

Client Alert **Tax Litigation**

Whether to Seek Protection Under the IRS' New Employee Retention Credit (ERC) Voluntary Disclosure Program

Insights for Taxpayers with Doubtful ERC Claims in Light of the Current IRS Crackdown and Pending Anti-ERC Abuse Legislation

The Employee Retention Credit ("ERC") was enacted by Congress to provide relief for businesses negatively impacted by the COVID-19 pandemic and provides significant financial benefits to those businesses (up to \$26,000 for each qualifying employee). However, in its haste to get the funds out to businesses that needed help, Congress did not provide detailed eligibility rules nor a robust process to determine whether most applicants were, in fact, entitled to receive the money they were seeking. The priority was on getting the money out to businesses which ostensibly needed it quickly.

However well-intentioned this approach was, the lure of "free money from the government" caused some business owners to apply knowing they did not really qualify for one reason or another and also brought out many scammers who aggressively marketed themselves as "ERC consultants" to innocent business owners struggling to recover from the impact of COVID-19 on their businesses. These "ERC consultants" touted both their alleged expertise in making ERC claims and that any fees they charged were contingent on whether ERC benefits were received from IRS in apparent flagrant violation of Circular 230.

The result was that, in the last year, the IRS was deluged with well over 1 million ERC claims despite the last affected tax period (the third quarter of 2021) having ended over two years ago. IRS now suspects that a significant number of these claims were fraudulent and had already taken a number of steps to try to stem the tide of such claims, starting in March 2023 when IRS listed fraudulent ERC claims as the top abusive tax scheme in its 2023 "Dirty Dozen" list and later, in September, when IRS announced a moratorium on processing any new ERC claims until "at least December 31, 2023," which is still in effect.

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Most recently, in October 2023 in an apparent attempt to “thin the herd,” the IRS announced a simplified procedure for now-concerned ERC claimants who had not yet received or negotiated their refund checks to simply withdraw their claims with no penalty and no questions asked. Shortly thereafter, the IRS announced that 20,000 ERC claims were being summarily disallowed after investigation revealed that the applicant either did not exist during 2020 or 2021 or did not previously report having anywhere near the number of qualifying employees now being claimed.

Currently there are about 300 active IRS criminal investigations into ERC claims, a limited number of promoter examinations and a growing number of IRS ERC employment tax audits. These numbers increase every week.

On the Friday before Christmas, the IRS announced a new Voluntary Disclosure Program – ERC-VDP – specifically for businesses and business owners who previously applied for and received ERC benefits, have now heard of the impending IRS crackdown on fraudulent ERC claims and are having second thoughts.

In some ways, the ERC-VDP is similar to the IRS’ 2018 Voluntary Disclosure Program (“VDP”), which replaced the Offshore Voluntary Disclosure Initiative (“OVDI”) program that ran from March 2009 through September 2018. In other ways, there are differences in the protections available, which may be important in specific cases. Is participating in the new ERC-VDP a good idea given the current IRS view of ERC claims?

There is no one answer for everyone. However, one thing is clear – the new ERC-VDP is only for Taxpayers “who received but were not entitled to any . . . Employee Retention Credits. . .” Those who are or may be considered promoters or preparers are not eligible for the ERC-VDP.

How Does the ERC-VDP Work/Who Can Use It?

The ERC-VDP currently has a short 3-month application period. If a Taxpayer wants to apply, they must do so by March 22, 2024, although there is a possibility this may be extended. It is in IRS’ interest to do so because, like the original OVDI in 2009, there are a limited number of agents and a potentially very large number of claims to audit. The continuing availability of a program such as the ERC-VDP substantially decreases that ratio. In this regard, the ERC-VDP supplements the ERC withdrawal option announced in October. To date, \$100 million in claims have been withdrawn under that program.

The ERC-VDP is not for all ERC claimants – only Taxpayers who already claimed and received ERC refunds/credits and who now are conceding they were not entitled to any ERC refund or credit are eligible. If a Taxpayer claimed ERC benefits but now

realizes that their claim was overstated¹, they cannot use the ERC-VDP. It is an “all or nothing” proposition.

Also specifically ineligible are ERC claimants who:

- Have received an employment tax audit notice for a period from which ERC benefits were claimed.
- Have received an IRS notice and demand for repayment of all or part of their previously claimed and received ERC benefit.
- Are already under criminal investigation or have been notified that they are subjects of such a criminal investigation.

