What CPAs Need to Know about Employee Retention Credit Fraud

By Christopher M. Ferguson and David Taylor

Most taxpayers have likely received a solicitation recently claiming that they may be entitled to thousands of dollars in employee retention tax credits. The solicitations involve the Employee Retention Credit (ERC), a payroll tax credit created by the Coronavirus Aid Relief and Economic Security (CARES) Act that has been credited with preserving millions of jobs during the pandemic. According to the IRS, many of these solicitations are offering credits that are "too good to be true"— in some cases, they are downright fraudulent.

The IRS is targeting these ERC schemes aggressively. Within the past month, it has issued its third warning to taxpayers to be wary of ERC promoters, singled out ERC fraud on its 2023 "Dirty Dozen" list of abusive tax schemes, and issued guidance, doubling as warnings, to tax professionals with respect to the requirements of Circular 230 as applied to ERC claims (IR-2023-49, Mar. 20, 2023, https://bit.ly/3K4n50B). Criminal prosecutions have begun, and promoter investigations and congressional investigations are likely to follow.

It is likely that tax preparers have encountered several clients who are considering claiming ERC credits after responding to such promoter advertisements. This article explains the ERC program, the ways in which it has been vulnerable to fraud, the government's enforcement efforts around ERC fraud, and what tax practitioners can do to assist their clients, and themselves, when it comes to properly reporting ERC claims.

What is the Employee Retention Credit?

The ERC is a refundable tax credit that was created under the CARES Act and amended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020. The ERC, which allows employers to offset their employment taxes against a percentage of their "qualified wages" paid to employees, was created to incentivize employers to retain and continue to pay their employees during the COVID-19 pandemic. The ERC program has been credited with providing vital assistance to millions of struggling businesses during the pandemic (IR-2023-49, Mar. 20, 2023, https://bit.ly/3K4n50B).

Unlike other pandemic programs, which by design have fairly simple to follow criteria, the rules and eligibility criteria surrounding the ERC are relatively extensive and vary depending upon the period for which relief is claimed. An employer may qualify for the ERC in one of three ways. To be eligible, the employer's business must have—

- experienced a *full or partial suspension of operations* resulting from a government order issued due to the COVID-19 pandemic during 2020 or the first three quarters of 2021;
- experienced a *significant decline in gross receipts during 2020 or a decline in gross receipts during the first three quarters of 2021* as defined by the criteria set forth in the appropriate IRS guidance (Notice 2021-20 for 2020 and Notice 2021-23 for 2021); or
- qualified as *a recovery startup business* for the third or fourth quarters of 2021 as defined in Notice 2021-49. [IRC section 3134(c)(5)]

Determining whether a particular business qualifies under these criteria is no simple undertaking. It requires assessing such questions as: what constitutes a "government order issued due to the pandemic"; what constitutes a "significant decline" in gross receipts; and what constitutes a recovery startup business. The IRS has provided guidance on these, and other, questions in the form of three separate notices issued in 2021 (IRS Notice 2021-20, IRS Notice 2021-23, IRS Notice 2021-49) that still leave many open questions. Taxpayers will likely be looking to professional advisors to assist them in filing these claims.

An employer who qualifies as an "eligible employer" based on one of the above criteria may claim the ERC for any "qualified wages" paid during the relevant period (IRS Notice 2021-20). What constitutes "qualified wages" depends upon the period for which the ERC claim is made and the size of the employer.

For the period from March 13, 2020, through December 31, 2020, for large employers (defined as employers with more than 100 average full-time employees in 2019), qualified wages only includes wages that were paid to employees for time when employees were not providing services to the employer. For small employers (i.e., fewer than 100 employees), qualified wages consist of any wages paid to employees during the relevant period regardless of whether or not the employee was providing services to the employer. For this period, the ERC is capped at 50% of the first $10,000 of an employee's annual qualified wages, resulting in a maximum credit of $5,000 per employee (IRS Notice 2021-20).

