

## **New ERC Guidance About Suspended Operations and Supply Chains**

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, August 28, 2023, p. 1413

# New ERC Guidance About Suspended Operations and Supply Chains

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In this article, Sheppard examines the evolution of guidance on the employee retention credit, including the IRS's recent attempts to halt what it believes are abusive ERC claims based solely on supply chain disruptions.

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## I. Introduction

Many taxpayers desperately needed an economic injection from the U.S. government to withstand the massive issues caused by the COVID-19 pandemic. Needing financial benefits is one thing, but qualifying for them is another. When it came to eligibility for employee retention credits, employers had to demonstrate several things, including that their total revenue dropped by a certain percentage *or* that a governmental mandate triggered a partial or full suspension of their business operations. The first standard relies on hard figures, whereas the second is more flexible. The logical result is that many employers have claimed that they are entitled to ERCs, often in large quantities, because their operations supposedly were suspended in some manner. Equally predictable was the reaction by the IRS. It is convinced that some employers are abusing the rules, relying on suspensions that do not reach the relevant thresholds. This article addresses this important issue, focusing on the most recent IRS maneuvers to halt what it believes are improper ERC positions.

## II. Congressional and IRS Guidance

Congress passed four laws in less than two years regarding the ERC, and the IRS supplemented this by issuing multiple notices, revenue procedures, and other guidance to implement the legislative mandates. Given the focus of this article, just the surface of those rules is explained here.<sup>1</sup>

### A. First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act in March 2020.<sup>2</sup> This was a complicated piece of legislation, which introduced key aspects that evolved over time. The CARES Act generally provided that an “eligible employer” could get an ERC against “applicable employment taxes” equal to 50 percent of the “qualified wages” that it paid to each employee for each quarter, subject to a maximum.<sup>3</sup> Those three key terms are defined below.

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 by an order from an appropriate governmental authority that limited commerce, travel, or group meetings for commercial, social, religious, or other purposes

<sup>1</sup> For further details about the ERC rules and their evolution, see Hale E. 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); and Sheppard, “Employee Retention Credits: Analyzing Congressional and IRS Guidance From Start to Finish,” *J. Tax'n* (coming 2023).

<sup>2</sup> Joint Committee on Taxation, “Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security Act,” JCX-12R-20 (Apr. 23, 2020).

<sup>3</sup> CARES Act section 2301(a).

because of COVID-19 (the governmental order test).<sup>4</sup> That test is the heart of this article.

Second, the employer suffered a significant decline in gross receipts during a particular quarter (the reduced gross receipts test).<sup>5</sup> The period started with the quarter during which the gross receipts were less than 50 percent of the gross receipts during the same quarter the previous year, and ended the quarter after the gross receipts of the employer were greater than 80 percent of the gross receipts the previous year.<sup>6</sup>

The term “employment taxes” ordinarily refers to three items: (1) federal income taxes paid solely by employees through mandatory withholding by their employers; (2) amounts under FICA, which are paid partly by employees and partly by employers; and (3) amounts under FUTA, which are paid entirely by employers.<sup>7</sup> The term “applicable employment taxes” initially means FICA amounts for ERC purposes.<sup>8</sup>

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. If an eligible employer had an average of more than 100 full-time employees (a large eligible employer), qualified wages meant those paid to any employee *who was not providing services* as a result of the government order test or the reduced gross receipts test.<sup>9</sup> The CARES Act placed a limit on qualified wages when it came to large eligible employers. They could not exceed the amount that an employee would have been paid for actually working an equivalent duration during the 30 days immediately preceding the relevant period.<sup>10</sup> This cap was designed to avoid pay rate manipulation. For example, if a large eligible employer normally paid an employee \$15 per hour, but during the period that it met the

governmental order test or the reduced gross receipts test it paid the same employee \$20 per hour, then only \$15 per hour of the wages paid for only the hours when the employee was not providing services were considered qualified wages.<sup>11</sup> The tax treatment was more favorable when it came to less substantial businesses. When an eligible employer had an average of 100 or fewer full-time employees (small eligible employer), qualified wages meant *all wages* paid during a quarter, regardless of whether the employees were actually working.<sup>12</sup> In addition to the amounts described above, qualified wages included the qualified health plan expenses of the eligible employer properly allocable thereto.<sup>13</sup>

