PILLA TALKS TAXES

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The Employee Retention Credit

Congress Extends the Refundable Credit For Employment Taxes

The Employee Retention Credit (ERC) was created as part of the CARES Act in March 2020. It is intended to provide incentive for businesses to keep employees on the payroll despite COVID restrictions on economic activity. It was originally slated to terminate on December 31, 2020. However, since its creation, the ERC has gone through one major revision and two extensions, the latest one pushing the credit through December 2021.

OVERVIEW OF THE CREDIT

Rather than comparing the workings of the credit it its initial form as expressed in the CARES Act, I will parse only the elements of new Internal Revenue Code §3134. The ERC is now codified there, as amended by both the Taxpayer Certainty and Disaster Tax Relief Act (Division EE of the Consolidated Appropriations Act, 2021 (December 30, 2020)), and the American Rescue Plan Act (March 11, 2021).

The Relief Act amended and extended the ERC for the first and second calendar quarters of 2021. The American Rescue Plan Act modified and extended the credit for the third and fourth quarters of 2021. The zigzagging is mind-boggling. This article focuses on the application of the ERC for the third and fourth quarters of 2021.

IN THIS ISSUE

The maximum credit against a business's employment taxes is equal to 70% of wages paid during the quarter for which the credit is sought (with important limits). The credit applies only to the employer's share of certain employment taxes assessed on the wages paid to employees. The ERC is a refundable credit for certain companies, meaning that you can actually get back more money from the IRS than you paid in.

I discuss these and other issues in more detail below.

WHO QUALIFIES FOR THE CREDIT?

The credit is available to all employers, regardless of the number of employees, including tax-exempt organizations. To qualify, your business must meet two broad criteria. First, it must constitute an "eligible employer." Second, there must be a minimum drop in business gross receipts. I discuss these elements in turn.

1. Eligible employer. An eligible employer is a business with employees that meets the following two elements:

   a. It was conducting business activity for profit during the quarter for which the credit is claimed, and

   b. Its operations were "fully or partially suspended" during the quarter for which the credit is sought, due to state or local government shut-down orders limiting commerce, travel or group meetings (for commercial, social, religious, or other purposes) expressly because of COVID–19. See: Code §3134(c)(2)(A).

2. Drop in gross receipts. There must be a drop in gross receipts (defined below) for the quarter in which the credit is sought. Gross receipts for the quarter in question must be less than 80 percent of the gross receipts for the corresponding quarter of calendar year 2019. See: Code §3134(c)(2)(A).

For example, suppose your third quarter 2019 gross receipts were $50,000. To qualify for the credit in the third quarter of 2021, your gross receipts can be no greater than $39,950 (50,000 x .799). Keep in mind that receipts must be "less than" 80% of those for the comparable quarter in 2019.

This rule is determined on a quarter-by-quarter basis. Thus, a drop in gross receipts for a single quarter compared to the corresponding quarter in 2019 makes the business eligible for the credit, even if revenue in the other quarters is at or higher than 2019 levels.

WHAT ARE GROSS RECEIPTS?

The ability to claim the credit is tied to a drop in "gross receipts," not lost profit. See: §3134(c)(2)(A). There is a remarkable difference between the two. Gross receipts are defined by the regulations under Code §448(c) as total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources.

Think of gross receipts as all the money flowing into your business from sales, before paying a nickel's worth of operating expenses. On the other hand, "profit" is the money left over, available for the business owners to live on or use at their discretion, after paying business expenses (but before taxes). For businesses, income tax is paid on profits—not on gross receipts.

You are entitled to the ERC even if your business is profitable in 2021, but suffered a drop in gross receipts, computed on a quarter-by-quarter basis, compared to comparable quarters in 2019.

IF YOUR BUSINESS WAS NOT OPERATING IN 2019

If your business was not operating in 2019, you are considered a "recovery startup businesses." This is a business that began operations after February 15, 2020. See: §3134(c)(5). In this case, you qualify for the credit if your average annual gross receipts for the three-year period preceding the quarter in which the credit is sought does not exceed $1,000,000.

