

TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION



Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

September 30, 2024

Report Number: 2024-400-068

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document..

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HIGHLIGHTS: Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

Final Audit Report issued on September 30, 2024

Report Number 2024-400-068

Why TIGTA Did This Audit

In July 2021 and August 2022, TIGTA issued reports on the IRS's efforts to implement employer tax credits included in the Coronavirus Disease 2019 Pandemic (Pandemic) relief legislation. This report is a continuation of our review of the Employee Retention Credit (ERC).

The overall objective of this review was to assess the IRS's processes to ensure the accuracy of both original and amended returns with the ERC, and the IRS's compliance initiatives to prevent or recover erroneous ERC.

Impact on Tax Administration

The ERC was intended to provide businesses with relief from the adverse financial effects of the Pandemic. Delays in processing ERC claims may impact legitimate businesses that are eligible for the ERC and could result in increased interest paid by the IRS to these businesses, if a determination is made that the ERC claim is legitimate.

The IRS must balance taxpayer burden and potential interest it may be required to pay with ensuring adequate scrutiny of ERC claims. The unintended consequences of refundable credits are that they can result in the issuance of improper payments and can be the targets of unscrupulous individuals. As such, they pose a significant risk as an avenue for those seeking to defraud the Government.

On September 14, 2023, the IRS placed a moratorium on processing new ERC claims due to a surge in the volume of suspicious claims from unscrupulous actors.

What TIGTA Found

IRS management increased awareness about ERC eligibility requirements. For example, the IRS issued numerous press releases and electronic news articles to tax professionals and other subscribers about both eligibility requirements and ERC promoters. These news articles also directed taxpayers to frequently asked questions and other eligibility information on the IRS's website, such as a new eligibility checklist. The IRS also updated identity theft filters and reports it identified more than 155,000 tax returns claiming potentially erroneous ERC preventing \$487 million in refunds from being issued during Processing Years 2021 through 2023. However, the IRS does not apply updated filters to tax returns that were previously screened using old criteria. TIGTA identified 997 returns reporting \$19.6 million in potentially erroneous ERC through July 20, 2023, that the IRS did not identify.

Our review also found that through June 29, 2023, IRS management made decisions to double the threshold and change the referral criteria to include only returns that met specific return scenarios. The threshold and scenarios were used to determine which returns should be referred for possible preresult examination and which returns should have the ERC claim paid. According to IRS management, these changes were to deal with the influx of ERC claims and to expedite the processing of ERC claims. However, these decisions led to 184,923 returns claiming \$41.8 billion in the ERC from being considered for possible preresult examination.

Finally, IRS management implemented several initiatives after the moratorium that assessed or prevented erroneous ERC amounts. These initiatives have prevented \$1.6 billion in the ERC and allowed the IRS to assess \$573 million in the ERC as of April 13, 2024. However, TIGTA identified an additional 923 entities that claimed the ERC of \$105 million that should have received a disallowance letter but were not initially identified by the IRS.

What TIGTA Recommended

TIGTA made four recommendations, including that IRS management review the 997 tax returns not flagged by identity theft filters and the 184,923 tax returns not considered by the IRS for possible preresult examination, and consider these returns for post-refund compliance review to recover any potentially erroneous ERC paid. In addition, TIGTA recommended that the IRS send disallowance letters to the 923 entities that did not initially receive a letter.

The IRS agreed with three recommendations and plans to review and refer additional tax returns that met its updated identity theft filters for recapture where appropriate, issue disallowance letters to the 923 entities TIGTA identified, and update its strategy to identify businesses for ERC recapture in subsequent years. The IRS partially agreed to review the 184,923 tax returns citing the need to assess competing priorities, resources, and remaining time on statutes.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

U.S. DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20024

September 30, 2024

MEMORANDUM FOR: COMMISSIONER OF INTERNAL REVENUE

A handwritten signature in cursive script, reading "Danny R. Verneuille".

FROM: Danny R. Verneuille
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed (Audit No.: 202340030)

This report presents the results of our review to assess the Internal Revenue Service's (IRS) processes to ensure the accuracy of both original and amended returns with the Employee Retention Credit (ERC), and the IRS's compliance initiatives to prevent or recover erroneous ERC. This review is part of our Fiscal Year 2024 Annual Audit Plan and addresses the major management and performance challenge of *Tax Fraud and Improper Payments*.

Management's complete response to the draft report is included as Appendix III. If you have any questions, please contact me or Diana M. Tengesdal, Assistant Inspector General for Audit (Returns Processing and Account Services).

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Background

The Employee Retention Credit (ERC) is a refundable employer tax credit introduced in the *Coronavirus Aid, Relief, and Economic Security Act (CARES Act)*.¹ The credit encouraged eligible employers to keep employees on their payroll despite experiencing economic hardship related to the Coronavirus Disease 2019 Pandemic (Pandemic). Employers could claim the ERC on Form 941, *Employer's QUARTERLY Federal Tax Return*.² Eligible employers that did not claim the ERC on their original Form 941 or that wanted to adjust the amount originally claimed could file a Form 941-X, *Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund* (Forms 941-X claims are hereafter referred to as ERC claims).³

The legislation relating to the ERC was amended three separate times between March 2020 and November 2021.⁴ The amendments changed both the amount of the credit and eligibility requirements. For example, the credit increased from \$5,000 per employee per tax year to \$7,000 per employee per quarter. The amendments also occurred at a time when the Internal Revenue Service (IRS) was not only dealing with the Pandemic, but also working to implement processes to effectively process legitimate claims while providing adequate scrutiny. The timing of the various legislative changes increased the number of ERC claims received by the IRS.

Figure 1 provides a summary of ERC legislative changes.

¹ The ERC can be a nonrefundable credit, a refundable credit, or both, depending on the amount of the credit that can be claimed for a particular tax period and the amount(s) of certain other nonrefundable credit(s) being reported. How the credit is applied depends on the tax period for which it is being claimed. Pub. L. No. 116-136, 134 Stat. 281 (codified as amended in scattered sections of 2, 5, 12, 15, 20, 21, 29, 42, and 45 U.S.C.), as amended by the *COVID-Related Tax Relief Act of 2020* and the *Taxpayer Certainty and Disaster Tax Relief Act of 2020* (2020). See Appendix IV for a glossary of terms.

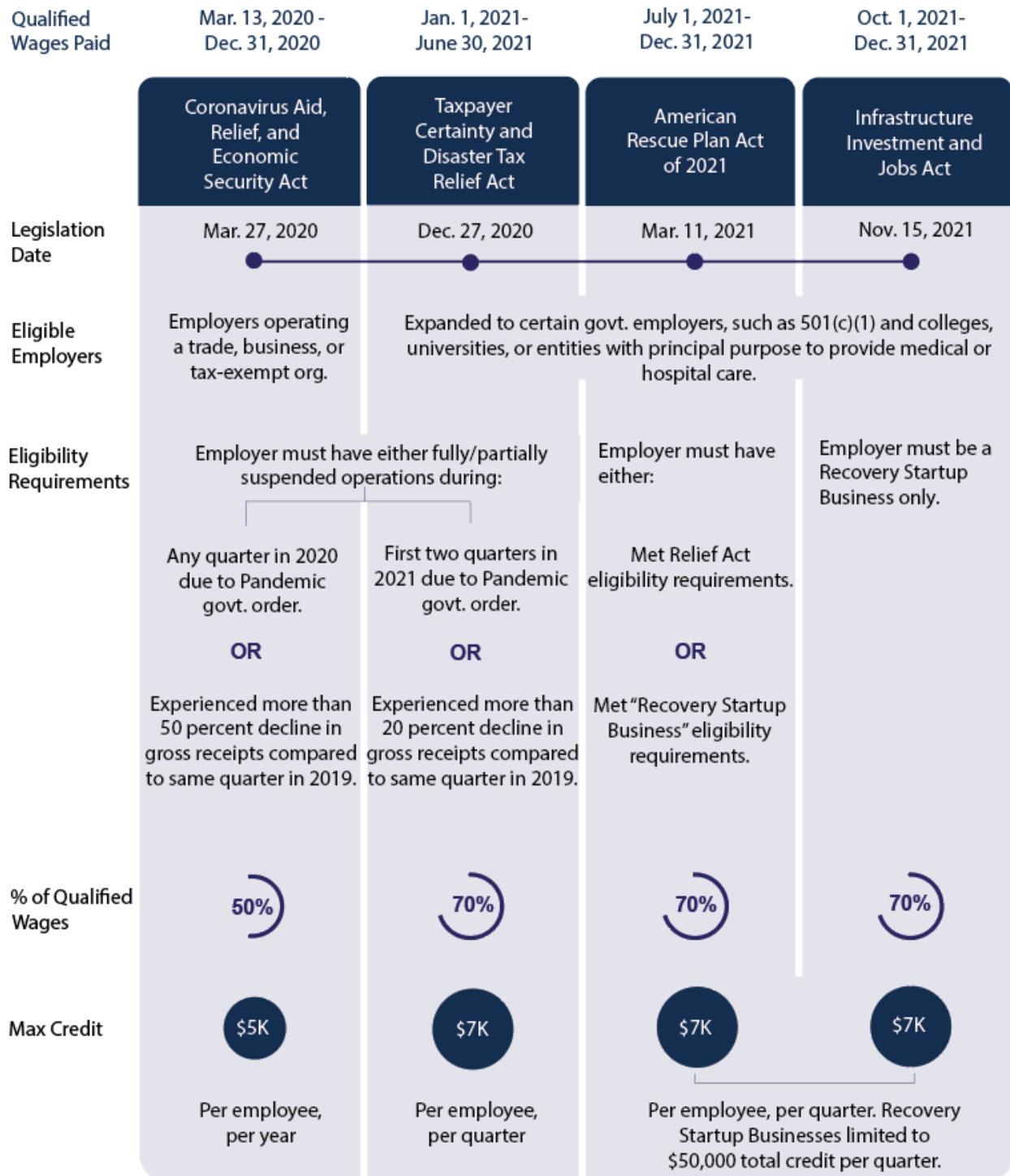
² Employers could also claim the ERC on Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*, Form 944, *Employer's ANNUAL Federal Tax Return*, and Form CT-1, *Employer's Annual Railroad Retirement Tax Return*.

