

# How companies can plan for a successful outcome during an ERC audit

The best thing businesses can do is to evaluate its ERC substantiation materials now—so they can increase their chances of a fast and successful outcome when an IRS audit arises.

# Introduction

When companies receive an IRS notice that their ERC filing has been selected for audit, they typically are caught off-guard and have no internal process or records readily available to formulate a response by the auditor's deadline.

Conversely, they respond to the auditor's notice with incomplete information, or what they perceive to be a correct response (but is not). In either case, they end up in a prolonged and costly audit that requires considerable resources to navigate, and ultimately results in a less than favorable outcome.

Recent IRS guidance indicates that the agency will increasingly target companies that have filed ERC claims in the coming years. And for any companies that have filed ERC claims involving Q3 or Q4 2021, Congress has extended the normal 3-year audit period by two (2) additional years.<sup>1</sup>

In this document, we aim to show business owners and their teams what they can do now to prepare for an eventual audit of their ERC claim. By dedicating the necessary resources to this preparation in advance, companies have an opportunity to significantly increase the chances of a successful ERC audit outcome down the road.

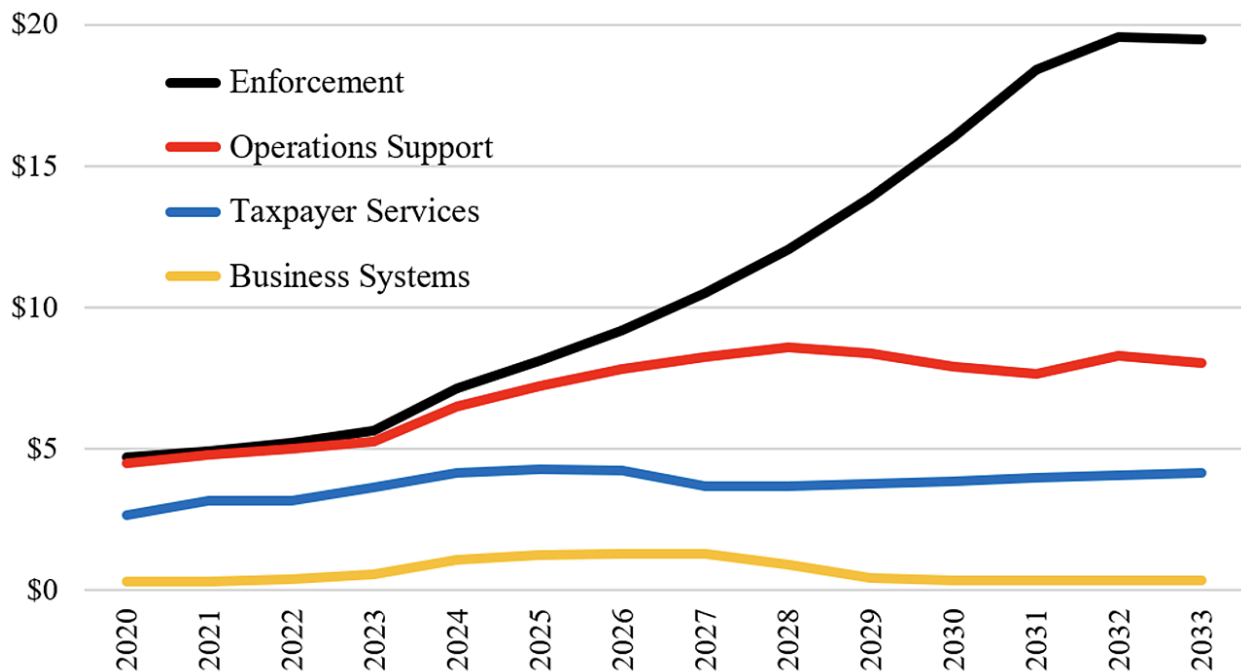
<sup>1</sup> Note that there is no statute of limitations for claims involving fraud.

