

The Practical Guide to Navigating an **Employee Retention Credit Audit**



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Introduction

On December 5, 2022, the Internal Revenue Service (“IRS”) publicly released a Training Manual intended to serve as self-study and reference material for IRS examiners and agents tasked with administering the Employee Retention Credit (“ERC”) field audits and related matters. In substance, the Training Manual is a compilation of direct text from **IRS Notices 2021-20, 2021-23, and 2021-49** (released between March and August of 2021), capturing well over half of the content therefrom. Tax practitioners, including those of us at Sagemont, were pleased to see that there were no material deviations from the most substantive and comprehensive guidance that we have relied on for well over a year. It was similarly reassuring to see the IRS send a signal that their auditors should be at least starting with the same “rules of the road” as the employers and their advisors that have already pursued, or intend to pursue, the ERC.

While the Training Manual is sure to provide IRS examiners a 30,000-foot view of the ERC, the Training Manual, and related Notices are intentionally more conceptual in nature, and it should be expected that the IRS will look to the more technical Internal Revenue Code (the “Code”), Treasury Regulations (the “Regs”), Internal Revenue Manuals (the “IRM”), as well as yet to be (and perhaps never to be) supplemental guidance on how to effectively examine an employer’s ERC claim.

The forthcoming guide intends to serve as practical guidance for employers and advisors on how one might expect to successfully substantiate an ERC claim with the IRS. The authors of this guide include highly experienced “big firm” CPAs and attorneys with decades of tax advisory experience who desired to compile a highly detailed document to assist employers and tax professionals in preparing for a possible IRS audit. We also hope this guide is useful to the IRS as a supplemental resource for examining or otherwise evaluating ERC claims.

Making the Claim

The basic process of making an ERC claim is typically accomplished through the filing of an original Form 941, *Employer's QUARTERLY Federal Tax Return*, or an amendment thereto via Form 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund*. As the vast majority of ERC claims were, or will be, made on Forms 941-X, for the purpose of this guide we will refer specifically to that form.¹ An employer making an ERC claim is generally only responsible for communicating to the IRS five key interconnected amounts on the form itself:

- ▶ the “non-refundable” portion of the ERC on Line 18;
- ▶ the “refundable” portion of the ERC on Line 26;
- ▶ the total amount of the ERC on Line 27;
- ▶ the amount of “qualified wages” on Line 30, and
- ▶ the amount of “qualified health expenses” on Line 31.²

While a written explanation must be provided in Part 4 of the form, virtually all examples of Forms 941-X that we've seen prepared by payroll providers, tax practitioners, or employers themselves, include something very general along the lines of: “we are filing Form 941-X to report qualified wages and health expenses to claim the employee retention credit.” In almost no cases have we seen employers volunteer specific details about the underlying eligible criteria and/or tests that were used to establish eligible employer status (as it appears that such information is required to be retained, rather than reported on the form, as further discussed below).

¹ If you filed Form 941, Form 941-X includes a mapping of the equivalent Form 941 lines in the parentheses following the numbers and descriptions in Part 3 of the form.

² In some cases, there will be no “refundable” portion, and in many cases, there will be no qualified health expenses. For the sake of doubt, Line 18 flows to Line 23 on the form, and Lines 23 and 26 total to the final amount of the ERC claimed on Line 27. For any credits claimed with respect to the first quarter of 2020, the qualified wages and health expenses are reported on Line 33a of the form (for Q2 2020 only).

Notice 2021-20 “Substantiation” / Version 1.0 of the Infamous “IDR”

Based on the limited information supplied to the IRS on Forms 941 or 941-X in making a claim, the IRS will need to obtain meaningful additional source documentation, analysis, and quantitative details as part of its examination process to validate an ERC claim. The operative term commonly used by the IRS, as is often required by the Code, Regs, or supporting rulings and guidance, is “**substantiation**.” In the case of the ERC, substantiation was defined through **Notice 2021-20** in Question 70, Pages 100–101. Accordingly, this guide will walk step by step through each category of “records” outlined by the IRS in the subsequent section.

There is sufficient chatter and thought leadership sharing underway in the tax community, and it is well-established that ERC audits are already underway. While the authors of this guide have yet to encounter an ERC audit firsthand, they have been provided with redacted examples of an initial ERC Form 4564, *Information Document Request* (“IDR”), which is the IRS’s method of requesting information from a taxpayer relevant to an audit. It is often the case that the IRS uses a standard template for an initial IDR but may later customize the request with subsequent IDRs based on their review of the information provided in the “first round.” In practical terms, all employers under examination should anticipate and be prepared for multiple rounds of IDRs, particularly if the IRS examiner begins to hone in on a particular “issue,” and the subsequent rounds of IDRs will focus on areas deemed to be high risk based on the subjective view of the IRS examiner.