³ Employers could also file an ERC claim on Form 943-X, *Adjusted Employer's Annual Federal Tax Return for Agricultural Employees or Claim for Refund*, Form 944-X, *Adjusted Employer's ANNUAL Federal Tax Return or Claim for Refund*, and Form CT-1 X, *Adjusted Employer's Annual Railroad Retirement Tax Return or Claim for Refund*.

⁴ The *Taxpayer Certainty and Disaster Tax Relief Act of 2020*, Pub. L. No. 116-260 (2020); the *American Rescue Plan Act of 2021*, Pub. L. No. 117-2 (2021); and the *Infrastructure Investment and Jobs Act*, Pub. L. No. 117-58 (2021).

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Figure 1: Summary of ERC Legislative Changes⁵



Source: Treasury Inspector General for Tax Administration (TIGTA) summary of the legislation referenced in Figure 1 and IRS.gov. Note: "govt." refers to government and "org." refers to organization.

⁵ There are exceptions not noted in this graphic. See <https://www.irs.gov/newsroom/employee-retention-credit-2020-vs-2021-comparison-chart> for a complete list of eligibility requirements.

The IRS experienced delays in processing ERC claims

The IRS also experienced the effects of the Pandemic. For example, we previously reported that the Tax Processing Centers were closed between March 20, 2020, and June 29, 2020, which resulted in significant backlogs of unopened mail.⁶ In August 2022, we reported that continued processing delays prevented businesses from receiving Pandemic relief benefits.⁷ Specifically, the IRS did not begin processing ERC claims for 12 months, due to a lack of updated programming and procedural guidance.

Figure 2 shows the timeline of processing ERC claims through February 9, 2022.

Figure 2: Processing Timeline for ERC Claims



Source: TIGTA summary of Servicewide Electronic Research Program Alerts.

The IRS began processing ERC claims for the first time between March and April 2021. However, because these ERC claims were filed on paper forms, they were processed manually, not electronically. Thus, working through the backlog of ERC claims was challenging for the IRS and frustrating for employers and stakeholders.

Eligibility is difficult to determine without adequate data

Refundable tax credits, such as the ERC, present a unique risk to tax administration because taxpayers not only can have their tax reduced to zero; they can also receive a "refund" of excess credit. The unintended consequences of refundable credits are that they can result in the issuance of improper payments and can be the targets of unscrupulous individuals. As such, they pose a significant risk as an avenue for those seeking to defraud the Government.

Specifically for the ERC, the IRS does not have all the data it needs to verify the eligibility of the employer to claim the credit or accuracy of the claims by employers for the ERC. For example, the IRS had no data to support whether the employer fully or partially suspended operations due to a Pandemic government order, whether it experienced a decline in gross receipts, or how

⁶ TIGTA, Report No. 2021-46-023, *Results of the 2020 Filing Season and Effects of COVID-19 on Tax Processing Operations* (Mar. 2021).

⁷ TIGTA, Report No. 2022-46-059, *Delays Continue to Result in Businesses Not Receiving Pandemic Relief Benefits* (Aug. 2022).

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much it paid its employees during the relevant time period. In an instance like this, the only way the IRS could determine if an employer met these eligibility criteria would be through a resource-intensive examination, which would require the employer to cooperate and provide the necessary documentation for the IRS's review.

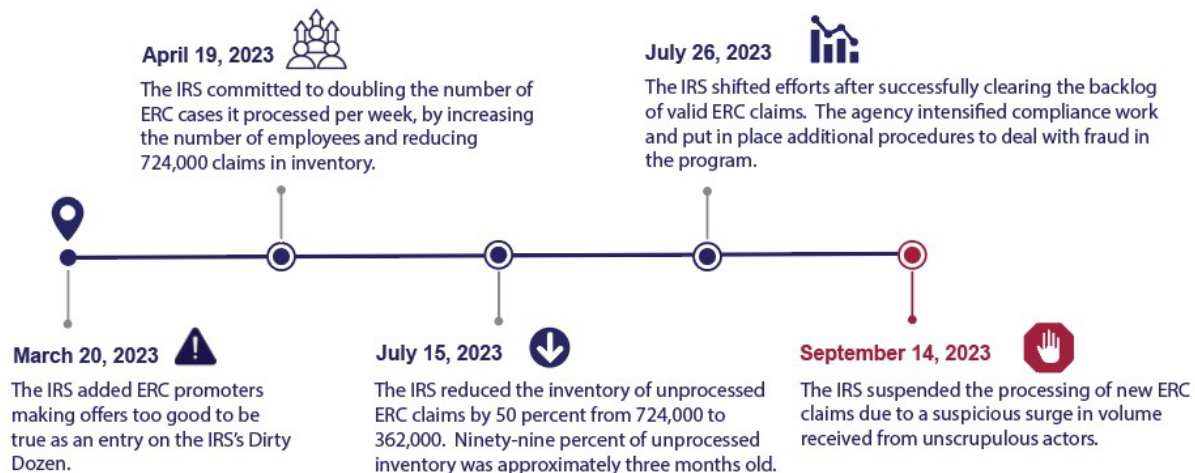
The IRS increased its focus on ineligible ERC

In March 2023, the IRS updated its annual "Dirty Dozen" list to include companies that promote large refunds related to the ERC, *i.e.*, making offers that are too good to be true. According to a news release, the IRS "spotlighted ERC following blatant attempts by promoters to con ineligible people to claim the credit." In this same news release, the IRS announced that it would be stepping up enforcement action involving these ERC claims and that "people considering filing for these claims – only valid during the pandemic, for a limited group of businesses – should be aware they are ultimately responsible for the accuracy of the information on their tax return."

The IRS added resources to assist with processing the inventory of ERC claims, as the IRS previously received ERC claims at a faster pace than it could process them. In addition, the IRS received more claims than when the ERC was originally enacted into law. For example, total amended business returns filed as of March 25, 2023, had already exceeded those filed during Fiscal Year 2021. Furthermore, the IRS continued to receive pressure from external stakeholders to accelerate processing tax returns claiming the ERC, because the ERC provided businesses with much needed relief from the adverse financial effects of the Pandemic. As a result, the IRS publicly committed to increase the number of employees working ERC cases to reduce the inventory.

Figure 3 provides an overview of events that occurred during Calendar Year 2023 leading up to the IRS's moratorium on processing the ERC.

Figure 3: Events Leading to the September 2023 Moratorium



Source: TIGTA summary of various press releases issued by the IRS and IRS inventory reports.