The sky was *not* the limit under the CARES Act. Indeed, the amount of qualified wages for any one employee could not be more than \$10,000 for *all* applicable quarters combined. This meant that the maximum ERC per employee for all of 2020 was \$5,000.<sup>14</sup>

Coverage of the ERC changed several times, but it originally applied to wages paid after March 12, 2020, and before January 1, 2021. In other words, the CARES Act had the ERC benefiting eligible employers during the second, third, and fourth quarters of 2020.<sup>15</sup>

The IRS soon stepped in to explain or expand various aspects of the CARES Act. It did so by releasing Notice 2021-20, 2021-11 IRB 922, in March 2021. That initial IRS guidance applied only to the periods contemplated by the CARES Act — the second, third, and fourth quarters of 2020.<sup>16</sup> The information in Notice 2021-20 was *massive*, with much of it far exceeding the express language of the CARES Act.<sup>17</sup> Portions of it are explored later in this article.

## B. Second, Third, and Fourth Laws

Congress enacted three more pieces of legislation after the CARES Act, and the IRS

<sup>4</sup> CARES Act section 2301(c)(2)(A)(ii)(I).

<sup>5</sup> CARES Act section 2301(c)(2)(A)(ii)(II).

<sup>6</sup> CARES Act section 2301(c)(2)(B).

<sup>7</sup> IRC sections 3101, 3111, 3301, and 3401. When dealing with compensation paid to railroad employees and representatives, the term “employment taxes” also encompasses amounts imposed by the Railroad Retirement Tax Act. *See* section 3221.

<sup>8</sup> CARES Act section 2301(c)(1). These consist of Social Security and Medicare taxes.

<sup>9</sup> CARES Act section 2301(c)(3)(A)(i).

<sup>10</sup> CARES Act section 2301(c)(3)(B).

<sup>11</sup> JCX-12R-20, *supra* note 2, at 41.

<sup>12</sup> CARES Act section 2301(c)(3)(A)(ii)(I) and (II).

<sup>13</sup> CARES Act section 2301(c)(3)(C)(i).

<sup>14</sup> CARES Act section 2301(b)(1); JCX-12R-20, *supra* note 2, at 38.

<sup>15</sup> CARES Act section 2301(m).

<sup>16</sup> Notice 2021-20, Section I.

<sup>17</sup> *Id.* at Section III.

followed suit with more guidance. These featured *many* critical clarifications and changes, of course, but only the few that are directly relevant to this article are highlighted below.

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 in December 2020.<sup>18</sup> The IRS, for its part, issued Notice 2021-23, 2021-16 IRB 1062. Among other things, the relief act expanded the time during which eligible employers might benefit. They could claim ERCs not only for the second, third, and fourth quarters of 2020 (as they could under the CARES Act), but also for the first and second quarters of 2021.<sup>19</sup> Eligible employers also could get increased amounts of ERCs, as follows. Initially, under the CARES Act, an eligible employer could claim ERCs for only 50 percent of qualified wages, up to a maximum of \$10,000 per employee for all of 2020. Simple math shows that eligible employers could get no more than \$5,000 per employee that year. Things changed in two ways for the first and second quarters of 2021 thanks to the relief act. The percentage increased from 50 percent to 70 percent, *and* the amount was calculated per quarter, not per year. As a result, if an eligible employer were to pay an employee \$10,000 in qualified wages in each of the first and second quarters of 2021, the ERCs would total \$14,000 (\$7,000 per quarter).<sup>20</sup>

Congress passed the American Rescue Plan Act of 2021 in March 2021.<sup>21</sup> Importantly, ARPA codified the ERC for the first time, making it section 3134 of the code. The IRS contributed with Notice 2021-49, 2021-34 IRB 316.<sup>22</sup> Like its predecessor, ARPA further expanded the ERC; it covered the third and fourth quarters of 2021.<sup>23</sup> Thus, at that point, the ERC was available for the second, third, and fourth quarters of 2020 (under the CARES Act), the first and second quarters of

