

5 Ways Taxpayers Can Spot Employee Retention Credit Scams

By **Derek Adams, Jesse Morton and Susan Rogers** (March 23, 2023)

On Monday, the Internal Revenue Service opened its 2023 Dirty Dozen list of prevalent tax scams with a renewed warning about the Employee Retention Credit, or ERC, a pandemic-era employment tax credit available to qualifying employers.[1]



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Recently confirmed IRS Commissioner Daniel Werfel cautioned:

Businesses need to think twice before filing a claim for these credits. While the credit has provided a financial lifeline to millions of businesses, there are promoters misleading people and businesses into thinking they can claim these credits. There are very specific guidelines around these pandemic-era credits; they are not available to just anyone. People should remember the IRS is actively auditing and conducting criminal investigations related to these false claims. We urge honest taxpayers not to be caught up in these schemes.[2]



Jesse Morton

The ERC's addition to the Dirty Dozen list was needed after a cottage industry of so-called ERC tax experts formed during 2021 and 2022, with claims of no risk for taxpayers, guaranteed qualification and promises of huge refunds.

These third parties, often driven by large contingency fees, have flooded the market and filled the airways with advertisements, going to new lengths to push this lucrative tax credit. While most stimulus funding fraud occurred in 2020 and 2021, as the government doled out trillions of dollars in federal relief, the ERC is unique in its longevity.



Susan Rogers

Even though the ERC was passed on March 27, 2020, as part of the Coronavirus Aid, Relief and Economic Security, or CARES, Act, employers have until April 15, 2024, to claim the credit for quarters in 2020, and until April 15, 2025, to claim the credit for quarters in 2021.[3]

As a result, it is peak season for unscrupulous actors seeking to monetize the credit, and the period of IRS and U.S. Department of Justice enforcement is only beginning.

Taxpayers and ERC mills should take heed of the IRS' warnings, as noncompliance can have serious consequences.

The first criminal case to stem from the ERC was brought by the DOJ on Feb. 3 against Zachary Bassett and Mason Warr and their Salt Lake City, Utah, consulting firm, COS Accounting & Tax LLC dba 1099 Tax Pros, for allegedly preparing and filing more than \$11 million in false and fraudulent ERC claims and other tax credits.[4]

Other cases will undoubtedly come, against both credit mills and taxpayers.

In this article, we examine the purpose and history of the ERC, and provide tips for identifying bad actors before it's too late.

Purpose of the Credit

The purpose of the ERC was to encourage businesses to keep employees on the payroll despite challenges faced amid the COVID-19 pandemic.[5] Rep. Stephanie Murphy, D-Fla., was the first proponent of the ERC, writing on March 21, 2020, that the credit "will provide strong support to businesses that have seen revenues significantly decline due to coronavirus, so long as they retain & pay their workers rather than lay them off." [6]

The credit, which can be up to a total of \$26,000 per employee and many millions of dollars in all, has been slowly building steam since 2020.

Slow Start

In 2020, 119,834 taxpayers claimed the ERC, resulting in only \$10.9 billion in claims.[7] This was about 2% of the funding distributed through the Paycheck Protection Program, which that year produced over five million loans and totaled more than \$525 billion in potentially forgivable loans.[8]

The reason for the ERC's slow start can be found at Section 2301(j) of the CARES Act, which prohibited a taxpayer from claiming the ERC if it had also obtained a PPP loan.[9] In 2020, the ERC's value to an employer was up to \$5,000 per employee and the PPP permitted a borrower to obtain up to \$20,833 per employee, plus benefits; thus, the choice was clear for most businesses.

This changed on Dec. 27, 2020, when Congress passed the Consolidated Appropriations Act of 2021, which included the Taxpayer Certainty and Disaster Tax Relief Act of 2020.

In addition to extending the ERC into 2021 and making it more lucrative for employers by raising it to \$7,000 per employee per quarter, the act removed the prohibition on taking both the ERC and the PPP.[10] And it did so retroactively.

Thus, taxpayers that qualified for the ERC could restate tax filings for quarters in 2020, as long they do not double-dip by using wages or benefits for the ERC that had already been utilized to claim forgiveness of their PPP loans.

