Employee Retention Credits: Analyzing Key Issues for Taxpayers Facing IRS Audits

HALE E. SHEPPARD, ESQ.

This article, the second in a multi-part series, provides a substantive analysis of key issues facing taxpayers claiming ERCs.

Introduction

There are thousands of blogs, articles, comments, advertisements, infomercials and more about the Employee Retention Credit ("ERC"). Many focus on the benefits of this tax relief measure, strongly encouraging taxpayers to apply. Others are more cynical, warning of complexities and likely actions by the Internal Revenue Service ("IRS"). Regardless of their slant, all these items generally have one thing in common: a disturbing lack of substance. Everything in the ERC realm seems to have devolved into hyperbolical sound bites based on partial information, which is *not* helpful for taxpayers and advisors who are looking to truly understand the situation and make informed decisions.

This article, which is the second in a multi-part series, tries to reverse this trend. It explains the reasons why Congress introduced the ERC, four laws and corresponding IRS guidance creating the volatile rules, period during which taxpayers can still claim ERCs, initial problems detected by IRS watchdogs, series of IRS announcements and warnings, training materials for IRS audit personnel, civil and/or criminal consequences for taxpayers filing unfounded or excessive claims, and extended assessments periods in the ERC context. In short, the goal of this article is to sup-

Hale E. Sheppard, Esq. (B.S., M.A., J.D., LL.M., LL.M.T.) is a Shareholder in the Tax Controversy Section of Chamberlain Hrdlicka. He specializes in tax audits, tax appeals, and Tax Court litigation. You can reach Hale by phone at (404) 658-5441 or by e-mail at hale.sheppard@chamberlainlaw.com

ply taxpayers and advisors with substance, not fluff, which they can consult as the IRS implements enforcement actions over the coming years.

Policy Considerations – What Was Congress Thinking?

Before getting into the weeds, so to speak, readers should understand the bigger picture. In particular, they need to appreciate why Congress decided to disburse COVID-related relief to taxpayers through employment taxes, instead of some other vehicle. Here is an abbreviated version of the official answer. The ERC reduces the after-tax cost for companies to compensate an employee. Because employees cost less, companies presumably are willing to retain more employees and/or pay for more hours than they otherwise would. Keeping individuals working increases their incomes, while decreasing unemployment compensation expenses for the U.S. government. Employment tax credits, like the ERC, get delivered quickly, they do not depend on whether the recipient has an income tax liability to offset, and they can be claimed by non-profit employers. Employment tax credits function particularly well for small businesses, which are often disproportionately hurt by economic downturns. Lastly, depending on the number of employees retained or given more workable hours, compared to actual costs in terms of foregone tax revenue, ERCs could be "economically efficient."[1]

Overview of Legislation and IRS Guidance

Nobody could predict how long the COVID pandemic would last or how badly it would damage the U.S. economy. Consequently, Congress and the IRS took what some might call a wait-and-see approach, introducing and adjusting the ERC as things developed in 2020 and 2021. This resulted in four laws passed in rapid succession, as well as IRS guidance hastily implementing such legislation.

This article is the second in a series. The first article analyzed the ERC rules over time, tackling concepts, terms, rules, exceptions and more in a methodical manner.[2] This current article offers less detail in this regard, as its purpose is to explain the main issues just enough to allow readers to comprehend the inevitable disputes between the IRS and taxpayers.[3]

First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") in March 2020.[4] This was a complicated piece of legislation, which introduced key aspects that later evolved.

General Rule

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.[5] What a mouthful. The three key terms are defined below.

Eligible Employer

An Eligible Employer meant an employer that was carrying on a trade or business in 2020, which also met one of the following two tests. First, the employer's operations were partially or fully suspended during a quarter because of an order from an "appropriate governmental authority" limiting commerce, travel, or group meetings for commercial, social, religious, or other purposes due to COVID ("Governmental Order Test").[6] Second, the employer suffered a significant decline in gross receipts during a particular quarter ("Reduced Gross Receipts Test").[7] 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.[8]

Applicable Employment Taxes

The term "employment taxes" ordinarily refers to three items, namely, (i) federal income taxes paid solely by employees through mandatory withholding by their employers, (ii) amounts under the Federal Insurance Contributions Act ("FICA"), which are paid partly by employees and partly by employers, and (iii) amounts under the Federal Unemployment Tax Act ("FUTA"), which are paid entirely by employers.[9] The term Applicable Employment Taxes means certain FICA amounts for ERC purposes.[10]

Qualified Wages

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.

Where an Eligible Employer had an average of more than 100 full-time employees ("Large Eligible Employer"), Qualified Wages meant those paid to any employee *who was not providing services* as a result of the Government Order Test or the Reduced Gross Receipts Test.[11] 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.[12] 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 wages paid, and only for those hours when the employee was not providing services, were considered Qualified Wages.[13]

The tax treatment was more favorable when it came to businesses of less stature. Specifically, where 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.[14]

In addition to the amounts described above, Qualified Wages included the "Qualified Health Plan Expenses" of the Eligible Employer properly allocable thereto.[15]

Limitations

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.[16]

Penalty Waiver

The CARES Act indicated that the IRS "shall waive" any failure-to-deposit penalties under Section 6656 if the Eligible Employer's lack of remittances to the IRS was due to "reasonable anticipation" of receiving ERCs.[17]

Applicability

Coverage of the ERC changed several times later, 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 benefitting Eligible Employers during the second, third, and fourth quarters of 2020.[18]

Notice 2021-20

The IRS released Notice 2021-20 in March 2021. It only applied to the periods contemplated by the CARES Act; that is, second, third and fourth quarters of 2020.[19] The IRS guidance in Notice 2021-20 was *massive*, with much of it far exceeding the express language of the CARES Act.[20] The first article in this series described the IRS guidance in detail.

Second Law

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 ("Relief Act") in December 2020.[21] It extended and modified the existing ERC law in several ways.[22]

Notice 2021-23

The IRS needed to provide yet more administrative direction after Congress enacted the Relief Act. This time it came in the form of Notice 2021-23. The new guidance generally did *not* change the information that the IRS previously supplied in Notice 2021-20, which only concerned the CARES Act and activities in the second, third and fourth quarters of 2020. Rather, Notice 2021-23 "amplified" its earlier guidance, taking into account changes that Congress made in the Relief Act.[23]

Expansion of ERC

Notice 2021-23 starts with scope, confirming that an Eligible Employer might be able to claim ERCs not only for the second, third and fourth quarters of 2020 (as it could under the CARES Act), but also for the first and second quarters of 2021.[24]

Increasing Maximum ERCs

Notice 2021-23 reminded taxpayers that for second, third and fourth quarters of 2020 an Eligible Employer could only claim ERCs for 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 first and second quarters of 2021 thanks to the Relief Act. The percentage increased from 50 to 70, *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, then the ERCs would total $14,000 (i.e., $7,000 per quarter).[25]

New Small and Large Eligible Employer Standards

Notice 2021-23 explained that whether amounts paid by an Eligible Employer will constitute Qualified Wages depends, in part, on the average number of full-time employees. The standards changed from 2020 to 2021 pursuant to the Relief Act.