2021 (under the relief act), and the third and fourth quarters of 2021 (under ARPA). ARPA also inserted a new type of eligible employer, the so-called recovery start-up business. That was an employer that (1) began operating a trade or business after February 15, 2020; (2) had average annual gross receipts of not more than \$1 million during the relevant period; and (3) did not otherwise qualify as an eligible employer under the governmental order test or the reduced gross receipts test.<sup>24</sup>

Things came to a close when Congress enacted the Infrastructure Investment and Jobs Act in November 2021. That legislation announced the end of the ERC and, to the surprise of many, *retroactively* shortened the periods for which eligible employers could claim benefits. Except recovery start-up businesses, eligible employers could no longer solicit ERCs for the fourth quarter of 2021. The IRS, often the bearer of bad news, issued Notice 2021-65, 2021-51 IRB 880, explaining that advance ERC payments received by most eligible employers for fourth quarter 2021 constituted erroneous refunds, that they had to be timely repaid, and that delinquencies would be penalized.<sup>25</sup> As a result of ARPA, most ERC claims were limited to the second, third, and fourth quarters of 2020, and the first, second, and third quarters of 2021.<sup>26</sup>

### III. Direction on Governmental Order Test

Employers with solid figures showing a precipitous drop in revenue because of COVID-19 likely applied, or will apply, for ERCs using the reduced gross receipts test. Those lacking that hard data probably will turn to the alternative, the governmental order test. As explained above, that standard is met in situations in which an employer was carrying on a trade or business and then its operations were partially or fully suspended as a result an order from an appropriate governmental authority limiting commerce, travel, or group meetings for

<sup>18</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).

<sup>19</sup> Notice 2021-23, Section III.A.

<sup>20</sup> *Id.* at Section III.D.

<sup>21</sup> ARPA section 9651.

<sup>22</sup> Notice 2021-20 continues to apply to the second, third, and fourth quarters of 2020, and Notice 2021-23 continues to apply to the first and second quarters of 2021. *See* Notice 2021-49, Section I.

<sup>23</sup> Notice 2021-49, Section III.A.

<sup>24</sup> *Id.* at Section III.D.

<sup>25</sup> Notice 2021-65, Section III, B.

<sup>26</sup> Infrastructure Investment and Jobs Act section 80604(a).

commercial, social, religious, or other purposes because of COVID-19.<sup>27</sup>

Sounds simple enough, right? Wrong. This is a complex matter, which surely will result in many disputes with the IRS down the road. The IRS has supplied four main sources of guidance about suspension of operations thus far, with the most recent information coming in July 2023. Each source is examined below.

### A. Initial FAQs From the IRS

After Congress enacted the CARES Act, but before the IRS had a chance to generate Notice 2021-20, the IRS released some quick guidance in June 2020 in the form of frequently asked questions. These were posted on its website. Several of the FAQs centered on different aspects the governmental order test, including what satisfies the suspended operations requirement.<sup>28</sup> The relevant FAQs are set forth below.

#### 1. If a governmental order requires nonessential businesses to suspend operations but allows essential businesses to continue operations, are essential businesses considered to have suffered a partial or full suspension of operations?

An employer that operates an essential business generally does *not* have a full or partial suspension of operations if the governmental order allows its operations to remain open. However, an employer that operates an essential business might have a partial suspension if, under the facts and circumstances, more than a nominal portion of its operations are suspended by a governmental order. For example, an employer that maintains both essential *and* nonessential business operations, each of which constitute more than a nominal portion, might have a partial suspension if a governmental order restricts the operations of the nonessential portion, even if the essential portion is unaffected. Further, 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 working hours.<sup>29</sup>

#### 2. If a governmental order causes suppliers to an essential business to suspend their operations, did the essential business have a suspension of operations?

