The IRS is coming for ERC overpayments

ERC claw backs can be considered withholding and payroll tax

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Why this article:

As the world moves out of the pandemic and all it brought to mankind, there has been a lingering oversight by Capital Restoration LLC (CRL) (to understand the strength of companies based upon operational performance. That was until about two weeks ago when a CRL associate who sits on an AICPA panel that encompasses Covid 19 related issues including Employee Retention Credit (ERC) provided updates on some of the issues. As of the end of September based upon the best information available the ERC program funneled $225 billion and counting into the economy which is on top of the $100 billion annually from student debt forgiveness through October of 2023 and Payroll Protection Program (PPP) funds into the hands of companies and consumers. While the US is a multi-trillion-dollar economy a ¼ trillion is not small change and changes the dynamics.

Why the concern:

The IRS Newsroom:

> *"The IRS continues to see aggressive marketing that lures ineligible taxpayers to claim the ERC. While the credit is real, many promoters are aggressively misrepresenting who can qualify for the credits. In many instances, the IRS is seeing businesses and organizations being misled by promoters into thinking they're eligible when they are not."*

Over the last few days, we have talked to a number of bankers about their experiences with ERC. In a conversation with a regional NE banker "most of his customers filed for ERC", and red lights started to go off. One response from a senior credit officer "I can honestly say that ERC claw back has received little to no attention from industry roundtables." Another comment was a banker saw no comments on borrowers' audited financials. In a conversation with another professional, he outlined a board's difficult time in refusing to file for an ERC claim even over the insistence by other board members that everyone is doing it. Not a single banker we talked to knew of the IRS's concern, which by all accounts are substantial.

WSJ 10/5/23 IRS Fight Against Pandemic Tax-Credit Scams Won't Be Simple or Fast - WSJ

> *The Internal Revenue Service has labeled promoters of a popular pandemic-era tax credit as unscrupulous scammers. The agency's task ahead: Turning that*

tough talk into victories in court. ……….. While paying billions of dollars, the IRS issued increasingly loud warnings, urging taxpayers to avoid ERC firms taking large upfront fees or a portion of refunds. ERC firms say that they follow IRS guidance and that any fraud is committed by other ERC firms………..

The government disrupted the industry in September with a moratorium on refunds for new claims. It plans to let employers withdraw or repay already-filed claims. ………… the April 2025 deadline for amended returns ………… . The IRS has started thousands of audits and hundreds of criminal inquiries. ……… as the IRS tries to claw back some of the $230 billion it paid in employee-retention credits

The IRS is concerned about third party facilitators who have made billions off the program. WSJ

Innovation Refunds has processed more than $6 billion in ERC claims, for which it could earn roughly $1.5 billion in fees. Some accountants who have seen its work question the quality of its analysis. …….. Innovation Refunds has relied on heavy marketing to fuel growth. The company spent $53 million on advertising in the first half of 2023. ………

The company ***struck deals with community banks, credit unions and other partners who received as much as 8% of Innovation Refunds' fee for referrals****. Banking associations and other trade groups earned a commission of as much as 2% on referrals made by their members.*

Around Oct 10th CRL received an ERC solicitation. Their website claims an ERC recovery of over $18 million most likely at the standard 25% fee. They earned more than many of us over the last two years.

"Hey Armand, you can now get ERC even if you had an increase in revenue or took PPP. Avg. amounts are around 10k per W2 employee.

Can I give you a call for 5 mins tomorrow to explain this new update?

Best,
[redacted]

."

Doing our research, it came to light that many companies that the IRS audited under the PPP program had questionable qualifications and they looked the other way. We all heard about the PPP fraud and a few flashy people and some minor headlines so business folks believe the ERC will be the same. Based upon the activity started by the IRS and DOJ supported by 87,000 new IRS agents it is time to make some noise.

AICPA notices on ERC:

9/19/23 **J**ournal of Accountancy: 'Tsunami' of ERC claims required IRS action to halt fraud

9/14/23 – IRS increasing efforts on ERC mills

7/23/23 – IRS increases criminal investigation into ERC fraud

A Quick look at ERC qualifications based upon IRS publication:

The ERC eligibility questions most likely creating confusion and issues in the market are discussed after this chart.