Attention for the ERC Grows in 2021

Following the Taxpayer Certainty and Disaster Tax Relief Act, the IRS sought to raise awareness about the ERC. On Jan. 26, 2021, the IRS issued a news release urging "employers to take advantage of the newly-extended employee retention credit, designed to make it easier for businesses that, despite challenges posed by COVID-19, choose to keep their employees on the payroll." [11]

During 2021, taxpayers began to learn about the ERC and its popularity grew with 367,285 claims totaling about \$32 billion, based on early reports in January 2022.[12]

In 2021, it also became clear that experts were needed — lawyers, consultants, accountants, CPAs and tax specialists — to help taxpayers navigate the complex rules that Congress created, and that the IRS implemented, for the ERC. Among the complexity, rules differed significantly between taxpayers claiming the credit for quarters in 2020 as compared to 2021.

In addition, while employers of all sizes could potentially qualify for the ERC, the eligible

wages and benefits an employer may claim depends on whether an employer is classified as a small employer or a large employer. Determining this is itself a complicated analysis, with different thresholds used for 2020 and 2021, a specific calculation methodology from the IRS that must be applied, and tax aggregation rules that must be carefully considered and analyzed.

Bad Actors Emerge

Given the ERC's complexity, the amount of money at stake and the opportunity for exploitation, it should be no surprise that so-called ERC tax experts began to emerge in 2021 and 2022.

These third parties typically charge a contingency fee of 15% or more for their services, with some even requiring payment up front and others not agreeing to refund any portion of a claim that is ultimately disallowed by the IRS.

Even those that agree to defend a taxpayer during audit, and to repay their fee if the credit is disallowed, typically fail to inform the taxpayer of the significant interest and penalties that could be applied by the IRS, for which the taxpayer may ultimately be responsible.

On Oct. 19, 2022, the IRS issued its first warning to taxpayers about the ERC, advising them to "beware of third parties promoting improper Employee Retention Credit claims."^[13] The IRS further advised:

Businesses are encouraged to be cautious of advertised schemes and direct solicitations promising tax savings that are too good to be true. Taxpayers are always responsible for the information reported on their tax returns. Improperly claiming the ERC could result in taxpayers being required to repay the credit along with penalties and interest.^[14]

On March 7, the IRS once again sounded the alarm, warning taxpayers that "promoters continue pushing ineligible people to file" for the ERC.^[15] This second warning was more pointed, with the Acting IRS Commissioner Doug O'Donnell stating that the "IRS is actively auditing and conducting criminal investigations related to these false [ERC] claims. People need to think twice before claiming this."^[16]

The IRS also stated that its "Office of Professional Responsibility is working on additional guidance for the tax professional community that will be available in the near future."^[17]

How to Identify Bad Actors — Red Flags

The following discussion highlights five red flags that we have frequently seen among bad actors operating ERC mills. This list is not exhaustive, but if one or more of these red flags applies to your so-called ERC tax expert, caution should be taken.

1. Contingency Fees

While not per se unlawful, taxpayers should be wary of consultants charging contingency fees for their services, especially those that are large or require payment up front.

The IRS' position is that attorneys, CPAs and enrolled agents are prohibited from charging contingency fees for services rendered, with certain exceptions — none of which apply to the ERC.^[18]

The IRS' prohibition of contingency fees applies to practice before the IRS, which the Code

of Federal Regulations broadly defines as "rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion." [19]

Thus, advice given by attorneys, CPAs or enrolled agents about a taxpayer's qualification for the ERC, will be viewed by the IRS as practice before the IRS, with contingency fees for those services prohibited. The rationale for this rule is easy to understand. The IRS wants tax experts to be objective, unbiased and operating with the taxpayer's best interest in mind.

Taxpayers should want this too. A contingency fee destroys this objectivity, as it gives the consultant a personal stake in the outcome of the tax filing. Whether consciously or subconsciously, this can make consultants more likely to take aggressive or unsupported positions on behalf of taxpayers.

This risk is heightened when the consultant does not agree to cover any interest or penalties that may later be applied by the IRS — and most do not.

One way that a contingency fee ERC consultant can mitigate this risk is by using an independent third party for the determination of a taxpayer's qualification for the ERC, and importantly, by paying that third party regardless of whether it finds that the taxpayer qualifies for the ERC.