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 because of a governmental order that causes the supplier to suspend its operations. For example, Employer A operates a manufacturing business that is considered essential in the jurisdiction where it operates. Its supplier of raw materials is required to shut down as the result of a governmental order. Employer A is unable to procure the raw materials from an alternate supplier. As a consequence of the suspension of the supplier, Employer A is unable to perform its operations. Under these facts and circumstances, Employer A 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.<sup>30</sup>

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

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, Employer B, an automobile repair business, is an essential business and is not required to close its locations or suspend its operations. Because of a governmental order that limits travel, Employer B's business has declined significantly. Employer

<sup>27</sup> CARES Act section 2301(c)(2)(A)(ii)(I).

<sup>28</sup> The author has abbreviated, simplified, clarified, or otherwise modified the FAQs to make them more understandable to readers.

<sup>29</sup> IRS, "COVID-19-Related Employee Retention Credits: Determining When an Employer's Trade or Business Operations Are Considered to Be Fully or Partially Suspended Due to a Governmental Order FAQs," at FAQ 30 (updated July 27, 2023).

<sup>30</sup> *Id.* at FAQ 31.



B does not have a partial or full suspension of operations.<sup>31</sup>

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

If an employer's workplace is closed by a governmental order, but it is able to continue operations comparable to those before the closure by making employees telework, the operations are not partially or fully suspended. However, if the closure of the workplace causes the employer to suspend business operations for certain purposes but not others, it might have a partial suspension as a result of the governmental order.

For example, Employer C, a software development company, maintains an office in a city where the mayor ordered that only essential businesses may operate. Employer C's business is not essential. Before the governmental order, all employees at the company teleworked once or twice per week, and business meetings were held at various locations. After the governmental order, the company ordered mandatory telework for all employees and limited client meetings to telephone or video conferences. Employer C's business operations are not partially or fully suspended because they may continue in a comparable manner.

Another example involves Employer D, a physical therapy facility in a city where the mayor ordered that only essential businesses may operate. Employer D's business is not essential. Before the governmental order, none of Employer D's employees teleworked, and all appointments, administration, and other duties were carried out at the workplace. After the governmental order, Employer D moves to an online format and can still serve some clients remotely, but employees cannot access specific equipment or tools that they typically use in therapy. Employer D'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 E, a scientific research company that conducts research in a laboratory *and* through the use of computer modeling. Employer E is located in a state where the governor ordered that only essential businesses may operate, and it is not essential. Before the governmental order, Employer E's laboratory research operations could not be conducted remotely and employees worked on-site, whereas computer-modeling operations could be done remotely and relevant employees often teleworked. After the governmental order, employees engaged in laboratory research cannot perform their work while the facility is closed, yet employees doing computer modeling are directed to telework, and those operations continue in a comparable manner. Employer E's operations are partially suspended by the governmental order because the laboratory research cannot continue in a comparable manner.<sup>32</sup>

**5. If a governmental order requires an employer to close its workplace for certain purposes, but it remains operational for limited purposes, does the employer have a suspension of operations?**

If an employer's workplace is closed by a governmental order for certain purposes, but it can remain open for other purposes or it can continue certain operations remotely, the operations are partially suspended. However, if *all* of 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 business, Employer F, must cease on-site dining because of a governmental order closing all restaurants, bars, and similar establishments. However, Employer F is allowed to continue food and beverage sales on a carryout, drive-through, and delivery basis. Employer F's business operations are partially suspended

<sup>31</sup> *Id.* at FAQ 32.

<sup>32</sup> *Id.* at FAQ 33.

because a portion of its operations (its indoor and outdoor dining service) is closed as a result of the governmental order.

The second example also involves Employer F, with a few changes. After two months, the government issues another order, this time allowing Employer F to offer sit-down service in its outdoor space, yet its indoor dining service remains closed. During this period, Employer F's business operations are partially suspended because more than a nominal portion of its business operations (its indoor dining service) is halted as a result of a governmental order.

Employer F is featured in the third example, too. The government issues yet another order the following month, under which Employer F 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 its business operations. Therefore, Employer F's operations are partially suspended.