Now, my question is this: If your business was not in operation on or before February 15, 2020, how can you have a prior three-year average of gross receipts in any amount? This language seems superfluous. It seems that the mere facts that your business was in operation only after February 15, 2020, and you earned under $1,000,000, qualify you as long as you paid wages during the quarter for which you apply for the credit.

If you were not in business in 2019, for purposes of the 2021 credit, you must compare your revenue in the corresponding quarter of 2020. See: Code §§3134(c)(2)(A)(ii)(III) and (c)(3)(B).

CALCULATING THE CREDIT

The language explaining the allowable credit amount is incredibly misleading. Consider this statutory language.

Section 3134(a) provides that the credit is "equal to 70 percent of the [wages] with respect to each employee" for the quarter in question. Section 3134(b)(1)(A) states the amount of wages "to any employee which may be taken into account under subsection (a)…for any quarter shall not exceed $10,000."

From this reading, one would believe that we are entitled to a credit of a maximum of $7,000 ($10,000 x .7) against the employment taxes owed on *each employee* for each quarter. In most cases, this would be a massive amount of money, even if there were just a few employees. But that's not the end of it.

Section 3134(b)(2) states that the credit allowed under (a) "shall not exceed the applicable employment taxes" assessed against the employer on the wages paid to the employees. Most certainly, the employment taxes assessed on wages paid do not even approach the amount of 70% of wages. Indeed, the specific employment taxes for which the credit applies are identified in §3134(c)(1). That section provides that the credit applies only to the employment taxes assessed under code §3111(b). That section imposes a tax of 1.45% of wages paid to every employee for "hospital insurance."

So in reality, the credit is limited to 1.45% of wages paid to employees, but the wages are capped at $10,000 per employee per quarter. If we have five employees, and each is paid $40,000, the cap for purposes of the credit calculation is $50,000 (5 x. 10,000). Next, we are entitled to a maximum of 1.45% as the credit on the $50,000, which is $725 (50,000 x .0145).

So how does the 70% figure mentioned in §3134(a) apply? I don't know. Regardless, the cap imposed by subsection (b)(2) (the 1.45% number) seems to control.

For purposes of the credit, wages are not limited to cash payments. Wages also include a portion of the cost of employer provided health care.

HOW QUALIFYING WAGES ARE FIGURED

Qualifying wages are based on the average number of employees in 2019. If you had *more than* 100 employees on average in 2019, the credit is allowed only for wages paid to employees who did *not* work during the current quarter for which the credit is claimed. This is because the credit is designed to incentivize employers to keep paying workers even if they don't work.

If you had 100 or fewer employees on average in 2019, the credit is based on wages paid to all employees during the quarter, whether or not they worked. Thus, most employers will qualify for the credit even if all of their employees continued to work.

SEVERELY FINANCIALLY DISTRESSED EMPLOYERS

The above rule is a bit different if you qualify as a "severely financially distressed employer." This is an employer whose gross receipts for the period in question are less than 10% of those for the corresponding calendar quarter in 2019. For example, suppose your gross receipts for the third quarter of 2019 were $50,000. To qualify, your gross receipts for the third quarter of 2021 must be "less than" $5,000 (50,000 x .1). See: §3134(c)(3)(C).

In that case, wages paid to any employee, whether they worked for not, count for purposes of the credit.

HOW TO CLAIM THE CREDIT

You can get the immediate benefit of the credit by simply reducing your required periodic deposits of payroll taxes. For example, if your current required payroll deposit amount is $5,000 (including amounts withheld from employees' wages), and your allowable credit is $2,000, you simply deposit the difference ($3,000) through your usual deposit ritual. You will not owe a penalty for reducing the deposit amount based on the allowable credit. You will account for the difference when you file Form 941, *Employer's Quarterly Federal Tax Return,* for the quarter.

THE CREDIT IS REFUNDABLE

The ERC is refundable, meaning that if your employment tax liability for a given quarter drops below zero because of the credit, the difference is refundable to you. In this regard, the credit operates much like the Earned Income Tax Credit.

ADVANCE PAYMENTS

Small employers can actually elect to get a check in the mail from the IRS as an "advance payment" of the ERC. In this sense, the credit works just like the Recovery Rebate Credit that was passed out to individuals twice during 2020, and again in 2021 (and perhaps, yet again later this year). The checks to individuals are in fact tax credits paid upfront by the IRS in the form of a check, rather than waiting to claim them on tax returns.

