IRS TO TARGET ABUSIVE ERTC CLAIMS: AN ANALYSIS OF GOVERNMENT SHUTDOWN & SUPPLY CHAIN RULES

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One of the biggest issues being discussed by the IRS, Congress, and the AICPA are the millions of businesses that are being targeted by tax credit companies looking to help them claim the Employment Retention Tax Credit (ERTC).

While it's true that many companies qualify, there is significant concern about abuse and fraud. Companies who are relying on government shutdowns and particularly supplier shutdowns should be especially diligent. These areas are drawing the most scrutiny and are ripe for misinterpretation. In this article, we will highlight a few of the key factors businesses should be aware of when evaluating whether they qualify for ERTC under the government shutdown test.

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During a recent September 8, 2022, AICPA town hall meeting, the AICPA noted the significance of this issue and their discussions with the IRS and Congress about aggressive ERTC firms. It is expected that the IRS will audit these claims aggressively given the level of abuse in this area. KBKG issued some guidelines in May of 2021 with recommendations for how to mitigate risk in this area.

Background

The employee retention tax credit (ERTC) is a refundable credit designed to benefit businesses that were affected during the COVID-19 pandemic by either a government shutdown order ("government shutdown test") or a significant decline in gross receipts ("gross receipts test"). Businesses can qualify via either method, and the credit is available for certain wage and health costs paid during qualified periods between March 13, 2020 – September 30, 2021. There is an additional recovery start-up credit from July 1, 2021 – December 31, 2021, available for start-up companies meeting additional eligibility requirements.

In early 2021, Congress revised the original ERTC rules to allow businesses who took advantage of PPP to retroactively claim the credit for 2020, extended the credit into 2021, expanded the availability of the credit to larger businesses, and increased the amount of the credit from $5,000 per employee in 2020 to $7,000 per employee per quarter in 2021.

Current State of the Industry

While the IRS has struggled to catch up on its backlog of amended individual and business tax returns that were delayed during COVID-19, this expansion of ERTC led to an influx of hundreds of thousands of amended payroll tax returns to claim ERTC. To make matters worse, the amended payroll tax returns used to claim ERTC do not require the filer to indicate which test they used to qualify or provide any up-front documentation, leaving the IRS in a position of having to pay out credits first and ask questions later. All of these factors have led to abuse and fraudulent claims, as highlighted in the recent *accountingtoday.com* article.

The IRS has published several Notices outlining rules and examples governing ERTC: Notice 2021-20, Notice 2021-23, Notice 2021-49, and Notice 2021-65. Information on the other qualifying criteria, including the more objective gross receipts test, can be found here.

Appropriate Governmental Authorities

As a first step in considering qualification under the government shutdown test, business owners should rely on the governmental order definition from Notice 2021-20, Q&A #10, partially included below (emphasis added):

Question 10: What "orders from an appropriate governmental authority" may be taken into account by an employer for purposes of determining eligibility for the employee retention credit?

> *Answer 10: "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" only if they limit commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to the coronavirus disease 2019 (COVID-19)" and relate to the suspension of an employer's operation of its trade or business. Orders that are not from the Federal government must be from a state or local government that has jurisdiction over the employer's operations. These orders are referred to as "governmental orders." Whether orders, proclamations, or decrees are governmental orders is determined without regard to the level of enforcement of the governmental order.*
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> *Statements from a governmental official, including comments made during press conferences or in interviews with the media, do not rise to the level of a governmental order for purposes of the employee retention credit. Additionally, the declaration of a State of Emergency by a governmental authority is not sufficient to rise to the level of a governmental order if it does not limit commerce, travel, or group meetings in any manner. Further, such a declaration that limits commerce, travel, or group meetings, but does so in a manner that does not affect the employer's operation of its trade or business does not rise to the level of a governmental order."*

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The key for the government shutdown test is determining if there were governmental orders from an appropriate governmental authority that disrupted more than a nominal portion of an employer's operations. A nominal portion of an employer's business operations is defined in Notice 2021-20 as 10% of the total gross receipts or 10% of the total employee hours being associated with that portion of the business, determined quarterly, and measured from 2019 gross receipts and employee hours. In the underlined sections above, many key exceptions are often ignored or not properly considered by providers in this area. Notice 2021-20 offers a number of

additional exceptions to qualifying that should be carefully considered before claiming a credit. ***Examples of business hardships that wouldn't qualify under this initial test on their own include:***

- *General business disruption due to international supply chain issues (see next section for additional context)*
- *Increased costs to comply with CDC recommendations, decreased profits (the gross receipts test focuses on top line revenue rather than profits)*
- *Lack of customer demand*
- *Labor shortages – difficulty hiring qualified personnel to run a business*
- *Wearing masks or working behind a plexiglass screen to minimize the spread of COVID-19*
- *General difficulty running a business if there isn't an associated government order limiting operations*
- *Guidance offering recommendations (rather than orders) to limit the spread of COVID-19*

Supplier / Supply Chain Shutdowns

Notice 2021-20 provides a method of qualifying if an employer's supplier was affected by government shutdowns, for example below (emphasis added).