Notice 2021-23 began by summarizing the original rules. For purposes of the ERC for 2020, for an Eligible Employer with an average of more than 100 full-time employees in 2019, Qualified Wages were those paid to employees for the time that they were not providing services because of the Governmental Order Test or the Reduced Gross Receipts Test. By contrast, for an Eligible Employer with 100 or fewer full-time

NOTES

1. Congressional Research Service. COVID-19: The Employee Retention Tax Credit. Report IN11299 (May 12, 2020), pgs. 2-3.
2. *See* Hale E. Sheppard, "Employee Retention Credits: Analyzing Congressional and IRS Guidance from Start to Finish," 139 JTAX 3 (2023).
3. Like the first article, this one does *not* address special rules related to deferral of employment tax payments, tax-exempt organizations, government instrumentalities, tribal governments, employers in U.S. territories, aggregated entities treated as a single employer, qualified health plan expenses, and Paycheck Protection Program loans.
4. Public Law 116-126; U.S. 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 (April 23, 2020).
5. Public Law 116-126, Section 2301(a).
6. Public Law 116-126, Section 2301(c)(2)(A)(ii)(I).
7. Public Law 116-126, Section 2301(c)(2)(A)(ii)(II).
8. Public Law 116-126, Section 2301(c)(2)(B).
9. Section 3101, Section 3111, Section 3301, and Section 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.
10. Public Law 116-126, Section 2301(c)(1). These consist of Social Security and Medicare taxes.
11. Public Law 116-126, Section 2301(c)(3)(A)(i).
12. Public Law 116-126, Section 2301(c)(3)(B).
13. U.S. 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 (April 23, 2020), pg. 41.
14. Public Law 116-126, Section 2301(c)(3)(A)(ii)(I) and (II).
15. Public Law 116-126, Section 2301(c)(3)(C)(i).
16. Public Law 116-126, Section 2301(b)(1); U.S. 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 (April 23, 2020), pg. 38.
17. Public Law 116-126, Section 2301(k).
18. Public Law 116-126, Section 2301(m).
19. Notice 2021-20, Section I.
20. Notice 2021-20, Section III.
21. Public Law 116-260, Division EE, Section 207 (Dec. 27, 2020). The Relief Act was one portion of the larger Consolidated Appropriations Act of 2021.
22. *See, generally*, U.S. Joint Committee on Taxation. Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security. JCX-3-21 (Feb. 8, 2021), pgs. 66-70.
23. Notice 2021-23, Section II. This article does not explore all new data provided in Notice 2021-23; it focuses on the most relevant aspects.
24. Notice 2021-23, Section III, A.
25. Notice 2021-23, Section III, D.
26. Notice 2021-23, Section III, E.
27. *Id.*
28. *Id.*
29. Notice 2021-23, Section III, C.
30. *Id.*
31. *Id.*
32. Public Law 117-2, Section 9651 (March 11, 2021).
33. Notice 2021-20 continues to apply to second, third and fourth quarters 2020, and Notice 2021-23 continues to apply to first and second quarters 2021. *See* Notice 2021-49, Section I.
34. Notice 2021-49, Section I.
35. Notice 2021-49, Section III, A.
36. U.S. House of Representatives. American Rescue Plan Act of 2021. 117th Congress, First Session. Report 117-7 (Feb. 24, 2021), pg. 776.

employees in 2019, Qualified Wages were those paid to any employee (regardless of whether they were providing services or not) during any quarter that business operations were partially or fully suspended because of the Governmental Order Test or when the employer met the Reduced Gross Receipts Test.[26]

The Relief Act modified the figures regarding full-time employees. In particular, Large Eligible Employers became those whose average number of full-time employees was more than 500 ("2021 Large Eligible Employer"), while Small Eligible Employers were those with an average of 500 or less ("2021 Small Eligible Employer").[27] In other words, the threshold went from 100 to 500 full-time employees, the result of which was that more taxpayers qualified as Small Eligible Employers.

Abolishing Limit for Large Eligible Employers

Notice 2021-23 explained that, under the CARES Act, the Qualified Wages for Large Eligible Employers could not exceed what an employee would have been paid for actually working an equivalent amount during the 30 days immediately preceding the start of the suspension because of the Governmental Order Test or when the employer met the Reduced Gross Receipts Test. The Relief Act abolished that limit, such that it did *not* apply for determining Qualified Wages for first and second quarters of 2021.[28]

Reduced Gross Receipts Test Easier to Meet

Notice 2021-23 explained that, under the CARES Act, the period during which an employer met the Reduced Gross Receipts Test was generally determined by identifying the first quarter in 2020, if any, in which its gross receipts were less than 50 percent of its gross receipts for the same quarter in 2019. Moreover, the period ended after the first quarter in which the employer's gross receipts in 2020 exceeded 80 percent of its gross receipts for the same quarter in 2019, or on January 1, 2021, whichever occurred first.

The Relief Act introduced changes. Specifically, that legislation provided that an employer would be an Eligible Employer for any quarter during which its gross receipts were less than 80 percent of its gross receipts for the same quarter in 2019. Thus, when it came to the ERC for the first and second quarters of 2021, the determination of Eligible Employer status was made separately for each quarter and was based on a threshold of 80 percent.[29] To put it another way, a less significant drop in revenue still qualified a taxpayer as an Eligible Employer.

Notice 2021-23 underscored other changes in the Relief Act focused on what quarters should be compared in determining whether the Reduced Gross Receipts Test was met. It explained that, if the employer was not in existence as of the beginning of the same quarter in 2019, then the test should be applied substituting 2020 for 2019. The result was that if an employer did not exist at the beginning of the first quarter of 2019, then it ordinarily compared its gross receipts from first quarter of 2021 to those in first quarter of 2020. Similarly, if an employer did not exist at the start of second quarter of 2019, then it normally compared gross receipts from the second quarter of 2021 to those from second quarter of 2020.[30]

Election of Measurable Quarters

Notice 2021-23 pointed out that the Relief Act permitted an employer to elect to use an alternative/different quarter to calculate gross receipts. With this election, an employer generally determined whether the Reduced Gross Receipts Test was met for a particular quarter in 2021 by comparing its gross receipts from the immediately-preceding quarter with those for the corresponding quarter in 2019 (and by substituting 2020 for 2019 if the employer did not exist at the start of that quarter in 2019).