The third party should be paid a fee that is not contingent on anything — for example, a fixed fee payment for their analysis rendered. This approach can be beneficial to taxpayers in avoiding upfront costs, but it also serves to maintain the consultant's independence in the process.

2. Claims of Little or No Risk to Taxpayers

Any reputable tax expert will inform their clients that the ERC is a high-risk area that will be subject to significant government enforcement efforts for years to come. The risk of paying interest and penalties is real, and those can add substantially to the amount a taxpayer may be required to pay if its credit is ultimately disallowed.

For example, Title 26 of the U.S. Code, Section 6662, permits the IRS to impose an accuracy-related penalty of 20% of an underpayment of tax that results from a taxpayer's careless, reckless or intentional disregard of the rules. Section 6663 increases that penalty to 75% in instances of fraud.

Moreover, if a taxpayer underpays employment tax, interest will be assessed, and it generally accrues from the due date of the original return to the date the tax was paid. The IRS uses the federal short-term rate, plus three or five additional percentage points, depending on whether the underpayment is a large corporate underpayment — an underpayment exceeding \$100,000 by a C corporation.

The current rates are 7% or 9%, with the higher rate reserved for large corporate underpayments. [20]

As an example, if a taxpayer underpays its employment taxes by \$2 million due to an erroneous ERC claim that is discovered through an IRS audit three years from now, in addition to repayment of the \$2 million, the IRS may seek approximately \$590,058 in interest — if rates remain as they are today — plus \$400,000 in penalties if the IRS

determines the taxpayer was careless and \$1.5 million in penalties if the IRS finds fraud by the taxpayer.

Congress has already extended the IRS audit period from 3 years to 5 years, for review of ERC claims in quarter three of 2021.[21]

In addition, the Inflation Reduction Act, signed into law on Aug. 16, 2022, provided more than \$45 billion to the IRS for tax enforcement activities.

The ERC is an area of high priority for IRS enforcement and audits of taxpayers will be ongoing for many years. If a so-called tax expert tells you that is not the case or that they have never lost an audit, beware. If it sounds too good to be true, it probably is.

3. Promises of Qualification

There are two methods for potential qualification for the ERC in an applicable quarter. One method is the gross receipts significant decline test, which examines a taxpayer's gross receipts in that quarter and compares it to the taxpayer's gross receipts in the same quarter of 2019.

Although this test can be complicated, when applied correctly, the taxpayer either qualifies or it does not. Most ERC mills, however, are not focused on this test, since under it most taxpayers do not qualify. In fact, in our experience, some ERC mills do not even analyze whether the taxpayer qualifies under the gross receipts significant decline test.

The second method of potential qualification under the Cares Act is if "the operation of the trade or business ... is fully or partially suspended during the calendar quarter due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to [COVID-19]."[22]

Unlike the gross receipts significant decline test, the "partial suspension test" is a facts and circumstances analysis, based on applicable government orders and the impacts that those orders had on a taxpayer's operation of its trade or business during the relevant quarter.[23]

And unlike the gross receipts significant decline test, a taxpayer's qualification is not binary, rather the facts and circumstances dictate the strength of that taxpayer's argument for qualification, and the likelihood that the taxpayer's claim will be upheld during an IRS audit.

The facts and circumstances also dictate whether a taxpayer has a good faith basis to claim the credit to begin with, and the likelihood that the IRS will seek to impose penalties upon the taxpayer.

The gray area surrounding the partial suspension test, however, has allowed ERC mills to exploit this test and claim, falsely, that most taxpayers qualify for all applicable ERC quarters based on a partial suspension of operations. ERC mills typically provide little to no support for this assertion, including minimal analysis of the facts and circumstances applicable to the specific taxpayer's operations.

Performing a legitimate facts and circumstances analysis, however, requires weeks or months of analysis, and should be memorialized in a detailed memorandum, supported by a legal tax opinion.

It should analyze the taxpayer's operations before and during the COVID-19 pandemic, relevant appropriate governmental authority that applied to the taxpayer and the duration by which such authority applied, as well as how that governmental authority affected the taxpayer's operations.

It requires an understanding of the taxpayer's specific industry, the taxpayer's operations, and an analysis of operational metrics and data in order to provide concrete support for any asserted impacts. Such an exercise typically results in dozens of pages of detailed analysis — not merely bullet points or high-level statements.

