

## What Does the Employee Retention Credit – Voluntary Disclosure Program Mean for Future Enforcement Efforts by the Internal Revenue Service Against Businesses and Preparers?

By Brandon N. Mourges

Last month, the Internal Revenue Service (IRS) announced the Employee Retention Credit – Voluntary Disclosure Program (ERC VDP).<sup>1</sup> This is the latest step taken by the agency to crack down on the perceived abuses by both taxpayers and promoters, which claimed billions of dollars in credits aimed at helping struggling businesses retain employees during the COVID-19 pandemic.<sup>2</sup> The ERC VDP, which is open until March 22, 2024, allows countless numbers of ineligible businesses to address potential exposure to significant civil and criminal penalties.<sup>3</sup> Furthermore, the ERC VCP is likely to be used by the IRS to gather information that will be used in future civil and criminal enforcement actions against some claiming the credits as well as many “promoters” who profited from the program. Any business that claimed the credit, or an anyone who advised on claiming the credit, should review their eligibility determinations and weigh available options in light of the potential for increased enforcement actions by the IRS.

**How We Got Here.** When the country was in the grips of the COVID-19 pandemic, Congress authorized several programs aimed at providing financial assistance to affected employers. Although most of the initial publicity focused on the financial benefits of the Paycheck Protection Program (PPP), the last two years have seen an increasing focus on the benefits offered by the Employee Retention Credit (ERC) provisions within various pieces of legislation, including the CARES Act and American Recovery Plan Act. Moreover, with legislation subsequent to the announcement of the PPP, eligibility for the ERC was greatly expanded and the financial incentives were greatly increased. For 2021, many businesses were eligible to claim up to \$21,000 per employee for the first three quarters of the year.<sup>4</sup>

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<sup>1</sup> Employee Retention Credit – Voluntary Disclosure Program, *available at*: <https://www.irs.gov/coronavirus/employee-retention-credit-voluntary-disclosure-program> (last viewed Dec. 28, 2023).

<sup>2</sup> *See, e.g., IRS Commissioner signals new phase of Employee Retention Credit work; with backlog eliminated, additional procedures will be put in place to deal with growing fraud risk*, IR-2023-135, July 26, 2023, *available at*: <https://www.irs.gov/newsroom/irs-commissioner-signals-new-phase-of-employee-retention-credit-work-with-backlog-eliminated-additional-procedures-will-be-put-in-place-to-deal-with-growing-fraud-risk>; *Red flags for Employee Retention Credit claims; IRS reminds businesses to watch out for warning signs of aggressive promotion that can mislead people into making improper ERC claims*, IR-2023-170, Sept. 14, 2023, *available at*: <https://www.irs.gov/newsroom/red-flags-for-employee-retention-credit-claims-irs-reminds-businesses-to-watch-out-for-warning-signs-of-aggressive-promotion-that-can-mislead-people-into-making-improper-erc-claims>; *IRS opens 2023 Dirty Dozen with warning about Employee Retention Credit claims; increased scrutiny follows aggressive promoters making offers too good to be true*, IR-2023-49, March 20, 2023, *available at*: <https://www.irs.gov/newsroom/irs-opens-2023-dirty-dozen-with-warning-about-employee-retention-credit-claims-increased-scrutiny-follows-aggressive-promoters-making-offers-too-good-to-be-true>.

<sup>3</sup> Prior to the announcement of the ERC VDP, the IRS indicated that they were sending an initial round of more than 20,000 letters to taxpayers notifying them of disallowed ERC claims. *See IRS expands work on aggressive Employee Retention Credit claims; 20,000 disallowance letters being mailed, more action and voluntary disclosure program coming*, IR-2023-230, Dec. 6, 2023, *available at*: <https://www.irs.gov/newsroom/irs-expands-work-on-aggressive-employee-retention-credit-claims-20000-disallowance-letters-being-mailed-more-action-and-voluntary-disclosure-program-coming>.

<sup>4</sup> 26 U.S.C. § 3134(a) (credit equal to 70% of first \$10,000 in eligible wages for first three quarters of 2021 for continuing business).

Seizing on the lack of guidance from the IRS and the subjective nature of eligibility under the “full or partial suspension” test, many businesses were targeted with solicitations by those that could “qualify” them for refunds in the hundreds of thousands if not millions of dollars.<sup>5</sup> Those solicitations were honed by employment information publicly available as a result of the Paycheck Protection Program and from increasing word-of-mouth.<sup>6</sup> Many businesses saw this as a win-win situation as, even though they contracted to pay a large percentage of the refund to these “advisors,” there was no upfront cost for seeking these refunds. Many of those businesses were not familiar with the requirements of the ERC, placed a large amount of trust in advisors based on their credentials and professional backgrounds, and assumed the IRS would simply not issue refunds that they were not legally entitled to.