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

After the moratorium was announced, the IRS continued processing ERC claims it had already received, but with additional scrutiny and at a much slower rate. New ERC claims received by the IRS after the moratorium were held while the agency developed plans for handling growing concerns with noncompliance. The IRS subsequently announced a series of initiatives intended to either prevent ineligible ERC claims from being paid or to recover erroneous ERC claims previously paid. This included:

- Withdrawal initiative.⁸ The withdrawal option allowed certain employers, including those that were pressured or misled by ERC promoters into filing ineligible requests for the ERC, to withdraw their submission. Eligible employers were those that had not yet received a refund, or that received a check but had not yet cashed or deposited it. Claims that were withdrawn will be treated as if they were never filed. As such, the IRS will not impose penalties or interest. As of April 17, 2024, the IRS was still accepting requests for ERC withdrawals.
- Voluntary Disclosure Program (VDP).⁹ This initiative incentivized businesses that received the ERC in error to voluntarily repay 80 percent of the claim the business received. In addition, the employer was not required to repay any interest it may have received on the ERC refund, and the IRS would not charge penalties and interest on the claimed ERC amount if the employer repaid the 80 percent in full. This initiative was in effect from December 21, 2023, through March 22, 2024.

In addition, the IRS conducted data analysis and sent letters to employers in two high-risk categories. This included employers that did not meet certain eligibility requirements for the ERC and employers whose claims were erroneous or excessive, as detailed below:

- Entity did not exist or did not pay employees during the period of ERC eligibility.¹⁰ As shown in Figure 1, the ERC applied to qualified wages for periods from March 13, 2020, through December 31, 2021. Entities that were established after December 31, 2021, or did not have employees who were paid during an eligible period were not entitled to claim the ERC. The IRS sent Letter 105 C, *Claim Disallowed*, to employers that did not meet these basic eligibility requirements.
- Recapture letters.¹¹ The IRS identified employers for which the ERC paid exceeded the maximum allowable amount based upon the number of Forms W-2, *Wage and Tax Statement*, the amount of qualified wages, or the amount of compensation reported. The IRS sent Letter 6577, *ERC 2020 W-2*, to these employers proposing tax adjustments to their Tax Year 2020 tax return to recapture the erroneously claimed ERC.

⁸ IR-2023-193, Oct. 19, 2023.

⁹ IR-2023-247, Dec. 21, 2023.

¹⁰ IR-2023-230, Dec. 6, 2023.

¹¹ IR-2023-247, Dec. 21, 2023.

Results of Review

This review is a continuation of our review of the IRS's processing of claims for the ERC. We previously issued reports in July 2021 and August 2022. The results in this report are presented as of April 18, 2024.

The backlog and processing of ERC claims continued to be a challenge for the IRS during Calendar Years 2022 and 2023. As of April 13, 2024, the IRS reported 1.4 million in ERC inventory waiting to be worked. However, the IRS's increased focus on ineligible requests for the ERC prevented \$1.6 billion and assessed \$573 million in the ERC as of April 18, 2024.¹²

Management Increased Awareness About the Eligibility Requirements and Prevented Erroneous Employee Retention Credit Amounts

With an increased number of ineligible ERC requests identified, the IRS took steps to increase eligibility awareness and prevent potentially erroneous ERC. These steps included:

- Conducting outreach and raising awareness about both eligibility requirements and ERC promoters. The IRS issued numerous press releases and electronic news articles to tax professionals and other subscribers on these topics. These news articles also directed taxpayers to frequently asked questions and other eligibility information on the IRS's website.
- Publishing a new eligibility checklist on IRS.gov with a tool to allow businesses to answer step-by-step questions to determine their eligibility for the ERC. The IRS also provided a printable checklist with all five eligibility questions and information about how to claim the ERC or resolve an incorrect ERC claim previously filed. Our review of this checklist found that it was accurate, complete, and streamlined for taxpayers.
- Creating six business rules to identify potentially erroneous ERC claimed on original returns at tax return filing. Business rules are used to validate information included on electronically filed tax returns for acceptance into tax return processing. The IRS rejects electronically filed tax returns from processing when the return does not meet a business rule condition. Our review of the six business rules found that they were accurately accepting and rejecting electronically filed returns claiming the ERC.
- Implementing three identity theft filters to identify suspicious Forms 941 reporting the ERC, all of which were updated for Processing Year (PY) 2023. During PYs 2021 through 2023, the IRS reports it identified more than 155,000 tax returns claiming potentially erroneous ERC and prevented \$487 million in refunds from being issued. The IRS proactively updates the identity theft filters when it receives information relating to new schemes. However, when the IRS modifies or updates its filter criteria, it does not apply the updated filters to tax returns that were previously screened using the old criteria.

Using the IRS's updated filter criteria as of July 20, 2023, we analyzed Forms 941 that were processed during PYs 2021 through 2023, as of the same date. Our review

¹² Using its recapture regulations, the IRS is reclaiming excessive or erroneous ERC through normal tax assessment and collection procedures.

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

identified 997 Forms 941 reporting \$19.6 million (\$19.1 million refundable and \$0.5 million nonrefundable) in potentially erroneous ERC claims. Because potentially erroneous ERC was paid and given the IRS's emphasis to more heavily scrutinize potentially erroneous ERC, it is important that the IRS review these returns and recover any erroneous amounts.

Recommendation 1 (E-Mail Alert): On February 28, 2024, we alerted the ERC Team Lead of our concern and recommended that the IRS review the 997 tax returns we identified and consider them for post-refund compliance review to recover potentially erroneous ERC paid.

Management's Response to E-Mail Alert: IRS management agreed with the recommendation. Taxpayer Services previously identified 525 of these modules for potential recapture of an improperly paid credit. The IRS will analyze the remaining 472 modules and refer these to the Small Business/Self-Employed Division for recapture where appropriate.

Management's Decisions Led to Billions of Dollars in Claims Not Being Considered for Prerefund Examination

Beginning in January 2022, IRS management decided to double the referral threshold. Subsequently, in November 2022, the IRS further changed its referral criteria to include only returns that met specific return scenarios. The threshold and scenarios were used to determine which returns should be referred for possible prerefund examination and which returns should have the ERC claim paid. The IRS continued to use these revised criteria through June 2023. When we asked IRS management why they made these changes, they stated the changes were intended to deal with the influx of ERC claims and expedite the processing of ERC claims. However, these decisions led to hundreds of thousands of returns with billions of dollars in ERC claims not being considered for possible prerefund examination.

Increased thresholds resulted in \$19.5 billion in unreviewed ERC

From January 6, 2022, through June 29, 2023, the IRS doubled its normal threshold for the Accounts Management function to refer ERC claims for possible examination. However, our review of more than 1.9 million ERC claims processed by the IRS during that time frame identified 139,993 Tax Years 2020 and 2021 claims for \$19.5 billion in the ERC that exceeded the IRS's original threshold but were below the IRS's updated threshold. As a result, these ERC claims were not referred for possible prerefund examination. We estimate that \$824 million in refundable ERC and \$135.5 million in nonrefundable ERC may have been allowed because of the IRS's increased thresholds.

Further refinements of referral criteria resulted in \$22.3 billion in the ERC that bypassed possible prerefund examination

From November 7, 2022, through June 29, 2023, the IRS further limited referrals of ERC claims for possible prerefund examination by only requiring review of two of the 11 test scenarios developed to identify potentially erroneous ERC claims. According to the IRS, the shift to these two tests served to strengthen the referral criteria and limit referrals to potentially questionable returns. Thus, the only ERC claims referred were cases that failed one of the two specified tests.

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

Our review of more than 1.9 million ERC claims processed by the IRS during the same time frame identified 44,930 Tax Years 2020 and 2021 ERC claims totaling \$22.3 billion that exceeded the IRS's updated threshold for referral and passed the two specified test scenarios. These ERC claims were neither referred for possible prerefund examination nor tested on the remaining nine scenarios developed to identify potentially erroneous ERC claims. We estimate that \$948.3 million in refundable ERC and \$149 million in nonrefundable ERC may have been allowed because of the IRS's limited referral criteria.

Recommendation 2 (E-Mail Alert): On February 28, 2024, we alerted the ERC Team Lead of our concern and recommended that the IRS review the 139,993 and 44,930 Tax Years 2020 and 2021 returns and consider them for post-refund compliance to recover any potentially erroneous ERC paid.