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[37] Notice 2021-49, Section III, D.

[38] *Id.*

[39] *Id.*

[40] Section 6501(b)(2); Treas. Reg. § 301-6501(b)-1(b); Private Letter Ruling 8510004.

[41] Treas. Reg. § 301.6501(b)-1(b).

[42] Notice 2021-49, Section III, G; Section 6501(b)(2).

[43] Notice 2021-49, Section III, G.

[44] Notice 2021-49, Section IV.

[45] *Id.*

[46] Revenue Procedure 2021-33, Section 1. *See* Paycheck Protection Program Flexibility Act of 2020, Public Law 116-142.

[47] Revenue Procedure 2021-33, Section 3.03.

[48] *Id.*

[49] Revenue Procedure 2021-33, Section 6.

[50] Public Law 117-58 (Nov. 15, 2021).

[51] Public Law 117-58, Section 80604(a) (Nov. 15, 2021).

[52] *Id.*

[53] *Id.*

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

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

[56] Section 6511(a); Treas. Reg. § 301.6511(a)-1(a); Section 6511(b)(1); Treas. Reg. § 301.6511(b)-1(a).

[57] Section 6501(b)(2); Treas. Reg. § 301-6501(b)-1(b); Section 6513(c); Treas. Reg. § 301.6513-1(c).

[58] Treas. Reg. § 301.6501(b)-1(b).

[59] Treasury Inspector General for Tax Administration. Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions. Reference Number 2020-46-041 (June 30, 2020).

[60] Treasury Inspector General for Tax Administration. Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions. Reference Number 2020-46-041 (June 30, 2020), pgs. 18-19.

[61] Treasury Inspector General for Tax Administration. Interim Results of the 2020 Filing Season: Effect of COVID-19 Shutdown on Tax Processing and Customer Service Operations and Assessment of Efforts to Implement Legislative Provisions. Reference Number 2020-46-041 (June 30, 2020), pgs. 4-8.

[62] Treasury Inspector General for Tax Administration. Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic. Report No. 2021-46-043 (July 9, 2021).

[63] Treasury Inspector General for Tax Administration. Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic. Report No. 2021-46-043 (July 9, 2021), pgs. 7-8.

[64] Treasury Inspector General for Tax Administration. Implementation of Tax Year 2020 Employer Tax Credits Enacted in Response to the COVID-19 Pandemic. Report No. 2021-46-043 (July 9, 2021), pg. 9.

[65] *Id.*

[66] Treasury Inspector General for Tax Administration. Effects of the COVID-19 Pandemic on Business Tax Return Processing Operations. Report No. 2021-46-064 (September 2, 2021), pgs. 10-11.

[67] Treasury Inspector General for Tax Administration. Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits. Report No. 2022-46-059 (August 31, 2022).

[68] Treasury Inspector General for Tax Administration. Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits. Report No. 2022-46-059 (August 31, 2022), pg. 4.

For instance, for first quarter 2021, an employer could elect to use its gross receipts from fourth quarter 2020 and compare them to those from fourth quarter 2019. When it came to second quarter 2021, an employer could elect to compare gross receipts from first quarter 2021 to those of first quarter 2019. If, however, an employer did not exist at the beginning of first quarter 2019, the employer could elect to measure the decrease for second quarter 2021 by comparing gross receipts for first quarter 2021 with those from first quarter 2020.[31]

Third Law

Congress passed the American Rescue Plan Act of 2021 ("ARP Act") in March 2021.[32] Importantly, the ARP Act "codified" the ERC for the first time, making it Section 3134 of the Internal Revenue Code.

Notice 2021-49

Notice 2021-49 was next in the series of IRS guidance. It retained and "amplified" the earlier information in Notice 2021-20 (relating to the CARES Act) and Notice 2021-23 (relating to the Relief Act).[33] It also supplied new data concerning the ARP Act, its expansion of the ERC to third and fourth quarters of 2021, and its introduction of Section 3134.[34] Certain aspects of Notice 2021-49 are explored below.

Expansion of ERC

Notice 2021-49 confirmed that, under Section 3134, an Eligible Employer could claim ERCs for third and fourth quarters of 2021.[35] Thus, at that point, the ERC was available with respect to second, third, and fourth quarters of 2020 (under the CARES Act), first and second quarters of 2021 (under the Relief Act), and third and fourth quarters of 2021 (under the ARP Act). Why did Congress prolong the ERC period by two additional months? According to the legislative history, the U.S. economy had lost about 10 million jobs, the financial slowdown from COVID persisted, and many individuals count on their jobs not only for wages, but also for healthcare, retirement savings, childcare, and other benefits.[36]

Recovery Startup Businesses

Notice 2021-49 explained that the ARP Act inserted a new type of Eligible Employer, the so-called Recovery Startup Business. That was an employer (i) that began operating a trade or business after February 15, 2020, (ii) had average annual gross receipts of not more than $1 million during the relevant period, and (iii) did not otherwise qualify as an Eligible Employer under the Governmental Order Test or the Reduced Gross Receipts Test.[37]

The ARP Act imposed a cap on the ERCs that a Recovery Startup Business could claim; they could not exceed $50,000 for each of third and fourth quarter 2021. Notice 2021-49 explained that the analysis of whether an employer was a Recovery Startup Business had to be done separately for each quarter.[38]

Severely Financially Distressed Employers

The ARP Act introduced the notion of Severely Financially Distressed Employers. According to Notice 2021-49, for purposes of the ERC for third and fourth quarters of 2021, an Eligible Employer was a Severely Financially Distressed Employer if its gross receipts were less than 10 percent for the same quarter in 2019 (or in 2020, if the employer did not exist in 2019). The earlier restriction on Qualified Wages for Large Eligible Employers disappeared in these instances. Thus, for third and fourth quarters of 2021, a Severely Financially Distressed Employer, which was also a Large Eligible Employer, could treat *all* wages paid to its employees as Qualified Wages, not just to those employees who were not providing services.[39]

Expanded Assessment Period

Readers need some background on timing issues in order to understand certain changes explained in Notice 2021-49. Forms 941 (Employer's Quarterly Federal Tax Return) for all four quarters of a particular year are deemed filed

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[69] Treasury Inspector General for Tax Administration. Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits. Report No. 2022-46-059 (August 31, 2022), pgs. 14-15.