> *Notice 2021-20, Q&A 12 Example: Employer A operates an auto parts manufacturing business that is considered an essential trade or business in the jurisdiction where it operates. Employer A's supplier of raw materials is required to shut down its operations due to a governmental order. Employer A is unable to procure these raw materials from an alternate supplier. As a consequence of the suspension of Employer A's supplier, Employer A is not able to perform its operations. Under these facts and circumstances, Employer A would be considered an Eligible Employer because its operations have been suspended as a result of the governmental order that suspended operations of its supplier.*

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One of the long-lasting effects of COVID-19 has been supply chain disruption on a global basis. We have seen an increasing amount of ERTC providers telling entire industries they qualify for the government shutdown test because they could not get all of their supplies. Those providers are generally relying on the above Notice 2021-20, Q&A 12, which discusses government orders that suspend a supplier's operations as their reasoning for qualification. However, this is a multiple-

pronged test and there are some key factors that are often not being considered.

A business can qualify for ERTC due to supply chain disruption if all of the following criteria are met:

- *If a U.S. governmental order (see appropriate governmental authority definition above) causes a supplier to suspend its operations, and supplier(s) are unable to make deliveries of critical goods or materials, and*
- *The business is unable to purchase critical goods from an alternative supplier.*

There were clearly businesses that were disrupted due to supplier shutdowns, but keep in mind that many governmental orders across the country did not apply to "essential businesses", and the definition of "essential businesses" varied on a state-by-state and often county-by-county basis. In cases where a supplier was suspended by a government shutdown order, it is still necessary to document that those supplies could not be sourced from an alternate supplier and that they affected more than a nominal portion of the business's operations as noted above. Business owners should keep in mind that documentation should be kept proving out each of those points if they expect to sustain ERTC credits qualified via this approach upon IRS audit, especially given the amount of abuse in this particular area.

Aggregated Groups

Notice 2021-20 outlines aggregation rules that require all entities under common control under sections 52(a) and (b), members of an affiliated service group under section 414(m), or otherwise aggregated under section 414(o) of the Code, to be treated as a single employer for purposes of applying the employee retention credit.

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This is a nuanced area of the Internal Revenue Code, and an area that a pop-up ERTC provider might not be considering properly, or at all.

If a business's owners have no ownership in any other businesses, this likely won't interfere with their qualification, but it should always be considered and documented by a professional when evaluating ERTC eligibility.

Aggregated groups must be considered on a combined basis,

meaning that one business that might have been affected by a shutdown order or a significant decline in gross receipts cannot simply qualify and claim the credit on its own unless they determine that its entire aggregated group qualifies. This can impact qualification in the following ways:

- *Average full-time employee count to determine whether an aggregated group is a small eligible employer for purposes of the 2020 credit (under 100 average 2019 full-time employees) or the 2021 credit (under 500 average 2019 full-time employees).*
- *A significant decline in gross receipts can only be considered on a combined basis. This includes any revenue from commonly owned or aggregated businesses, regardless of whether those other businesses have any payroll.*
- *The government shutdown test, specifically whether a government shutdown affected more than a nominal portion of the business, must be considered across the entire aggregated group. A single business in a large, aggregated group might have been suspended by a government shutdown order, but the aggregated group will only qualify if they can prove that the shutdown affected more than a nominal portion of the entire aggregated group.*

A free preliminary analysis can give you an idea of how an ERTC study can benefit your company. Contact us today.

Conclusion

Be a skeptic, don't accept an assessment without making sure that the individual or firm reporting on the ERTC credits has considered all of the facts. As noted above, there are a number of ERTC mills that are advertising aggressively and taking risky positions. Make sure you are dealing with a reputable firm and be sure to include your CPA in the process. This program was designed to truly help those employers that were most impacted by the pandemic and still retained employees. It is true that some employers may still technically qualify even though they actually had an increase in revenue. It should be noted that this is generally the exception, not the rule. Lastly, make sure you are prepared for an audit. This program is expected to be targeted by IRS auditors due to the high likelihood of significant fraud. Employers that legitimately qualify should be certain to take the credit without worry, just be prepared.

Details on the KBKG team's ERTC profile can be found here.

Contact a KBKG specialist to discuss options on how to maximize depreciation deductions on your capital improvements. Our team is available to answer any questions you may have.

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Ian Williams is a Director for KBKG, specializing in Research & Development and employment tax credits. Ian spent eleven years at a Big Four accounting firm specializing in R&D tax credits and fixed asset studies across a variety of industries. He has extensive experience in software, heavy manufacturing, aerospace, automotive, and consumer products industries, as well as defending credit claims with the IRS. » Full Bio