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

Employer H, a hospital, is the focus of the fifth example. Under a governmental order, it is an essential business for its emergency room, intensive care unit, and other services for conditions requiring urgent medical care. However, the governmental order prevents Employer H from conducting any elective or non-urgent medical procedures because they are deemed nonessential. Although Employer H is an essential business, it has a partial suspension of operations because of the governmental order.

The sixth example involves Employer I, 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 I did not suffer a partial suspension.

The final example discusses a couple of situations with Employer J, a large retailer that

must close its storefront location because of a governmental order. It 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, though, the government issues another order, under which Employer J can reopen its storefront under specified conditions. It can allow only a set number of customers inside at one time because of social-distancing mandates. This results in some customers being forced to wait in line outside for a short period during busy times. Those conditions do not have more than a nominal effect on business operations. Therefore, during this second period, Employer J did not have a partial suspension.<sup>33</sup>

#### **6. Are the operations of an employer partially suspended if it must reduce its operating hours because of a governmental order?**

An employer that reduces its hours as the result of a governmental order has partially suspended its operations because they have been limited. For instance, Employer K runs a food-processing facility that normally operates 24 hours a day. A governmental order issued by the local health department requires all food-processing businesses to deep clean their workplaces once every 24 hours to reduce the risk of COVID-19. Employer K reduces its daily operating hours by five to comply with the order. It has partially suspended its operations.<sup>34</sup>

#### **7. 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?**

Employers that operate in multiple locations and are subject to governmental orders limiting operations in some jurisdictions have a partial suspension of operations. This discrepancy might be attributable to the fact that the employers are considered essential businesses in only some jurisdictions. To operate consistently in all jurisdictions, employers might establish a policy

<sup>33</sup> *Id.* at FAQ 34.

<sup>34</sup> *Id.* at FAQ 35.

that complies with local governmental orders, as well as guidance from the Centers for Disease Control and Prevention and the Department of Homeland Security. Consequently, even though the employer may not be subject to a governmental order to suspend operations in certain jurisdictions, and may merely be following CDC or DHS guidance, the employer would still have partially suspended operations. Accordingly, the employer would be an eligible employer for all its operations in all locations.

Assume, for example, that Employer L is a national retail store chain with operations in every state. In some jurisdictions, Employer L is subject to a governmental order to close its stores, but it is permitted to offer curbside service, whereby customers can order items online or by phone and personally pick them up in a vehicle. In other jurisdictions, Employer L is not subject to any governmental order, or it is considered an essential business, permitting its stores to remain open. Employer L establishes a companywide policy, which adheres to the local governmental orders *and* CDC and DHS guidance, requiring closure of all stores and continuance of only curbside service. Under these circumstances, Employer L would have a partial suspension, making it an eligible employer nationwide.<sup>35</sup>

**8. If the operations of a trade or business of one member of an aggregated group are suspended by a governmental order, are those of the other members of the group also suspended?**

All members of an aggregated group are treated as a single employer for ERC purposes. Accordingly, if a trade or business is operated by multiple members of an aggregated group, and the operations of one member of that group are suspended by a governmental order, then all members of the group have a partial suspension, even if another member of the group is located in a jurisdiction that is not subject to a governmental order. For instance, Employer M is a restaurant chain that operates a single business through multiple subsidiary corporations located in various jurisdictions. The operations of some members of the group are stopped by

<sup>35</sup> *Id.* at FAQ 36.

governmental orders, while those of other members proceed. As a result of a governmental order affecting some members, operations of all members of Employer M's group are partially suspended.<sup>36</sup>

**9. 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?**

In this situation, 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 calendar quarter, then the employer is an eligible employer for the entire calendar quarter, but it can claim ERCs only for the wages paid while the governmental order was in effect.

For example, a state issued an order for all nonessential businesses to close from March 10, 2020, through April 30, 2020. Employer N, which operates a nonessential business in the state, closes during that period in accordance with the governmental order. Employer N 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 (the date the CARES Act took effect) through April 30, 2020 (the date the governmental order expired).<sup>37</sup>

**B. Notice 2021-20**

The IRS next provided direction about the governmental order test in general, and partial or full suspension of business operations in particular, in Notice 2021-20.<sup>38</sup> The IRS issued that guidance in March 2021, which was about nine months after it released the initial FAQs discussed above. Much of the information in Notice 2021-20 was similar or identical to that in the earlier FAQs. Only the new aspects are discussed here.

