7 Warning Signs That Your Employee Retention Credit may be Incorrect

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The IRS recently issued a news release outlining potential warning signs for businesses to use to determine whether their Employee Retention Credit (ERC) was proper as the March 22 deadline to apply for the Voluntary Disclosure Program (VDP) approaches.

In IR-2024-39, the IRS identifies seven common ”red flags” that it will focus on to help small businesses that may need to resolve incorrect claims.

While details of the IRS response to what it views as heightened abuse of the ERC program are still emerging, it is expected that the agency will issue notices for thousands of audits over the next year. In addition to these audits, the IRS will partner with the DOJ to pursue criminal charges against businesses and providers who committed fraud by knowingly applying for and receiving ERC funds for a business that did not qualify for the credit.

It is vitally important that businesses who received ERC refunds review their claim to verify that it qualifies based on recent guidance and clarification provided by the IRS over the last six months. This review will be especially important for businesses who engaged third party providers to determine ERC eligibility and to prepare their amended returns.

The Seven Suspicious Signs an ERC Could be Incorrect

The following signs are “red flags” that the IRS will be focusing on as it begins its review of past ERC claims:

1. Claiming too many quarters

   Not every business will qualify for the ERC. Of the businesses that do qualify, it is uncommon that they will qualify for every quarter available as part of the program.

2. Using government orders that don’t meet the full or partial shutdown criteria

The presence of a governmental order affecting businesses in your area is not enough to qualify based on the full or partial shutdown test. To claim the ERC under the governmental order criteria it must meet one of the following descriptions:

• The government order must have been in effect **and** the employer's operations must have been fully or partially suspended by the government order during the period for which the business is claiming the credit.

• The government order must be due to the COVID-19 pandemic.

• The order must be a government order, not guidance, a recommendation or a statement.

3. Relying on incomplete or inaccurate calculations to determine eligibility

There are specific guidelines concerning when a credit can be claimed for certain employees. Simply qualifying for a quarter does not mean that all wages paid during that quarter will qualify for the ERC.

Consideration must be given to each employee to determine whether the wages paid to that employee qualify for the ERC. Failure to do so can lead to overclaiming the credit or claiming the credit for an ineligible employee.

4. Qualifying for the credit based on supply chain interruptions

Many promoters qualified business for any supply chain interruption no matter how impactful the disruption may have been to the operation of the business. To qualify for the ERC based on a supply chain interruption, a supplier used by the business must themselves have been fully or partially shut down due to a documentable governmental order.

Because of this, qualification for the ERC based on supply chain is very uncommon. For more information on supply chain, see rules on supply chain issues and examples in the 2023 legal memo on supply chain disruptions.

5. Claiming an ERC for wages paid outside of the suspension period for a business affected by a governmental order

Qualification for a full quarter based on a governmental order that ends in the middle of the quarter is possible. A business can only claim the ERC for wages that were paid during the period that was affected by the governmental order.

6. Claiming an ERC refund for periods when the business didn't exist or didn't pay any wages

If the business didn't exist or pay wages to its employees, it cannot claim the ERC regardless of whether it might otherwise qualify for the credit.

7. Relying on a promoter who advises that there is "nothing to lose" if you file an ERC claim

> According to the IRS, "Businesses that incorrectly claim the ERC risk repayment requirements, penalties, interest, audit and potential expenses of hiring someone to help resolve the incorrect claim, amend previous returns or represent them in an audit."

It is very important that businesses review their ERC claim to determine if any of these seven signs are present and to take corrective action when necessary. The IRS is focusing on these signs as the starting point to begin the review of an ERC claim and may begin an audit of a claim if one or more of these signs are present.

If you received an ERC refund and you believe that one or more of these signs may be applicable to your business, it may be necessary to engage a third party to review the claim. A qualified tax attorney with significant ERC experience should be consulted to verify that the business meets the qualification criteria of this complex program.

If a business would like to take advantage of the 20% discount on repayment offered through the VDP, it should complete any review prior to the March 22 deadline.