations, or it voluntarily closed its business or reduced its hours.³⁸

Question: Is a business suspended if it has a supply chain issue?

Answer: A supply chain problem, by itself, does not qualify an employer for the ERC. The IRS offers a "narrow" and "limited" exception for situations in which an employer's operations were not partially or fully suspended, but its supplier's were. The exception applies only "when the employer absolutely could not operate without the supplier's product, and the supplier

³⁴ 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.

³⁵ As before, the author of this article has abbreviated, simplified, clarified, or otherwise modified the questions to make them more understandable.

³⁶ IRS, *supra* note 34.

³⁷ *Id.*

³⁸ *Id.*

was fully or partially suspended.” To prove eligibility for the ERC on these grounds, in addition to securing the governmental order pertinent to the supplier, the employer must demonstrate to the IRS that the order caused the supplier to suspend its operations; the employer could not obtain the same goods or materials elsewhere “regardless of cost”; and the order and resulting suspension of the supplier’s operations also caused the suspension of the employer’s operations.³⁹

Question: What type of governmental order qualifies an employer for the ERC?

Answer: The governmental order may be at the local, state, or federal level. Examples include an order by a city’s mayor indicating that all nonessential businesses must close for a particular period of time, an emergency proclamation by a state mandating that all residents (except essential workers) shelter in place, an order from a local official imposing a curfew that affects the operating hours of a business, and an order by a local health department requiring workplace closure for cleaning and disinfecting.⁴⁰

Question: Can I rely on a recommendation, bulletin, or statement issued by a government authority to qualify for the ERC?

Answer: Recommendations or statements “encouraging” employers to take some actions do not constitute governmental “orders.”⁴¹

Question: How does being an essential business affect an employer’s eligibility?

Answer: Being an essential business does not necessarily render an employer ineligible for the ERC. It can still qualify, if appropriate, under the governmental order test or reduced gross receipts test.⁴²

F. Memo About OSHA Communications

The IRS guidance that is perhaps most disappointing or frustrating to taxpayers is a

recent generic legal advice memo addressing the relationship between the governmental order test, partial or full suspension of business operations, and “communications” by the Occupational Safety and Health Administration.⁴³ The IRS issued the memo in October 2023, which was more than three and a half years after Congress enacted the CARES Act, more than two and a half years after the IRS published Notice 2021-20, and several years after many taxpayers had filed ERC claims.

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

The memo reviewed the relevant provisions in the CARES Act, as well as the applicable information in Notice 2021-20. Next, the memo described three documents that OSHA issued in connection with COVID-19. The first was the “Interim Enforcement Response Plan,” released in April 2020, which recommended multiple safety controls, including social distancing, maintaining ventilation systems, and using masks. The memo emphasized that OSHA’s website features a disclaimer expressly stating that OSHA rules are set by statute, standards, and regulations, and that interpretations of these sources, including those in the Interim Enforcement Response Plan, “cannot create additional employer obligations.” The memo went on to explain that the Interim Enforcement Response Plan was not addressed to any specific employer, did not establish a blanket mandate or new requirements for all workplaces, and represented nothing more than instructions to field personnel about evaluating workplace hazards triggered by COVID-19.

The second OSHA communication, called “Protecting Workers Guidance,” was published in January 2021. The memo explained that, although this document referenced “mandatory OSHA standards,” it merely contained recommendations that were “advisory in nature and informational in content,” and did not constitute a law, standard, or regulation.

³⁹ *Id.*

⁴⁰ IRS, *supra* note 34, at “Qualifying Government Orders,” question 1 (added July 28, 2023).

⁴¹ *Id.* at “Qualifying Government Orders,” question 2 (updated Sept. 14, 2023).

⁴² *Id.* at “Eligibility,” question 6 (added Sept. 14, 2023).

⁴³ AM 2023-007 (Oct. 18, 2023).

The third item mentioned in the memo was an OSHA “directive” issued in February 2020, which provided personnel guidance regarding policies and procedures for home-based worksites. The directive noted that “OSHA respects the privacy of the home and has never conducted inspections of home offices.”

The memo then began its analysis. It noted that the CARES Act, later codified with changes as section 3134, requires a governmental “order,” and it 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 memo 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 did not command or mandate any employer to take any action. The memo then got more specific, looking to the Occupational Safety and Health Act. It explained that nonbinding guidance, such as that contained in the Interim Enforcement Response Plan and the Protecting Workers Guidance, is not considered an “order” under that legislation. The memo concluded as follows:

Given that the communications disseminated by OSHA do not conform to the ordinary meaning of the term order at the time Congress enacted [the CARES Act and section 3134] and do not conform to the meaning of the term order in the OSH Act, these [communications] are not orders for the purposes of the [ERC] and cannot be used to claim the [ERC] by employers, even if the employers took steps in response to the communications.

The IRS was not finished yet, though. The memo further explained that the OSHA communications probably would not support an ERC claim, even if they were considered governmental “orders.” Why? The rules require that an employer be subject to a governmental order that causes a partial or full suspension of their operations. The memo 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 memo ended by broadly proclaiming that it “did not adopt and enforce any widely applicable standards that limited commerce, travel, or group meetings due to COVID.”

Backpedaling slightly, the memo recognized that if the OSHA communications became mandatory for some employers because they were embraced by an appropriate governmental authority, an employer might be able to claim ERCs.

The memo concluded by applying its reasoning to two scenarios. In the first scenario, the employer is located in a jurisdiction that lifted all COVID-19-related orders in first quarter 2021. At that time, the employer ceased all mitigation measures other than encouraging employees to wear masks and use routine hygienic practices. The employer claimed ERCs for the second and third quarters of 2021 on grounds that its business operations were partially suspended because of the OSHA communications. The IRS concluded in the memo 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 to three times per week. Starting in 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 because its employees were already equipped to telework before COVID-19 hit; and (4) as stated in its directive, OSHA does not inspect home offices.

G. Latest Questions and Answers

Less than a month after issuing the generic legal advice memo about OSHA communications, the IRS added to its growing FAQs.⁴⁴

Question: Are communications from OSHA governmental orders for ERC purposes?

Answer: An employer normally will not be considered eligible for the ERC solely because it followed “general guidance or recommendations” found in OSHA communications. However, if an appropriate governmental authority, such as a state governor, issued an order making OSHA communications mandatory, an employer might be able to claim ERCs. The IRS will deem an employer eligible if it provides a copy of an order from an appropriate governmental authority requiring compliance with OSHA communications and demonstrates that complying either caused suspension of more than a nominal portion of its business operations or required modifications that had more than a nominal effect on its operations.⁴⁵

IV. Conclusion

Is the IRS narrowing or restricting access to the ERC contrary to the standards set by Congress? If so, does the IRS have authority to make those changes? If so, can the IRS exercise its power by issuing guidance in some form other than regulations? If so, what weight, if any, do FAQs, notices, generic legal advice memorandums, and other IRS pronouncements carry in the ERC context?

Those and other key questions are still unanswered at this point. However, what is undisputed is that the IRS is citing, and relying on, its own guidance when ignoring, rejecting, or otherwise challenging many ERC claims based on the governmental order test. Taxpayers, therefore, should gain a thorough understanding of the IRS’s positions as ERC disputes ramp up. ■

⁴⁴ Consistent with the pattern, the author of this article has abbreviated, simplified, clarified, or otherwise modified the questions to make them more understandable.

⁴⁵ IRS, *supra* note 34, at “Qualifying Government Orders,” question 7 (added Nov. 7, 2023).




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