Unfortunately, the need to expeditiously issue refunds for COVID-19 relief – from the perspective of both businesses and the IRS – took precedence over ensuring the proper application of the ERC.<sup>7</sup> Regardless of one’s interpretations of eligibility provisions under the ERC – which are significantly lacking and still yet to be scrutinized in either a court of law or the court of public opinion<sup>8</sup> – many businesses received refunds that should never have been issued. Worse yet, many advisors received large percentages of these refunds – which may run afoul of ethical rules<sup>9</sup> and run counter to the purpose of the program – for businesses that may or may not have actually qualified for the credit in the first place. For many unfortunate businesses, they may eventually not only be out the money paid to their advisors, but they will also be forced into an audit with the IRS ending with repayment of refunds and assessment of stiff penalties.

To that end, although likely too late, the IRS has increasingly sounded the alarm on those that might claim the ERC. Those warnings increased in the summer of 2023 with adverse interpretations of the IRS regarding the suspension test.<sup>10</sup> According to the IRS, many would-be applicants for the ERC were ineligible under that test because their suspension was not more than “nominal” and “supply chain” effects alone did not qualify a business for the ERC. Those warnings increased in the past several months with the

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<sup>5</sup> The statutory language provides that a business may be eligible if “the operation of the trade or business...is fully or partially suspended during the calendar quarter due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to the coronavirus disease 2019 (COVID-19)...” 26 U.S.C. § 3134(c)(2)(A)(ii)(I). Although the IRS has released some notices regarding the interpretation of this section, there is very little legislative history regarding its interpretation and the IRS has not published any authoritative regulations.

<sup>6</sup> Online databases, such as ProPublica, allow any person to search for any recipient of funding from the PPP provided the loan exceeded a certain threshold. As of December 28, 2023, that website alone listed information on more than 11.5 million loans and provided data such as the loan amount, the forgiveness amount, payroll, rent, jobs reported, industry, and location.

<sup>7</sup> See, e.g., U.S. Government Accountability Office, *IRS Implemented Tax Relief for Employers Quickly, but Could Strengthen Its Compliance Efforts*, May 2022, available at: <https://www.gao.gov/assets/730/720547.pdf> (last visited Dec. 28, 2023).

<sup>8</sup> Although the IRS has published guidance on its position, there does not appear to be any reported court case dealing with the interpretation of the ERC’s eligibility provisions.

<sup>9</sup> See, e.g., Treasury Circular 230 § 10.27 (regarding contingent fees). In addition, the AICPA has issued guidance suggesting it would be unethical for accountants to charge contingent fees relating to ERC claims.

<sup>10</sup> See, e.g., IRS CCM AM 2023-05, *Whether an Employer Experienced a Full or Partial Suspension...*, June 30, 2023, available at: <https://www.irs.gov/pub/iranoa/am-2023-005-508v.pdf>.

imposition of a moratorium on processing ERC claims and the announcement of a withdrawal procedure.<sup>11</sup> While the force of the interpretations of the IRS are not yet tested and are likely to be challenged, it is clear that the IRS intends to scrutinize a large number of claims, regardless of whether they are pending or already paid. The IRS has already announced training protocols and an increased focus on ERC audits.<sup>12</sup> The increasing volume of these warnings has now become full-throat with the announcement of the ERC VDP. This is a clear indication that IRS intends to pursue heightened penalties and criminal sanctions against businesses and advisors that have intentionally abused the terms of the program.

**The Terms of the ERC VCP.** Much like other voluntary disclosure initiatives of the IRS in the past – e.g., the Offshore Voluntary Disclosure Program and the Voluntary Disclosure Practice<sup>13</sup> – the ERC VDP is designed to promote compliance in an area of perceived widespread abuse where the IRS does not have sufficient resources to pursue all violations. These programs are generally used as information gathering tools and are a further indication that undisclosed violations should be subjected to greater civil penalties.