Eligibility questions	*Next steps*
1. Did you have employees and pay wages to them between March 13, 2020, and December 31, 2021? For more info, see irs.gov/ercqualified	*• If yes, go to #2.* *• If no, you aren't eligible to claim the ERC. If you improperly claimed ERC, see Part C.*
2. During that time, were you: *• A self-employed individual who didn't have employees?* *• A household employer?*	*• If yes to either question, you aren't eligible to claim the ERC. If you improperly claimed ERC, see Part C.* *If no, go to #3.*
3. Did your trade or business experience a significant decline in gross receipts during the eligibility periods during 2020 or the first three calendar quarters (Jan. through Sept.) of 2021? *For more info and examples, see the ERC frequently asked questions: irs.gov/ercdecline*	*• If yes, you may be eligible for the ERC. You will need to confirm that your decline in receipts meets requirements. See the ERC frequently asked questions: irs.gov/ercdecline. If you meet the requirements, skip to Part B.* *• If no, go to #4.*
4. Were you a recovery startup business? That's certain businesses or organizations that began carrying on a trade or business after February 15, 2020. The new trade or business doesn't need to be pandemic- or recovery-related. *For more info, see the ERC frequently asked questions: irs.gov/recovery*	*• If yes, you may be eligible for the ERC, but you must confirm that your gross receipts meet specific requirements related to recovery startup businesses. See the ERC frequently asked questions: irs.gov/ercrecovery. If you meet those requirements, skip to Part B.* *• If no, go to #5.*

5. Was the operation of your business or organization fully or partially suspended by a government order due to the COVID-19 pandemic during 2020 or the first three calendar quarters (Jan. through Sept.) of 2021? It must have been a government order, not guidance, a recommendation or a statement. *For more info, see the ERC frequently asked* *questions: see see irs.gov/ercqualified*	*• If yes, you may be eligible for the ERC. See #6, and make sure you can show that the government order was a) related to COVID-19 and b) resulted in your trade or business operations being fully or partially suspended.* *• If no, you are not eligible to claim the ERC. If you improperly claimed ERC, go to Part C.*
6. Are you claiming the ERC because of supply chain issues? *For more info, see the ERC frequently asked* *questions: irs.gov/ercsupply*	*• If yes, be extremely cautious; this is a common point of confusion, and even if you experienced supply chain disruptions you often will not be eligible as a supply chain issue by itself does not qualify you for the ERC. Review carefully the ERC frequently asked questions at irs.gov/ercsupply, as they address supply chain issues. If you still believe you qualify, go to Part B. If you improperly claimed ERC due to a supply chain issue that doesn't qualify, go to Part C.* *• If no, go to Part B.*

One of the issues facing many will be the lack of regulations and court rulings on the new law. A law such as this with subjective language usually is followed by IRS regulations and guidelines and many sections have court president to assist. The IRS has issued notices which we will call guidelines outlined below, but no court has ruled and congress has not passed defining the issue. A quick look at the subjective issues headed to court. Clauses 1, 2, 4 are fairly clear cut or outside this scope.

Clause three uses the phrase "significant decline" not a specific calculation. The IRS released guidance under Section III.E. of Notice 2021-20 in which the change in revenue needed to be 50%. Guidance for 2021 Section 2301(c)(2)(A)(ii)(II) of the CARES Act, as amended by section 207(d)(1)(A) of the Relief Act, which requires revenue to be 80% or less than the same quarter in 2019.

In our opinion if revenue decline does not meet the guidelines and the client has other thoughts a collateral reserve should be considered until after April of 2025 which is congress's current extended time line to claw back funds. Don't forget those penalties and interest that accrue as well as those professional fees.

Clause five requires the business to have been shut down by "government order". Legal opinion please.

Clause six deals with supply chain issues. The IRS issued guidance requires the supplier to meet government shut down requirements and prove goods not available elsewhere etc. Not going to be an easy task. But for detailed guideline click here. It would be our fair guess many would have used this clause early in the process before the IRS guidelines were released, which will most likely end up in court.

The language in the guidelines leaves one to wonder that if the supply for product A is encumbered as outlined in the guidelines, yet the company produces other products that allowed them to operate at break-even, under the proposed guidelines they may qualify for an ERC.

Generally speaking, common sense, if a major supply chain disruption occurred revenue would be impaired as shelves would be empty for sale or manufacturing.