[70] Treasury Inspector General for Tax Administration. Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits. Report No. 2022-46-059 (August 31, 2022), pg. 13.

[71] *Id.*

[72] *Id.*

[73] Congressional Research Service. CARES Act Assistance for Employers and Employees – The Paycheck Protection Program, Employee Retention Tax Credit, and Unemployment Insurance Benefits: An Overview (Part 1). Report IN1324 (April 21, 2020); Congressional Research Service. CARES Act Assistance for Employers and Employees – The Paycheck Protection Program, Employee Retention Tax Credit, and Unemployment Insurance Benefits: An Overview (Part 2). Report IN1329 (April 21, 2020); Congressional Research Service. COVID-19: The Employee Retention Tax Credit. Report IN11299 (May 12, 2020); Congressional Research Service. Business Use of Tax and Other Provisions in the CARES Act and Other COVID-19 Legislation: Evidence from Surveys. Report IN11430 (July 23, 2020); Congressional Research Service. The COVID-Related Tax Relief Act of 2020 and Other COVID-Related Tax Provisions in P.L. 116-260. Report R46649 (January 5, 2021); Congressional Research Service. The Employee Retention and Employee Retention and Rehiring Tax Credits. Report IF11721 (January 7, 2021); Congressional Research Service. Early Sunset of the Employee Retention Credit. Report IN11819 (December 8, 2021); Congressional Research Service. Payroll Taxes: An Overview of Taxes Imposed and Past Payroll Tax Relief. Report R47062 (April 4, 2022).

[74] News Release 2020-62 (April 1, 2020); Fact Sheet FS-202005 (May 2020); News Release 2020-89 (May 7, 2020); News Release 2020-221 (September 24, 2020).

[75] News Release 2020-158 (July 15, 2020).

[76] News Release 2020-169 (July 27, 2020). The IRS took the opportunity to broadcast this warning: "Any refund of these credits paid to a taxpayer that exceeds the amount the taxpayer is allowed is an erroneous refund for which the IRS must seek repayment." *Id.*

[77] News Release 2021-21 (January 26, 2021); News Release 2021-74 (April 2, 2021); News Release 2021-65 (August 4, 2021).

[78] News Release 2021-65 (March 31, 2021).

[79] News Release 2021-242 (December 6, 2021).

[80] IRS Tax Tip 2023-44 (April 4, 2023).

[81] News Release 2022-183 (October 19, 2022).

[82] Information Release IR-2023-40 (March 7, 2023).

[83] Information Release IR-2023-49 (March 20, 2023).

[84] Information Release IR-2023-71 (April 5, 2023).

[85] Information Release IR-2023-105 (May 25, 2023).

[86] Nathan J. Richman, "Employee Retention Credit Claimants May See Help from the IRS," Tax Notes Doc. 2023-16685 (June 9, 2023).

[87] Nathan J. Richman, "IRS Readying Hard Look at Employee Retention Credit Claims," 177 Tax Notes Federal 747 (Oct. 31, 2022); "IRS Releases Employee Retention Credit Training Guide," Tax Analysts Document No. 2022-38592 (providing a document called "Lesson 3 – Tax Credit for Employee Retention – Student "Guide" (Revised 7/2022)).

on April 15 of the succeeding year.[40] For example, Form 941 for second quarter 2020 actually must be filed by July 31, 2020 (*i.e.,* the last day of the month following the end of the relevant quarter), but it is deemed to be filed on April 15, 2021. The general assessment-period for such Form 941 starts running on April 15, 2021, and does not expire until three years later, on April 15, 2024.[41]

Notice 2021-49 clarified the extended assessment-period in the context of the ERC. It said that the assessment-period for any amount attributable to an ERC would not expire before the date that is five years (instead of three years) after the date on which the pertinent Form 941 is filed, or the date on which such Form 941 is deemed to have been filed, whichever is later.[42] For instance, if an Eligible Employer filed a timely Form 941 for third quarter 2021 claiming ERCs, such Form 941 is deemed to have been filed on April 15, 2022, and the assessment-period would stay open until April 15, 2027.

Importantly for taxpayers, Notice 2021-49 indicated that the extended assessment-period applied to ERC claims for third and fourth quarters of 2021 under the ARP Act, but did *not* affect claims for earlier quarters in 2020 or 2021 under the CARES Act or Relief Act, respectively.[43]

Comprehensive Clean Up

Notice 2021-49 also contained some general clean up, if you will, offering supplemental guidance on different issues that had arisen since Congress first introduced the ERC and the IRS began implementing it.[44] This information generally applied to *all* quarters covered by the ERC under *all* legislation, spanning second quarter 2020 through fourth quarter 2021. Specifically, Notice 2021-49 answered questions regarding the definition of full-time employees, treatment of tips, special rules for related parties, inconsistent alternative-quarter elections for comparing gross receipts, and unique rules in cases where employers acquire a business.[45]

Revenue Procedure 2021-33

Revenue Procedure 2021-33 created a "safe harbor" that allowed taxpayers to exclude certain items from gross receipts when calculating that figure for ERC purposes. These included loans forgiven under the Paycheck Protection Program ("PPP").[46]

Revenue Procedure 2021-33 says that an employer can ignore various things, among them any PPP loan forgiveness, when analyzing its eligibility to claim ERCs for a particular quarter, as long as the employer "consistently applies" the safe harbor.[47] This means that the employer must disregard the loans for all relevant quarters, and not include and exclude amounts at its whim with the goal of satisfying a particular standard or percentage.[48]

The safe harbor applied to *all* periods relevant to the ERC, namely, second quarter 2020 through fourth quarter 2021.[49]

Fourth Law

Things came to an unexpected close when Congress enacted the Infrastructure Investment and Jobs Act ("IIJA") in November 2021.[50] 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. Just nine months earlier, Congress underscored several lofty reasons for expanding the ERC to cover 2021 in its entirety. It changed course with the IIJA, though, generally eliminating fourth quarter 2021. As a result, most ERC claims were limited to second, third and fourth quarters of 2020, and first, second and third quarters of 2021.[51]

Recovery Startup Businesses were spared. They, and only they, could continue claiming ERCs for fourth quarter 2021.[52] Congress made it easier for taxpayers to be Recovery Startup Businesses, too. It removed the requirement that an employer could not otherwise qualify as an Eligible Employer pursuant to the

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[88] Nathan J. Richman, "IRS Readying Hard Look at Employee Retention Credit Claims," 177 Tax Notes Federal 747 (Oct. 31, 2022).