4. Ignoring Notice 2021-20

IRS Notice 2021-20 is the only comprehensive guidance regarding what constitutes a partial suspension of operations. The statutory language itself is minimal and open to interpretation. Thus, while the IRS' guidance in the notice is not in the form of final regulations, it can be relied upon by the taxpayer, and ignoring it is to the taxpayer's detriment.

It is the only indication we have of how the IRS will conduct its analysis during audit, and what support the IRS will require to establish a partial suspension of operations by a taxpayer. Seventeen pages of text in Notice 2021-20 are devoted to this very issue, and provide significant examples and guidance for use by the taxpayer or its consultants.[24]

Notice 2021-20 also directs taxpayers as to the documentation required during an audit, including, among other things:

- Specific government orders relied upon;
- Records to support an employer's conclusion that "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;"
- Records that substantiate a significant decline in gross receipts, if applicable; and
- Documentation concerning whether the employer is a member of an aggregated group treated as a single employer.[25]

Notice 2021-20 was published by the IRS in Internal Revenue Bulletin 2021-11.[26] The significance of this is that guidance issued in an IRS notice that is published in the Internal Revenue Bulletin may be relied upon by taxpayers, and used as precedent, meaning it will guide the IRS' analysis during audit.[27]

Furthermore, the IRS has created a training manual for its auditors, which largely incorporates the guidance from IRS 2021-20.[28]

While notices do not have the force and effect of U.S. Department of the Treasury regulations, they still will carry weight with any court that analyzes a dispute between a taxpayer and the IRS regarding ERC qualification.

Thus, any consultant that does not hew closely to the guidance delivered in IRS 2021-20 — or worse, chooses to ignore it entirely — is doing the taxpayer a disservice and positioning them for a problematic audit.

5. Relying on Federal Guidance as Opposed to Orders

The statute not only requires that a taxpayer experience a full or partial suspension of operations during an applicable quarter, but also that such a suspension be "due to orders from an appropriate governmental authority." [29]

Notice 2021-20 further elaborates on what the IRS considers an appropriate governmental authority. Notice Q&A 10 provides specific direction on this question, stating: Orders, proclamations, or decrees from the Federal government or any State or local government may be taken into account by an employer as "orders from an appropriate governmental authority." [30]

As examples, the IRS includes an order from a city's mayor, a state's emergency proclamation, an order from a local official or an order from a local health department.

IRS Notice 2021-20 also references recommendations by the U.S. Centers for Disease Control and Prevention and the U.S Department of Homeland Security as guidance that would not constitute an order from an appropriate governmental authority. [31]

The IRS' exclusion of this federal guidance from its list of exemplar appropriate governmental authority, and its later reference to such guidance as not constituting an appropriate governmental authority seems to make the IRS' position clear.

Certain ERC mills point to guidance from federal government agencies such as the Occupational Safety and Health Administration, the CDC, or DHS as appropriate governmental orders.

However, the IRS will take the position during audit, as it referenced in Notice 2021-20, that such guidance does not constitute appropriate governmental authority and may not be relied on by a taxpayer to support a full or partial suspension of operations.

Thus, any analysis that relies solely on guidance documents issued by federal agencies such as OSHA, the CDC, or DHS is insufficient and will not provide the taxpayer with an adequate basis to claim a full or partial suspension of operations.

Advice to Taxpayers Considering the ERC

The following are steps business owners should take before signing a contract or engagement letter with a prospective ERC consultant.

- Do not commit to the first person to call or the first website that pops up offering ERC services. Advertising dollars do not equal quality of service.

- Ask questions, lots of them, based on the above red flags and best practices.
- Ask for and follow up on references, and network with industry peers for first-hand accounts of experiences with ERC claims and consultants.
- Verify credentials, and compliance and discipline history with licensing and certifications boards. Most boards have a public directory that can be searched.
- Do not be in a rush to sign a contract or engagement letter. Take the required time to properly review any documents in their entirety to know exactly what they state, what to expect from the consultant, what the fee structure is, what each party's responsibilities are and any caveats.
- Provide as much detailed supporting documentation as possible so that the claim can be properly analyzed and reported.
- Review the report and returns prepared in their entirety, scrutinizing them for any indication of absent, insufficient, or troublesome analysis. Verify that they accurately reflect the unique facts and circumstances of the business, and the governmental orders impacts.
- Seek independent advice if questions, issues or concerns arise before, during or after the claim's report and returns are prepared, presented and filed.

