



Considerations for IRS examinations of ERC claims

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With an extended examination period for the employee retention credit and repeated IRS warnings of promoted schemes, practitioners and their clients should take care to document and support credit claims.

This column summarizes recent developments in the IRS's civil enforcement of the employee retention credit (ERC), with a focus on its examinations. The IRS has been active in alerting taxpayers and tax professionals regarding attempts to promote ERCs to ineligible taxpayers, recently including ERC schemes on its 2023 Dirty Dozen list ([News Release IR-2023-71](#)). Tax practitioners who worked to properly document and report these important credits regularly receive calls from clients regarding ERC solicitations. For their clients who have claimed an ERC, practitioners can help prepare for any IRS examination by reviewing which documents revenue agents are likely to request and knowing how they will review this information. Sec. 3134(l) provides a five-year statute of limitation for examination of taxpayers' ERC-related amounts, which gives the IRS additional time to conduct these examinations.

As background, the IRS published guidance in Notice 2021-20, Notice 2021-23, and Notice 2021-49 setting forth requirements for substantiation of eligibility and document retention related to each of the three iterations of the ERC in 2020 and 2021 (see also Nellen, "[Documenting COVID-19 Employment Tax Credits](#)," 53-1 *The Tax Adviser* 36 (January 2022)). Revenue agents will anticipate compliance with these documentation requirements.

Accordingly, return preparers should retain the required information, having analyzed their clients' eligibility according to the differing ERC requirements between March 2020 and the end of 2021.

As indicated in the Dirty Dozen list, a substantive examination of ERC positions would be preceded by an initial inquiry into whether the ERC claim was part of a scam, including an identity-theft scheme. Consider establishing early in the examination that the payroll tax returns setting forth eligibility for the ERC were prepared by a longtime trusted adviser and return preparer or at least reviewed or referred by one.

It should be relatively clear whether an examination pertains to an ERC position, because the IRS's initial information document request (IDR) will likely refer to Form 941, *Employer's Quarterly Federal Tax Return*, (or Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*) for the period at issue and expressly state that the IRS needs to review documentation to determine whether the taxpayer is an eligible employer for purposes of the ERC.

As a procedural matter, although employers may have received advance payments of the ERC by filing Form 7200, *Advance Payment of Employer Credits Due to COVID-19*, the amounts under examination would be the credit amounts reported on an employer's

employment tax returns, as they are the final credit amounts posted to the employer's tax accounts. Still, Form 7200 provided the Service an opportunity to review ERC information earlier in the filing period, such as the total number of employees to whom the taxpayer paid qualified wages, prior-year employee information, and information about other credits. Consider these prior representations as information is provided during the examination.

Review of income tax deductions for ERC wages

If an ERC examination has not yet begun, the client or return preparer (or a new return preparer) should consider reviewing reporting positions during 2020 and 2021 against the documents that the IRS expects to have been maintained since the ERC was claimed. A frequently stated position by revenue agents is that if a number is on the tax return, documents should already be in the taxpayer's file to support that position. With the ERC, it is more complicated because it implicates two reporting regimes (income tax and payroll tax reporting) as well as, potentially, the Paycheck Protection Program (PPP) or other relief programs, including any subsequent loan forgiveness. External income tax return preparers for an employer might not prepare the payroll tax returns for the same business.

For the 2020 and 2021 calendar-year income tax periods, preparers should consider reviewing any Forms 941 or Forms 941-X filed by the employer to determine any ERC positions taken and whether the taxpayer was eligible for the ERC. To the extent the employer obtained ERC benefits, an appropriate reduction in the income tax deductions for those wages should also be reviewed. While this additional work may be difficult for a client to digest, given representations from companies that focus on ERC claims, it can help

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A client with an identified erroneous ERC or related underpayment can then make an informed decision regarding potential mitigation of penalties. The IRS reminded taxpayers in [News Release IR-2022-89](#) that reasonable-cause or first-time abatement penalty relief may be available where a taxpayer owed additional taxes because a deduction for qualified wages was reduced but was unable to pay the additional tax because it had not yet received the associated ERC refund. Note that the steps taxpayers take to comply, and the timing of those steps, are relevant to a reasonable-cause determination (see Internal Revenue Manual §§20.1.1.3.2(5) and 20.1.1.3.2.2(2)). Another consideration is that a timely and otherwise qualified amended return filed to correct the reporting of wage deductions may mitigate penalties on any understatement (see Regs. Secs. 1.6664-2(c)(1)–(3)).