Employers with not more than 500 employees during 2019 (or 2020 if not in business in 2019) may elect "to receive an advance payment of the credit" from the IRS. The precise manner of making the election and receiving the check will be determined by the IRS through regulations. See: §3134(j). Do this by submitting Form 7200, *Advance Payment of Employer Credits Due to COVID-19.*

NO DOUBLE-DIP

The ERC is limited based on all the other funding programs that have come down the pike in the last year. Section 3134 precludes the ERC to the extent that so much of the wages paid during the quarter in question were taken into account with respect any of the following programs:

1. Paycheck Protection Program (PPP) loans,
2. So-called §7(a) SBA loans,
3. The Shuttered Venue Operators Grant (see the February 2021 issue of PTT for the details of the program), or
4. The Restaurant Revitalization Grant (see the March 2021 issue of PTT for the details of the program).

On the other hand, if it is determined that all or part of your PPP or SBA loan was not forgiven, the wages paid with the proceeds of such loans do count for ERC purposes. The IRS must issue regulations to help businesses sort through this morass. See: §3134(h).

EXCLUSIONS

Any employer that is a federal, state or local government agency or body does not qualify for the ERC. See: §3134(f).

EXTENSION OF THE STATUTE OF LIMITATIONS

The troubling part of the ERC statute is the effect it has on the assessment statute of limitations. Ordinarily, the IRS has just three years from the date a return is filed in which to make an assessment of tax with respect to that return. This is known as the assessment statute expiration date (ASED).

Employment tax returns are filed quarterly. The assessment statute begins running the date the final return is filed for the calendar year in question. For example, returns for the four quarters of 2020 are filed in April, July, October of 2020, and January 2021. The three-year ASED for all four returns begins to run as of the date of filing the return for the fourth quarter (assuming all returns are filed on time).

However, for any return that claims the ERC, the ASED is five years from the date the return is filed. Based on the two-year extension of the ASED, you can be sure the IRS is serious about auditing and enforcing the rules covering the ERC.

CONCLUSION

The ERC offers substantial tax savings to businesses with employees that must be considered. It will afford substantial savings to those who qualify. However, §3134 is another massively complex statute, in a long line of massively complex statutes, which have emerged from Congress over the past year. Therefore, before embarking on this claim, be sure to consult counsel knowledgeable in this area.

The New Child Tax Credit

Welfare Payments Administered by the IRS

One of the biggest problems the IRS faces as the federal government usurps more authority over the lives of the average American is "mission creep." This is where Congress assigns to the IRS responsibilities beyond the mere task of tax collection.

This has been a major problem since the Obama Administration and the adoption of the Affordable Care Act. In addition, there are as least six "refundable" tax credits in the tax code. A tax credit is a provision that reduces one's final tax bill, dollar-for-dollar. A tax credit differs from tax deductions and exemptions, which reduce taxable income, rather than your final tax bill directly. Deductions and exemptions reduce one's tax liability by the amount deducted multiplied by the one's marginal tax rate.

Refundable credits work to give people more money in refunds than they actually paid in taxes in the first place. The most notable of these credits is the Earned Income Tax Credit. For all practical purposes, refundable credits are welfare programs administered by the IRS through the tax code, and driven by one's tax return.

Congress has again added to the list of refundable credits with a provision of the American Rescue Plan Act. Under the new law we have a substantially expanded Child Tax Credit. The credit is broken into two elements.

The first provides that households with children under age 6 may claim up to $3,600 per child as a credit. The second element applies for children ages 6 to 17. In that case, the credit is $3,000 per child. The new rules phase out the additional credit amount for single individuals with Adjusted Gross Income under $75,000, $112,500 for head of household, and $150,000 for married filing jointly.

The credit is now fully refundable for 2021 only. Under the current rules, one half of the credit will be mailed to taxpayers in monthly checks beginning in July 2021, continuing through December 2021. The other half will be claimed as a credit against taxes owed on the 2021 tax return (to be filed in April 2022). The Biden Administration is currently pushing to make the refundable aspect of the credit permanent through the American Families Act.

