Larson Gross

ERC claims under scrutiny: key warning signs and how to prepare

The Employee Retention Credit was designed to help businesses during the pandemic, but it became a target for predatory ERC mills, leading to numerous ineligible claims. This prompted the IRS to impose a moratorium on processing ERC claims in September 2023.

In June 2024, the IRS resumed processing over 1 million ERC claims after a thorough review, categorizing them into high-risk, which are likely to be denied, unacceptable risk, which requires additional scrutiny, and low-risk, which are likely legitimate. Approximately 60-70% of claims fall into the unacceptable risk category, meaning most claimants will face intensified scrutiny in the coming months.

That said, the majority of businesses with pending ERC claims should prepare for this heightened level of examination. Proactive measures can significantly reduce the risk of penalties and interest if the IRS requests additional information.

In this document, we'll outline the warning signs of faulty ERC claims and offer guidance on the steps to take if you identify any of these issues in your claims.

Red flags indicating potential denial of ERC claims

The IRS has identified and shared several red flags from their review of millions of claims. Businesses are urged to review their filings to confirm eligibility and ensure the claims do not exhibit any warning signs or key mistakes. Businesses with these indicators should consult a trusted tax professional and consider using the special ERC Withdrawal Program to avoid potential penalties.

While the following list isn't exhaustive, it does cover some of the major indicators of erroneous claims. Being aware of these red flags and understanding how to address them can help bolster your claims if you're asked to provide more information.

Essential businesses claiming ERC despite full operations

Essential businesses that continued to operate during the pandemic without a significant decline in gross receipts are generally ineligible for the ERC. In many cases, these businesses weren't eligible because their operations weren't fully or partially suspended by a qualifying government order. Unfortunately, misguided promoters encouraged many of these businesses to claim the ERC. It is important to note that minor modifications, such as requiring employees to wash hands or wear masks, do not qualify as operational suspensions under ERC guidelines.

Inadequate documentation of government orders

Even if you experienced a decline in gross receipts due to a government order, you still need to provide substantial evidence to support your claim. This includes proving that the government order suspended more than a nominal portion of your business operations. The IRS defines "more than nominal" as at least 10% of the business, based on either gross receipts or the total hours employees spent working in that part of the business.

If your business had to modify its operations but all parts could still function, it might be considered partially suspended if you can show at least a 10% reduction in your ability to provide goods or services in the normal course of business.

It's uncommon to qualify for the ERC for an entire calendar quarter if business operations were only suspended during part of the quarter. In such cases, you can only claim the ERC for wages paid during the suspension period, not the entire quarter. Ensuring accurate and detailed documentation of these circumstances is necessary to substantiate your claim.

Incorrect reporting of family members' wages

Claims that include wages paid to individuals related to the majority owner of the business are often ineligible for the ERC. If business owners claimed the ERC using wages paid to related individuals, those claims are likely either for the wrong amount or entirely ineligible.

For ERC purposes, the definition of family members is quite expansive. Naturally, it includes your spouse, children, grandchildren, and siblings. But it also includes your parents and their ancestors, step-family members, nieces, nephews, aunts, uncles, in-laws, and any other members of your household.

Claiming the ERC on wages already used for Paycheck Protection Program (PPP) loan forgiveness

The Small Business Administration offered Paycheck Protection Program loans to help businesses retain their workforce during the pandemic. Although the program ended in 2021, borrowers could still apply for loan forgiveness afterward.

If the SBA forgave the loan, businesses cannot claim the ERC on wages reported as payroll costs to secure loan forgiveness. However, taxpayers can use the remaining qualified wages not used for the PPP loan to determine their credit. Properly allocating wages between the Paycheck Protection Program and the ERC is necessary to avoid invalid claims.

Incorrect claims by large employers

Large employers can only claim the ERC for wages paid to employees who were not providing services. You were considered a large employer if you had more than 100 full-time employees in 2019. The criteria later changed where you were considered a large employer only if you had more than 500 full-time employees in 2020. Many large employers mistakenly included wages for employees who continued working, which is not allowed under ERC rules.

Overclaiming due to miscalculations

Employers must exercise caution to avoid overclaiming ERC by incorrectly applying credit amounts across multiple tax periods. It’s uncommon to qualify for all quarters, so carefully review your eligibility for each period individually.

Also, be cautious about claiming the ERC for all wages paid to every employee. ERC laws changed throughout 2020 and 2021, with different limits and credit amounts for each period. Specific rules determine which wages qualify based on the tax period.

The IRS urges employers to thoroughly review calculations to avoid overclaiming, which can happen if the same credit amount is mistakenly applied across multiple periods.

Ensuring compliance and preparing for IRS scrutiny

These are just some of the warning signs that may indicate potential issues with your ERC claims. If you previously filed an ERC claim that is still pending, it's wise to consult an expert tax advisor. They can help ensure that your claims comply with all necessary regulations and that you have the proper documentation to substantiate them.

A tax advisor can also assist with the special ERC withdrawal program if you believe you may have filed an erroneous claim. For more information or assistance with your ERC claims, please contact our office.

About Larson Gross

Ted Larson and Dennis Gross founded our firm in 1949. They built the business based on excellence, passion, integrity, trust and pro-action — values still important to us more than seven decades later.

Even well into their retirement years, Ted Larson and Dennis Gross continued to have the best interest of the firm at heart. Mr. Larson would come into the office on a regular basis to meet every new face and make a personal connection with each of our team members. He remembered the name of every employee, as well as the names of their spouses and children, and would greet clients by name as he passed by the reception desk. Sometimes, you'd even find a newspaper clipping on your desk that Mr. Larson dropped off, highlighting that your son made the honor roll. This is the example of a genuine relationship we strive to embody with our people and clients.

Today, we're led by ten partners who are growing our firm with respect for where we've come from and a new vision for future success. Our 120-plus team members and three offices located in Bellingham, Lynden and Burlington make us the 10th largest public accounting firm in the Puget Sound region. While we're determined to expand our impact and help strengthen as many businesses and individuals as we can, we're also committed to remaining a locally-owned organization. We're incredibly proud of where we've come from and look forward to a future of possibility

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