Management's Response to E-Mail Alert: IRS management partially agreed with the recommendation. The Small Business/Self-Employed Division will check all returns processed with the ERC for potentially excessive or improper payment under its recapture program. The IRS cannot agree that the 139,993 and 44,930 Tax Years 2020 and 2021 returns included potentially erroneous ERC paid simply because the returns did not meet the referral criteria. The IRS will consider additional post-refund compliance actions to recover potentially erroneous or excessive ERC paid after assessing competing priorities, available resources, and time remaining on the statute of limitations.

Office of Audit Comment: We understand that the IRS has competing priorities and limited resources. The tax returns we identified were not previously considered for prerefund examination by the IRS before the associated ERC claims were paid. This occurred because management changed the referral threshold and scenarios as a way to deal with the increased number of ERC claims. As a result, these tax returns present a significant risk to tax administration because the IRS now has to try and recover the funds that were already paid. Using the IRS's examination rates for ERC claims, we estimated that more than \$2 billion in erroneous ERC may have been potentially paid in error. Therefore, the IRS should prioritize and review those returns where the statute remains.

Management Implemented Several Initiatives That Assessed or Prevented Erroneous Employee Retention Credit Amounts

Because ERC claims are paper filed, the IRS developed a process for capturing key data to analyze the backlogged inventory. The IRS had employees manually transcribe data from each ERC claim while it worked on a more efficient and accurate technology solution that allowed for systemic transcription of key data elements. The captured data were analyzed by the IRS's Research, Applied Analytics, and Statistics function to evaluate the potential risk of questionable, invalid, potentially ineligible, or overstated claims. Beginning February 9, 2024, the IRS exclusively used the technology solution to transcribe ERC claims.

A team of cross-functional IRS employees, referred to as the ERC team, explored options and initiatives to assess or prevent erroneous ERC amounts. Figure 4 lists each initiative, the date it was announced publicly, and the amounts prevented or assessed by each initiative.

**Figure 4: Summary of Amounts Prevented
or Assessed by ERC Initiatives Implemented**

ERC Initiative	Date Announced	Total Amount
Entity-Level Disallowance Letters	12/06/2023	\$1.3 billion
Withdrawal Requests	10/19/2023	\$341 million
Total Prevented		\$1.6 billion
Recapture Letters	12/21/2023	\$573 million
VDP	12/21/2023	\$0 ¹³
Total Assessed		\$573 million

Source: IRS press releases, TIGTA data analysis of IRS ERC-transcribed data, and ERC Commissioner briefing dated April 18, 2024 (data as of April 13, 2024).

As shown in Figure 4, these initiatives have prevented \$1.6 billion and assessed \$573 million in the ERC as of April 13, 2024.

Entity-level disallowance letters

The IRS identified 16,185 entities that were ineligible for the ERC and had unprocessed returns with the ERC as of September 14, 2023. The IRS determined that these entities were ineligible because either the entity was established after December 31, 2021, or because the entity had no employees who were paid during an eligible period. As of April 13, 2024, the IRS sent letters to 13,802 of the 16,185 entities.¹⁴ The IRS has yet to report the amount of erroneous ERC claims that were prevented through the disallowance letters. However, based upon data available for 3,669 entities, we estimate that the IRS has prevented at least \$1.3 billion in erroneous ERC claims.¹⁵

Moreover, our review of unprocessed ERC claims on Forms 941-X as of September 14, 2023, identified an additional 923 entities that were not initially identified by the IRS. This includes:

- 873 entities claiming the ERC of \$100.8 million (\$90.4 million refundable and \$10.4 million nonrefundable) with no employees who were paid during Tax Years 2019 through 2021.
- 50 entities claiming the ERC of \$4.2 million (\$3.9 million refundable and \$312,802 nonrefundable) that were established after December 31, 2021.

¹³ While not yet assessed, the IRS reports it received 2,609 VDP applications disclosing over \$1 billion in the ERC.

¹⁴ The disallowance of the ERC and adjustments to each entity's tax account is a manual process that is generally completed by the same employees who assist taxpayers via IRS telephone lines. The IRS's focus during the 2024 Filing Season has been to deliver the required level of service on the telephone.

¹⁵ The erroneous ERC amounts are only available for returns that were transcribed by the IRS. Amounts reported are subject to the amounts being transcribed correctly.

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

We shared the 923 entities that we identified with IRS management and asked that they review these cases to determine if they should be disallowed. IRS management agreed that the ERC claims associated with these entities should be disallowed. In addition, management performed a subsequent analysis on these entities and found that the claims were categorized as very high-risk/unprocessable. As a result, the IRS plans to issue these entities a disallowance letter. However, the IRS has not finalized its plans for issuing the letters.

Recommendation 3: The Commissioner, Small Business/Self-Employed Division, should ensure that the 923 entities we identified receive a disallowance letter to prevent erroneous ERC claims from being paid.

Management's Response: IRS management agreed with the recommendation and had previously identified these entities. The Small Business/Self-Employed Division will provide Taxpayer Services with a list of the 923 modules to be issued disallowance letters.

Withdrawal requests

As of April 13, 2024, the IRS reports it received 6,125 withdrawal requests for 3,602 entities.¹⁶ Of the 6,125 withdrawal requests, the IRS closed 5,123 (84 percent) preventing \$341 million in erroneous ERC. The remaining 1,002 withdrawal requests were not yet closed by the IRS as of April 13, 2024. As previously mentioned, the withdrawal process is for those taxpayers whose ERC has not been paid yet, or who received a check but have not yet cashed or deposited it. Claims that are withdrawn will be treated as if they were never filed.

To be eligible for the withdrawal process, the business must have:

- Filed an adjusted employment tax return, such as Form 941-X, claiming only the ERC.
- Faxed a signed and dated copy of the adjusted return, with the words "withdrawn" in the left margin, and the name and title of an authorized person in the right margin of the first page.¹⁷

Processing the withdrawal requests is a manually intensive process. The withdrawal requests are generally submitted via a dedicated fax line and delivered as electronic images to a shared drive. Imaging software is used to create a new case in the Correspondence Imaging Inventory database with a priority and category code. They are then assigned to an IRS employee who reviews the documentation to verify basic eligibility requirements are met and captures key data in a tracking spreadsheet. In addition, the IRS employee is required to input certain transaction codes on the entity's tax account to show if the withdrawal was accepted/rejected and to release any refund freezes. With this being such a manual process, it is subject to human error.

¹⁶ Generally, a business files four quarterly employment tax returns each year. Thus, a business may withdraw multiple tax forms claiming the ERC.

¹⁷ An authorized person depends on the type of business. For example, for a sole proprietorship, the individual who owns the business can sign. For a corporation, the president or vice-president may sign for the business.

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

We evaluated a statistically valid sample of 89 withdrawal requests processed by the IRS from November 13, 2023, through December 2, 2023.¹⁸ Our review found that IRS employees made some errors when recording information in the tracking spreadsheet. For example, an employee entered an incorrect date or understated the amount of the ERC withdrawn. In addition, employees did not always take required actions when processing the withdrawal requests. For example, they failed to enter required notes or transaction codes on the entity's tax account. Although the IRS generally made the correct determination when accepting or rejecting the withdrawal, incorrect tracking affects the IRS's ability to report complete and accurate information about the withdrawal program.

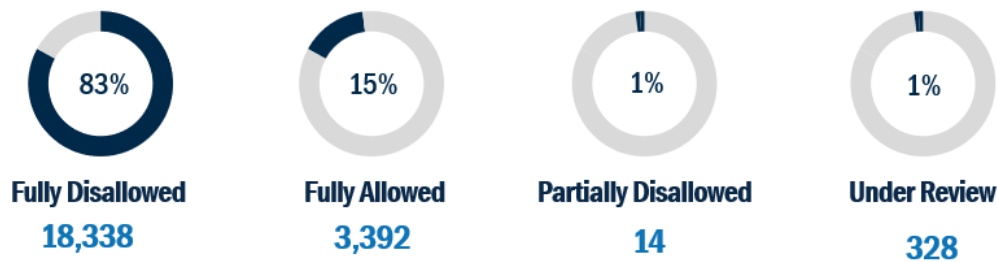
We shared our concern about employee errors with IRS management and asked if management considered whether they would complete their own quality reviews of ERC withdrawal requests.

Management Action: In response to our raising this concern, IRS management implemented a weekly targeted review of ERC withdrawal requests and shared feedback with employees who made mistakes processing the withdrawal requests. According to the IRS, steps were also taken to correct the mistakes that were identified. The IRS's own review has also identified concerns with errors. As of April 13, 2024, IRS management's review of 220 processed withdrawal requests identified that 62 (28 percent) contained errors.