The refundable aspect of the credit promises to load even more duties on the IRS. The IRS must determine the amount to be sent to taxpayers every month. That must be based on one's income,

filing status, and both the number and ages of eligible children to accurately determine the payment to be mailed. The monthly payment system is slated to begin in July. That is probably wishful thinking. Please recall that it took about two years to set up the system of paying advance premium tax credits under Obamacare.

It is quite easy to see how Biden's plan of loading more refundable tax credits into the law, and making those credits subject to advance payments to citizens, will morph into a system of fixed monthly cash benefits paid by the federal government to tens of millions of American families.

Can you say "Universal Basic Income"?

False Narratives Drive IRS Funding Push

BY DANIEL J. PILLA

President Biden recently submitted to Congress his fiscal year 2022 discretionary spending request. Unsurprisingly, the president seeks more money for the IRS. Under the plan, the IRS's budget would grow by $1.2 billion (10.4 percent) over the 2021 appropriation. Almost 65 percent of the new money is directed squarely at enforcement. According to a statement by Treasury Secretary Janet Yellen, the budget "will increase resources for tax enforcement by $0.9 billion."

Specifically, the IRS wants to hire more auditors and tax collectors—including highly specialized auditors—to focus on high income earners, corporations and offshore transactions. The primary goal is to close the alleged "tax gap" attributable to the top 1 percent of income earners, which is thought to be substantially higher than previously believed.

The argument driving this thinking is "that 36% of federal income taxes unpaid are owed by the top 1% [of income earners] and that collecting all unpaid federal income tax from this group would increase federal revenues by about $175 billion annually." (Tax Evasion at The Top of The Income Distribution, National Bureau of Economic Research (NBER), Working Paper 28542, March 2021, pg 4)

As more government benefits are promised to a broader segment of the population the more desperate government becomes to collect money. And as the demand for revenue grows, it becomes increasingly necessary to break thumbs to get it. This attitude is abundantly clear in the messages sent to the public regarding the president's proposed appropriation.

What is not abundantly clear to the public is that the push to provide the IRS with more enforcement resources is driven by at least three false narratives. Let me elaborate.

1. <u>More money will be collected through increased enforcement</u>. The idea here is that the only way to collect more money is through increased enforcement. The facts indicate otherwise. It is well documented by the National Taxpayer Advocate (NTA) in her <u>Annual Reports to Congress</u> that 98 percent of all federal revenue is paid without the need of IRS enforcement. In 2019, $3.56 trillion was raked in by the federal government. Less than 2 percent of that was collected through enforcement actions.

If there's a problem, much of it stems from ignorance or confusion rather than willful tax evasion. The problem, as further documented repeatedly by the NTA, is we have a tax code consisting of more than 4 million words that was changed more than 5,900 times since 2001, not including the blizzard of changes in both 2017 (with the Tax Cuts and Jobs Act) and 2020 as a result of all the COVID changes. The tax code is mind-numbingly complex. This causes confusion, and more than anything else, confusion is what leads to the underpayment of taxes.

For this reason, policy makers simply must abandon their "Go-Get-'em" attitude in favor of education, outreach and assistance programs. The National Taxpayer Advocate, in her 2016 Annual Report to Congress (pg 50), stated that the IRS is "overly focused on enforcement" at the expense of understanding the full scope of factors responsible for underpayment, chief among them being tax law complexity. In fact, the NTA points out that "unnecessary coercion" can actually reduce voluntary compliance (pg 53).

People will largely do what the law requires *if* they know what the law requires. Yet the IRS has cut down its education and assistance programs (blaming reduced resources) but does not hesitate to beef up its enforcement arms. The current budget proposal continues to operate under the false assumption that enforcement spending will lead to a significant increase in collections. The truth is there is much more to be gained by helping people to comply with the law on the front end rather than grinding them into powder after the fact. Prevention is much cheaper than cure.

2. Taxpayers cheat on their taxes. The idea is that if people cheat on their taxes, it follows that more audit coverage (enforcement) will catch them and lead to more revenue. The problem is that the data driving this theory are proven to be unsound.

