

## Preparing for an ERC Audit? Six Key Questions IRS Will Ask

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You can't say that we didn't warn you!

It's the season for IRS ERC exams – yes, right during tax season, when you have nothing better to do. Have you or your clients heeded all the warnings and lifelines that the IRS has provided?

Let's start by reiterating again CPAs' responsibility when it comes to ERC. In March 2023, the IRS Office of Professional Responsibility released Bulletin 2023-02, which highlighted the fact that practitioners were obligated to meet the provisions of Circular 230 in regards to ERC, whether a third party was used for calculation or not. Specifically, Section 10.22(a) requires "Diligence as to Accuracy." What this means in practice according to 2023-02:

- Reasonable inquiry to confirm ERC eligibility
- Further inquiry if information from client appears to be incorrect, incomplete, or inconsistent
- If practitioner cannot reasonably conclude that client is eligible, they should not prepare the return
- Inform client of penalties for noncompliance

Sharyn Fisk, IRS OPR Director, says her office will evaluate the facts and circumstances of each situation and there's not a one-size-fits-all answer to what due diligence looks like. But she was very clear in an interview with *TaxNotes*: "Not asking questions of a client or the third party who handled the ERC claim isn't exercising due diligence, Fisk said, emphasizing the importance of documentation as a way for tax practitioners to protect themselves."<sup>i</sup>

The IRS has already begun to respond to the increasing incidence of fraudulent claims throughout ERC's lifetime. To start, in October 2023, the IRS issued IR-2023-193 detailing a special withdrawal process to help those who filed an ERC claim and were concerned about its accuracy.

Later, on December 6, 2023, IR-2023-230 announced that the IRS was sending out "an initial round" of more than 20,000 letters to taxpayers notifying them of disallowed ERC claims. From what we have seen, these letters are only for 2020 claims, while 2021 disallowances will assuredly be coming shortly. We suspect round three will then come through an automated system that will flag things like whether a business claimed all available quarters, automatically claimed \$26,000 per employee, claimed PPP but did not account for it, or if state and federal wage numbers did not match.

Finally, on December 21, 2023, IRS Announcement 2024-3 outlined the details of the new ERC Voluntary Disclosure Program (VDP) for businesses that claimed and received an ERC refund but were not eligible. This program is only available through March 22, 2024. If you decide to "come clean," and you meet the other qualifications for this program, the advantages include:

- You need to repay only 80% of the ERC you received
- The IRS will not charge penalties or interest
- You do not have to report the 20% of the ERC you get to keep as income
- You don't have to amend income tax returns to reduce wage expenses

It is not a guarantee that you will be approved for VDP. You will need to make your case. So, if you or your client used a pop-up scammer to claim the ERC and you doubt the refund's validity, reach out to a trusted provider who can guide you through the ERC-VDP program before it expires! It's important to note that you will be precluded from VDP if you have been contacted by the IRS regarding your ERC claim or if an ERC mill has already provided your name during the course of a promoter exam.

If you end up dealing with an ERC audit, just be prepared to cover these Six Key Questions that the IRS will most likely be asking:

#### Question #1

*Did your provider start operating during COVID or have "ERC" in their name?*

If yes to either, watch out! The IRS has been explicit that there will be heavier scrutiny on these businesses so expect them to dig in their heels!

#### Question #2

*Has the income tax return been amended to add back payroll expenses pursuant to IRC 280C?*

If not, YIKES! ERC mills are not properly advising clients that this is MANDATORY! In fact, we are hearing many stories where such providers do not even realize this is a requirement.

#### Question #3

*Is the taxpayer part of a controlled group?*

This is a huge one many providers are missing. You may be asking yourself "why does the IRS need this?" Well, for the ERC calculation, you must aggregate all entities that are part of a controlled group. If you didn't do this, you'd better keep your fingers crossed!