Recapture letters

As of April 13, 2024, the IRS mailed Letter 6577 to 12,408 businesses assessing \$572.9 million in potentially erroneous ERC previously paid for 22,072 Tax Year 2020 ERC returns. Figure 5 provides a summary of the results of the recapture letters for the 22,072 ERC returns.

Figure 5: Summary of Recapture Letter Results



Source: Information provided by the IRS's ERC team (data as of April 13, 2024).

We asked the IRS why 15 percent of the recapture letters sent to businesses resulted in the ERC claim being fully allowed.¹⁹ IRS management explained that the data used to identify the number of Forms W-2 filed by the employer sometimes did not include an accurate count for that employer. This can occur when a Form W-2 is filed late, or the Form W-2 was furnished to the employee but not the IRS. We also asked IRS management if they planned to update the strategy or methodology for identifying businesses for recapture for subsequent tax years.

¹⁸ Our sample was selected using a 95 percent confidence interval, 50 percent error rate, and ± 10 percent precision factor.

¹⁹ In Tax Year 2021, the IRS reported a 7 percent no-change rate for employment tax return examinations.

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

IRS management stated they updated their strategy to include a secondary source for analysis of Forms W-2 prior to contacting the taxpayer; however, the strategy was not available at the time we concluded our review. Therefore, we could not verify IRS management's assertion.

Recommendation 4: The Commissioner, Small Business/Self-Employed Division, should ensure that any subsequent analysis to identify businesses for recapture letters uses accurate wage data and takes into consideration lessons learned from the Tax Year 2020 recapture letters.

Management's Response: IRS management agreed with the recommendation. The Small Business/Self-Employed Division will ensure that the strategy for identifying businesses for recapture for subsequent years is updated to include a secondary source for analysis of Form W-2 data prior to contacting the taxpayer.

The VDP

The ERC VDP was open from December 21, 2023, through March 22, 2024. To apply for the ERC VDP, employers submitted Form 15434, *Application for Employee Retention Credit (ERC) Voluntary Disclosure Program*, online via the IRS's Document Upload Tool. According to the IRS, through March 22, 2024, it received 2,609 applications disclosing over \$1 billion in the ERC. However, the IRS does not have any data yet to show how many applicants repaid and the amount of their repayment *i.e.*, paid in full or on a payment plan.

As of April 17, 2024, the IRS has processed two applications. We reviewed both applications and did not find any concerns with the IRS's processing of these applications.

Other initiatives were implemented during Calendar Year 2024

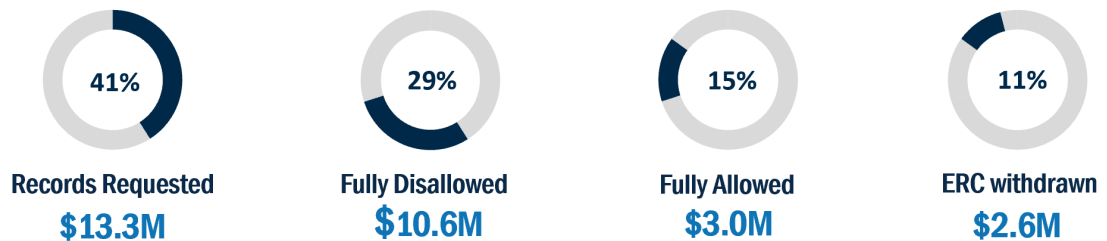
The IRS also implemented other initiatives during Calendar Year 2024. According to the IRS, the purpose of these initiatives was to collect data on taxpayer compliance and to determine how businesses respond to the notices, which will help inform the IRS's future compliance plans.

- **Prerefund audits.** The week of January 15, 2024, the IRS mailed 500 Letters 6612, *Pre-Refund ERC Claim Examination*. The businesses were selected at random, with a few exclusions from unprocessed amended ERC returns that were received by the IRS prior to September 14, 2023.²⁰ These businesses claimed refunds totaling \$80.8 million for 1,736 tax periods. As of April 13, 2024, the IRS reported it has received responses from 273 businesses. Of the remaining 227 letters that were sent, 166 businesses have not yet responded, 51 businesses requested an extension, and the remaining 10 businesses had their cases closed without an examination.

The IRS completed a quality review of 173 of the 273 businesses that provided a response to Letter 6612. The 173 responses addressed 551 tax periods. Figure 6 shows the percentage and dollar amounts of prerefund audit dispositions for all 551 tax periods as of April 13, 2024.

²⁰ Exclusions included returns already selected for further review, third-party payers, churches, and withdrawn claims.

Figure 6: Prerefund Audit Dispositions



The remaining 4 percent will be partially disallowed due to taxpayer computational error.

Source: TIGTA graphic based upon information provided by the IRS's ERC team.

As shown in Figure 6, the IRS has provided most businesses with an additional opportunity to substantiate the ERC reported by requesting additional records. Therefore, the number of audits that will result in full disallowance is currently unknown.

- **Educational notices.** On February 9, 2024, the IRS mailed CP 271, *Pre-refund Compliance Notice*, to 2,990 businesses. Like the prerefund audits, these businesses were selected at random, with a few exclusions, from unprocessed amended returns with the ERC that were received by the IRS prior to September 14, 2023. The letter asks the business to confirm it is entitled to the ERC claimed, by reviewing the abbreviated checklist provided in the letter. If the business determines it is entitled to the ERC, no action is needed. If the business determines it is not entitled to the ERC, the business is encouraged to withdraw its claim following the instructions provided in the letter. As of April 17, 2024, the IRS reports 42 businesses have withdrawn their ERC claims totaling \$1.1 million.

When asked if they had plans to send additional notices, IRS management initially indicated that they did not and instead would focus their efforts on their other compliance initiatives. However, we suggested that they consider sending these educational notices to targeted risk populations, instead of at random, to increase their effectiveness.

Management Action: As of April 11, 2024, IRS management indicated they will consider educational notices for other targeted risk populations.

- **Educational sessions hosted by IRS's Criminal Investigation (CI).** On January 25, 2024, the IRS announced that CI would host educational sessions for preparers. CI mailed 220 letters to preparers inviting them to a session at a location near them on a specific date/time. These sessions were hosted at IRS field offices across the country from February 12, 2024, through February 16, 2024. In general, the preparers that were identified were associated with numerous tax return filings with ERC claims. CI reports that 123 (56 percent) preparers responded with 116 confirming attendance and seven declining the invitation. The remaining 97 (44 percent) preparers did not respond to the letter. As of April 25, 2024, CI stated that it plans to study the impact of these educational sessions and whether there were behavioral changes made by these preparers in the coming years.

Future of the ERC

The ERC team worked with the IRS's Research, Applied Analytics, and Statistics function to evaluate the risk of erroneous ERC payments. Specifically, by evaluating the quality and the amount of ERC claims to identify the potential risk factors based on different characteristics of the business or found on the return itself. The ERC team is using this information to help guide its decisions and to continue to refine and finalize its compliance plans. The ERC team completed its initial evaluation of potential risk factors in June 2024.

In August 2024, the IRS announced additional actions to help businesses and prevent improper payments in the ERC program, including to accelerate more payments. Specifically, the IRS stated it will now start processing the highest and lowest risk claims filed between September 14, 2023, and January 31, 2024. Moreover, the IRS announced that it was reopening the VDP, through November 22, 2024, for the ERC claimed during Tax Year 2021. As of September 2024, the moratorium remains in effect for claims received after January 31, 2024. The ERC team will continue to work with the Research, Applied Analytics, and Statistics function to refine and update the potential risk factors to determine how to work the remaining ERC inventory

Delays in processing ERC claims may impact legitimate businesses that are eligible for the ERC and could result in increased interest paid by the IRS to these businesses, if a determination is made that the ERC claim is legitimate. The ERC team is working with the Office of Servicewide Interest to calculate the amount of estimated credit interest that could potentially be paid because of the delayed processing of ERC claims.²¹ The ERC team is using these estimates to compare the risk of paying potentially erroneous ERC claims to the potential amounts of interest paid as it moves forward with its decisions on how to work the inventory. According to the IRS's estimates, the moratorium and additional time taken to analyze and process ERC claims will be a cost savings to the Government, *i.e.*, the IRS will pay less in interest on the legitimate claims when compared to the claims identified as high risk and likely erroneous.