<sup>36</sup> *Id.* at FAQ 37.

<sup>37</sup> *Id.* at FAQ 38.

<sup>38</sup> Notice 2021-20, Section III.D.



**1. If an employer voluntarily suspends operations or voluntarily reduces hours because of COVID-19, but these actions are not the result of a governmental order, is the employer an eligible employer?**

An employer that voluntarily suspends operations or reduces hours because of COVID-19 is not eligible for ERCs on the basis of a partial or full suspension.<sup>39</sup>

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

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 an 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 trade or 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." This 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 permitted no or minimal teleworking, the employer's 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.<sup>40</sup>

<sup>39</sup> *Id.* at Q&A 14.

<sup>40</sup> *Id.* at Q&A 16.

**3. What factors will the IRS take into account in determining whether a modification required by a governmental order had more than a nominal effect on business operations?**

The types of modifications contemplated are those mandated by a governmental order as a condition to 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; or changing the format of service, like allowing the sale of carryout or prepacked food but not sit-down dining. The mere 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.<sup>41</sup>

For purposes of the ERC, a portion of an employer's business operations will constitute more than a nominal portion if either (1) the gross receipts from that portion of the business operations are not less than 10 percent of the total gross receipts, or (2) the hours of service performed by employees in that portion of the business are not less than 10 percent of the total number of hours of service performed by all employees in the business.<sup>42</sup>

**C. IRS Generic Legal Advice Memorandum**

After a reprieve of approximately two and a half years, the IRS supplied additional guidance in July 2023 regarding its interpretation of partial or full suspension of operations. This time, it came in the form of a generic legal advice memorandum.<sup>43</sup> This guidance centered on the interplay between suspended operations and supply chain problems.

The memo set the stage by highlighting two things. First, it referenced the limited guidance that the IRS had provided in the initial FAQs and Notice 2021-20 about the relationship between

<sup>41</sup> *Id.* at Q&A 18.

<sup>42</sup> *Id.* at Q&A 11. Taxpayers must do the gross receipts calculation and the hours of service calculation using the figures from the same quarter in 2019.

<sup>43</sup> AM 2023-005.

employers and suppliers.<sup>44</sup> Second, it pointed to earlier warnings about what taxpayers will need to provide to the IRS to validate their ERC claims when challenged. The IRS explained that employers will need to retain many records to “adequately substantiate eligibility” for the ERC, including “any governmental order to suspend the employer’s business operations” and “any records the employer relied upon to determine whether more than a nominal portion of its operations were suspended due to a governmental order or whether a governmental order had more than a nominal effect on its business operations.”<sup>45</sup>

The memo then summarized the two items in the preceding paragraph as follows. The IRS allows an employer “to step into the shoes” of its supplier. However, this is not easy, because an employer must show that (1) the supplier was subject to an acceptable governmental order during the relevant period, (2) the order caused the supplier to suspend its operations, (3) the inability to obtain goods or materials from the supplier caused a partial or full suspension of the employer’s operations, and (4) the employer was unable to procure goods or materials from an alternative source.<sup>46</sup> The IRS analyzed five scenarios in the memo against that backdrop.

### 1. Scenario 1.

In scenario 1, Employer A was not subject to a governmental order limiting commerce, travel, or group meetings because of COVID-19 at any time. However, during 2020 and 2021, Employer A experienced several delays in receiving critical goods from Supplier 1. At all times during 2020 and 2021, Employer A continued to operate because it had a surplus of the critical goods normally provided by Supplier 1. Employer A assumed that Supplier 1’s delay in delivering critical goods was caused by COVID-19. Employer A inquired in this regard, and Supplier 1 vaguely confirmed that the delay was the result of COVID-19, but it did not provide a copy of any

governmental order, and Employer A was unable to locate one independently.