Conclusion

Criminal convictions for fraud involving stimulus funding are now frequently reported in the news. Taxpayers should learn from cautionary tales involving the PPP, Economic Injury Disaster Loan program and other programs — don't make the same mistake with your ERC filing.

Even those that escape criminal prosecution may face an unpleasant and expensive proceeding if they do not file ERC claims that are legitimate and supported by sufficient analysis to withstand the forthcoming IRS audits.

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[1] <https://www.irs.gov/newsroom/irs-opens-2023-dirty-dozen-with-warning-about-employee-retention-credit-claims-increased-scrutiny-follows-aggressive-promoters-making-offers-too-good-to-be-true>.

[2] Id.

[3] Modified and/or extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE, Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, 134 Stat. 1182 at Section 206-207) (December 27, 2020), Section 9651 of the American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat. 4 (March 11, 2021), and Section 80604 of the Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, 135 Stat. 429 (November 15, 2021).

[4] <https://www.justice.gov/usao-ut/pr/utah-county-residents-and-accounting-business-charged-11-million-covid-related-tax-fraud#:~:text=According%20to%20court%20documents%2C%20Zachary%20Bassett%2C%2039%2C%20of,leave%20wage%20credits%20for%20clients%20of%20COS%20Accounting>.

[5] See e.g., <https://www.irs.gov/newsroom/new-law-extends-covid-tax-credit-for-employers-who-keep-workers-on-payroll> (The ERC is "designed to make it easier for businesses that, despite challenges posed by COVID-19, choose to keep their employees on the payroll."); <https://crsreports.congress.gov/product/pdf/IN/IN11299> ("Employee retention remains a policy concern, as a number of economic sectors have announced layoffs resulting from the COVID-19 induced economic fallout.").

[6] <https://twitter.com/RepStephMurphy/status/1241442694074941440?s=20>.

[7] GAO-22-104280, COVID-19: IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Its Compliance Efforts, at 2.

[8] Paycheck Protection Program (PPP): Approvals through 08/08/2020 (sba.gov).

[9] CARES Act, Pub. L. 116-138, March 27, 2020, at § 2301(j) ("RULE FOR EMPLOYERS TAKING SMALL BUSINESS INTERRUPTION LOAN.—If an eligible employer receives a covered loan under paragraph (36) of section 7(a) of the Small Business Act (15 U.S.C. 636(a)), as added by section 1102 of this Act, such employer shall not be eligible for the credit under this section.").

[10] Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, 134 Stat. 1182, Division EE at Sections 206-207.

[11] New law extends COVID tax credit for employers who keep workers on payroll | Internal Revenue Service (irs.gov).

[12] <https://www.gao.gov/assets/gao-22-104280.pdf>, at 18.

[13] <https://www.irs.gov/newsroom/employers-warned-to-beware-of-third-parties-promoting-improper-employee-retention-credit-claims>.

[14] Id.

[15] <https://www.irs.gov/newsroom/irs-issues-renewed-warning-on-employee-retention-credit-claims-false-claims-generate-compliance-risk-for-people-and-businesses-claiming-credit-improperly>.

[16] Id.

[17] Id.

[18] 31 C.F.R. § 10.27.

[19] 31 C.F.R. § 10.2(a)(4).

[20] <https://www.irs.gov/payments/quarterly-interest-rates>.

[21] The IRS also has five years to claims for Q4 of 2021, a quarter that was withdrawn for most taxpayers, but still available for some in rare instances.

[22] CARES Act, at § 2301(c)(2)(A).

[23] <https://www.irs.gov/pub/irs-drop/n-21-20.pdf>, at Q&A 11, 12, 17, 18.

[24] Id. at pgs. 17-44.

[25] Id. at Q&A 70.

[26] https://www.irs.gov/irb/2021-11_IRB.

[27] <https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs>.

[28] <https://aboutbtax.com/5Wh>.

[29] CARES Act, at § 2301(c)(2)(A).

[30] <https://www.irs.gov/pub/irs-drop/n-21-20.pdf>, at Q&A 10.

[31] Id. at Q&A 20.