Statement of Roger Harris, President of Padgett Business Services

Hearing on the Employee Retention Tax Credit Experience: Confusion, Delays, and Fraud

United States House of Representatives
Committee on Ways and Means
Subcommittee on Oversight

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Chairman Schweikert, Ranking Member Pascrell, and members of the House Committee on Ways and Means' Subcommittee on Oversight, thank you for the opportunity to testify today regarding the Employee Retention Tax Credit (ERTC).

My name is Roger Harris, and I am the President of Padgett Business Services based in Athens, Georgia.

Padgett is a national accounting, advisory, and tax preparation company with approximately 200 offices across the U.S. that has served tens of thousands of small business clients for 60 years. Prior to becoming President of Padgett in 1992, I ran one of the largest Padgett franchises with the company for 10 years. I have long been passionate about the intersection of small business and taxation.

I had the honor of serving as chairman of the Internal Revenue Service Advisory Council (IRSAC) in 2002 and 2003 and always welcome the opportunity to provide feedback to Congress on how to improve our tax system for small businesses.

Throughout the pandemic, we all saw first-hand both the positive impacts and unintended consequences that many of the legislative changes had on small businesses and other taxpayers.

I want to thank the committee for holding this hearing and putting a brighter spotlight on the ERTC and its existing concerns and opportunities. In examining how the ERTC played out, I am first and foremost cognizant of the circumstances under which this tax credit came about. We were in the middle of a pandemic, small businesses were fighting for their survival, and the ERTC was developed to provide a lifeline to businesses and keep Americans employed. Congress and the IRS did not have the time to develop and implement the perfect program and I believe that would have been an unrealistic standard given the urgency of the situation. I do believe, however, that there are lessons from the ERTC implementation that we must learn from, as well as steps we can take moving forward to improve some of the current challenges.

Throughout the pandemic, Padgett had the privilege of helping small businesses secure relief funding and navigate many of the policy and regulatory issues that arose along the way. At Padgett, our daily work is primarily with what would be considered "mom and pop" small businesses. Our clients have on average less than 20 employees and come from a wide range of industries.

Rollout of the ERTC and the Paper 941-X

As this committee is well-aware, the ERTC was originally created by the Coronavirus Aid, Relief and Economic Security (CARES) Act and was later amended by the Consolidated Appropriations

Act (CAA), which Congress passed in December 2020. One of the changes made at the end of 2020 allowed a business to retroactively claim the ERTC even if the business had secured a Paycheck Protection Program (PPP) loan. Originally, under the CARES Act, businesses were forced to choose one relief program over the other. This change opened the opportunity for thousands of businesses that had received a PPP loan to go back and retroactively claim the ERTC for 2020.

While the change presented an additional lifeline for businesses, many of which continued to struggle due to the pandemic, it also created a challenge for the IRS which at the time was already struggling under the demands of the pandemic. One of the first critical decisions the IRS made in implementing the policy changes to the ERTC was that the retroactive credit needed be claimed on the 2020 tax returns, requiring businesses to amend their prior 941s in order to claim the credit. However, amended 941s (941-Xs) can only be filed on paper with no electronic option. Therefore, despite the warnings of many tax professionals, the decision by the IRS to not allow businesses to simply claim the retroactive credits on their upcoming quarterly 941 exacerbated an already massive paper backlog. In an attempt to reduce the backlog, suggestions were given to the IRS that they create a dedicated P.O. Box or a specific marking for these retroactive filings. Instead, the retroactive ERTCs were simply put in line with all the other 941-Xs, which already had a paper backlog of many months, therefore compounding the pre-existing problem.

Delay and Backlogs

At Padgett, we sought to help our eligible clients apply for the ERTC as soon as possible, helping to mitigate any delay. Many tax preparers, however, did not help their clients take this on immediately since they were in the throes of tax season. I think this delay by many in the tax professional community contributed to some of the issues we are seeing today.

Initially, most businesses had to wait 9-12 months to receive the credit aimed at helping them weather the pandemic. The wait soon became over a year or longer for some businesses. As many of us have witnessed, these backlogs have created an immeasurable amount of frustration for businesses as well as real financial harm.

Another Amended Tax Form

There are several additional issues beyond the initial claiming of the credit and backlogs that businesses have had to navigate in relation to the ERTC. As businesses began to receive the credit, many business owners and even some tax practitioners initially believed that once they received their money, they would be finished with the ERTC. However, a significant number of these businesses were required to amend their prior income tax return (1040) to account for the credit in the year which they qualified. For example, if they received the credit for tax year 2020, then the 2020 1040 would need to be amended, even though the funds arrived much later. This requirement came after Treasury clarified that, based on the statute, the taxpayer must reduce the wage expense equal to the amount of ERTC credits received.

For pass-through entities with multiple partners or shareholders, each partner or shareholder would be required to amend their 1040. In some cases, this could lead to hundreds of individuals having to amend their tax returns because one entity received the ERTC.

Ideally, small business taxpayers would have had the option to amend their prior income tax return *or* include the refunds as income on their current return, removing cumbersome administrative work and additional costs. This approach would have especially made sense for small businesses who use the cash method of accounting, since they already report their income and expenses in the year funds are received or expenses are paid.