The IRS concluded in the memo that Employer A is *not* an eligible employer because it cannot demonstrate that a governmental order applicable to Supplier 1 partially or fully suspended Supplier 1’s trade or 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. Consequently, Employer A did not experience a suspension of operations because of an inability to obtain Supplier 1’s critical goods. The relevant inquiry, the IRS emphasized, is whether Employer A’s operations could continue. Since Employer A was able to continue its own business operations despite the supply chain disruption, it was not subject to a partial or full suspension.

### 2. Scenario 2.

In scenario 2, Employer B was not subject to a governmental order limiting commerce, travel, or group meetings because of COVID-19 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 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. Further, 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 is not an eligible employer because it cannot demonstrate that a governmental order applicable to Supplier 2 partially or fully suspended Supplier 2’s operations. Moreover, although COVID-19 may have been a contributing factor to the bottleneck at the port or the truck driver shortage, Employer B could not substantiate that any governmental order caused those problems.

<sup>44</sup> See IRS, *supra* note 29, at FAQ 31; Notice 2021-20, Section III.D, Q&A 12.

<sup>45</sup> Notice 2021-20, Section III.D, Q&A 70.

<sup>46</sup> AM 2023-005.

### 3. Scenario 3.

In scenario 3, Employer C and Supplier 3 were located in a jurisdiction that issued governmental orders suspending both of their business operations during April 2020. The orders were lifted in May 2020. For the remainder of 2020 and 2021, Employer C experienced a delay in receiving critical goods from Supplier 3. Supplier 3 did not provide a reason for the delay, but Employer C assumed that it was the result of the governmental order in place back in April 2020.

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

### 4. Scenario 4.

In scenario 4, Employer D was not subject to a governmental order limiting commerce, travel, or group meetings because of COVID-19 at any time. During 2020 and 2021, Employer D could not obtain critical goods from Supplier 4, but it managed to get them from an alternative supplier. The alternative supplier charged 35 percent more than Supplier 4. This meant that Employer D could continue operating its business, but it was not as profitable as it had been in 2019.

The memo indicates that Employer D was not an eligible employer because it was not prevented from operating at any point during 2020 or 2021, and incurring a higher cost for critical goods, alone, does not constitute a partial or full suspension.

### 5. Scenario 5.

In scenario 5, Employer E operated a large retail business selling a variety of products. It was not subject to a governmental order limiting

commerce, travel, or group meetings because of COVID-19 in 2021. As a result of several supply chain disruptions, Employer E was unable to stock a limited number of products, and it was obligated to raise prices on other products that were in short supply. However, the product shortage did not prevent Employer E from continuing to fully operate during 2021.

The IRS explained in the memo that Employer E was not an eligible employer during 2021 because it cannot demonstrate that (1) a governmental order applicable to a supplier of critical goods or materials caused the supplier to suspend operations, and (2) Employer E was unable to obtain critical goods and materials elsewhere. The IRS observed that Employer E was able to operate its business at all times in 2021. Although certain products were unavailable, Employer E was still able to offer a wide variety of products to its customers, and it was not forced to partially suspend operations.

### D. New FAQs From the IRS

The IRS issued yet more guidance less than a week after the generic legal advice memorandum was released. The most recent guidance appeared as new FAQs posted on the website in late July 2023.<sup>47</sup> Those involving suspension of operations under the governmental order test are discussed below.<sup>48</sup>

#### 1. Who is ineligible to claim the ERC?

One taxpayer that is ineligible yet "often targeted by ERC scam promoters" is an employer that "experienced supply chain disruptions but did not experience a full or partial suspension of operations by a qualifying order."<sup>49</sup>

#### 2. Is being subject to a governmental order enough for ERC eligibility?

No, employers must demonstrate that the governmental order was related to COVID-19 and

<sup>47</sup> 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.

<sup>48</sup> The author has abbreviated, simplified, clarified, or otherwise modified the new FAQs to make them more understandable to readers.