[89] *Id.*

[90] "IRS Releases Employee Retention Credit Training Guide," Tax Analysts Document No. 2022-38592.

[91] *Id.*

[92] Lauren Lorrichio, "Documents Shed Light on IRS Scrutiny of Employee Retention Credit," 2022 Tax Notes Federal Today 232-7 (Dec. 5, 2022), "IRS Slide Show Training on COVID Credits, Deferral," Tax Analysts Document No. 2023-13616.

[93] Lauren Lorrichio, "Documents Shed Light on IRS Scrutiny of Employee Retention Credit," 2022 Tax Notes Federal Today 232-7 (Dec. 5, 2022).

[94] "IRS Slide Show Training on COVID Credits, Deferral," Tax Analysts Doc. No. 2023-13616.

[95] "IRS Slide Show Training on COVID Credits, Deferral," Tax Analysts Doc. No. 2023-13616 (emphasis added).

[96] Section 6656(a).

[97] Section 6656(b).

[98] Section 6656(a).

[99] Notice 2021-20, Section III, FAQ 60.

[100] News Release 2022-183 (October 19, 2022).

[101] "IRS Releases Employee Retention Credit Training Guide," Tax Analysts Document No. 2022-38592.

[102] Section 6662(a).

[103] Section 6664(c).

[104] Section 6663(a); Section 7454(a); Tax Court Rule 142(b).

[105] Section 6663(b).

[106] *Meier v. Commissioner*, 91 T.C. 273 (1988). *See also Toushin v. Commissioner*, 223 F.3d 642 (7th Cir. 2000); *Bradford v. Commissioner*, 796 F.2d 303 (9th Cir. 1986); *Hicks Co. v. Commissioner*, 56 T.C. 982 1971). *See also* I.R.M. § 20.1.5.12.2 (10-01-2005).

[107] *Graves v. Commissioner*, T.C. Memo. 1994-616; *See also Gow v. Commissioner*, T.C. Memo. 2000-93.

[108] Section 6601; Section 6621.

[109] Section 7201, Section 7206, Section 7207; 18 U.S.C. § 286; 18 U.S.C. § 287.

[110] Information Release IR-2023-105 (May 25, 2023).

[111] Nathan J. Richman, "Employee Retention Credit Claimants May See Help from the IRS," Tax Notes Doc. 2023-16685 (June 9, 2023).

[112] Section 6501(b)(2); Treas. Reg. § 301-6501(b)-1(b); Section 6513(c); Treas. Reg. § 301.6513-1(c).

[113] Treas. Reg. § 301.6501(b)-1(b).

[114] Section 6501(a).

[115] Public Law 117-2, Section 9651(a) (March 11, 2021).

[116] Notice 2021-49, Section III, G. Section 6501(b)(2) has special rules for employment tax returns. It states that if a return for any period ending with or within a calendar year is filed before April 15 of the following year, then it shall be considered filed on April 15. In other words, the filing date is pushed until later, thereby creating a longer assessment-period for the IRS.

[117] Notice 2021-49, Section III, G.

[118] Section 6501(c)(1); Section 6501(c)(2); Treas. Reg. § 301.6501(c)-1(a); Treas. Reg. § 301.6501(c)-1(b).

[119] *Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984).

[120] Section 6514; Section 7405; Section 6532(b).

[121] Section 6532(b); Treas. Reg. § 301.6532-2.

Governmental Order Test or Reduced Gross Receipts Test.[53]

Notice 2021-65

The IRS issued Notice 2021-65 to clarify the IIJA. It started, of course, with confirmation that Eligible Employers, other than Recovery Startup Businesses, could *not* claim ERCs for fourth quarter 2021.[54] The next logical step for the IRS was recouping funds. It did so by explaining that advance ERC payments received by most Eligible Employers for fourth quarter 2021 constituted "erroneous refunds," they must be timely and fully repaid, and delinquencies would be penalized.[55]

More ERC Claims Still Coming

Eligible Employers could have solicited ERCs on *timely* Forms 941 for each relevant quarter in 2020 and/or 2021. Alternatively, they could, and in many instances still can, seek ERCs after the fact by filing Forms 941-X (Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund).

Readers need to take a step back to grasp this timing issue. 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.[56] As explained earlier in this article, Forms 941 for all four quarters of a particular year are deemed filed on April 15 of the next year.[57] For example, Form 941 for second quarter 2020 had to be filed by July 31, 2020 (*i.e.,* the last day of the month following the end of the relevant quarter), but is deemed to have been filed nearly nine months later, on April 15, 2021.[58]

ERCs were available for second, third and fourth quarters of 2020. Assuming that an Eligible Employer filed the corresponding Forms 941 on time, the law would treat them as being filed with the IRS on April 15, 2021. Thus, applying the three-year limit described above, the Eligible Employer can file Forms 941-X making ERC claims until April 15, 2024.

ERCs were also available for first, second, third and fourth quarters of 2021, though the last quarter was ultimately restricted to Recovery Startup 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 can file Forms 941-X claiming ERCs, or more of them, until April 15, 2025.

In summary, Eligible Employers could conceivably make ERC claims for a long time.

Watchdog Reports

The Treasury Inspector General for Tax Administration ("TIGTA") has published several reports describing what many predicted; that is, troubles with ERCs from the outset. The first one identified some early problems.[59] As of just May 2020, the IRS had already flagged over one million Forms 941 as erroneous or possibly fraudulent.[60] The report also explained that the IRS had improperly made (i) payments to deceased, incarcerated, and nonresident taxpayers, (ii) duplicate payments to taxpayers who changed filing status or who live in U.S. territories, and (vi) multiple payments to the same back account.[61]

The second TIGTA report continued in a similar fashion.[62] It indicated that the IRS did not catch several hundred Forms 941 for 2020, claiming ERCs of more than $92 million, with strong indicators of fraud.[63] Moreover, the IRS granted ERCs to over 500 governmental entities, which, by their very nature, could not qualify as Eligible Employers.[64] The report further underscored that the IRS was not equipped to address taxpayers gaming the system by filing Forms 7200 (Advance Payments of Employer Credits Due to COVID-19) requesting immediate outlays, and later not filing Forms 941 to reconcile the correct amount of ERCs.[65]