While we’ve heard of some tweaks to the IDRs provided in connection with the ERC, in substance the items requested by the IRS correspond to the “Records” defined in Question 70 of **Notice 2021-20**. Accordingly, as the IRS generally expects taxpayers to keep “contemporaneous” documentation, to give yourself the best chance of success in sustaining an examination, you should have all records and supplemental information at your disposal **at the time of filing**.

Practical Guidance on Substantiation

The sections below discuss each category of records defined in **Notice 2021-20** and key differences or verbiage that the IRS has used in the sample IDR discussed above. This guide will also provide practical guidance and identify potential source documentation necessary for substantiation.

Navigating the Guide:

Each section of the guide will be organized in the same way:



Notice 2021-20 Text

Exact language from IRS Notice 2021-20 that defines the category of “records” that may be requested by the IRS.

Sample IDR

Exact language from a sample IDR provided to Sagemont. Note we have seen several iterations of these IDRs, so we have selected the most commonly used request.

Potential Source Documentation

A non-exhaustive list of potential items of source documentation that might be used to substantiate and support your ERC claim. These are the not-so-well-defined “records” the IRS is referring to in the Notice.

Practical Guidance

Based on the authors’ deep experience with the ERC, these sections provide practical guidance and tips related to each category of records.

1. Governmental Orders

Notice 2021-20 Text:

“[A]ny governmental order to suspend the employer’s business operations.”

Sample IDR:

“Documentation that the operations were fully or partially suspended due to orders from an appropriate government authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19.”

Potential Source Documentation:

- ▶ *Orders*: Physical or electronic copies of the actual federal, state, or local executive orders that either caused the employer to fully shut down or caused such employer to restrict or modify all, or a portion of, their operations.
- ▶ *Narrative or Summary*: Internally or externally produced summaries of the orders and/or chronology of periods covered and corresponding directives (i.e., shutdowns, restrictions, modifications). For example, if you used an external service provider to assist you with evaluating eligibility, that service provider should have provided a written report summarizing: (i) each governmental order; (ii) which portion of the eligibility window each governmental order governed; (iii) which **specific** suspensions, restrictions, and/or modifications were mandated by each such governmental order; and (iv) how long such suspensions, restrictions, and/or modifications lasted.

Practical Guidance:

For employers that established some or all of their eligible employer period based on the full or partial suspension of business operations (“FPSO”) test, it will be necessary to first prove to the IRS that there was a valid governmental order. At a minimum, the IRS will want to see copies of the actual governmental orders. Providing the IRS with a narrative or summary of the orders, or legal opinion reflecting their application, may be helpful but may not be critical if the orders clearly establish a window of applicability that overlaps the relevant part of your eligible employer period.

- ▶ “Federal” Orders: It is yet to be determined if and how the IRS might receive or view certain purported “federal” orders issued by the Centers For Disease Control and Prevention (“CDC”) or the Occupational Safety and Health Administration (“OSHA”). It may be prudent to expect heightened scrutiny by the IRS for employers relying solely on CDC or OSHA guidance for part or all of their eligibility period, particularly outside certain highly regulated industries such as healthcare. Consider reviewing this detailed [ARTICLE](#) discussing the “OSHA Position” for more information.
- ▶ “Dead Links”: As we move farther away from the effective dates of the various governmental orders, it is becoming increasingly common to see the website links mapped to orders become “dead links.” Therefore, we strongly recommend saving a copy of any orders that you relied upon to substantiate your eligible employer status before these web pages become unavailable.
- ▶ Paper Copies: We have anecdotally heard of situations in which employers and/or advisors have taken the approach of providing complete orders in paper format, often totaling tens or hundreds of pages. While it’s possible that the “bury them with paperwork” approach might effectively deter a detailed review, we’ve also heard that agents may request that an employer pinpoint the exact parts/sections of the orders relevant to the facts at hand. In our experience, it is best not to irritate/annoy agents with these types of tactics. If the orders are provided in electronic format, you might also expect that an agent may ask you to highlight or otherwise identify the relevant sections.

2. More than Nominal Tests

Notice 2021-20 Text:

“[A]ny records the employer relied upon to determine whether more than a nominal portion of its operations were suspended due to a governmental order or whether a governmental order had more than a nominal effect on its business operations.”

Sample IDR Language:

Not available; although we have been informed that more recent IDRs have included some language requesting evidence that the more than nominal effect test was met.