The NBER's report (mentioned above) is based exclusively on data mined by the IRS through National Research Program (NRP) audits. NRP audits are just what they purport to be—"research" audits in which the targeted returns are selected entirely at random. The audits are generally grueling, line-by-line exams. They are not instituted because the IRS believes or even suspects an error. Rather, they are designed to detect patterns of "cheating" among similarly situated taxpayers. NRP audit results are then used to build a database known as the Discriminate Income Function (DIF) system.

The DIF system compares every line of every tax return with statistical averages for persons in one's same income range and profession. If any line of the return is out of sync with the averages, the difference is scored. The higher the score, the greater the likelihood of an erroneous return; and therefore, the more likely the return will be selected for audit. About two-thirds of all returns selected for "routine" audits are selected through the DIF system. The DIF system effectively constitutes "financial profiling" of all Americans who file returns.

The problem with using NRP audit results to build the DIF database is that, as I document in my book, **How to Win Your Tax Audit**, the IRS's audit results are wrong between 60 and 90 percent of the time (depending on the issue). This high error rate is achieved due to a number of reasons, not the least of which is that tax examiners use tactics of bluff and intimation, misinformation and disinformation when talking to taxpayers about the law and their rights. This causes citizens to accept audit results that are inaccurate and which should be challenged, but typically are not.

In 1995, the IRS sought funding to run what was then known as the Taxpayer Compliance Measurement Program (TCMP). TCMP was the forerunner to the NRP. It operated in exactly the same way and for the same reason. On July 18, 1995, I provided testimony to the House Ways and Means Subcommittee on Oversight in opposition to funding that project.

I articulated over a dozen reasons why the results of most audits are inaccurate. The reasons I expressed then are equally valid today, especially the claim that a complicated tax code causes confusion for both tax pros and auditors. Keep in mind that my testimony occurred in 1995, before Congress treated us to more than 5,900 tax law changes.

Any "tax gap" analysis based on NRP audits is fundamentally flawed because the underlying audit results upon which the research is built are simply wrong. The reality is that people don't generally cheat on their taxes. True, they make mistakes, but precious few set out to deliberately cheat as evidenced by the 98:2 ratio of taxes paid without the need of IRS intervention. Rather, the overarching problem is the complexity of the tax code.

3. Your tax burden increases when others don't pay. Lawmakers, administrators and law enforcement personnel all sing the same tune when it comes to non-payment. They claim that when others don't pay their taxes, the amount honest people must pay necessarily increases to make up the difference.

Indeed, when IRS Commissioner Charles Rettig was recently asked about the allegation that the highest-income Americans were not paying their "fair share," he responded by saying: "If people aren't paying their fair share, it's borne by the people who are paying their fair share."

This proposition is, in a word, nonsense. There is no provision whatsoever—whether in the tax code, the regulations, IRS policy statements, or the countless thousands of court decisions interpreting tax law—that in

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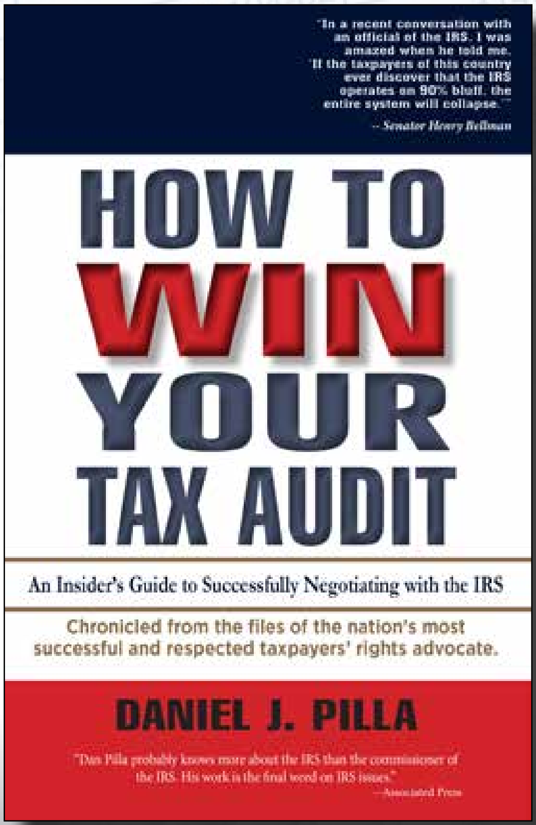

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any way imposes an increased burden on honest people because of the failures of dishonest people.