# 1 Why it makes sense to start preparing now

The IRS has made no secret that it intends to devote considerable resources to ERC audits in coming years due to the proliferation of “ERC mills” in recent years. Simultaneously, the agency has trained auditors examining ERC claims of businesses that may have made errors or misrepresentations in their claims, including if they’re suspected of fraud or noncompliance. As the level of annual funding increases in coming years (see below), it is reasonable to expect that the IRS will continue to dedicate considerable resources to ERC audits in the next 5-7 years.



**Exhibit 1: Current projections for IRS outlays, \$Billions**



Source: Budget of the U.S. Government, Analytical Perspectives, Table 25-1.

## Common ERC Audit Triggers

- Discrepancies in claimed ERC amounts compared to industry averages.
- Suspiciously high credit claims that necessitate more investigation.
- Mistakes in documentation submitted during the ERC claim process.

## 2 What to prepare

Businesses claiming the ERC can significantly increase their chances of a smooth audit process by taking proactive measures in advance. Recommended preparation includes the following:

- Maintain accurate and detailed records of all ERC-related transactions used to support a claim, including employee information, payroll records, financial statements, invoices, and receipts.
- Conduct an internal compliance check to identify any potential issues or errors in the business's ERC calculations and claims.
- Hire a qualified tax professional to review your documentation and calculations for accuracy.
- Organize all the business's supporting documents in a systematic manner to make it easier for auditors to review.
- Confirm that your employees meet the eligibility criteria for ERC (e.g., no contractors, disqualified family members, etc.).
- If your claim was made based on the *full or partial suspension of operations* test, compile all government orders used, along with a defined timeline and detailed impact statement/narrative.
- Remain up to date with the ERC guidelines and regulations to stay in compliance with any changes.

### Exhibit 2: Sample ERC IDR

|                                     |   |  |
|-------------------------------------|---|--|
| Form 4564<br>(Rev. September 2020)  | Department of the Treasury - Internal Revenue Service | Request Number<br>01                     |
| <b>Information Document Request</b> |   |  |
| To: [REDACTED]                      | Subject:<br>Form 941 - June 30, 2020                  | Request Number<br>01                     |
|                                     | SANS number [REDACTED]                                | Submitted to:<br>Organization [REDACTED] |
|                                     | Date of Previous Request<br>None                      |  |

*Description of documents requested*

We received your Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for refund*, for the quarter ended June 30, 2020, on November 2, 2020.

The following are items necessary to determine if you are eligible for the employee retention credit requested on Form 941-X and if it was computed correctly. The due date is listed at the bottom of the page. You may provide the records as documents or electronically on a flash drive. Do not send original documents, only legible copies. Questions that may arise from the information you provide will be addressed in a subsequent letter.

1. Workpapers that were used to prepare the Form 941-X.
2. Documentation that you are an eligible employer for purposes of the employee retention credit based on either significant decline in gross receipts or full or partial suspension of operations.
  - Significant decline in gross receipts
    - Records you used to determine that the organization experienced a significant decline in gross receipts from the same quarter in 2019.
  - Full or Partial Suspension of Operations
    - A copy of the governmental order which caused a full or partial suspension of your operations.
    - Records relied upon to determine whether more than a nominal portion of operations were suspended due to a governmental order or whether a governmental order had more than a nominal effect on business operations.
3. Documentation of the average number of full-time employees employed during 2020.

Information Due By [REDACTED]

|  |                         |                  |
|--|-------------------------|------------------|
| Name and Title of Requestor:<br>Internal Revenue Agent | Employee ID: [REDACTED] | Date: [REDACTED] |
| FROM: [REDACTED]<br>Office Location: [REDACTED]        |                         |                  |

Page 1  
www.irs.gov Form 4564 (Rev. 9-2020)

|                                     |   |  |
|-------------------------------------|---|--|
| Form 4564<br>(Rev. September 2020)  | Department of the Treasury - Internal Revenue Service | Request Number<br>01                     |
| <b>Information Document Request</b> |   |  |
| To: [REDACTED]                      | Subject:<br>Form 941 - June 30, 2020                  | Request Number<br>01                     |
|                                     | SANS number [REDACTED]                                | Submitted to:<br>Organization [REDACTED] |
|                                     | Date of Previous Request<br>None                      |  |

*Description of documents requested*

4. Documentation of the calculation of the employee retention credit.

- Records of which employees received qualified wages and in what amounts; and in the case of a larger employer, work records and documentation showing that wages were paid for time and employee was not providing services.
- Documentation to show how you determined the amount of allocable qualified health plan expenses.