Importantly, the ERC VDP is not available to advisors – it is only applicable to businesses that received the ERC. To qualify, a business must not already be under civil examination or criminal investigation, it must not have received a notice of noncompliance, and it must not have received a demand for repayment of the ERC.<sup>14</sup> If those prerequisites are met, the business must complete a Form 15434 (Application for Employee Retention Credit (ERC) Voluntary Disclosure Program). That application requires that the business calculate the amount to be repaid – 80% of the ERC – and that it identify and describe the advisor and the services provided with respect to the ERC. Once accepted, the business must cooperate with the IRS in its review of the ERC claims. This might include reviewing and verification the accuracy of returns, submitting to an interview, and providing details about relationships with advisors. Assuming that a business fully cooperates, it will enter into a closing agreement with the IRS regarding repayment of the credit. A few of the financial benefits include that the business will only be required to pay back 80% of the credit, it will not be required to pay interest on the overpayment of the refund, and it will not have to amend its income tax returns to reduce corresponding wage deductions. Of further importance, the ERC VDP requires that a participant agree to repay 80% of the entire credit claimed for the period – that is, partial claims are not allowed in this process and each period is an all-or-nothing proposition.

One important difference between the ERC VDP and other voluntary disclosure practices is that *it does not resolve potential criminal liability or penalties for fraud*. To that end, the IRS specifically indicates that “if you willfully filed an employment tax return that fraudulently claimed ERC, or if you assisted or

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<sup>11</sup> See *To protect taxpayers from scams, IRS orders immediate stop to new Employee Retention Credit processing amid surge of questionable claims; concerns from tax pros*, IR-2023-169, Sept. 14, 2023, available at: <https://www.irs.gov/newsroom/to-protect-taxpayers-from-scams-irs-orders-immediate-stop-to-new-employee-retention-credit-processing-amid-surge-of-questionable-claims-concerns-from-tax-pros>. See also *Withdraw an Employee Retention Credit (ERC) claim*, available at: <https://www.irs.gov/newsroom/withdraw-an-employee-retention-credit-erc-claim> (last visited Dec. 28, 2023).

<sup>12</sup> See, e.g., *Employee Retention Credit positions and audits*, available at: <https://www.irs.gov/pub/irs-utl/2023ntf-14-employee-retention-credit-positions-and-audits.pdf> (last visited Dec. 28, 2023).

<sup>13</sup> See *IRS Criminal Investigation Voluntary Disclosure Practice*, available at: <https://www.irs.gov/compliance/criminal-investigation/irs-criminal-investigation-voluntary-disclosure-practice> (last visited Dec. 28, 2023).

<sup>14</sup> See *Frequently asked questions about the Employee Retention Credit Voluntary Disclosure Program*, available at: <https://www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit-voluntary-disclosure-program> (last visited Dec. 28, 2023).

conspired in such conduct, filing for ERC-VDP will not exempt you from potential criminal investigation and prosecution.”<sup>15</sup> That is in stark contrast to other programs, such as the Voluntary Disclosure Practice, which provide that the IRS will generally not recommend prosecution. Presumably, businesses and individuals with concerns about penalties for outright fraud should avail themselves of the Voluntary Disclosure Practice instead.<sup>16</sup> Further, businesses with eligibility for some quarters or parts of quarters may be better-suited to addressing compliance outside of the ERC VDP.

**What Does This Mean for Businesses.** For businesses that claimed the Employee Retention Credit or are still considering claiming this credit, the announcement of the ERC VDP should serve as both a warning and a chance to make amends. There are many taxpayers who needed, and clearly qualified for, the ERC. But many others claimed significant refunds under auspicious interpretations of the rules – many involving the “full or partial suspension” test. And like the Paycheck Protection Program before it, there are many others who simply claimed the credit without any valid basis in fact or law.

For businesses that incorrectly relied on the advice of a promoter, strong consideration should be given to the ERC VDP. Whatever the mindset might have been in pursuing the credit, the chances of criminal liability resulting from these claims should be reduced greatly by participating in the ERC VDP – it is not in the interest of the IRS to make examples of those trying to make amends as that would deter other offenders from coming forward. Furthermore, participants in the ERC VDP are likely to be subjected to a much more streamlined and focused examination. On the other hand, those not entering the ERC VDP are likely to have more tax periods and tax returns scrutinized and other non-ERC issues could be developed by the IRS. Furthermore, businesses that claimed the credit could be subject to various civil penalties including, but not limited to, failure to file penalties (up to 25%), failure to pay penalties (up to 25%), failure to deposit penalties (up to 15%), accuracy-related penalties (up to 20%), trust fund recovery penalties, and more. While the ERC VDP requires repayment of 80% of the credit, this amount could theoretically be less than half the exposure a business would face if subjected to a combination of these penalties and corresponding interest. Moreover, this required payment could be even less in comparison if other issues are identified in an audit.