The third report highlighted the fact that the IRS was understaffed and underpowered in terms of technology. These deficiencies resulted in significant delays in processing Forms 941 with ERC claims, as well as Forms 7200 seeking advanced payments. The setbacks, predictably, caused the IRS to issue millions of inaccurate tax bills and penalty notices for delinquencies, followed by an equally massive number of abatements.[66]

The fourth report from TIGTA was more detailed in its criticisms.[67] It explained that the filing season was already underway when Congress enacted many of the COVID-related laws, such as the CARES Act, so the IRS did not have adequate time to make the necessary programming changes. This caused the IRS not to perform certain validations, and some erroneous or fraudulent ERC claims went undetected.[68] The fourth report also indicated that, in processing Forms 941-X seeking large refunds derived from ERC claims, many IRS employees did not properly refer them to the Examination Division. TIGTA found this problematic because such scrutiny is necessary to stop improper, excessive or fraudulent refunds before they go out the door. Why the failure to seek help from the Examination Division? According to the IRS personnel interviewed by TIGTA, they "just forgot" to make the referral, guidance and training regarding ERC processing was unclear, or the rules changed frequently.[69] The last major problem identified by TIGTA in the fourth report involved the retroactive modification of the law, thereby limiting ERC claims for fourth quarter 2021 to Recovery Startup Businesses. The IRS did not have a procedure to confirm that a taxpayer alleging Recovery Startup Business status really was one; it simply relied on the taxpayer's affirmation on Form 941 or Form 941-X.[70] Such reliance was clearly unjustified, as TIGTA identified hundreds of taxpayers that likely were not Recovery Startup Businesses, despite their affirmations, which improperly claimed about $20 million in ERCs. How did TIGTA know? Well, some taxpayers claiming to be Recovery Startup Businesses applied for their Employer Identification Numbers *before* the key date, February 15, 2020. Other taxpayers conveniently claimed to be Recovery Startup Businesses on their Forms 941 for fourth quarter 2021, but not for third quarter 2021.[71] On a related note, TIGTA also discovered that the IRS allowed ERCs for fourth quarter

2021 to many taxpayers that did not even identify themselves as Recovery Startup Businesses in the first place, particularly those that paper-filed Forms 941.[72]

The Congressional Research Service, like TIGTA, issued various documents evaluating various aspects of the ERC.[73]

IRS Pronouncements – Downhill Slide

The IRS has issued a significant number of New Releases, Information Releases, Fact Sheets, and the like referencing the ERC. They started out positive, but turned negative as the IRS began detecting abuses. Below is an abbreviated chronology.

The IRS published several items in early 2020 generally notifying taxpayers of various tax benefits introduced by Congress for those suffering because of COVID, including the ERC.[74] Next, the IRS informed taxpayers that it had experienced some delays in processing ERC claims and requests for advanced payments on Forms 7200.[75] The IRS also announced it was issuing regulations explaining how taxpayers must reconcile the amount of ERCs initially claimed with the amount they really deserved, and then take corrective actions.[76] Subsequent pronouncements from the IRS were uplifting; they told taxpayers that the ERC had been extended three times by Congress, making benefits available throughout 2021.[77]

Things went downhill from there. Marking the one-year anniversary of the introduction of the ERC, the IRS explained that criminal investigations and civil examinations were underway. Regarding the former, the IRS indicated that the Criminal Division was "pledging its continued commitment to investigating COVID-19 fraud," including instances related to the ERC. The Head of the Criminal Division added that the IRS "would not cease until every fraudulently obtained dollar is accounted for and the individuals behind the schemes are prosecuted to the fullest extent of the law."[78]

The IRS later announced that Congress had retroactively shortened the period for which taxpayers could claim the ERC by enacting the IIJA. The fourth quarter 2021 was eliminated for most Eligible Employers, such that they could only seek benefits from second quarter 2020 through third quarter 2021.[79]

The IRS then disseminated a "tax tip" whose title was remarkably blunt: "Watch Out for Employee Retention Credit Schemes." It explained that the IRS had been warning taxpayers about promoter scams since Fall 2022, yet taxpayers that do not meet the Eligible Employer standard continue trying to claim ERCs in 2023. The IRS also noted friction between return preparers and their clients attributable to the rosy picture of ERCs painted by promoters. It stated that "tax professionals are also reporting receiving undue pressure from clients to claim the ERC as a result of these scams."[80]

About six months later, the IRS again warned taxpayers to "be wary" of companies advising them to claim large ERCs because many of them are taking improper positions regarding eligibility and amounts. According to the IRS, unscrupulous companies were charging large upfront fees or contingent fees based on the size of the tax refund, instructing taxpayers to take unsupported positions with the IRS regarding the ERC, and then compounding the problem by failing to tell the taxpayers that they must have a corresponding decrease in the deduction that they claim on their federal income tax returns for wages paid. The IRS then told taxpayers to proactively fix that situation: "If the business filed an income tax return deducting qualified wages before it filed an employment tax return claiming the credit, the business should file an amended income tax return to correct any overstated wage deduction." The IRS also warned taxpayers that they will be held accountable if they fall prey to "advertised schemes and direct solicitations promising savings that are too good to be true" because taxpayers "are always responsible for the information reported on their tax returns."[81] The IRS repeated these admonitions three months later, referring to them as "renewed warnings."[82]

The IRS continued down this path, announcing in March 2023 that improper ERC claims not only made it onto the Dirty Dozen list, they topped it.[83] The IRS described the ERC scourge as follows:

> Taxpayers should be aware of aggressive pitches from scammers who promote large refunds related to the [ERC]. The warning follows blatant attempts by promoters to con ineligible people to claim the credit. The IRS highlighted these schemes from promoters who have been blasting ads on radio and the internet touting refunds involving [ERCs]. These promotions can be based on inaccurate information related to eligibility for, and computation of, the credit. Additionally, some of these advertisements exist solely to collect the taxpayer's personally identifiable information in exchange for false promises. The scammers then use the information to conduct identity theft.[84]

The IRS upped the rhetoric soon thereafter, declaring that "aggressive marketing" of ERCs persisted and there was "a barrage of aggressive broadcast advertising, direct mail solicitations, and online promotions." The IRS then laid out some "tell-tale signs of misleading claims." Among them were (i) unsolicited calls or advertisements mentioning an "easy application process," (ii) statements that the promoter can determine ERC eligibility within minutes, (iii) large upfront fees or a contingent fee based on a percentage of the refund obtained, and (iv) statements to the effect that all taxpayers should apply for ERCs because there is nothing to lose. The IRS also reiterated that it was already conducting civil examinations and criminal investigations.[85]

More recently, high-ranking IRS enforcement officials acknowledged that the ERC constitutes a "substantial compliance issue" because of the huge number of claims and the incidence of non-compliance, with "much of it bordering on fraud." They also called it a "case study on a program ripe for improper claims" as a result of IRS underfunding, large numbers of taxpayers desperate for a post-COVID financial boost, pervasive paper-filing of returns, and complicated qualification rules.[86]

From Talk to Action

The IRS disseminated lots of guidance and warnings over a two-year period. It moved from words to actions in late 2022.