It is our understanding Christmas Tree Stores had a substantial supply issue related to storage fees at the docks. Under the guidelines dock / shipping / storage type disruptions are outside the ERC. Would a judge see it differently?

The IRS through its newsletters is asking taxpayers to step forward. The uptick and awareness have just begun. The ERC is payroll tax related and it impacts companies, fiduciaries, and lenders. The following highlights some of the issues.

Why ERC claw backs are returns of refunded and or unpaid withholding and payroll taxes.

The ERC credit is claimed on IRS form 941 which provides data on withholding, FICA, and the company's deposits. Generally, as noted by attorneys, unpaid withholding taxes have preference and payroll taxes can get primed out of a revolving loan after the 45-day holding period.

The denial of the credit provides the IRS all the power encompassed in very tough regulations that can impose massive penalties and fines for unpaid withholding taxes.

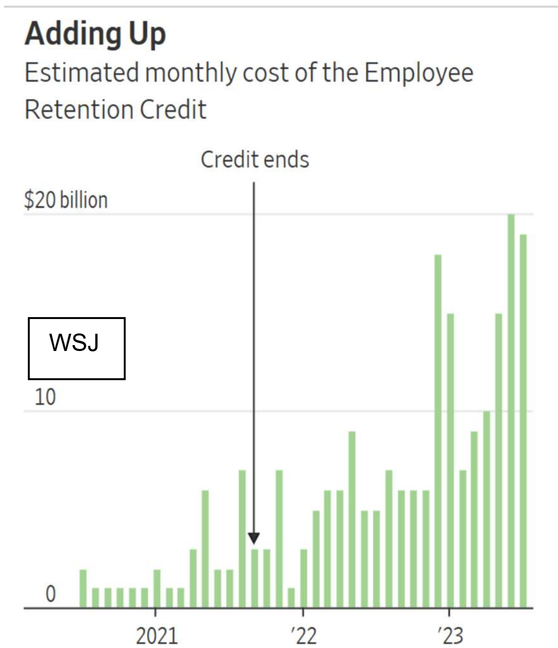
Just to add another piece the regulations require the company to reduce labor costs on their tax return by the amount of the credit so hopefully the company is not outside the statute of limitations to file an amended return for a refund.

Magnitude of the Claw Back:

At this point IRS published reports have about 3.6 million processed filings with another 800,000 unprocessed and growing, waiting for the current moratorium to expire in January 2024. Recent published data indicates that the IRS is investigating 250 cases with individual claims over $11 million each. It appears the IRS started with the largest claims first. Of the 250 cases, 15 have been either referred to DOJ for repayment and it is ongoing for the remaining companies per the release in September.

In the WSJ article sited above it discusses the magnitude of 3.6 million filings and how much can be accomplished by the IRS. Public sentiment may come into play as it appears many people are tired of the handouts. In this particular situation the IRS can target specific preparers and claims over X dollars. History has shown that the Service in normal times likes to come and pay a visit after sending along a check. Auditing the data of ERC claims and their compliance with the guidelines should not be a time-consuming task and the computer does the rest so as the IRS adds new resources the deficiency and audit notices should increase.

The IRS through its news releases is asking taxpayers to step forward and be sure their claims are accurate. The uptick in awareness has just begun. Because the ERC is payroll taxes and withholding related it impacts companies, fiduciaries, and lenders' collateral. The following highlights some of the issues:



- 3.6 million claims filled with payouts to date over $225 billion, 800,000 claims in que, and the IRS informing the public about fraud and their increased efforts to recoup the inappropriate payouts,

- bankers taking fees for referrals (WSJ),

- congress extended the time for the IRS to recoup the funds,

- for customers, and those responsible for depositing payroll funds the repayment can extend to them including penalties and interest,

- and the impact on the borrowing base and the bank's collateral.

During PPP the government turned to the banks to assist in the distribution of funds and processing of documents hopefully eliminating some fraud. It appears that banks may unexpectedly be the protectors as best they can as they will need to protect themselves as well.

About the authors:

Armand Lucarelli, CPA and Joe Anoli, CPA operate a boutique consulting firm focused on middle market companies in transition. [Capital Restoration] is a Boutique strategic financial consulting firm servicing midsize enterprises in transition. Turning financial challenges into opportunities for a bright future. CRL is an award winning nationally recognized firm leading enterprises through unique challenges.