Finally, on January 31, 2024, the U.S. House of Representatives passed legislation which would have prevented any credit or refund for the ERC for any claim filed after January 31, 2024.²² The legislation would have also extended the assessment statute of limitation for ERC claims to six years. However, as of September 2024, the legislation has not advanced further. IRS Commissioner Werfel has publicly commented that the legislation would be helpful in the IRS's administration of the ERC.²³

²¹ For ERC interest estimates, interest was calculated from the normal due date of the original return to an estimated overpayment refund date. Additionally, for amended returns processed within 45 days of receipt, interest on the overpayment generally stops accruing on the amended return received date – Internal Revenue Code § 6611(e)(2).

²² H.R. 7024 – Tax Relief for American Families and Workers Act of 2024 (118th Congress 2023-2024).

²³ IRS Commissioner Werfel Written Testimony before the House Ways and Means Committee on February 15, 2024.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to assess the IRS's processes to ensure the accuracy of both original and amended returns with the ERC, and the IRS's compliance initiatives to prevent or recover erroneous ERC. To accomplish our objective, we:

- Determined if the new eligibility checklist was accurate, complete, and streamlined for taxpayers.
- Determined whether the processes to identify potentially fraudulent original returns were working as intended during Calendar Year 2023.
- Met with IRS management to discuss their efforts to prevent or recover erroneous ERC and any new compliance initiatives they were considering.
- Assessed each of the IRS's new compliance initiatives, including the withdrawal option, the VDP, entity disallowance letters, recapture letters, educational notices, prerefund audits, and CI educational visits for accuracy and effectiveness.
- Reviewed a statistically valid stratified sample of 89 ERC withdrawal requests from the population of 932 ERC withdrawal requests processed by the IRS and determined whether the withdrawal requests were correctly processed and tracked. Our stratified sample was selected using a 95 percent confidence interval, a 50 percent error rate, and a ± 10 percent precision factor. We used a statistical sample because we planned to project the population. TIGTA's contract statistician assisted with developing the sampling plan.
- Determined whether inconsistent and changing referral criteria resulted in potentially fraudulent ERC being processed and paid.

Performance of This Review

This review was performed at the Cincinnati, Ohio, and Ogden, Utah, Accounts Management locations during the period July 2023 through April 2024. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Major contributors to the report were Diana Tengesdal, Assistant Inspector General for Audit (Returns Processing and Account Services); Linna Hung, Director; Jeffrey Cullum, Audit Manager; Jaclynne Durrant, Lead Auditor; Van Warmke, Senior Auditor; Hee Koo Kang, Auditor; and Sandy Ramos, Auditor.

Data Validation Methodology

During this review, we obtained data extracts from the following:

- TIGTA's Data Center Warehouse: Accounts Management Services, Business Master File, Business Tax Return File, and the Correspondence Imaging Inventory.
- The IRS's Compliance Data Warehouse: Form 94X Accepted and Rejected Files, Form 94X-X Transcribed Data, Business Transaction History, and Small Business Administration Payment Protection Program Loan Data.
- The IRS's ERC Shared Drive: ERC Withdrawal Claims and VDP Applications.

Before relying on the data, we ensured that each file contained the specific data elements we requested. In addition, we selected judgmental samples of each extract and verified that the data in the extracts were the same as the data captured in IRS systems, such as the Integrated Data Retrieval System. We also performed analysis to ensure the validity and reasonableness of our data, such as ranges of dollar values and obvious invalid values. We determined that the data were sufficiently reliable for purposes of this report.

Internal Controls Methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS management's processes for preventing erroneous ERC and identifying/recapturing erroneous ERC paid, and management's assessment of identifying low-, medium-, and high-risk ERC returns. We tested these internal controls by discussing IRS management's initiatives with them to understand the thought processes and requesting/reviewing all documentation related to each of IRS management's compliance initiatives to ensure that the logic was reasonable and fair.

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to Congress.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; \$19,087,019 in potentially erroneous refundable ERC claimed on 976 of the 997 tax returns that met updated identity theft filter criteria and should be part of a post-refund review (see Recommendation 1).¹

Methodology Used to Measure the Reported Benefit:

The IRS implemented three ERC identity theft filters. Using the IRS's filter criteria as of July 18, 2023, we replicated the three filters by querying the Business Return Transaction File as of July 20, 2023, for Forms 941 claiming the ERC during PYs 2021 through 2023. Our analysis identified 1,961 Forms 941 that met one or more of the updated identity theft filters but were not identified by the IRS because the updated filter criteria was not in place when these returns were processed. In addition, to be conservative, we also identified any transaction codes posted to the Business Master File Other Transactions Table as of October 26, 2023, that could reflect the potential for post-refund examinations or adjustments. As a result, we limited our results to 976 of the Forms 941 claiming \$19,087,019 in refundable ERC.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$544,285 in potentially erroneous nonrefundable ERC claimed on 773 of the 997 tax returns that met updated identity theft filter criteria and should be part of a post-refund review (see Recommendation 1).

Methodology Used to Measure the Reported Benefit:

The IRS implemented three ERC identity theft filters. Using the IRS's filter criteria as of July 18, 2023, we replicated the three filters by querying the Business Return Transaction File as of July 20, 2023, for Forms 941 claiming the ERC during PYs 2021 through 2023. Our analysis identified 1,961 Forms 941 that met one or more of the updated identity theft filters but were not identified by the IRS because the updated filter criteria was not in place when these returns were processed. In addition, to be conservative, we also identified any transaction codes posted to the Business Master File Other Transactions Table as of October 26, 2023, that could reflect the potential for post-refund examinations or adjustments. As a result, we limited our results to 773 Forms 941 claiming \$544,285 in nonrefundable ERC.

¹ Since a taxpayer may claim both a refundable and nonrefundable ERC amount, the total number of tax returns, Forms 941-X, and entities will not be equal in each set of outcome measures presented in Appendix II.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; \$1,772,359,718 in refundable ERC claimed on 182,717 of the 184,923 Forms 941-X for Tax Years 2020 and 2021 that were not considered for possible examination due to changing referral criteria (see Recommendation 2).

Methodology Used to Measure the Reported Benefit:

The IRS doubled the threshold for its examination referral criteria for Accounts Management employees processing Forms 941-X with the ERC and changed its criteria to include only returns that met specific return scenarios when considering potential referral. Specifically, our review identified:

- 138,415 amended returns with refundable ERC of \$16,714,212,232 processed by the IRS between January 6, 2022, and June 29, 2023, that exceeded the IRS’s original threshold but was below the IRS’s updated threshold. The IRS’s referral data from January 2022 (prior to changes discussed in the report) showed that [REDACTED] of returns referred were selected. In addition, Fiscal Year 2024 examination closure results as of April 11, 2024, showed that [REDACTED] of all closed ERC examinations resulted in a full disallowance of the ERC. Based upon this, we estimate that \$824,010,663 ($\$16,714,212,232 \times [REDACTED] \times [REDACTED]$) in refundable ERC may have been allowed because of the IRS doubling its threshold and not considering these returns for possible examination, as it had previously.
- 44,302 amended returns with refundable ERC of \$19,236,289,147 processed by the IRS between November 7, 2022, and June 29, 2023, that met the IRS’s updated threshold for referral but were not tested on nine scenarios developed to identify potentially erroneous ERC or referred for possible examination. The IRS’s referral data from January 2022 (prior to changes discussed in the report) showed that [REDACTED] of returns referred were selected. In addition, Fiscal Year 2024 examination closure results as of April 11, 2024, showed that [REDACTED] of all closed ERC examinations resulted in a full disallowance of the ERC. Based upon this, we estimate that \$948,349,055 ($\$19,236,289,147 \times [REDACTED] \times [REDACTED]$) in refundable ERC may have been allowed because of the IRS limiting its referral criteria to specific potentially erroneous ERC scenarios.

$$\$1,772,359,718 = \$824,010,663 + \$948,349,055.$$

Management’s Response: IRS management disagreed with this outcome. All returns processed with the ERC will be checked for potentially excessive or improper payment under their recapture program. The IRS will consider additional post-refund compliance actions after assessing competing priorities, available resources, and time remaining on the statute of limitations. The IRS cannot determine the corresponding dollar amounts until appropriate actions are taken to review and address the Forms 941-X.