Preparing for an IRS examination

Not surprisingly, a revenue agent's scrutiny of ERC benefits starts with comparing the reported positions to the information that was required to be retained as set forth in the IRS's published guidance. The primary ERC requirements will be the focus of IDRs, such as whether the business (1) sustained a full or partial suspension of operations due to orders from an appropriate governmental authority limiting the business during an eligible period; (2) experienced a significant

decline in gross receipts during 2020 or a decline in gross receipts during the first three quarters of 2021; or (3) qualified as a recovery startup business for the third or fourth quarter of 2021 (see Sec. 3134(c)(2)(A)).

Still, there are many nuances based on the relevant reporting periods, such as the number of employees receiving qualified wages or other COVID-19 relief obtained (i.e., forgiveness of PPP loans), as well as such considerations as other credits reported. To facilitate a review of potential issues, the IRS provides a [comparison chart](#) of the 2020 versus 2021 eligibility requirements and other criteria for the ERC. The ERC was amended three times after it was originally enacted in March 2020 as a provision of the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136 (with amendments by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the Consolidated Appropriations Act, 2021, P.L. 116-260; the American Rescue Plan Act of 2021, P.L. 117-2; and the Infrastructure Investment and Jobs Act, P.L. 117-58). Thus, the IRS's cumulative guidance is helpful for reviewing the changing ERC rules since 2020. Additionally, other background and guidance is available at the [AICPA's ERC Guidance and Resources Hub](#).

IDR examples

Below are examples of documents that may be requested during an ERC-focused IRS examination, based on recent IDRs, as well as information the IRS has stated it will request. One

potential issue, worker classification, may also be relevant to examinations of other tax positions and periods.

Examiners will also request copies of worksheets used by preparers to compute credits and other amounts included on the employment tax returns. The initial IDR may request a list of employees paid wages for the ERC claimed and the amount of wages paid to them. An additional request is whether any employees who received wages included in the ERC computations were related individuals for purposes of the credit (Sec. 3134(e); see also Roane, “[IRS Guidance Denies ERC for Most Majority Owners’ Wages](#),” *Tax Insider* (Sept. 23, 2021)). Revenue agents may also request documentation to show how the preparer determined qualified health plan expenses that the employer allocated to the ERC computations.

Revenue agents will also need to determine whether a taxpayer is a “large employer” (more than 100 average full-time employees for 2020 or, for 2021, more than 500, both as measured during 2019), in which case they will also need to determine qualified wages by inquiring about whether the employees provided services (Sec. 3134(c)(3)). Again, the revenue agents are asking questions that work through each of the requirements for obtaining the ERC. Accordingly, IDRs for ERC positions for the third quarter of 2021 would initially ask for documentation regarding whether the employer was severely financially distressed (Sec. 3134(c)(3)(C); Notice 2021-49, § III.E).

Information requests that may be particularly difficult to address in preparation for an examination (if not contemporaneously maintained) are those asking for documentation that operations were fully or partially suspended due to orders from an appropriate governmental authority due to COVID-19. Employers may have workers in many municipalities, counties, or states, which will make these records difficult to re-create.

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While taxpayers are not required to create documents to produce during an examination, they may need to do so to meet their burden of proof that the eligibility requirements are met. If the returns were prepared by a company that specializes in the credit, employers should request a copy of their workpapers and other records that document the relevant governmental orders.