Also ineligible are claimants if:

- IRS has received information from third parties or from an enforcement action (third party search warrant or summons enforcement on a promoter or preparer) about the Taxpayer’s non-compliance.

What Are the Advantages?/How to Apply

The benefit offered by IRS under the ERC-VDP is quite generous. This was probably intended in order to induce large numbers of Taxpayers who have received ERC benefits they now think they were not entitled to claim to voluntarily withdraw those claims. Under the ERC-VDP, if the Taxpayer is approved to participate, they only have to give back 80% of the benefits received. The Taxpayer also avoids all penalties and interest (provided they make repayment in full at the time their ERC-VDP application is approved). In addition to being allowed to keep 20% of the benefits they received, participants in the ERC-VDP do not have to reduce the wages expense deduction claimed on their income tax returns as they otherwise would have to do.

A Taxpayer can apply by submitting a new Form 15434 (Application for Employee Retention Credit (ERC) Voluntary Disclosure Program) electronically to IRS using the IRS Document Upload Tool. However, if the Taxpayer outsourced its payroll tax obligations to a third party payroll/employee leasing organization, the third party (not the Taxpayer) must file Form 15434.

The Form must be signed under penalty of perjury by both the Taxpayer and any Representative that the Taxpayer has engaged to help with the ERC-VDP application. The Form requires the Taxpayer to provide information about “preparers/advisors who assisted you in filing your ERC claim(s) for refund” including their identity, contact information and a description of the service each preparer or advisor provided.

¹ An ERC claim might be overstated if the employer was eligible and had incorrectly calculated the number of eligible employees or the amount of eligible wages in submitting the original claim.

What's Not to Like About the ERC-VDP?

The ERC-VDP, unlike the current regular VDP, is described by IRS as a “civil settlement program.” It is not part of the IRS Criminal Investigation’s (“IRS-CI”) Voluntary Disclosure Practice and for that reason, the FAQs accompanying the program announcement state that there is no need for a pre-clearance to be requested before submitting information beyond the Taxpayer’s identity (as in regular VDP) nor is there any IRS-CI review of the completed application or “preliminary acceptance” letter issued. There is also no clear statement in the Announcement or the FAQs of IRS’ intent not to prosecute any ERC applicant who may have been intentionally complicit in making a false ERC claim along with a preparer/promoter. However, it is difficult to imagine IRS or the Department of Justice criminally prosecuting even a “willful” violator who IRS was totally unaware of and who applied for the ERC-VDP and fully complied with its requirements. Nonetheless, such a Taxpayer should consult experienced criminal tax counsel before making an ERC-VDP application.

What If a Taxpayer Is Ineligible – What Can They Do?

The ERC-VDP, like the previously announced “withdrawal” option, is an all or nothing program. Taxpayers with partially allowable claims cannot use the ERC-VDP.

Is there nothing those Taxpayers who had overstated but partly allowable ERC claims can do besides hope they are not audited?

All is not lost.

Some clients may simply refile reduced claims now, although there is currently an indefinite IRS moratorium on processing any new ERC claims. However, extra caution is indicated in cases where the client appears to clearly not qualify for a large part of what was originally claimed and may have made significant misrepresentations in their original ERC claim. These clients may be viewed by IRS as potentially criminally culpable.

For Taxpayers who seek advice from non-lawyer tax professionals, they should also be aware that there is no privilege which might shield the candid discussions that are needed to decide on what to do. Such Taxpayers risk making their situation worse by proceeding further without privileged legal advice first.

For some business owners who haven’t received their claimed benefits or negotiated their checks, the withdrawal process may be the best approach and it may also head off an impending audit. However, if the claim being withdrawn might be viewed by IRS

as fraudulent, the Supreme Court has held in the income tax context, that a Taxpayer in such a case cannot “unring the bell” and that a later corrective filing does not nullify the consequences of a prior fraudulent one. That would also seem to be true of simply withdrawing a fraudulent but not paid ERC claim.

In the criminal context, a voluntary withdrawal of an unacted upon or unpaid ERC claim is not per se a silver bullet under the IRS-CI’s VDP although it is a factor in IRS-CI’s decision to recommend prosecution.

Bottom line – there may still be consequences. One such consequence for Taxpayers who received ERC benefits improperly may be that the statute of limitations (which closes for timely filed 2020 Form 941s on April 15, 2024) remains open indefinitely and permits IRS to fully examine the Taxpayer’s employment tax compliance years later and make assessments of additional tax and civil fraud (75%) penalties plus interest.