Potential Source Documentation:

- ▶ Financial Records:
- ▶ Quarterly gross receipts from 2019, 2020, and 2021 by business segment.
 - ▶ Note, while a gross receipts decline is not mandatory to demonstrate eligibility under a “partial suspension,” it should be expected that the IRS will request the gross receipts as part of the overall analysis. Consider reviewing this [ARTICLE](#) for further discussion on revenue decline and partial suspensions.
- ▶ Hours of Service Records: Quarterly headcount and/or hours of service reports by business segment for 2019, 2020, and 2021.
- ▶ Internal KPI Reports: Internal reports documenting Key Performance Indicators (“KPIs”) for 2019, 2020, and 2021.
- ▶ Internal Communications related to Restrictions/Modifications: Internal communications requiring company personnel to: (i) adhere to governmental orders and/or (ii) modify their processes, procedures, and/or practices.

Practical Guidance:

For employers that establish some or all of their eligible employer period based on the FPSO test, it will be necessary to prove that: (i) the applicable governmental orders effected a “more than nominal portion” of your business (i.e., a portion of the business that accounted for at least 10% of the gross receipts or hours of service for the same quarter in 2019), and (ii) such “more than nominal portion” experienced a “more than nominal effect” due to the adherence to such governmental orders (ideally, the “effect” should be a more than 10% quarter-over-quarter decline in either gross receipts, service hours, or KPIs, as **Notice 2021-20** establishes a 10% decline as a safe harbor in establishing a “more than nominal effect”).

More Than Nominal Portion Test:

- ▶ Financial Records should provide evidence that an affected segment or “portion” of your business accounted for more than 10% of the gross receipts in 2019 (and therefore constitutes a “more than nominal portion” of your business).
- ▶ Hours of Service Records may also establish that a particular segment or “portion” of your business accounted for more than 10% of your hours of service in a 2019 quarter (and therefore constitutes a “more than nominal portion” of your business).

More Than Nominal Effect Test:

- ▶ Financial Records may be an indication of a more than nominal effect if they reflect: (i) a more than 10% decline in gross receipts derived from the “more than nominal portion” of the business by comparing the applicable 2020 and 2021 quarters to the same quarter in 2019 **and** (ii) that the decline in gross receipts is representative of the impact of “restrictions and modifications” from a governmental order.
- ▶ Hour of Service Records may be an indication of a more than nominal effect if they reflect: (i) a more than 10% decline in service hours in a given quarter in 2020 or 2021 as compared to the same quarter in 2019 **and** (ii) that the decline in hours is representative of the impact of “restrictions and modifications” from a governmental order.
- ▶ Internal KPI Reports, other than revenue or service hours, may be an indication of a more than nominal effect if: (i) they reflect a more than 10% decline comparing KPIs documented for the applicable 2020 or 2021 quarter to the KPIs documented for the same quarter in 2019 **and** (ii) the decline in KPIs is representative of the impact of “restrictions and modifications” from a governmental order. Example KPIs might be the number of widgets produced, the number of units of service provided, or some other non-revenue, non-hour indication of an operational impact due to COVID-19 restrictions and modifications.
- ▶ Internal Communications may be helpful in evidencing that: (i) an employer adhered to applicable governmental orders, (ii) such orders restricted and/or modified the employer’s operations, and (iii) such restrictions and/or modifications caused a more than nominal effect. This includes internal communications for a multi-jurisdictional employer that established a companywide COVID-19 precaution regime (perhaps to avoid the incongruence of implementing divergent regimes across locations). The authors have heard anecdotally from other tax professionals fielding IRS audits that there has been an uptick in requests for “proof” that an employer followed orders.

3. Significant Decline in Gross Receipts

Notice 2021-20 Text:

“[A]ny records the employer used to determine it had experienced a significant decline in gross receipts.”

Sample IDR Language:

“Documentation that the taxpayer experienced a significant decline in gross receipts during the calendar quarter for which the Employee Retention Credit was claimed; NOTE: If the taxpayer is part of an aggregated group, the taxpayer must provide gross receipts for the aggregated group and not just the individual entity.”

Potential Source Documentation:

- ▶ Financial Statements: Quarterly financial statements for 2019, 2020, and 2021 prepared on the same method (e.g., cash or accrual) as utilized on the business’s federal income tax return.
- ▶ Income Tax Returns: Federal income tax returns for 2019, 2020, and 2021.
- ▶ Workpapers: Workpapers for 2019, 2020, and 2021 that reflect any book-to-tax adjustments, particularly those affecting gross receipts, as well as any consolidating calculations for aggregated entities.

Practical Guidance:

Rev Proc. 2021-33 clarified that gross receipts should generally be calculated on the same accounting method used in that taxable year for federal income tax purposes and that a tax-exempt organization should generally use the same accounting method that it regularly uses to keep its books and records. Accordingly, the quarterly financial statements should be tied to the income tax returns for a given year.