The Relief Act significantly increased the maximum ERC available to employers for 2021. First, it expanded the definition of what constitutes a small employer to include employers with up to 500 (rather than 100) employees. It also permitted "severely financially distressed" large employers (defined as large employers whose gross receipts for the relevant quarter were less than 10% of the employer's gross receipts for the same quarter in 2019), to claim all wages paid to its employees as

"qualified wages" regardless of whether the employee was providing services to the employer. More significantly, the Relief Act increased the allowable credit to include 70% of the first $10,000 of an employee's wages per quarter, resulting in a maximum credit of $21,000 per employee for the year (Taxpayer Certainty and Disaster Tax Relief Act of 2020, section 207). Eligibility for the ERC was also expanded to include recovery startup businesses during the third and fourth quarters of 2021 in the American Rescue Plan Act of 2021 (IRC section 3134).

There are some important offsets that employers must heed. Wage deductions claimed on a business's federal income tax return must be reduced by the amount of the credit [IR-2023-40 (Mar. 7, 2023), https://bit.ly/3GhZtVf]. Also, employers who received forgivable loans under the Payroll Protection Program (PPP) cannot "double dip" by seeking a credit for wages that were included in the employer's PPP loan forgiveness application (IRS Notice 2021-20). Initially, employers who received PPP loans were prohibited from claiming the credit. The Relief Act relaxed this prohibition to allow the employers to claim the credit for wages that were not included in a PPP loan.

Notice 2020-21 also imposes record-keeping requirements. Upon audit, taxpayers must produce, among other things, records substantiating the basis for which they are claiming the credit, such as the government order that forms the basis of their claim or records demonstrating that their business experienced a substantial decline in revenue or experienced a full or partial shutdown during the relevant period.

During the periods covered by the ERC program, employers could claim the credit on their quarterly payroll returns (Form 941X). Alternatively, they could seek an advance payment of the ERC by filing Form 7200. Eligible employers can still claim the credit currently by filing an amended payroll tax return (Form 941-X) for each quarter during which they paid qualifying wages. Because amended payroll returns may be filed up to three years after the deadline for the original returns, employers will be able to claim ERC credits into 2025.

Is There a Problem with ERC Claims?

There is nothing inherently problematic with claiming ERC credits. In fact, during the midst of the pandemic, the IRS undertook efforts to publicize the credit, affirmatively "urg[ing] employers to take advantage of the newly-extended employee retention credit." (IR-2021-21, Jan. 26, 2021, https://bit.ly/412Fkds)

As the ERC gained notoriety, however, it spawned a cottage industry of self-touted "ERC experts" seeking to profit by luring taxpayers into submitting ERC claims to which they were not entitled. Rather than objectively guiding clients through the ERC rules, these promoters largely ignore, or misrepresent, the guidance provided by the IRS in order to churn out as many ERC claims as possible, for which they receive large fees. Some of these promoters go as far as to claim that all businesses qualify for the credit; this is not true. Others claim that certain types of government orders qualify as a shutdown order for purposes of claiming the credit when, in fact, they do not (Derek Adams, Jesse Morton and Susan Rogers, "5 Ways Taxpayers Can Spot Employer Retention Credit Scams," LAW360, Mar. 23, 2023, https://bit.ly/3mayNif). According to the IRS, promoters also are failing to advise taxpayers that they cannot deduct wages covered by ERC credits on the business's income tax returns or that they cannot claim the credit for wages that formed the basis of a PPP loan application that was granted (IR-2022-183, Oct. 19, 2022, https://bit.ly/40XkCMc). Promoters also fail to advise taxpayers of the record-keeping requirements imposed by Notice 2020-21, leaving the taxpayer unprepared to substantiate their claim in the event of an audit (Adams, Morton and Rogers, 2023).

Many of the promoters of ERC schemes charge contingency fees tied to the amount of the refund claimed, with fees as high as 15%, another major red flag (IR-2022-183, note 13). The amount of credits available to employers under the ERC program can be quite substantial.