For example, to qualify for ERC in 2020, an eligible small employer must have fewer than 100 full-time employees (FTEs) on average in 2019. Let's say that in 2019, Entity A is part of a controlled group with entities B and C. Entity A has 90 FTEs, Entity B has 20 FTEs and Entity C has 20 FTEs. Looking solely at each entity, they each have fewer than 100 FTEs in 2019, so you may initially think that they are eligible to claim the ERC in 2020. However, when you aggregate the FTE count, it totals 130 FTEs in 2019. So, they are most likely not eligible for ERC in 2020, outside of some limited circumstances.

Similarly, when determining whether a business qualifies under the revenue decline test, you measure their 2020/2021 gross receipts against their 2019 gross receipts in the relevant quarter. If an entity is part of a controlled group, you must aggregate all of the gross receipts when performing this analysis.

#### Question #4

*Where is your proof of the government order and full or partial shutdown for each relevant quarter?*

The IRS asks for not just the number of the government order, but a copy of the actual order. These typically come from the websites for each state/city/county. It needs to be clear that the order is a

mandate and not merely guidance, i.e. does the order say you “shall” do something or that you “should” do something? In addition to retrieving a copy of the order, a detailed explanation of how the orders applied to the taxpayer should be provided, specifying exact dates and other proof of the full shutdown. Some examples of proof include: data showing hours clocked-in/out during the closure period, emails, contemporaneous announcements that clearly indicate a closure, etc.

For a partial shutdown, there must be a “more than nominal” impact, defined as a more than 10% impact to business operations. The IRS will request detailed information showing how a governmental order resulted in more than a nominal effect to business operations.

Importantly, a narrative alone WILL NOT suffice! For example, we had a situation where a nursing home came to us for help after their ERC claim was disallowed in audit. They tried to show that their business was more than nominally impacted with a narrative that COVID policies affected their day-to-day operations in how they delivered care, merely mentioning that certain offerings were no longer provided, such as physical therapy. The IRS agent didn’t buy it. When we got involved, we were able to demonstrate a quantifiable impact to the business of more than 10%. The IRS reversed its denial and allowed the credit in full.

#### Question #5

*Is part of your ERC claim due to a supply chain disruption?*

The IRS is intensifying its approach towards taxpayers who claimed ERC due to a supply chain disruption. According to Notice 2021-20, taxpayers can claim the ERC if their SUPPLIER’S operations were fully or partially halted due to a governmental order, and as a result, the taxpayer’s business operations were also suspended due to the lack of critical goods.

The IRS has requested various details from these taxpayers including: 1) copies of governmental orders that led to the suspension of the SUPPLIER’s operations during the relevant quarters, 2) evidence that the supplier experienced a full or partial suspension of operations with specific operational data from the supplier, 3) clarification on which goods were delayed and why they were critical, and 4) evidence that the inability to source these critical goods had a significant impact on the taxpayer’s business.

#### Question #6

*Did the taxpayer apply for a PPP (Paycheck Protection Program) loan and later have it forgiven?*

In other words, did you or your client “double-dip?” No...no...no! If the taxpayer applied for a PPP loan and later had it forgiven, they cannot use those same wages to calculate their ERC. That is double dipping that will get you in double trouble.

The IRS will therefore ask to see the following: 1) loan application, 2) loan forgiveness application, 3) documentation submitted with the forgiveness application itemizing payroll and non-payroll expenses, and 4) calculations proving that there was no double dipping between PPP and ERC.

In summary, it’s been a wild ride with the ERC. The IRS has gone to great lengths to issue warnings to taxpayers about the marketing scammers pushing you to claim the ERC without having the knowledge

and expertise to perform the analysis and calculations accurately. For these folks, speaking with a trusted advisory about the new ERC-VDP may be your best strategy.

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<sup>i</sup> Lorriggio, L, (2024, January 22). OPR: No Guarantees on Consequences of Filing Amended ERC Returns. *TaxNotes*.