- ▶ Schedule M Adjustments: Book-to-tax adjustments are much more commonly made for deductions rather than items of income, and typically on an annual, rather than quarterly, basis. Nonetheless, to the extent that such adjustments were made to revenue items in calculating taxable income, the gross receipts workpapers should reflect the adjustments on a quarterly basis. Similarly, such workpapers should eliminate any Paycheck Protection Program (“PPP”) loan forgiveness income.
- ▶ Aggregation: In the event that two or more entities are required to be aggregated (whether under the parent-subsiary, brother-sister, or affiliated service group/management organization rules, as discussed below), the gross receipts must be calculated as if such entities were a single entity. Accordingly, the businesses should maintain workpapers, similar to consolidating financial statements, combining the gross receipts for each such entity and eliminating any intercompany transactions (as a single entity may not transact with itself).

- ▶ *Alternative Revenue Rules:* Employers that began operations in 2019 or 2020 should be prepared to demonstrate the calculation of “imputed” revenues used in lieu of the usual quarterly period required when they were not operational (or operational for part of the quarter).

4. Qualified Wage Records & Calculation

Notice 2021-20 Text:

“[A]ny records of which employees received qualified wages and in what amounts.”

Sample IDR Language:

- ▶ *Employees:* “A list of employees who were paid wages for which the Employee Retention Credit was claimed.”
- ▶ *Related Parties:* “Whether any of the taxpayer’s employees who received wages included in the Employee Retention Credit are related individuals to a majority shareholder.”
- ▶ *Amounts:* “The amount of wages paid to each employee for which the Employee Retention Credit was claimed.”
- ▶ *PPP Forgiveness Application:* “Application for Paycheck Protection Program loan forgiveness” (if applicable).
- ▶ *PPP Forgiveness Letter:* “Copy of employer’s forgiveness letter received from loan provider and/or Small Business Association (SBA)” (if applicable).
- ▶ *Paid Sick and Family Leave Credits:* “A list of employees who were paid sick and/or family leave.”

Potential Source Documentation:

- ▶ *Payroll Summary (or Similar) Report:* Maintain a payroll register report from January 1, 2020, through September 30, 2021 (through December 31, 2021, if claiming ERC as a Recovery Startup Business), that includes the following fields:

- ▶ Company Name;
 - ▶ Full Employee Name;
 - ▶ Employee ID (if applicable);
 - ▶ Paycheck Date;
 - ▶ Gross Pay (Wages); and
 - ▶ Employer Paid Health Insurance (if applicable).
-
- ▶ Reconciliation of Forms 941 to Payroll Report: Maintain a quarterly report that compares the data on the payroll register with the Forms 941. Areas to check and/or reconcile include:
 - ▶ Number of employees who received wages, tips, or other compensation;
 - ▶ Total compensation paid to employees;
 - ▶ Federal income tax withheld from employees' wages;
 - ▶ Taxable Social Security wages and tips;
 - ▶ Taxable Medicare wages and tips; and
 - ▶ Total tax payments made for the quarter, including federal income tax, Social Security tax, and Medicare tax withheld from employees' wages plus the employer's share of Social Security and Medicare taxes.
 - ▶ Form 3508: Maintain PPP Round 1 and Round 2 Loan Forgiveness Application(s), if applicable, to support payroll and non-payroll costs utilized for forgiveness.
 - ▶ PPP Forgiveness Letter: Maintain a copy of the employer's forgiveness letter(s) received from the loan provider and/or Small Business Association ("SBA"), if applicable.
 - ▶ Paid Sick and Family Leave Credits: Maintain a schedule of employee wages related to any claimed Family Medical Leave or Sick Leave credits for 2020 or 2021 (e.g., FFCRA) if not already provided in the "Payroll and Employer-Paid Health Information." Such a schedule should include the following:
 - ▶ A list of employees who were paid sick and/or family leave;
 - ▶ The dates the employees were paid sick and/or family leave;
 - ▶ The amounts paid to each employee for sick and/or family leave (including whether any of the payments were exempt from FICA or exempt from RRTA); and
 - ▶ Documentation to show how the employer determined the amount of qualified sick and family leave wages paid to employees that are eligible for the credit.
 - ▶ ERC Workpapers: While the amounts ultimately reported on the Forms 941-X are cumulative, the business should maintain the supporting workpapers, bringing together the above information to calculate employee-by-employee qualifying wages and credit amounts and, in particular, to be able to demonstrate the ERC-PPP interplay calculations.

