

ERC Abuse Revives Debate Over Contingency Fees

by Lauren Loricchio

As concerns mount over abuse of the employee retention credit program, some members of the tax community say contingency fee arrangements are partly to blame.

“Many transactions that the IRS has taken issue with over the years have included some type of contingency fee or some type of fee that was related to a refund or tax savings,” said Mary E. Wood of Meadows, Collier, Reed, Cousins, Crouch & Ungerman LLP. “Anytime you have that available, you just have the potential for more abuse.”

While the program began with the good intentions of helping employers keep employees on the payroll during the COVID-19 pandemic, Robert Kerr of Kerr Consulting LLC said he believes the structure of the credit practically begged for abuse and that “contingency fees served as kerosene” for the kindling.

The widespread use of contingency fee arrangements in the preparation of ERC claims has revived a debate about the fees and whether Congress should step in to curb their use.

The IRS has repeatedly warned taxpayers to be wary of ERC promoters charging fees based on a percentage of the refund amount. “You should always avoid a tax preparer basing their fee on the amount of the refund,” the agency says on its website.

The issue prompted IRS Commissioner Daniel Werfel to ask senators to ban contingency fees for preparing ERC returns, citing concerns that the fees have led businesses to file ERC claims they’re ineligible for. The Tax Relief for American Families and Workers Act of 2024 (H.R. 7024), which passed the House on January 31 and is awaiting action in the Senate, would allow the IRS to impose increased penalties on ERC promoters that charged contingency fees.

“Everyone seems to agree that the ERC is riddled with fraud and the driver of that fraud is promoters charging high fees,” Daniel Chodan of Trout CPA said in an email to *Tax Notes*.

Chodan said the bill doesn’t go far enough and that Congress should ban fees that are based on a percentage of a tax refund.

Observing that other tax areas will likely cause similar problems in the future, Chodan said the bill “might have been the best opportunity to set a broad structure in place for IRS enforcement of preparers and to remove percent-of-refund fee incentives.”

Proponents of the fees say they make sense for small businesses that can’t afford to pay large upfront fees for tax advice.

‘Skin in the Game’

ERC advisory firms — sometimes referred to as ERC mills — often charge contingency fees for their role in refund claims.

Although her firm doesn’t charge contingency fees for ERC claims, Rebecca Sheppard of Frost Law told *Tax Notes* that she has received pushback from clients who would prefer a contingent fee arrangement. Sheppard said she understands why contingency fees make people feel safe when the IRS is warning taxpayers about inaccurate and invalid claims.

“You’ve got skin in the game, the same as the taxpayer,” she said.

Circular 230, which governs the rules of practice before the IRS for accountants, enrolled agents, and lawyers, generally prohibits those covered from charging contingent fees. The prohibition extends to professionals helping to assemble and file claims for refunds or credits, the agency says.

However, federal court rulings have restricted the IRS’s ability to regulate return preparers and place restrictions on contingency fees related to tax refund claims.

The IRS took steps to regulate unenrolled preparers in 2010, but the regulations were challenged in court. In *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), Supreme Court Justice Brett M. Kavanaugh, then writing for a panel of the D.C. Circuit, held that the IRS lacked statutory authority to require tax return preparers to register with the agency or fulfill other regulatory requirements like Circular 230’s ethics rules.

That holding was extended in *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014), to the IRS’s attempt to apply a rule from Circular 230 against contingency fees to a CPA filing a refund claim.

The effect of the rulings was to restrict the application of Circular 230 to more active

engagements, like representing taxpayers in audits, and to exclude mere return preparation.

Loving created two tiers of tax professionals — those who are held to professional standards and those who aren't required to abide by them, according to Sharyn Fisk, director of the IRS Office of Professional Responsibility. The result is that those tax preparers can stay outside the scope of review of ethics organizations such as OPR, Fisk said January 19 during the American Bar Association Section of Taxation meeting.

Fisk pointed out that the average person can't distinguish between a practitioner subject to Circular 230 and someone preparing their taxes who isn't. "If there's misconduct by somebody who's not a practitioner, because they're not [subject to] regulations or sanctions — that affects us all," she said.

James Creech of Baker Tilly US LLP said at the ABA meeting that attorneys can hypothetically violate model rules such as those set forth by the ABA, but that unless the state bar acts on an attorney's law license, they can continue to practice.

Fisk also noted that an attorney's license could be suspended or revoked by her office. Fisk said OPR routinely checks with state boards for action taken regarding practitioners. She acknowledged that OPR doesn't have a routine reporting process with states regarding professionals who have been sanctioned under Circular 230.

The Biden administration's fiscal 2025 revenue proposals — released March 11 — would give the IRS the authority to regulate tax return preparers, which would in turn allow the agency to restrict contingency fees. Similar requests have been made since fiscal 2015.

Ethical Concerns

Contingency fee arrangements related to tax refund claims can lead to conflicts of interest because the tax return preparer has an economic stake in the claim being accepted and an incentive to maximize the refund claim, according to Christopher M. Ferguson of Kostelanetz LLP.

Ferguson said the potential conflict of interest is "exacerbated in the ERC context, because the firm is not just purely preparing the ERC claim forms, but in many of these cases they're making determinations as to eligibility."

The concern then comes down to whether the opportunity for a substantial contingency fee is clouding the judgment of firms that are providing the advice, Ferguson said.

Section 10.27 of Circular 230 states that practitioners can't charge an unconscionable fee in connection with any matter before the IRS.

"That is the part of 10.27 that was not touched by any of this case law," Karen Hawkins, who was OPR's director from April 2009 to July 2015, told *Tax Notes*.

Determining whether a fee is unconscionable depends on whether it's appropriate under the taxpayer's circumstances, said Hawkins, a member of Tax Analysts' board of directors.

If the taxpayer is aware of the rules and the risks they're taking, there may be a way to negotiate a contingency fee, Hawkins said. But in situations when a less savvy small business gets assistance, "taking advantage of them with any kind of a fee, I think, would be subject to question if it turns out to be the wrong kind of advice," she said.

The IRS clearly views contingency fees as being "a harbinger of firms who may be providing advice to taxpayers to claim the credit where it's not sustainable, because the fees present a potential conflict of interest," Ferguson said, adding that he expects the IRS's focus will be on the advice, not the contingency fee itself.

"What this is going to come down to isn't the fees per se, but the advice that's being given and whether the IRS is going to be able to show that there were false statements or that the people at the ERC firms are encouraging taxpayers to take positions that are not supportable," Ferguson said.

Kerr said that while he's also not a big fan of contingency fees, if return preparers charge them and give bad advice, there should be a way to claw back the proceeds.

Ferguson pointed out that while contingency fees led to problems with the ERC, the fees have helped raise awareness about the ERC program, which initially had a limited uptake. Once firms determined they could make a profit from the claims, they began to promote it. But the IRS got more than it bargained for, he said. ■

Nathan J. Richman contributed to this article.