As many of the solicitations advertise, an eligible employer can, in theory, claim credits of up to $26,000 per employee ($21,000 in 2021 and $5,000 in 2020). An employer claiming the maximum amount of qualifying wages for 400 employees could receive credits totaling $10.4 million. This means big business for promoters who collect contingency fees from each taxpayer and provides tantalizing incentives to drive up the amounts of such credits, regardless of guidelines.

How Is the Government Responding?

The federal government is responding to ERC fraud aggressively, and with increasing urgency. The IRS issued its first warnings about dubious ERC promotions in two successive bulletins issued three weeks apart in October and November 2022 (IR-2022-183, note 12; COVID Tax Tip 2022-170, Nov. 7, 2023, https://bit.ly/411yzsI). These notices admonished taxpayers to "be cautious of schemes and direct solicitations promising tax savings that are too good to be true." They also reminded businesses that "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" (COVID Tax Tip 2022-170, note 16).

The IRS's attempts to combat ERC fraud have become more strident as tax return deadlines have approached. Within the first week of March, the IRS singled out ERC fraud as the first entry on its 2023 "Dirty Dozen" list of abusive tax schemes and issued its third warning in six months to taxpayers (IR-2023-40, Note 9; IR-2023-49, note 2). These announcements included the IRS's most pointed warning to date from IRS Commissioner Danny Werfel, who once again cautioned taxpayers not to get drawn in by dubious promoter schemes, noting: "There are very specific guidelines around these pandemic-era credits; they are not available to just anyone. People should remember that 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." (IR-2023-49)

At the same time as these pronouncements, on March 7, 2023, the IRS's Office of Professional Responsibility released Issue 2023-02, which warned practitioners about ERC fraud, and provided guidance for practitioners who represent clients in seeking these credits. OPR Issue 2023-02 also made a point of reminding practitioners of their ethical responsibilities in representing clients who are pushing to make these claims (https://bit.ly/3MhEe9U).

The IRS's attempts to combat ERC fraud have become more strident as tax return deadlines have approached.

Congress has also acted. The American Rescue Plan of 2021 extended the statute of limitations for the IRS to assess any amount attributable to an ERC claim from three years to five years, giving the IRS additional time to investigate illegitimate ERC claims [IRC section 3134(l)]. The IRS has also expressed its intention to bring promoter investigations, and congressional investigations have been called for.

Criminal charges are on the table as well. In June 2022, in the District of Utah, a promoter pled guilty to aiding in the filing of false tax returns for soliciting numerous ride share owners and other sole proprietors to form LLCs that were then used to claim fraudulent ERC credits. In total, the scam secured over $11 million in fraudulent refunds (U.S. Treasury Inspector General for Tax Administration, "Tax Preparer Pleads Guilty after Defrauding Clients and the Internal Revenue Service," Aug. 23, 2022, https://bit.ly/3m7qp32).

Given the massive number of allegedly fraudulent credits that have already been claimed, and the fact that employers can still claim these credits through 2025 on amended payroll tax returns, CPAs should expect to see ERC audits and investigations continue for years.

What Does This Mean For Preparers?

Given the wave of ERC credit promotion schemes in the media, taxpayers have been appearing in droves at the doors of their tax preparers. In some cases, the promoters themselves recruit tax preparers to prepare returns for their clients. The OPR's release of Issue 2023-02 in March makes it clear that the IRS is counting on tax professionals to serve as gatekeepers in its efforts to stem the tide of illegitimate ERC claims.

OPR Issue 2023-02 listed three provisions of Circular 230, which establishes professional standards for practicing before the IRS that are triggered when representing a client who intends to claim the ERC credit on a return. The first, section 10.22(a), relates to diligence as to accuracy, and requires practitioners to exercise due diligence in preparing and filing tax returns or other documents on a client's behalf with the IRS and in ensuring the correctness of the practitioner's written and oral representations to the IRS. To be clear, tax preparers are not

required to be detectives, and may rely in good faith on information provided to them by taxpayers without verification. However, for this reliance to be in good faith, the practitioner must make reasonable inquiries of a client and may not accept incomplete information or ignore inconsistent information [Circular 230, section 10.34(d)].