<sup>49</sup> IRS, *supra* note 47 (Eligibility FAQ 3).

that it resulted in a partial or full suspension of their trade or business.<sup>50</sup>

### 3. What does it mean to be partially or fully suspended?

The answer depends on “your specific situation.” However, an employer does not qualify if (1) all its employees were able to telework during the pandemic; (2) its customers were affected by a stay-at-home order, but no governmental order applied directly to the taxpayer’s business operations; or (3) it voluntarily closed its business or reduced its hours.<sup>51</sup>

### 4. Is an employer suspended if it has a supply chain issue?

A supply chain problem, alone, does not qualify an employer for the ERC. The IRS offers a narrow and limited exception for situations in which an employer was not partially or fully suspended, but its supplier was. However, this exception applies only “when the employer absolutely could not operate without the supplier’s product, and the supplier 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 (1) the order caused the supplier to suspend its operations; (2) the employer could not obtain the same goods or materials elsewhere, “regardless of cost”; and (3) the order and resulting suspension of the supplier’s operations also caused the suspension of the employer’s operations. Employers should be wary of anyone who says that they qualify for the ERC “based on supply chain issues” without asking for data on how their business was affected, the situation of their suppliers, and relevant documentation.<sup>52</sup>

## IV. Time to Spare

Eligible employers could have solicited ERCs on *timely* Forms 941, “Employer’s Quarterly Federal Tax Return,” for each relevant quarter in 2020 and 2021. Alternatively, they could, and in

many instances still can, seek ERCs by filing Form 941-X, “Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund.”

A taxpayer normally must file a refund claim, including a Form 941-X seeking ERCs, within three years after filing the relevant Form 941, or within two years after paying the relevant taxes, whichever period expires later.<sup>53</sup> Forms 941 for all four quarters of a year are deemed filed on April 15 of the next year.<sup>54</sup> For example, Form 941 for second quarter 2020 had to be filed by July 31, 2020 (the last day of the month following the end of the second quarter), but is deemed to have been filed nearly nine months later, on April 15, 2021.<sup>55</sup>

This special manner of setting the filing date affects how long additional ERC claims can be made, in favor of taxpayers. ERCs were available for the second, third, and fourth quarters of 2020. Assuming that an eligible employer filed Forms 941 for these periods on time, the law would treat them as being filed on April 15, 2021. Thus, applying the three-year limit described above, the eligible employer could file Forms 941-X making ERC claims until April 15, 2024. ERCs were also available for the first, second, third, and fourth quarters of 2021, though the last quarter was ultimately restricted to recovery start-up businesses. Again, assuming that an eligible employer filed Forms 941 on time, the IRS would deem them filed on April 15, 2022. Taking into account the three-year restriction, an eligible employer could file Forms 941-X claiming ERCs until April 15, 2025.

## V. Conclusion

The IRS believes that improper ERC claims are being filed by employers that suffered “supply chain disruptions but did not experience a full or partial suspension of operations.” Its recent efforts to halt this practice consist of two items of dubious legal authority: a generic legal advice memorandum and FAQs. Moreover, those items were not even issued until long *after* many employers had already solicited ERCs on their

<sup>50</sup> *Id.* (Qualifying Orders FAQ 3).

<sup>51</sup> *Id.* (Qualifying Orders FAQ 4).

<sup>52</sup> *Id.* (Qualifying Orders FAQ 5).

<sup>53</sup> Section 6511(a); reg. section 301.6511(a)-1(a); section 6511(b)(1); and reg. section 301.6511(b)-1(a).

<sup>54</sup> Section 6501(b)(2); reg. section 301-6501(b)-1(b); section 6513(c); and reg. section 301.6513-1(c).

<sup>55</sup> Reg. section 301.6501(b)-1(b).



original Forms 941 for 2020 or 2021. The latest IRS guidance focused on supply chains seems designed to dissuade employers from relying on the governmental order test, essentially encouraging them to file Forms 941-X to eliminate prior ERC claims or to refrain from filing Forms 941-X with aggressive positions. Given the circumstances, it will be interesting to see whether employers, or those facilitating their ERC claims, will heed that message. ■

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