Practical Guidance:

- ▶ Qualified Wages to Form 941: Wages being claimed for ERC should align with wages on Forms 941 for the 2020 and 2021 quarters, as well as the wage deduction on the applicable income tax return. The IRS may be on the lookout for Forms 1099 or FICA-exempt employees including clergy or certain workers on U.S. visas. Note, the IRS also systematically bounces Form 941-X filings where the amount of Qualified Wages reported is in excess of the Form 941 social security wages.
- ▶ FFCRA: To the extent a company had wages for qualified sick and/or family leave under the FFCRA, these wages must be excluded from Qualified Wages for purposes of the ERC. Similarly, employers that are taking research and development credits should be mindful of certain overlap rules.
- ▶ PPP: While an employer that received a PPP loan can still claim an ERC with respect to Qualified Wages in that quarter, the supporting calculations for the ERC claimed should support that the same wages were not used to both qualify for forgiveness of a PPP loan and as ERC Qualified Wages. We recommend maintaining a breakout of specific wages associated with any PPP Loans that were forgiven vs. wages associated with the ERC and/or Sick and Family Leave Credits.
- ▶ Related Parties: The supporting calculations for the ERC should also reflect the wages paid to the following persons related to the majority owner of the business (i.e., greater than 50% owner), if any, have been excluded:
 - ▶ A child or a descendant of a child;
 - ▶ A brother, sister, stepbrother, or stepsister;
 - ▶ The father or mother, or an ancestor of either;
 - ▶ A stepfather or stepmother;
 - ▶ A niece or nephew;
 - ▶ An aunt or uncle; or
 - ▶ A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

5. Large Employer Wage Records

Notice 2021-20 Text:

*“Large eligible employers may treat wages (other than any wages taken into account under sections 7001 and 7003 of the FFCRA) ... only for the time [employees] are **not providing services** during the period in the calendar quarter in which the employer’s business operations are fully or partially suspended due to a governmental order or during a calendar quarter in which the employer experiences a significant decline in gross receipts as qualified wages” (emphasis added).*

Sample IDR Language:

“For large employers, documentation of how the employer determined that the employees were not providing services.”

Potential Source Documentation:

- ▶ Payroll Codes for Paid Leave: Payroll Codes (ideally within the payroll register) showing which wages were paid to employees while they were sent home, on paid leave, or otherwise not providing services can be used as evidence of non-working wages.
- ▶ Payroll Codes for Unpaid Leave: Payroll Codes (ideally within the payroll register) showing unpaid leave to support an allocation of employer-paid healthcare expense and/or accrued PTO paid or accrued during periods in which an employee was not providing services.
- ▶ Documentation of Decreased Tasks: Documentation of instances in which employees were performing a lower quantum of tasks or working a decreased number of hours but being paid the same level of compensation as they were paid prior to the pandemic. This may only apply if the employer has facts comparable to FAQ #36, Example 2 of the Notice.

Practical Guidance:

During eligible “**large** employer” periods, **only** non-working wages may be used to support an ERC. This **may** include wages paid to employees who were performing a lower quantum of tasks or working a decreased number of hours but being paid the same level of compensation as they were paid prior to the pandemic (to the extent of the portion allocable to the reduced tasks). However, there is sufficient uncertainty on how the IRS may view situations where employees are present at work but completely idle. Therefore, we strongly recommend consulting a tax advisor prior to evaluating “decreased task” wages for potential ERC eligibility.

Accordingly, the aforementioned source documentation (and calculations therefrom) should, as applicable, be able to support:

- ▶ Wages paid to an employee while such employee was providing no services to the employer;
- ▶ Employer-paid healthcare expense paid for such employee while such employee was providing no services to the employer, including where such employee was furloughed;
- ▶ PTO accrued for such employee while such employee was providing no services to the employer;
- ▶ The portion of wages paid to an employee for the portion of their normal working hours in which they were not working;
- ▶ The portion of employer-paid healthcare expense paid for such employee for the portion of their normal working hours in which they were not working; and
- ▶ The portion of PTO accrued for such employee for the portion of their normal working hours in which they were not working.

Please note that when identifying large employer-eligible wages, such wages need to be both: (i) ascribed to a period of time in which the employee was not providing services and (ii) paid within an ERC-eligible period. In other words, the employer must have been within an FPSO or SDGR eligible window when such non-working wages were paid to such non-working employee.

6. Allocable Health Plan Expenses

Notice 2021-20 Text:

“Documentation to show how the employer determined the amount of allocable qualified health plan expenses.”

Sample IDR Language:

“Documentation to show how the Eligible Employer determined the amount of qualified health plan expenses that the Eligible Employer allocated to wages (if applicable).”

- **Uncommon Situation:** “Bargained Benefits”: “Documentation to show how the Eligible Employer determined the amounts of collectively bargained benefits that the Eligible Employer allocated to wages” (if applicable).

Potential Source Documentation:

- ▶ ER Health Plan (or Similar) Report: If the employer-paid health benefit is not included in the Payroll Register (noted above), we recommend maintaining a per-employee schedule of employer-paid health benefits by month for 2020 and 2021.
- ▶ Gross Health Insurance Invoices: In some cases, it may be required to show proof of the actual satisfaction of invoices to healthcare providers.