Consider that government websites may be updated periodically, or website links may simply no longer work. Accordingly, document any relevant orders by saving information from websites as soon as possible. Also, consider contacting the government if the information is not otherwise available. A related request will focus on whether the taxpayer experienced a significant decline in gross receipts during the calendar quarter for which the ERC was claimed.

As noted above, the IRS will request applications for PPP loans as well as for PPP loan forgiveness. If relevant, the Service will also ask for a copy of the employer’s forgiveness letter received from a loan provider and/or the U.S. Small Business Administration.

The IRS will also review reporting positions to determine if an employer took the Sec. 41, 45A, 45P, 45S, 51, or 1396 credit; the COBRA (Consolidated Omnibus Budget Reconciliation Act) premium assistance credit; or the paid sick and family leave credits for the same wages used to compute the ERC in the applicable periods (see Secs. 3134(c)(3)(D) and 6432(c)(1)). As these positions are interrelated, the IRS will confirm they were computed correctly.

Another issue potentially rising out of ERC positions is worker classification as an employee versus an independent contractor. To qualify for the significant benefits of the ERC (and other COVID-19 relief), some companies considered reclassifying as employees workers they had previously classified as independent contractors. Shining a light on worker classification as an employee in the 2020 and 2021 tax periods could raise the same issue for prior years. ERC benefits tied to employee classification and recent measures by federal and state authorities help continue a trend toward a preference for employee classification (see, e.g., U.S. Department of Labor [proposed regulations](#) and California Assembly Bill 5 and its “ABC test”).

The example document requests in this column are not all-inclusive, and revenue agents are trained to identify issues and ask follow-up questions after reviewing the information they receive. ERC examinations are somewhat like research-and-development credit exams in that, while taxpayers view the Internal Revenue Code as an authority that sets forth why they should receive a credit, revenue agents view each requirement as one of many hurdles that need to be cleared to qualify for the credit.

Office of Professional Responsibility guidance

While responsible tax professionals did their best to navigate the different iterations of the ERC and follow IRS guidance during the pandemic, third parties have continued to push ineligible employers to file claims for

the credit. On April 4, 2023, the IRS issued [Tax Tip 2023-44](#), again providing information on how to report illegal tax-related ERC claims and activities. Such notices have been issued regularly since the IRS initially published a warning on Oct. 19, 2022 ([News Release IR-2022-183](#)). By then, tax professionals had been calling for the IRS to publicize certain promoters who continued to solicit business clients to claim ERCs improperly. The public warning was well received because it gave tax professionals a publication to show their long-standing clients, rebutting third-party solicitations regarding inflated credits, perhaps for significant upfront fees (see, e.g., AICPA news release, "[AICPA Encouraged by IRS Warning of ERC Mills](#)" (Oct. 23, 2022)).

The IRS Office of Professional Responsibility (OPR) issued *OPR Bulletin* No. 2023-02 with an alert

titled "[Professional Responsibility and the Employee Retention Credit](#)" on March 7, 2023 — the same day the IRS issued [News Release IR-2023-40](#), which renewed the IRS's October 2022 warning.

The OPR alert highlights some professional obligations to consider regarding ERC positions. For instance, Section 10.22(a) of Treasury Circular 230, *Regulations Governing Practice Before the Internal Revenue Service* (31 C.F.R. Part 10), requires a practitioner to exercise due diligence in preparing and filing tax returns and documents for clients. Section 10.34(c) requires practitioners to advise clients of potential penalties on a tax return the practitioner prepares for the client or when advising clients about positions taken. This can be relevant when going through the preexamination considerations noted above.

As foreshadowed in the IRS alerts and notices cited above, the ERC filings for the 2020 and 2021 tax periods and subsequent refund claims reflecting ERC benefits for these periods are ripe for IRS examinations and enforcement. Accordingly, tax professionals should review their clients' reported ERC positions with care and be prepared for examination. ■

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