In addition to the burden of having to amend their 2020 tax returns, in most cases a penalty notice is automatically generated since the tax liability increases from the amended 1040 will show up in the system as late (due to no fault at all from the taxpayer). The IRS acknowledged the potential penalties and the need for relief in a statement on April 18, 2022. As solutions, the IRS reminded taxpayers that they can seek relief by showing reasonable cause or under the IRS's First Time Penalty Abatement program. However, these are labor intensive and often time-consuming processes that are not available to all taxpayers (i.e., those that have already used their first-time penalty abatement). These options also lead to more paperwork and back and forth than an agency that is already backlogged and overwhelmed can handle.

Fraud Penetrates the Program and Complications Continue

There has been increased attention in recent months around potential fraud that is occurring in the ERTC program. The IRS has spoken out aggressively against this fraud and has warned taxpayers to be wary of advertisements around the ERTC. The IRS listed scams involving the ERTC on their Dirty Dozen list of tax scams and made clear that they are stepping up enforcement around ERTC claims. The IRS has also repeatedly warned about third parties who continue to widely advertise their services targeting taxpayers who may not be eligible for the ERTC.

At Padgett, we have seen the complications that these third-party mills have caused businesses and tax professionals. With our own clients, we did a thorough assessment early after the ERTC passed and changes were made to see who qualified for the credit and who did not. Many of these businesses, that we advised did not qualify for the credit, have since been approached by third-party mills who have erroneously asserted that the businesses actually qualify. A business may claim and receive a sizable ERTC without having to give any upfront justification to the IRS. Businesses simply must add the amount of the ERTC claim to their 941 filing. The lack of a documentation or certification requirement has fostered the environment we find ourselves in today.

One disadvantage for small businesses that use a third-party mill with questionable practices is that if they are eventually audited, they will be asked to furnish documentation on how they qualified for the ERTC and how the claimed credit was calculated. If this background documentation has not been provided to the business, then they could very likely be unable to demonstrate to the IRS how they qualified for and calculated the credit. As businesses are audited in future years, many of the third-party mills could very likely no longer be in existence.

IRS Issues Guidance for Tax Professionals

One area that has been particularly challenging for tax professionals involves the intersection between potential ERTC fraud and the need for businesses to reduce the wage expense equal to the amount of ERTC credits received in their 1040s. In a number of cases, Padgett has had businesses that used a third party to file for their ERTC come to us and request we amend their 1040 to adjust for the credit they received.

In guidance that was released by the IRS's Office of Professional Responsibility on March 7, 2023, it was stated, "[i]f the practitioner cannot reasonably conclude that the client is or was eligible to claim the ERC, then the practitioner should not prepare an original or amended return that claims or perpetuates a potentially improper credit." In situations where the tax preparer is not completely comfortable or convinced that the ERTC should have been taken in the first place, this creates the uncomfortable situation of having to decline to amend the 1040 for the client. It could also end up costing the government money, as the amended 1040 would have resulted in a higher tax liability for the taxpayer.

Returning ERTC and Deductibility of Fees

This situation raises an additional tax issue related to how you treat the large fees that many small businesses paid to third-party mills that calculated and applied for the ERTC on their behalf. The fees charged by many of these third-party mills have been reported to be a significant percentage of the amount of the ERTC credits, amounting to tens of thousands of dollars for many small business taxpayers. There have and will continue to be situations where a tax professional, relying on the OPR guidance, will decide not to file an amended 1040 out of fear that it would perpetuate an improper credit, and will advise the client to return the original ERTC. The question then

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arises, that if the client returns the ERTC received, can the fee paid to the third-party mills be claimed as a business deduction? One of the problems tax practitioners will confront in correcting an erroneous ERTC claim is that the taxpayer is asked to return 100% of the ERTC claimed when they only received a portion of the money because of the fees paid to the third-party mills. Not allowing the deduction only penalizes the small business owner who is trying to do the right thing and return an improper ERTC that they might have been initially misled to take. Additional guidance or clarification from the IRS on this deductibility issue is needed to help both tax practitioners as well as taxpayers.

Conclusion

The short history of the ERTC raises a wide range of issues and could serve as a case study for challenging and evolving tax policy. The credit was passed at a difficult time for both our country and the IRS and encompasses successes, challenges, and lessons learned. The ERTC has given thousands of businesses a lifeline and critical funds as they have come out of the pandemic. The wait, however, has been far too long for many businesses. The lack of controls when submitting for the credit have also led to excessive fraud.

Aspects of the ERTC remind us that failing to proactively address issues as they become apparent will only compound, making existing problems worse. The IRS must fundamentally change the way they address and get ahead of problems, including working with stakeholders and being willing to adapt and make changes in real time to overcome foreseeable obstacles. Leadership within the agency must set the tone and establish a culture that thinks strategically about potential problems in advance, rather than letting narrow decisions snowball into greater challenges for the agency.

I am pleased to say that Commissioner Werfel has begun taking those important steps. Since his confirmation in March, he has reached out to tax professionals and other stakeholders for input and has made addressing issues around the ERTC a top priority. He also understands the importance of modernizing IRS technology to help prevent these types of challenges in the future. I am hopeful that with Commissioner Werfel's leadership we will see real improvement at the IRS.