Practical Guidance:

“Wages” for purposes of the ERC include amounts paid by an eligible employer to provide and maintain a group health plan, but only to the extent that the amounts are excluded from the gross income of the employees. Amounts that the employee paid for health plan expenses with after-tax contributions are not considered qualified health expenses for purposes of the ERC. Accordingly, the employer should maintain documentation to reflect such qualifying amounts, which also support the following:

- ▶ The qualified health plan expenses do not include contributions to HSAs or Archer MSAs;
- ▶ The qualified health plan expenses do not include contributions to a QSEHRA (although they may include employer contributions to an HRA or a health FSA); and
- ▶ The qualified health plan expenses do not include expenses that are allocable to the qualified sick leave and qualified family leave wages for which the employer claimed credit under the FFCRA.

7. Aggregation

Notice 2021-20 Text:

“Documentation related to the determination of whether the employer is a member of an aggregated group treated as a single employer for purposes of the employee retention credit and, if so, how the aggregation affects the determination and allocation of the credit.”

Sample IDR Language:

Not available, although we have been informed that more recent IDRs have included some language requesting evidence regarding aggregation.

Potential Source Documentation:

- ▶ Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns*;
- ▶ Form 1065, Schedule K-1, *Partner’s Share of Income, Deductions, Credits, etc.*;
- ▶ Form 1120-S, Schedule K-1, *Shareholder’s Share of Income, Deductions, Credits, etc.*;
- ▶ Form 1120, Schedule G, *Information on Certain Persons Owning the Corporation’s Voting Stock*;
- ▶ Organizational Chart;

- ▶ Capitalization (Cap) Table;
- ▶ Stock Certificates/Register;
- ▶ Operating Agreement;
- ▶ Partnership Agreement;
- ▶ Management Agreement;
- ▶ Sale and Purchase Agreement;
- ▶ Board of Director Rosters;
- ▶ Benefit Plan Agreements/Reports; and
- ▶ Certifications from significant stakeholders as to whether they own an interest in any other business.

Practical Guidance:

All persons treated as a single employer under Code section 52(a) or (b), or section 414(m) or (o), are treated as a single employer for purposes of the ERC. The rules under Code section 52(a) or (b) are based on ownership percentages, while the rules under Code section 414 (applicable to affiliated service groups/management organizations) are based on a mix of operational factors, as well as common ownership or control. Accordingly, documentation should be maintained both in regard to ownership, as well as any special affiliated services/management arrangements.

In general, the Form 1094-C may be used as a starting point for aggregation as such forms are required annually to disclose to the IRS whether a given entity is part of an aggregated group in conjunction with fulfilling any applicable healthcare coverage requirements. However, since these forms relate to healthcare reporting and are often prepared without a thorough analysis of the aggregation rules by a tax professional, they are often incorrect when it comes to aggregation. Accordingly, while the Form 1094-C may serve as a starting point, it is not binding for purposes of the ERC. As such, the underlying records noted above should be maintained to establish the correct aggregation.

For parent–subsidiary structures, the most illustrative starting point is an organizational chart reflecting any entities that are connected by greater than 50% ownership (by vote or value). This chart should then be further substantiated by the above items (such as a cap table or operating agreement), and ultimately be consistent with any ownership reported on any applicable income tax return for the relevant period.

For entities that are not connected to another entity via a direct/indirect ownership chain but are ultimately at least 80% owned by five or fewer individuals, you should retain a confirmation from such owners as to whether they jointly own any other businesses together (as they would be required to be aggregated).

For entities that share services or are managed by another entity, agreements such as operating agreements, partnership agreements, management agreements, and benefit plan agreements/reports should support the relationships amongst the entities, in addition to establishing any overlapping ownership.

Additionally, as certain additional rules apply for nonprofit organizations and entities that were either acquired or disposed of during the relevant years (and therefore may only be aggregated for a portion of the relevant years), items such as Board of Director Rosters and Benefit Plan Agreements/Reports for nonprofit organizations should be maintained to determine whether they have a connection to another such nonprofit organization, and Sale and Purchase Agreements should be maintained to reflect the relevant periods of common control for entities acquired or disposed of.

8. Forms 7200

Notice 2021-20 Text/Sample IDR Language:

“Copies of any completed Forms 7200 that the employer submitted to the IRS.”

Potential Source Documentation:

- ▶ Form 7200: *Advance Payment of Employer Credits Due to COVID-19*.
- ▶ Workpapers: Maintain any workpapers used to support the figures reported on the Form 7200.

Practical Guidance:

- ▶ Prior to January 31, 2022, Eligible Employers could claim ERC by either reducing their federal employment tax deposit or by claiming the remaining amount at the end of the year on Form 7200. Form 7200 has since expired and is no longer accepted by the IRS.
- ▶ Historically, Form 7200 asked for detailed information to reconcile advance credit payments and reduced deposits and was used to request an advance payment for the ERC from the IRS.
- ▶ Note, we have rarely seen employers successfully claim an advance payment on ERC through Form 7200. Rather, ERC is being predominantly claimed through amended payroll tax returns (e.g., Form 941-X). In any case, we recommend maintaining copies of any executed and filed Form 7200s, as well as all other supporting information discussed herein, as while the Form utilized to claim the credit may be different, the underlying rules for eligibility remain the same.