To properly weigh this option, businesses should review their ERC claims and the underlying substantiation. That review would include a review of the basis for their eligibility – e.g., by reviewing financial records if eligibility was based on a reduction in gross receipts or by reviewing relevant orders and business conditions that justified a claim of suspension. It would also include a review of wages paid in each period, the intersection of the Paycheck Protection Program, payments made to owners and relatives, or any other documentation that would bear on the proper calculation of the credit. Given the high stakes, the number of eligibility factors, and the probable conflict with prior advisors, businesses should strongly consider engaging with a new, independent legal advisor on this issue. Businesses will also want to consider potential civil and criminal liability of their key personnel (to the extent they were involved in claiming the ERC) and potential options for recourse against promoters. There are many other factual and legal considerations that factor into any decision to enter the ERC VDP and missteps can be costly.

**What Does This Mean for ERC Advisors.** The ERC VCP was almost certainly a result of the perception of the IRS that certain advisors and preparers were profiting from pushing businesses into the ERC when they did not qualify. Many unscrupulous advisors received significant commissions as a direct result of

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<sup>15</sup> *Id.*

<sup>16</sup> While the Voluntary Disclosure Practice would likely reduce or resolve potential criminal exposure, the financial cost would be much more severe, as all applicable tax, penalties, and interest would need to be paid for resolution.

providing questionable advice regarding the ERC. Their incentives were not necessarily to properly obtain needed funding for their clients. Advisors that provided boilerplate advice, or outright incorrect advice, to “qualify” a business for the ERC are likely to face scrutiny and penalties. The IRS has made examples of such promoters in the past<sup>17</sup> and will likely do so here.

Advisors, like those businesses receiving the ERC, should review the accuracy of the advice and filings made on behalf of clients. Supporting information should be gathered and organized in the event that they are audited or a former client implicates them in the ERC VDP or otherwise. For some advisors, outside counsel should be sought as soon as possible as a prophylactic measure. There may be legal options available to minimize the risk of civil liability to both the IRS or their prior clients.<sup>18</sup> In that regard, it is unlikely that all participants in the ERC VDP are going to repay refunds without seeking repayment from, or potentially litigating against, their advisors. There may also be legal options to minimize potential criminal exposure.<sup>19</sup>

**Conclusion.** If your business received the ERC, you should keep informed of developments regarding enforcement in this area and options available to mitigate risk. Although many, if not most, ERC applicants are entitled to these refunds and will never be subjected to an audit, many others will be. Any examination can be expensive, in both financial and non-financial terms. Given the substantial amount of many ERC claims, an adverse determination – which might include repayment of the refunds, additional monetary penalties, and criminal liability – could threaten the viability of a business and the well-being of its owners. At the very least, businesses should maintain complete and accurate records supporting their claims, be prepared in the event of an audit, and consider seeking independent advice to review the validity of their claims and corresponding options. Likewise, advisors should ensure that their opinions and calculations are fully supported and they should prepare for perhaps even more intense scrutiny than the ERC claimants themselves. Given the frequency of announcements and warnings from the IRS and the Department of Justice relating to COVID-19 related fraud, we are only seeing the beginning of this issue and it likely to become front-and-center for tax enforcement over the next decade.

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<sup>17</sup> See, e.g., Department of Justice, *New Jersey Tax Preparer Arrested for Fraudulently Seeking Over \$124 Million in COVID-19 Employment Tax Credits*, July 31, 2023, available at: <https://www.justice.gov/opa/pr/new-jersey-tax-preparer-arrested-fraudulently-seeking-over-124-million-covid-19-employment>; Department of Justice, *Justice Department Announces Results of Nationwide COVID-19 Fraud Enforcement Action*, August 23, 2023, available at: <https://www.justice.gov/opa/pr/justice-department-announces-results-nationwide-covid-19-fraud-enforcement-action>.

<sup>18</sup> Tax advisors providing faulty advice regarding the ERC may also be subject to penalties and licensure issues from other regulatory bodies.

<sup>19</sup> Although advisors may not be eligible for the ERC VDP, there may be other voluntary actions that can be taken to disclose prior tax violations and mitigate penalties. Aside from civil penalties relating to understatements (26 U.S.C. § 6694 and 26 U.S.C. § 6695), many criminal statutes could be utilized by the IRS to pursue promoters. See, e.g., 26 U.S.C. § 7201 (tax evasion), 26 U.S.C. § 7206 (filing a false return), 18 U.S.C. § 287 (false claims), 18 U.S.C. § 1001 (false statements).