The second pertinent section of Circular 230 (section 10.34) relates to positions taken on a tax return. Section 10.34 prohibits a practitioner from advising a client to take a tax return position that the practitioner knows or should know is an unreasonable position or a position that lacks a reasonable basis, without disclosure. Tax preparers are also required to advise a taxpayer of penalties that are reasonably likely to apply to a position taken on a return if they provided advice with respect to the position or signed the return, as well as to advise of the ability to avoid penalties with disclosure.

The third relevant section of Circular 230 (section 10.37) relates to written advice provided to a client. For purposes of Circular 230, written advice can apply to something as basic as advice contained in an email communication. OPR Issue 2023-02 particularly focuses on section 10.37(a)(3), which allows a practitioner to rely on the advice of others only if the reliance is reasonable under all of the facts and circumstances, including whether the other advisor had a conflict of interest within the meaning of section 10.29. Tellingly, the OPR emphasizes that an advisor may have a conflict of interest "because of the amount and character of the fee," going on to note that section 10.27 of Circular 230 severely limits the circumstances when a professional advisor may charge a contingency fee to a client. This is an unmistakable reference to promoters of ERC claims.

The takeaway from OPR Issue 2023-02 is that CPAs must proceed with caution when claiming ERC credits for clients. CPAs advising taxpayers on ERC claims would be well served to familiarize themselves with the guidance provided by the IRS in Notices 2021-20, 2021-23, and 2021-49. Although preparers may accept information provided by their clients without verification, they cannot ignore red flags. The claims of taxpayers who cannot produce a government order that meets the criteria set forth in Notice 2021-20, or who cannot substantiate a partial or total shutdown of their business, should be viewed with heightened skepticism. Arguably the most significant red flags, according to the IRS, are taxpayers who have been advised that they are entitled to significant ERC credits by so-called experts charging large contingency fees.

CPAs who ignore any of the above-referenced red flags when advising clients in making ERC claims do so at their own risk. Given the abundance of warnings and guidance issued by the IRS, the Office of Professional Responsibility will likely not hesitate to institute disciplinary proceedings against those perceived to have ignored Circular 230. The IRS also may seek preparer penalties under IRC section 6694. In cases where the IRS believes the preparer knew or had reason to believe that the preparer's assistance will be used in a "material matter" (defined as a statement having a substantial impact on the taxpayer's decision process) and result in an understatement of tax, the IRS may assert penalties under IRC section 6701. With respect to corporate taxpayers, such penalties may amount to $10,000 per return on which the ERC is claimed. Violations of section 6701, and willful violations of section 6694(b), result in mandatory referrals to the Office of Professional Responsibility [IRM 20.1.6.12.3 (8-25-20)]. Finally, in the most egregious cases involving willful violations, there is always the specter of criminal sanctions.

The takeaway from OPR Issue 2023-02 is that CPAs must proceed with caution when claiming ERC credits for clients.

Be Wary of Red Flags

The ERC program brought businesses crucial relief during the pandemic, saving untold numbers of jobs. But it also brought a wave of fraud. With promoters continuing to peddle these claims to businesses who do not qualify for the credit, coupled with the fact that these credits can be claimed on amended payroll returns for the next two years, it is likely that we will be seeing IRS audits and investigations of taxpayers and promoters for years to come. CPAs advising taxpayers with respect to the credit are well advised to educate themselves on IRS guidance in this area, along with red flags for spotting potentially fraudulent claims for credits and their obligations under Circular 230. By doing so, they will be protecting not just their clients, but themselves as well. ■

Christopher Ferguson, JD, *is a partner at Kostelanetz LLP, where he concentrates his practice on white collar criminal defense and regulatory matters with a special focus on civil and criminal tax controversies.* ***David Taylor*** *is a paralegal with Kostelanetz LLP.*