9. Employment Tax Returns

Notice 2021-20 Text:

“Copies of the completed federal employment tax returns that the employer submitted to the IRS (or, for employers that use third-party payers to meet their employment tax obligations, records of information provided to the third-party payer regarding the employer’s entitlement to the credit claimed on the federal employment tax return).”

Sample IDR Language:

“Please provide copies to the IRS of the following documents:

- ▶ Form 941, *Employer’s QUARTERLY Federal Tax Return* – All four quarters 2020 and 2021;
- ▶ Form 940, *Employer’s Annual Federal Unemployment (FUTA) Tax Return* – 2020 and 2021;
- ▶ Form W-3/W-2s for 2020 and 2021; and
- ▶ Form 941-X, *Adjusted Employer’s QUARTERLY Federal Tax Return or Claim for Refund*.

Potential Source Documentation:

- ▶ Form 941: *Employer’s QUARTERLY Federal Tax Return*;
- ▶ Form 941-X: *Adjusted Employer’s QUARTERLY Federal Tax Return or Claim for Refund*;
- ▶ Form 943: *Employer’s Annual Federal Tax Return for Agricultural Employees*;
- ▶ Form 943-X: *Adjusted Employer’s Annual Federal Tax Return for Agricultural Employees or Claim for Refund*;
- ▶ Form 944: *Employer’s ANNUAL Federal Tax Return*;
- ▶ Form 944-X: *Adjusted Employer’s Annual Federal Tax Return or Claim for Refund*;
- ▶ Form 940: *Employer’s Annual Federal Unemployment (FUTA) Tax Return*;
- ▶ Forms W-2: *Wage and Tax Statement*; and
- ▶ Form W-3: *Transmittal of Wage and Tax Statements*.

Practical Guidance:

In most cases, eligible employers have claimed the ERC on an amended payroll tax return. While it may seem surprising, we have seen multiple instances where a business has prepared its payroll tax returns, but never filed them or, similarly, filed a Form 941 when a Form 944 was required or vice versa. Accordingly, as you cannot claim the ERC on an amended tax return if you did not file an original return, copies of both the filed original and amended returns should be maintained.

In addition, the wages claimed on the original returns should support the amount of wages claimed as qualifying for the ERC. For instance, while there may be some discrepancy due to the inclusion of qualified healthcare expenses, the wages claimed for the ERC cannot be greater than the wages reported on the original return (unless the amended return is also reporting missed wages and the taxes thereon). Additionally, the wages claimed should not exceed those claimed on the applicable Forms W-2/W-3.

10. Other Items

Income Tax Returns

Sample IDR Language: "Please provide copies to the IRS of the following documents:

- ▶ Form 1120, *U.S. Corporate Income Tax Return* for 2020 and 2021." (Expect the IRS to ask for 1120-S, 1065, etc.).

Practical Guidance: According to the IRS, an employer receiving an ERC refund does not include the credit in gross income for federal income tax purposes. However, the amount of ERC claimed should reduce the wage expenses that an eligible employer could otherwise deduct on its federal income tax return, which in effect, may result in an increase in federal taxable income. Accordingly, the IRS typically asks for the business income tax returns to check whether the business filed an amended return to reduce its wage expense and pay the applicable income tax thereon (for each period where they claimed the ERC). Therefore, we would recommend maintaining copies of any filed amended federal income tax returns, or, at a minimum, draft amended federal income tax return(s) ready to present to the IRS to adjust the wage deduction.

Note, for pass-through entities, the IRS may expand this request to the business owners, as the federal income tax is ultimately paid on their respective federal income tax returns.

Recovery Startup Business

Sample IDR Language: “Documentation that the employer is a recovery startup business during the calendar quarter for which the Employee Retention Credit was claimed (if applicable).”

Potential Source Documentation:

- ▶ Organizational Documents: There should be some documentary evidence to prove that either: (1) a business was formed after February 15, 2020; or (2) was formed prior to February 15, 2020, but was not operational until after 2020.

Professional Employer Organizations (“PEOs”)

Sample IDR Language: “For Eligible Employers that use third-party payers, records of information provided to the third-party payer regarding the Eligible Employer’s entitlement to the credit claimed on Form 941.”

Practical Guidance: Typically, the documentation required for the user of a third-party payer should be identical to that of a traditional payroll employer. Be prepared to share the same information provided to the PEO or third-party payer with an IRS examiner as well.

