Employee Retention Credit: Prompt Response Necessary as IRS Sharply Increases Compliance Action Through Taxpayer Audits

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To combat a wave of frivolous employee retention credit (ERC) claims, the IRS has sharply increased compliance action through audits and criminal investigations, with more activity planned in the future. In this heightened enforcement environment, employers are advised to act swiftly when responding to IRS notices regarding ERC claims.

Immediate Action Required for Employers Receiving IRS Audit Notifications

Employers must be aware that failing to respond to IRS notices within the time frame specified can lead the IRS to disallow the entire ERC claim and issue a notice of disallowance. Once the IRS formally disallows a refund claim, the taxpayer may be permitted to first file a protest with the IRS Office of Appeals or, in some cases, the taxpayer may decide to file a lawsuit in federal court to litigate the issue. Both scenarios subject employers to the necessary defense of an often burdensome and costly refund claim controversy, further delaying the much-needed ERC relief promised by Congress.

Successful defense of any ERC examination will depend greatly on an understanding of the risks and eligibility criteria to avoid the costly repercussions of noncompliance, including the potential for general examination. As noted below, the IRS highlighted in Notice IR-2024-39 warnings signs that ERC claims may be incorrect, urging businesses to revisit eligibility.

Key Examination Risks Identified by the IRS

1. **Claiming Too Many Quarters:** It is unusual for employers to qualify for the ERC in all available quarters. A meticulous review of eligibility for each quarter is advised to avoid overstating claims.
2. **Non-Qualifying Government Orders:** The IRS has clarified that not all government orders related to COVID-19 qualify for the ERC. Orders must have directly affected the employer's operations, and mere guidance or recommendations do not suffice. Businesses must be able to document and substantiate the impact of qualifying government orders.
3. **Employee Counts and Calculation Errors:** With changes in the law during 2020 and 2021, employers must be vigilant in their calculations, adhering to the dollar limits and credit amounts for qualified wages.
4. **Supply Chain Disruptions:** Qualifying for the ERC based solely on supply chain issues is rare. Employers must demonstrate that their supplier was affected by a qualifying government order.
5. **Overstating the Eligibility Period:** Claiming the ERC for an entire calendar quarter is possible only if the business was impacted for the full duration. Employers are entitled to claim only the actual suspension period and must maintain accurate payroll records.

Navigating Refund Claim Controversies Amid Increased IRS Action

Contact our tax professionals at Kernutt Stokes to ensure compliance and to effectively manage the challenges of the IRS's ongoing enforcement actions.