# IRS Issues ERC Warnings and Related Guidance on Supply Chain Disruptions

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Over the last several weeks, the IRS has issued a number of public statements regarding the Employee Retention Credit (ERC) – a legal advice memo on qualification for the ERC because of supply chain disruptions, a new set of questions and answers and additional warnings regarding ERC promoters making unsubstantiated eligibility claims. This article summarizes what we've learned from this new guidance.

The Employee Retention Credit (ERC) has been around for over three years now; however, businesses still have time to submit their claims and get some much-needed funds for their businesses which may still be reeling from the effects of the pandemic and the current inflationary environment. Businesses may be attracted by advertisements stating that "their business may be eligible for an ERC of $26,000 per employee." However, there are limitations on eligibility. Furthermore, the IRS is cracking down on ERC scams and making clear statements refuting the ERC promoters' now familiar refrains.

### IRS Memo Summary

The IRS issued a Generic Legal Advice Memo on July 21, 2023 (AM 2023-005) to provide further clarification on ERC qualification based on supply chain disruptions. Prior to this memo, the IRS Notice 2021-20 provided limited guidance in the form of an exception treating an Employer as fully or partially shut down by a government order even if no government order directly impacted the business. If the business supplier's inability to deliver their products was due to a government order which, in turn, fully or partially shut down the Employer, the business would be considered as shut down. The new memo provides specific examples of conditions needed to claim a supply chain disruption under this exception.

### Supply Chain Disruption: IRS Scenarios

The IRS Memo 2023-005 provides five scenarios in which a business supply chain disruption occurred and eligibility for ERC exists.

- **Scenario 1** – The Employer was not subject to any government shutdowns at any time due to COVID-19 and continued to operate on a surplus of goods from its supplier. However, the Employer did experience shipping delays from its supplier, to which the supplier vaguely claimed that the delay was caused by COVID-19 but did not provide a government order and was unable to locate one. **IRS FINDING: NOT AN ELIGIBLE EMPLOYER**

- **Scenario 2** – The Employer was not subject to any government shutdowns at any time due to COVID-19; however, critical goods were stuck at a port in another state. The employer assumed that the delay was due to COVID-19 and could not identify any government orders that caused the hold-up. The supplier stated that there was a truck driver shortage and news media outlets broadcasted several reasons for the delay including COVID-19, increases in consumer spending and infrastructure. **IRS FINDING: NOT AN ELIGIBLE EMPLOYER**

- **Scenario 3** – Both Employer and supplier had government orders suspending both their business operations for April 2020. The orders were lifted in May 2020; however, the Employer had a delay in receiving critical goods from the supplier for the remainder of 2020 and for 2021. The supplier did not provide a reason for the delay. **IRS FINDING: ELIGIBLE EMPLOYER FOR APRIL 2020 ONLY**

- **Scenario 4** – The Employer was not subject to any government shutdowns at any time due to COVID-19. The Employer could not obtain critical supplies during 2020 and 2021 from its supplier, however, was able to obtain its critical supplies from another supplier at a 35% markup and was able to operate its business. **IRS FINDING: NOT AN ELIGIBLE EMPLOYER**

- **Scenario 5** – The Employer operates a large retail business selling a wide range of products and was not subject to any government shutdowns at any time due to COVID-19 in 2021. The Employer was not able to stock a number of products and was forced to raise prices on other products in short supply. The product shortage did not prevent the Employer from being fully operational in 2021. **IRS FINDING: NOT AN ELIGIBLE EMPLOYER**

### Discussion

As the examples above illustrate, a showing that a government order shut down a business' supplier is key to any supply chain argument for qualification for the ERC. Without that, any argument for qualification will fail. This has always been true of the supply chain exception, going back to Notice 2020-21, but the memo makes it exceptionally clear.

Other key takeaways:

- The business must have stopped or significantly limited its operations because it was unable to obtain critical goods from its supplier or an alternate supplier;

- Residual delays after the lifting of a government order do not qualify. ERC qualification is only permitted during the period in which the government order exists; and

- Experiencing higher costs for critical goods does not mean a business experienced a full or partial shut-down of operations.

The above scenarios provide much light on the topic of ERC qualification under a supply chain disruption. Documentation for ERC qualification based on supply chain disruption may include copies of relevant government orders affecting both the business and the supplier, documentation that critical goods cannot be obtained from alternative suppliers and government orders in support of transportation delays. Ultimately, the onus is on the business to provide adequate documentation in support of the ERC.

### New IRS FAQs and Warnings

On July 27, 2023 (with further updates on July 28), the IRS published new ERC FAQs on its website. Currently, the FAQs do not contain any new clarifications of prior guidance, but the tone is set by FAQ #1.

*Q1. Is every business eligible for the Employee Retention Credit?*

*A1. No.*

This is coupled with a further warning published on July 26, 2023 regarding ERC scams. The IRS is clearly indicating that they intend to increase audit activity around the ERC in an attempt to expose both outright fraud and aggressive positions. IRS Commissioner Danny Werfel noted "We will work with Treasury to explore legislative solutions we can share with Congress to help address fraud and error, including potentially putting an earlier ending date for businesses to claim the credit and increase IRS oversight of return preparers."

***PKF O'Connor Davies Observation:*** The potential for an early end to the ability to file ERC claims (currently slated to expire on April 15, 2024 for 2020 payroll tax returns and April 15, 2025 for 2021 payroll tax returns) is something for businesses still considering the ERC to be mindful of, although any such change in the end date would likely require Congressional action. However, it should still not replace careful consideration regarding qualification, especially given the IRS' increased audit activity.

### Contact Us

PKF O’Connor Davies has helped hundreds of companies across a number of industries determine their ERC qualification, calculate their credit and help them file amended payroll tax returns.

If you have questions about the employee retention credit, contact your client service partner or:


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