Conclusion

In conclusion, to avoid audit risk and general noncompliance, we recommend that taxpayers filing for the ERC perform a thorough assessment and maintain adequate and complete documentation substantiating eligibility and the underlying calculation. Taxpayers should also express concern if their ERC advisor has not asked them for the same source documentation for which the IRS would ask in the event of an audit. It's our view that a prudent ERC advisor will preemptively collect all of the documentation necessary to: (i) ensure that all applicable facts and circumstances were considered and (ii) provide the client with an audit-ready file.

Regardless of the strength of an eligibility position, taxpayers should be prepared for the IRS to examine their filing since their underlying ERC analysis is *not* provided with the payroll tax returns and, therefore, the strength of an eligibility position may not be inversely proportionate with the risk of being selected for an IRS audit. Noncompliance identified by the IRS may lead to penalties, interest, and having to repay amounts received.

Please reach out to Sagemont for any further information.

About the Authors:



Kenneth Dettman, CPA

CEO and Managing Director



Kenneth (“Kenny”) Dettman, CPA, is the CEO and Managing Director of Sagemont in Fort Lauderdale, FL, and is responsible for the management of the executive leadership team, oversight of strategic growth and innovation initiatives, and the development of our external strategic partnerships.

Kenny was previously a tax partner at a global top 25 consulting firm, Alvarez & Marsal (“A&M”), where he primarily focused on tax planning and compliance for privately held businesses for nearly 15 years. Kenny also served as the Interim Co-Head of Global Tax for A&M in 2020, managing the internal tax function across 65 offices and 5,000-plus professionals in 25 countries, all while leading A&M’s task force on the ERC from March 2020 through the end of 2021.

While at A&M, Kenny established himself as the leading tax expert in the firm on both the ERC and the Paycheck Protection Program (“PPP”) and concentrated primarily on helping institutionally owned businesses that were “sized out” of the PPP, claim the ERC. He left A&M after 2021 to assume the CEO role at Sagemont.

Kenny is considered to be a pioneer in the ERC service industry, having facilitated the first ever “advance funding” with the leading asset-based lender specializing in ERC claims, while also successfully sourcing and underwriting one of the first ERC “tax insurance” policies in the country.

Kenny began his lifelong career as a tax advisor after earning a Bachelor’s degree in accounting and Master’s degrees in both accounting and international business from the University of Florida. He is a licensed Certified Public Accountant and a member of the American Institute of Certified Public Accountants and has frequently lectured on tax topics to the Tax Executives Institute (TEI), Bloomberg BNA, and other industry and tax organizations.



Maxwell Burns, CPA

Managing Director



Maxwell Burns is one of Sagemont’s Managing Directors. He comes from a family of accountants and is the oldest of four accountant brothers.

Maxwell is a highly technical CPA with the “Big Four” and top-tier tax advisory experience, including tenures at KPMG and Alvarez & Marsal. Most recently, Maxwell left his role at RSM, a market-leading audit, tax, and consulting firm, where he focused on cross-border mergers and acquisitions, tax advisory, and structuring for private equity clients and strategic corporate investors.

He brings 10 years of public accounting and M&A tax experience to Sagemont and has been tasked with leading Sagemont’s team of tax, payroll, and accounting professionals. Maxwell supervises the entire ERC accounting process from start to finish.

Maxwell received his Master’s degree in accounting (taxation) from Florida State University in 2012, and a Bachelor’s degree in accounting from the University of Florida in 2010. He is a licensed CPA in the State of New York.



Kyle Morabito

CLO and Managing Director



Kyle Morabito, Esq. is the Chief Legal Officer and Managing Director of Sagemont. Kyle manages Sagemont's internal legal team and develops and manages Sagemont's partnerships with external professional advisors, including national law firms. Kyle is a corporate, M&A, and private equity attorney with international law firm and Wall Street experience.

Prior to Sagemont, Kyle worked with a team of attorneys and professionals that was integral in drafting the first ERC in U.S. history for Hurricane Katrina and the ERC for COVID-19. Additionally, Kyle has filed multiple eight-figure ERCs and worked closely on the preparation and finalization of multiple legal opinions substantiating eligibility for eight-figure ERCs.

Kyle spent the first decade of his legal career as a corporate attorney at DLA Piper, McDermott Will & Emery, and Bilzin Sumberg, where he advised private equity funds, publicly traded companies, and institutional investors in connection with mergers, acquisitions, divestitures, financings, and general corporate law matters.

Kyle attended law school at the New York University School of Law and taught law for business managers at the NYU Stern School of Business.

Prior to law school, Kyle worked at Merrill Lynch's investment bank in Manhattan as a Wall Street trader. Kyle received his Master of Science in finance in 2008 and a Bachelor of Science in finance in 2007 from the University of Florida.



sagemontadvisors.com

info@sagemontadvisors.com

754-202-3055

608 SW 4th Ave, Fort Lauderdale, FL 33315