Office of Audit Comment: As management noted in its response, administering the ERC was complex and resource intensive. Our outcome measure illustrates the impact on tax administration of ERC claims that were not considered for examination due to changing referral criteria. The actual amount of the

Management Took Actions to Address Erroneous Employee Retention Credit Claims; However, Some Questionable Claims Still Need to Be Addressed

approximately \$1.8 billion in cost savings is contingent upon the IRS's ability to review the potentially excessive or improper payments as part of its post-refund compliance activities and on the extent that taxpayers can adequately substantiate these claims once contacted.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$284,551,288 in nonrefundable ERC claimed on 168,836 of the 184,923 Forms 941-X for Tax Years 2020 and 2021 that were not considered for possible examination due to changing referral criteria (see Recommendation 2).

Methodology Used to Measure the Reported Benefit:

The IRS doubled the threshold for its examination referral criteria for Accounts Management employees processing Forms 941-X with the ERC and changed its criteria to include only returns that met specific return scenarios when considering potential referral. Specifically, our review identified:

- 127,581 amended returns with nonrefundable ERC of \$2,748,745,346 processed by the IRS between January 6, 2022, and June 29, 2023, that exceeded the IRS's original threshold but was below the IRS's updated threshold. The IRS's referral data from January 2022 (prior to changes discussed in the report) showed that [REDACTED] of returns referred were selected. In addition, Fiscal Year 2024 examination closure results as of April 11, 2024, showed that [REDACTED] of all closed ERC examinations resulted in a full disallowance of the ERC. Based upon this, we estimate that \$135,513,146 ($2,748,745,346 \times [REDACTED] \times [REDACTED]$) in nonrefundable ERC may have been allowed because of the IRS doubling its threshold and not considering these returns for possible examination, as it had previously.
- 41,255 amended returns with nonrefundable ERC of \$3,023,086,045 processed by the IRS between November 7, 2022, and June 29, 2023, that met the IRS's updated threshold for referral but were not tested on nine scenarios developed to identify potentially erroneous ERC or referred for possible examination. The IRS's referral data from January 2022 (prior to changes discussed in the report) showed that [REDACTED] of returns referred were selected. In addition, Fiscal Year 2024 examination closure results as of April 11, 2024, showed that [REDACTED] of all closed ERC examinations resulted in a full disallowance of the ERC. Based upon this, we estimate that \$149,038,142 ($\$3,023,086,045 \times [REDACTED] \times [REDACTED]$) in nonrefundable ERC may have been allowed because of the IRS limiting its referral criteria to specific potentially erroneous ERC scenarios.

$\$284,551,288 = \$135,513,146 + \$149,038,142.$

Management's Response: IRS management disagreed with this outcome. All returns processed with the ERC will be checked for potentially excessive or improper payment under their recapture program. The IRS will consider additional post-refund compliance actions after assessing competing priorities, available resources, and time remaining on the statute of limitations. The IRS cannot determine the corresponding dollar amounts until appropriate actions are taken to review and address the Forms 941-X.

Office of Audit Comment: As management noted in its response, administering the ERC was complex and resource intensive. Our outcome measure illustrates the impact on tax administration of ERC claims that were not considered for examination due to changing referral criteria. The actual amount of the approximately \$285 million in revenue protection is contingent upon the IRS's ability to review the potentially excessive or improper payments as part of its post-refund compliance activities and on the extent that taxpayers can adequately substantiate these claims once contacted.

Type and Value of Outcome Measure:

- Cost Savings (Funds Put to Better Use) – Potential; \$94,302,374 in refundable potentially erroneous ERC claimed by 852 of the 923 entities that should have received a disallowance letter but were not initially identified by the IRS (see Recommendation 3).

Methodology Used to Measure the Reported Benefit:

The IRS identified entities that should receive an ERC disallowance letter and provided TIGTA with its criteria for identifying these entities and a list of entities identified. Using the IRS's criteria, we identified Forms 941-X reporting the ERC from the Correspondence Imaging Inventory that was received by the IRS as of September 14, 2023. These returns were limited to tax periods ending June 30, 2020, through December 31, 2021. Using Business Master File data, we limited our results to entities that were established after the ERC eligibility period, *i.e.*, December 31, 2021. We also analyzed Forms W-2 filed for Tax Years 2019, 2020, and 2021 to determine whether the entities were eligible to claim the ERC. We then compared our population to the population provided by the IRS and identified 50 entities established after December 31, 2021, and 873 entities with returns for the ERC that had no Forms W-2 filed, that were not initially identified by the IRS, and that did not receive an ERC disallowance letter. We identified a total of 923 entities (50 + 873) with 852 entities claiming refundable ERC totaling \$94,302,374.

Type and Value of Outcome Measure:

- Revenue Protection – Potential; \$10,712,328 in nonrefundable potentially erroneous ERC claimed by 686 of the 923 entities that should have received a disallowance letter but were not initially identified by the IRS (see Recommendation 3).

Methodology Used to Measure the Reported Benefit:

The IRS identified entities that should receive an ERC disallowance letter and provided TIGTA with its criteria for identifying these entities and a list of entities identified. Using the IRS's criteria, we identified Forms 941-X reporting the ERC from the Correspondence Imaging Inventory that was received by the IRS as of September 14, 2023. These returns were limited to tax periods ending June 30, 2020, through December 31, 2021. Using Business Master File data, we limited our results to entities that were established after the ERC eligibility period, *i.e.*, December 31, 2021. We also analyzed Forms W-2 filed for Tax Years 2019, 2020, and 2021 to determine whether the entities were eligible to claim the ERC. We then compared our population to the population provided by the IRS and identified 50 entities established after December 31, 2021, and 873 entities that had no Forms W-2 filed, that were not initially

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identified by the IRS, and that did not receive an ERC disallowance letter. We identified a total of 923 entities (50 + 873) with 686 entities claiming nonrefundable ERC totaling \$10,712,328.

Management's Response to the Draft Report



CHIEF TAX COMPLIANCE OFFICER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

September 9, 2024

MEMORANDUM FOR DANNY R. VERNEUILLE
ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Heather C. Maloy ^{Digitally signed by Heather C. Maloy}
Chief Tax Compliance Officer _{Date: 2024.09.09 13:21:34 -0400}

SUBJECT: Draft Audit Report – Management Took Actions to Address
Erroneous Employee Retention Credit Claims; However, Some
Questionable Claims Still Need to Be Addressed (Audit No.:
202340030)

Thank you for the opportunity to review and comment on your draft audit report. Congress enacted the Employee Retention Credit (ERC) in the depths of the COVID-19 pandemic. The ERC was a lifeline to protect millions of jobs and provided economic support for businesses. We worked hard to implement the ERC and, as of September 2023, delivered about 3.6 million ERC claims worth approximately \$230 billion to businesses.

Last year, promoters intensified marketing efforts, with TV and radio ads urging people to file what they called “risk-free claims” for ERC with the IRS. They charged a percentage of the potential refund to file a claim for the business. At the same time tax professionals met with the IRS Commissioner. These tax professionals shared that the marketers were pulling in taxpayers that clearly didn’t qualify under the complex ERC requirements. At the same time, the IRS began to receive, on average, 50,000 to 60,000 claims a week.

The ERC is complex and resource intensive. Our challenges grew with the flood of promoter claims that were being filed. It has been a time-consuming process to implement an approach to separate valid claims from invalid claims. To counter the flood of claims and protect small businesses, in September 2023, we placed a moratorium on processing new ERC claims. We transcribed the paper Forms 941-X and developed a risk scoring approach. Currently, we are moving claims in the highest risk category for issuance of claim disallowance letters while also moving claims in the lowest risk category for processing. This is a measured and judicious approach to

**Management Took Actions to Address Erroneous Employee Retention
Credit Claims; However, Some Questionable Claims Still Need to Be Addressed**

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increase our pace and begin reducing the overall inventory of pending claims. We are moving forward to deny claims when they appear improper and moving to pay legitimate claims.

We appreciate TIGTA's recognition of our extensive efforts to administer this incredibly complex credit by balancing our need to identify and process valid ERC claims with preventing improper payments of claims as well as recapturing those improper claims already paid. We agree with the recommendations made in the report and already have taken actions or have actions planned to address the concerns raised.

Attached are our comments and proposed actions to your recommendations. If you have any questions, please contact me, or John J. McInelly, ERC Team Lead, Small Business/Self-Employed Division.

Attachment

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Attachment

Recommendations

RECOMMENDATION 1 (E-Mail Alert):

On February 28, 2024, we alerted the ERC Team Lead of our concern and recommended that the IRS review the 997 tax returns we identified and consider them for post-refund compliance review to recover potentially erroneous ERC paid.