It is possible IRS may try to assert “trust fund” liability against the owner(s) of these businesses, although technically it would seem like this should not apply for ERC related Form 941 adjustments.

The regular IRS VDP may also be an option for some of these claimants but it typically requires full repayment of all additional tax plus interest and at least one 75% civil fraud penalty imposed on the year/period with the latest tax due. Most regular VDP cases involve multiple years of non-compliance but using VDP limits the required remediation to a lesser period of six years.

In ERC cases the requirements of the regular VDP may not be attractive because only a few Form 941 periods over only two years (2020-2021) are involved and full repayment of the tax due (even without considering what else may need to be repaid in the way of interest and penalties) may be a problem. In ERC cases, unlike other tax non-reporting cases, the business owner may not have received the benefit of the total ERC refunds received. Many “promoters” charge contingent fees of 10% or even 20% of the ERC refund that is paid by IRS so the business owner participating in a VDP might well wind up paying back more than they actually received as well as interest and penalties on the total refund. The business may not be able to complete its VDP without causing the financial distress that the ERC was intended to alleviate. Whether or not the business owner can pay the amount due under the regular VDP, the requirement of paying back more than what was received is a significant disincentive to applying to participate in the regular VDP.

Other (less onerous) “get into compliance” options such as the Streamlined Filing Compliance Procedure (“SFCP”) only apply to foreign-related non-compliance.

What About “Quiet Disclosure”?

While “quiet disclosure” is always an option, there are significant downside risks and questions. How would a “quiet” disclosure work? Reamending previously submitted Forms 941-X to reverse previously claimed ERC benefits (a specific line item on 941-X) is not very “quiet.” Even if not identified by IRS initially, there is the risk that IRS will later identify the Taxpayers through information obtained in promoter audits. If that happens, the Taxpayer can expect IRS to audit and assess the full amount of the erroneous refunds with 75% fraud penalties on the total tax due (plus interest) even if IRS-CI does not investigate the Taxpayer criminally.

New Proposed Legislation Makes Things Worse for ERC Claimants and Those Who Assist Them

Even more recently, on January 18, 2024, the House Ways and Means Committee approved and sent to the full House of Representatives a \$78 billion extension of several expiring business tax credits and an expansion of the Child Tax Credit, which is to be paid for by a number of measurers cracking down on or discouraging the further use of the ERC program.

These measurers most notably propose to shorten the time for filing any new ERC credit claims to January 31, 2024 (or some similarly near date shortly after the bill is signed into law). Under existing law, new ERC claims for 2020 can be filed up to April 15, 2024 and claims for 2021 (where much larger funds are available) can be filed until April 15, 2025.

While shortening the claim filing period for new ERC claims, the bill also extends the statute of limitations within which IRS can audit ERC filed claims and reassess any previously refunded amounts as additional tax to six years and imposes preparer due diligence requirements similar to those now in place for claiming Earned Income Credit (“EIC”) and imposes \$1000 monetary penalties on each failure to comply with the new diligence requirements. Preparers who fail to exercise due diligence could also be classified as “promoters” and be subject to the draconian monetary penalties imposed on promoters under IRC §6700 et. seq.

The existing promoter and material adviser monetary penalties are also increased under the bill and the legislation would require ERC promoters and material advisers to maintain records of their clients (as exists now for the sale of other abusive tax schemes).

Conclusion

Whether someone is a good candidate for the withdrawal process, the ERC-VDP, regular voluntary disclosure or a “quiet” disclosure is an “it depends” question. The answer requires an evaluation of the Taxpayer’s particular facts (both from a technical ERC compliance standpoint as well as the Taxpayer’s potential culpability for civil and/or criminal sanctions) to decide on the best course of action in that Taxpayer’s individual case.

The Sills Cummis Tax Fraud and Controversy team has decades of experience both in and out of government specifically in dealing with the IRS in potential voluntary disclosure matters including those related to ERC benefits. Be on the lookout for similar alerts which will follow on new developments about the ERC and other “hot” tax controversy issues.

If you would like additional information, please contact:

Richard J. Sapinski, Esq.

Client Alert Author; Co-Chair, Tax Fraud and Controversy Practice Group
rsapinski@sillscummis.com | (973) 643-5975

Joseph B. Shumofsky, Esq.

Member, Tax Fraud and Controversy Practice Group
jshumofsky@sillscummis.com | (973) 643-5382

Robert A. Stern, Esq.

Counsel, Tax Fraud and Controversy Practice Group
rstern@sillscummis.com | (973) 643-6788