5. Are you a member of an aggregated group? If so, how did you determine you were a member of an aggregated group? How did the aggregation affect the determination and allocation of the credit?
6. Did you receive a PPP loan? If so, was any portion of the loan forgiven? Provide a copy of the documentation that shows PPP loan forgiveness that included payroll costs, such as the forgiveness application.

Note: We ask that you provide the requested records and responses by [REDACTED]. I will review the documents and responses provided by you and inform you of its completeness within ten (10) business days of receipt. If you want to contact my manager, [REDACTED] he is available at [REDACTED].

Information Due By [REDACTED]

|  |                         |                  |
|--|-------------------------|------------------|
| Name and Title of Requestor:<br>Internal Revenue Agent | Employee ID: [REDACTED] | Date: [REDACTED] |
| FROM: [REDACTED]<br>Office Location: [REDACTED]        |                         |                  |

Page 2  
www.irs.gov Form 4564 (Rev. 9-2020)

### 3 Conclusion

By carefully and thoughtfully considering these recommended steps and taking the time to prepare for an ERC audit now, companies can not only help bolster the certainty of an efficient audit process, but also reconfirm that claiming the ERC itself was a valid decision.



## 4 How we can help

The IRS suggests that taxpayers who are considering claiming one or more tax credits take precautions (e.g., consult with an independent advisor) to avoid filing unsubstantiated returns that won't withstand audit scrutiny. Likewise, those who have already filed are also advised to consult an independent advisor, and consider filing an amended return, if deemed necessary.

Whether your organization is currently considering pursuing such tax credit(s), or has already done so, having an independent advisor conduct an analysis to evaluate your ability to withstand IRS scrutiny is often a good idea.

For organizations that need help with ERC audit readiness, our firm offers a three-phased approach with an optional fourth phase:

### **Phase I: ERC Audit Readiness Assessment**

- Conduct interviews with key team member(s) and advisors to determine level of evidentiary substantiation available.
- Guide your team in compiling supporting records, metrics, orders, calculation worksheets, etc., as applicable, to support your claim.

### **Phase II: Legal Research**

- Research relevant law to determine whether your organization more than likely satisfies eligibility requirements.

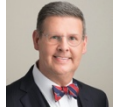
### **Phase III: Deliverable**

- Provide a written audit defensibility analysis report or tax opinion with our findings, including potential areas of concern (when necessary).

### **Phase IV: Post-Engagement Audit Support**

- Our firm is also available for defense in tax credit focused audits, should the need arise.

# 5 Author



**Jason Carr, Esq., LL.M.**  
Managing Attorney

Jason's practice is primarily focused on representing individuals and small businesses in domestic tax compliance matters, including audit defense, and defending against penalties. In addition to tax clients, he represents a select number of entrepreneurs, artists, and athletes in business and personal matters.

Jason is a member of the Texas Bar Association's Tax Section and published author on tax-related topics.

## **Connect**

Email: [jcarr@carrtaxlaw.com](mailto:jcarr@carrtaxlaw.com)

[LinkedIn](#) | [Download Profile](#)

## **Practice Areas**

Tax Credit Representation

IRS Audit Defense

IRS Debt Resolution

## **Education**

Georgetown Law, LL.M., Securities & Finance Reg.

Texas A&M University School of Law, J.D., Tax Law

University of Texas – Permian Basin, B.A., Psychology

Former Law Clerk, U.S. Dept. of Justice, Tax Division  
Licensed to Practice Law by Supreme Court of Texas  
Admitted to Practice Before U.S. Tax Court & the IRS

For more information, contact us:

**Jason Carr, Esq.**

214.800.2366

[jcarr@carrtaxlaw.com](mailto:jcarr@carrtaxlaw.com)

IRS Circular 230 Disclosure: Any U.S. federal tax advice contained in this document is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter contained in this website.

The information provided in this document is not, nor is it intended to be, legal advice. You should consult an attorney for individual advice regarding your own situation.