All you have to do is examine your tax return carefully, line by line. Look for any line on Form 1040—including any supporting schedule or statement—that contains words to the effect of, "additional tax owed because others didn't pay." There is no such line and there never was.

Your tax liability is determined solely and exclusively by your personal and financial facts and circumstances. In fact, it is a matter of settled law that taxes can be collected *only* from the person who actually owes the tax. See: *Acquilino v. United States*, 363 U.S. 509 (1960).

This argument is used only to inflame the passions and prejudices of the masses to justify the "Go-Get-'em" approach to tax administration. Your taxes are high (and getting higher) for one reason only: Congress spends too much of your money—period.

CONCLUSION

The single most important thing Congress can do to have a positive effect on compliance is to radically simplify the tax code. And I don't mean more tinkering around the edges such as we've seen for the past 25 years. It is time we come to grips with the reality that the current system is broken well beyond repair. It is time to bulldoze the graduated income tax system and start over with something that is truly simple, fair and efficient.

Further Legal Analysis of the "False Narrative"

BY SCOTT MACPHERSON

For weeks now, Americans coast to coast have been scrambling to file their 2020 federal income tax returns and pay their taxes. Regarding the income tax burden, politicians often speak of one's "fair share" — that is, all of us are supposed to pay our "fair share" of taxes. The assertion often repeated is that when one person does not pay his fair share, then the rest of us have to make up for it.

In this regard, IRS Commissioner Charles Rettig made the following assertion just last month:

> If people aren't paying their fair share, it's borne by the people who are paying their fair share."
>
> *[https://www.govexec.com/workforce/2021/04/irs-head-laments-growing-duties-amid-shrinking-workforce-we-do-get-outgunned/173333/]*

This assertion is patently false. Our tax statutes, regulations, and court opinions make it crystal clear, beyond any dispute, that the IRS cannot collect Taxpayer A's unpaid taxes from Taxpayer B. Restated in the Commissioner's language, if Taxpayer A does not pay his fair share, the loss is never borne by Taxpayer B.

I say this with reference to Treasury Regulation § 301.6203-1, which defines how a tax assessment is made. It provides, "The summary record, through supporting records, shall provide identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment." Take notice of this important fact: assessments are personal to a given taxpayer.

Internal Revenue Code § 6330 is the statute that requires the IRS to provide a taxpayer with the opportunity for a Collection Due Process hearing before any levy (seizure) of property is carried out in the collection of delinquent taxes. The statute further requires that, "The [hearing] officer shall at the hearing obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met." See: § 6330(c)(1).

One of the "procedures" that must be verified is the assessment procedure mentioned in the regulation above. That means that before any levy occurs against Taxpayer A, the IRS must have verified that Taxpayer A—not someone else—actually owes that debt.

Treasury Regulation § 301.6331-1(a)(1) clarifies this further. It provides that, "The district director may levy upon any property, or rights to property, whether real or personal, tangible or intangible, belonging to the taxpayer." Belonging to whom? Belonging to that specific individual taxpayer who actually owes the tax!

This is not just my interpretation of the statutes and regulations. This is the opinion also of the U.S. Supreme Court, as it so held in *Aquilino v. U.S.*, 363 U.S. 509, 513 (1960) and then restated in *Drye v. U.S.*, 528 U.S. 49, 55 (1999). According to the Supreme Court, the IRS can levy on the property of Citizen A in fulfillment of Citizen A's tax debt, but the IRS cannot levy on anyone else's property in fulfillment of Citizen A's tax debt.

For the IRS Commissioner to suggest otherwise betrays a shocking level of ignorance regarding the laws that he should be familiar with. For our elected legislators to suggest otherwise provides clear evidence that they are deliberately manipulating the emotions of the public with such bogus claims.

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How You Can Ask Dan Pilla a Question

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