The IRS announced that it had trained 300 Revenue Agents to conduct civil examinations of ERC claims, while Special Agents would focus on potential criminality by "promoters" and other "enablers" of such claims.[87] The IRS further explained that, even though the last period for which the ERC could be claimed passed many months ago, IRS scrutiny was just getting underway. IRS officials stated at a recent conference that "the IRS likely will see an influx of [ERC] claims as it works through the continuing echoes of pandemic-induced backlogs."[88] They also said that audits of all those claims will be "time-intensive because taxpayers will have to produce substantial documentation to show both qualification for, and the correct amount of, the credits."[89]

Consistent with that admonition, the IRS released in late 2022 an initial training guide for Revenue Agents. Its main goal, unsurprisingly, was for all personnel to be capable of (i) determining the specific quarters in 2020 and 2021 during which a taxpayer was an Eligible Employer, (ii) identifying what payments constituted Qualified Wages, (iii) calculating the correct amount of ERCs that a taxpayer could claim, (iv) applying any limitations on ERCs based on the number of full-time employees, and (v) understanding the interplay between ERCs and other tax benefits.[90] The IRS borrowed heavily from its earlier guidance, particularly Notice 2021-20, in crafting the training guide for Revenue Agents.[91]

Things did not end there. The IRS produced more expansive training materials, which were released publicly at the end of 2022.[92] In the words of one IRS official, such materials explain how Revenue Agents "should scrutinize" all aspects of the ERC and confirm that it "is being abused by third parties with schemes targeting employers that are ineligible."[93] Among other things, the training materials address fraud in detail. They enumerate several indicators of fraud in the ERC context, including (i) taxpayers who obtained their Employer Identification Numbers in 2020 or 2021, (ii) taxpayers who did not file Forms 941 before 2020, (iii) taxpayers that made no employment tax deposits whatsoever before claiming ERCs, (iv) taxpayers filing Forms 941 with a residential address instead of a business one, (v) taxpayers with no indication of the financial wherewithal required to pay wages to the large number of employees indicated on Forms 941, (vi) taxpayers for which there are minimal or no public records showing that they ever existed or operated, (vii) taxpayers whose Forms 7200 seeking advance payments were rejected by the IRS, (viii) taxpayers filing Forms 7200 that were processed by the IRS and later not submitting Forms 941 reporting the advance payments received, (ix) taxpayers filing Forms 941 but not income tax returns, and (x) taxpayers claiming on Forms 941 that absolutely all wages they paid during the relevant periods triggered ERCs.[94] The training materials also reminded Revenue Agents that auditing "refundable credits [like the ERC] requires extra scrutiny by the examiner in detecting fraud committed *by a taxpayer, promoter, and/or return preparer.*"[95]

Consequences for Non-Compliant Taxpayers

Wrongdoers in the ERC realm that are caught by the IRS will be obligated to repay employment and/or income taxes, face a variety of civil penalties, get hit with interest charges on both taxes and the penalties, and possibly encounter criminal charges. That bleak outcome is examined below.

Employment Taxes

Taxpayers that claimed ERCs essentially got an immediate reduction of their employment tax liabilities. If it turns out that such claims were completely baseless or just excessive, then the supposed Eligible Employers will be on the financial hook for the unpaid employment taxes.

Employment Tax Penalties

When a taxpayer fails to pay employment taxes in full, on time, and by an approved manner, the IRS generally can impose failure-to-deposit penalties.[96] These can reach up to 15 percent of the tax underpayment.[97] Penalties will not stick, though, if the taxpayer can demonstrate that the violation was due to "reasonable cause" and not due to "willful neglect."[98]

Income Taxes

Taxpayers that claimed unwarranted or inflated ERCs might have income tax liabilities, too. As explained above, the CARES Act stated that an Eligible Employer's income tax deduction for the Qualified Wages it paid, would be reduced by the amount of the ERC it receives.[99] A decrease in such deduction triggers an increase in the federal income tax liability. The IRS has recognized that some companies aggressively promoting the ERC exacerbate the problem by purposely omitting the reality that the ERC is not all roses. It causes a corresponding reduction in the federal income tax deduction that an Eligible Employer could otherwise claim for wages paid.[100]

The recent training materials for the hundreds of Revenue Agents tasked with auditing ERC issues emphasize that timing issues are tricky. They explain that the reduction of the wages-paid deduction for income tax purposes linked to the receipt of ERCs occurs for tax purposes during the year in which the Eligible Employer paid or incurred the wages. Consequently, when an Eligible Employer files a Form 941-X to claim ERCs, it must "file an amended federal income tax return . . . for the [previous] taxable year in which the Qualified Wages were paid or incurred to correct any overstated deduction taken with respect to the same wages on the original federal income tax return."[101]

Income Tax Penalties

Taxpayers that get the ERC but fail to adjust their federal income tax returns accordingly will face taxes, and to such taxes the IRS likely will add a penalty for "negligence."[102] Taxpayers might oppose such penalty on grounds that they had "reasonable cause" for the oversight and they acted in good faith.[103]

Civil Fraud Penalties

The IRS can impose a penalty, equal to a whopping 75 percent of the tax un-

derpayment, if it can establish, by clear and convincing evidence, that fraud exists.[104] To the relief of the IRS, as long as it manages to demonstrate that *any portion* of a tax underpayment is due to fraud, the *entire underpayment* ordinarily will be treated as fraudulent.[105]

Each allegation of fraud is decided on its own particular facts, and no single factor is decisive. However, several common indicators, known as "badges of fraud," exist. They include tax understatements, inadequate records, failure to file returns, implausible or inconsistent explanations, fictitious transactions or entities, concealment of assets, failure to cooperate with the IRS, engaging in illegal activities, and dealing in cash.[106] The taxpayer's level of sophistication is another relevant factor in determining fraud.[107]

Depending on the circumstances, the IRS might assert the large civil fraud penalties with respect to *both* the employment tax liabilities *and* income tax liabilities associated with ERCs.