CORRECTIVE ACTION 1 of 2:

We agree. Taxpayer Services previously identified 525 of these modules for potential recapture of an improperly paid credit. We will analyze the remaining 472 modules and refer these to Small Business/Self-Employed for recapture where appropriate.

IMPLEMENTATION DATE:

December 15, 2024

RESPONSIBLE OFFICIAL:

Director, Return Integrity Verification Program Management, Return Integrity and Compliance Services, Taxpayer Services Division

CORRECTIVE ACTION 1 of 2 MONITORING PLAN:

Taxpayer Services will monitor this corrective action as part of our internal management system of controls.

CORRECTIVE ACTION 2 of 2:

We agree. Small Business/Self-Employed will take appropriate action to address the 525 modules previously identified for a potential improperly paid credit as well as any additional modules referred to us by Taxpayer Services out of the remaining 472 TIGTA identified.

IMPLEMENTATION DATE:

May 15, 2025

RESPONSIBLE OFFICIAL:

Director, Specialty Exam Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION 2 of 2 MONITORING PLAN:

Small Business/Self-Employed will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2 (E-Mail Alert):

On February 28, 2024, we alerted the ERC Team Lead of our concern and recommended that the IRS review the 139,993 and 44,930 Tax Years 2020 and 2021 returns and consider them for post-refund compliance to recover potentially erroneous ERC paid.

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CORRECTIVE ACTION:

We partially agree. While Small Business/Self-Employed will check all returns processed with ERC for potentially excessive or improper payment under our recapture program, we cannot agree that the 139,993 and 44,930 Tax Years 2020 and 2021 returns included potentially erroneous ERC paid simply because the returns did not meet the referral criteria. We will consider additional post-refund compliance actions to recover potentially erroneous or excessive ERC paid after assessing competing priorities, available resources, and time remaining on the statute of limitations.

IMPLEMENTATION DATE:

August 15, 2025

RESPONSIBLE OFFICIAL

Director, Specialty Exam Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

Small Business/Self-Employed will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 3:

The Commissioner, Small Business/Self-Employed Division, should ensure that the 923 entities we identified receive a disallowance letter to prevent erroneous ERC claims from being paid.

CORRECTIVE ACTION 1 of 2:

We agree. These entities were previously identified by the IRS. Small Business/Self-Employed will provide Taxpayer Services with a list of the 923 modules to be issued disallowance letters.

IMPLEMENTATION DATE:

November 15, 2024

RESPONSIBLE OFFICIAL

Director, Specialty Exam Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION 1 of 2 MONITORING PLAN:

Small Business/Self-Employed will monitor this corrective action as part of our internal management system of controls.

CORRECTIVE ACTION 2 of 2:

We agree. Upon receipt of the list of 923 modules from Small Business/Self-Employed, Taxpayer Services will issue disallowance letters where appropriate.

**Management Took Actions to Address Erroneous Employee Retention
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IMPLEMENTATION DATE:

June 15, 2025

RESPONSIBLE OFFICIAL

Director, Accounts Management, Customer Account Services, Taxpayer Services
Division

CORRECTIVE ACTION 2 of 2 MONITORING PLAN:

Taxpayer Services will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 4:

The Commissioner, Small Business/Self-Employed Division, should ensure that any subsequent analysis to identify businesses for recapture letters uses accurate wage data and takes into consideration lessons learned from the Tax Year 2020 recapture letters.

CORRECTIVE ACTION:

We agree. Small Business/Self-Employed will ensure the strategy for identifying businesses for recapture for subsequent tax years is updated to include a secondary source for analysis of Form W-2, *Wage and Tax Statement*, data prior to contacting the taxpayer.

IMPLEMENTATION DATE:

December 15, 2024

RESPONSIBLE OFFICIAL

Director, Specialty Exam Policy, Small Business/Self-Employed Division

CORRECTIVE ACTION MONITORING PLAN:

Small Business/Self-Employed will monitor this corrective action as part of our internal management system of controls.

OUTCOME MEASURE:

Cost Savings (Funds Put to Better Use) – Potential; \$19,087,019 in potentially erroneous refundable ERC claimed on 976 of the 997 tax returns that met updated identity theft filter criteria and should be part of a post-refund review (see Recommendation 1).

IRS RESPONSE:

We agree there are indications that these returns contained potentially erroneous or improper ERC claims. We cannot determine the corresponding dollar amounts until appropriate actions are taken to review and address the returns as outlined in response to the Recommendation 1.

**Management Took Actions to Address Erroneous Employee Retention
Credit Claims; However, Some Questionable Claims Still Need to Be Addressed**

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OUTCOME MEASURE:

Revenue Protection – Potential; \$544,285 in potentially erroneous non-refundable ERC claimed on 773 of the 997 tax returns that met updated identity theft filter criteria and should be part of a post-refund review (see Recommendation 1).

IRS RESPONSE:

We agree there are indications that these returns contained potentially erroneous or improper ERC claims. We cannot determine the corresponding dollar amounts until appropriate actions are taken to review and address the returns as outlined in response to the Recommendation 1.

OUTCOME MEASURE:

Cost Savings (Funds Put to Better Use) – Potential; \$1,772,359,718 in refundable ERC claimed on 182,717 of the 184,923 Forms 941-X for Tax Years 2020 and 2021 that were not considered for possible examination due to changing referral criteria (see Recommendation 2).

IRS RESPONSE:

We disagree. All returns processed with ERC will be checked for potentially excessive or improper payment under our recapture program. We will consider additional post-refund compliance actions after assessing competing priorities, available resources, and time remaining on the statute of limitations. We cannot determine the corresponding dollar amounts until appropriate actions are taken to review and address the Forms 941-X.

OUTCOME MEASURE:

Revenue Protection – Potential; \$284,551,288 in non-refundable ERC claimed on 168,836 of the 184,923 Forms 941-X for Tax Years 2020 and 2021 that were not considered for possible examination due to changing referral criteria (see Recommendation 2).

IRS RESPONSE:

We disagree. All returns processed with ERC will be checked for potentially excessive or improper payment under our recapture program. We will consider additional post-refund compliance actions after assessing competing priorities, available resources, and time remaining on the statute of limitations. We cannot determine the corresponding dollar amounts until appropriate actions are taken to review and address the Forms 941-X.

OUTCOME MEASURE:

Cost Savings (Funds Put to Better Use) – Potential; \$94,302,374 in refundable potentially erroneous ERC claimed by 852 of the 923 entities that should have received a disallowance letter but were not initially identified by the IRS (see Recommendation 3).

**Management Took Actions to Address Erroneous Employee Retention
Credit Claims; However, Some Questionable Claims Still Need to Be Addressed**

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IRS RESPONSE:

We agree. These entities were previously identified by the IRS. We will issue disallowance letters where appropriate.

OUTCOME MEASURE:

Revenue Protection – Potential; \$10,712,328 in non-refundable potentially erroneous ERC claimed by 686 of the 923 entities that should have received a disallowance letter but were not initially identified by the IRS (see Recommendation 3).

IRS RESPONSE:

We agree. These entities were previously identified by the IRS. We will issue disallowance letters where appropriate.

Glossary of Terms

Term	Definition
Business Master File	The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.
Business Return Transaction File	Receives business tax return data, reformats and posts returns to the Return Transaction File, and does periodic file maintenance.
Fiscal Year	Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.
Integrated Data Retrieval System	IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.
Processing Year	The calendar year in which the IRS processes the tax return or document.
Refundable Tax Credit	Can be used to reduce a taxpayer's tax liability to zero. Any excess of the credit beyond the tax liability can be refunded to the taxpayer. A taxpayer can receive a refund even if they did not owe taxes or earn income.
Statute of Limitations	The time period established by law to review, analyze, and resolve taxpayer and IRS tax-related issues.
Tax Year	A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.
Transaction Code	A three-digit code used to identify actions being taken on a taxpayer's account.

Abbreviations

CARES Act	Coronavirus Aid, Relief, and Economic Security Act
CI	Criminal Investigation
ERC	Employee Retention Credit
IRS	Internal Revenue Service
PY	Processing Year
TIGTA	Treasury Inspector General for Tax Administration
VDP	Voluntary Disclosure Program



**To report fraud, waste, or abuse,
contact our hotline on the web at www.tigta.gov or via e-mail at
oi.govreports@tigta.treas.gov.**

**To make suggestions to improve IRS policies, processes, or systems
affecting taxpayers, contact us at www.tigta.gov/form/suggestions.**

Information you provide is confidential, and you may remain anonymous.