Interest Charges

Taxpayers with ERC violations will also be stuck with large interest charges, on *both* the tax liabilities and penalties. These run from the due date of the relevant return until the liability has been paid in full.[108]

Potential Criminal Sanctions

In extreme cases, where evidence exists that a taxpayer intentionally made false ERC claims, the IRS might pursue criminal sanctions. Convictions or settlements could trigger fines, jail time, or both. Tax crimes commonly raised by the IRS include tax evasion, making false statements, submitting false documents, and conspiracy to defraud the U.S. government.[109]

Summary by the IRS

The IRS has described the situation in which many taxpayers find themselves as follows. It warned that any taxpayer that "improperly claims the ERC must pay it back, possibly with penalties and interest" and a taxpayer "could find itself in a much worse cash position if it has to pay back the credit than if the credit were never claimed in the first place."[110] IRS enforcement officials echoed this sentiment, describing some potentially bad circumstances for susceptible taxpayers: "The [ERC] mills are selling the idea that nearly anyone can qualify for the ERC in exchange for 25 percent of the refund, and then absconding with their share [which] leaves taxpayers potentially subject to full repayment, penalties, and interest without access to the facilitators and their 25 percent."[111]

Observations about Enforcement Periods

Taxpayers claiming ERCs, along with their advisors, need to clearly understand just how long the IRS has to attack.

Normal Assessment Period

As explained above, Forms 941 for all four quarters of a particular year are deemed filed on April 15 of the next year.[112] For example, Form 941 for second quarter 2020 had to be filed by July 31, 2020, but is deemed to have been filed nearly nine months later, on April 15, 2021.[113]

The IRS generally has three years from the date on which a tax return is filed (or deemed to have been filed) in order to identify it as problematic, conduct an audit, and propose any changes.[114] Turning to the example, above, the normal assessment-period for Forms 941 for any quarter of 2020 would expire on April 15, 2024, while the standard assessment-period for 2021 would end on April 15, 2025. The IRS, in other words, has a long time to audit Forms 941 and Forms 941-X claiming ERCs, even under the most restrictive timeframe.

Five-Year Period for Certain Quarters in 2021

The ARP Act granted the IRS more time to audit taxpayers who might be misbehaving; it allows the IRS five years from date on which the relevant Form 941 is actually filed or treated as filed to challenge an Eligible Employer.[115] Notice 2021-49 clarified the extended assessment-period in the context of the ERC. It said that the assessment-period for any amount attributable to an ERC will not expire before the date that is five years (instead of three years) after the date on which the original Form 941 is filed, or the date on which such return is deemed to have been filed, whichever is later.[116] Take this example. If an Eligible Employer files a timely Form 941 for third quarter 2021 claiming ERCs, such Form 941 is deemed to have been filed on April 15, 2022, and the assessment-period stays open until April 15, 2027.

Importantly for taxpayers, Notice 2021-49 indicates that the extended assessment-period only applies to ERC claims for third and fourth quarters of 2021 under the ARP Act, but does *not* affect ERC claims for *earlier* quarters in 2020 or 2021.[117]

Endless Assessment-Periods

The IRS has repeatedly warned that many unscrupulous companies are urging taxpayers to take ERC positions that range from extremely aggressive to downright wrong. Accordingly, one must assume that the IRS will argue that the assessment-periods are endless with respect to those Forms 941 or Forms 941-X, as they are false, fraudulent, and designed to intentionally evade tax.[118]

Suits for Erroneous Refunds

When a taxpayer files a refund claim on Form 941-X based on ERCs, this does *not* create a new assessment-period, and it does *not* extend the existing assessment-period related to the original Form 941.[119] As a result, if the IRS pays a refund claim in response to a Form 941-X, and if the IRS discovers that such claim was unwarranted *after* the assessment-period expires, it has a few options. The IRS could seek voluntary repayment from the taxpayer, which seems improbable. It could "administratively offset" the ERC-related refund against another refund the IRS owes the taxpayer, but this only works if the taxpayer has overpayments elsewhere. Another possibility is filing a lawsuit to recover the "erroneous refund."[120]

With respect to the last option, litigation to recoup the refund, the IRS generally has two years from the time it paid the refund to initiate a suit. However, in situations where "any part of the refund was induced by fraud or misrepresentation of material fact," the timeline expands to five years from the payment date.[121]

As explained earlier, if an Eligible Employer timely filed Forms 941 for all four

quarters of 2021, the law would treat them as being filed on April 15, 2022. That means that the Eligible Employer could file Forms 941-X claiming ERCs until April 15, 2025. Assume it did just that. Further assume that the IRS issued the refund on May 15, 2025, after only a cursory review, because of processing challenges, insufficient human resources, and a desire to avoid public and congressional criticism for delaying the distribution of important tax relief to taxpayers still hurting from COVID. Finally, suppose that the IRS, with additional time to reflect, determined that the Form 941-X was fraudulent or contained material misrepresentations. In such case, the IRS would have five years from the payment date, until May 15, 2030, to file a suit to reclaim the erroneous refund.

Conclusion

This current article, combined with the earlier article in the series, highlight many of the complexities associated with the ERC. However, as these two articles expressly recognize, they only cover the tip of the proverbial iceberg; they do not attempt to address every aspect of the convoluted ERC rules. Doing so would result in a product too dense, and way too boring, for most taxpayers. It is better to focus on some clear realities with broader importance, as follows.

The ERC derives from four laws applying different rules to different quarters in different years, legislative history is scarce, the IRS issued a series of Notices full of complicated explanations and examples, and many of the rules evolved over time or got eliminated, sometimes retroactively. Add to that state of flux a seemingly endless number of "advisors" encouraging taxpayers to file aggressive or downright baseless ERC claims. Enter the IRS, which kicked off with public warnings, moved to training hundreds of specialized personnel, and then began unleashing examinations and investigations. The IRS's confidence level, at least at this early stage, might be boosted by several things. These include the possibility of asserting employment taxes, income taxes, and various penalties, the benefit of extended assessment-periods in many cases, and the chance to seek "erroneous refunds" from undeserving taxpayers for several years to come.

Under these circumstances, *all* taxpayers who claimed ERCs, even those that took reasonable and well-supported positions, should prepare for serious IRS scrutiny. Moreover, as will be explained in the next article in this series, *all* "advisors" who promoted, recommended, analyzed, or in any other way facilitated ERC claims that the IRS might find questionable should be getting ready for IRS attention, too. ●