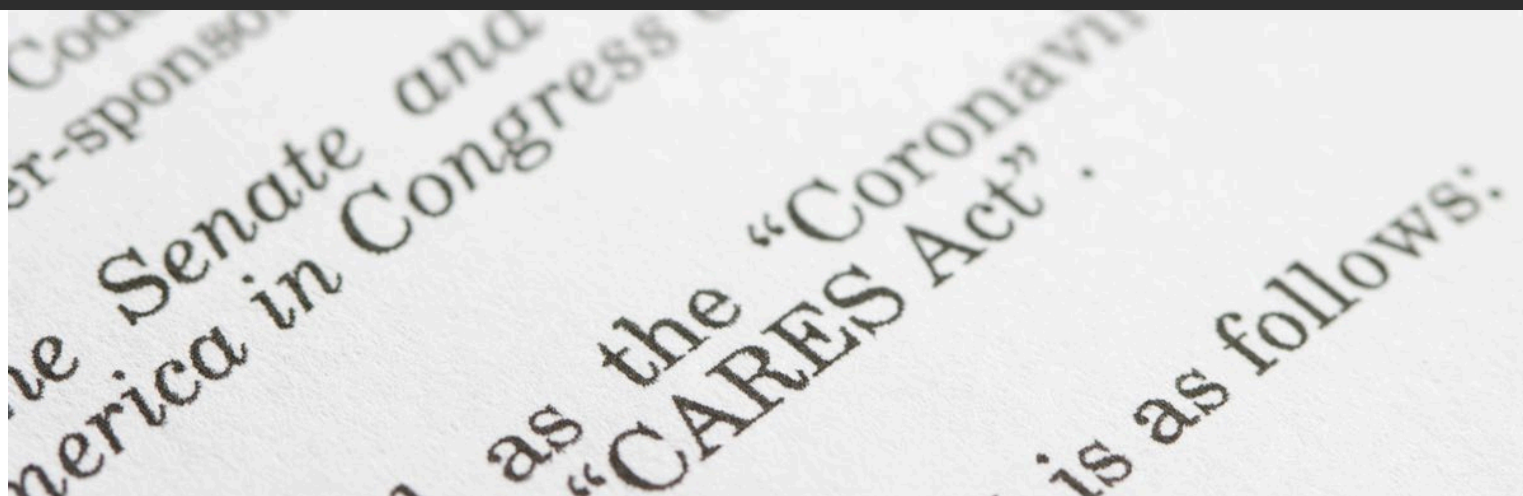


Alert | Health Emergency Preparedness Task Force: Coronavirus Disease (COVID-19)/Tax



July 2023

IRS Says General Supply Chain Disruptions Do Not Justify Employee Retention Credit

The IRS Office of Chief Counsel has published a [general legal memo](#) clarifying prior guidance to confirm that general supply chain disruptions alone do not justify a claim for the employee retention credit (ERC) under the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Some tax advisors tell businesses they are eligible to claim the ERC if their business suffered as a result of general supply chain disruptions. This new legal memo clearly states this is not the case. Because this is an entity-level tax, businesses should exercise caution in an M&A entity deal if the acquired company received the ERC due to supply chain disruptions. The IRS could claw-back the credit on a subsequent audit.

Congress enacted the ERC as part of the CARES Act and amended it twice to allow a refundable tax credit for wages paid between March 13, 2020, and Sept. 30, 2021. There is still time to file amended payroll tax returns to claim the ERC, but to do so, one of two threshold conditions must be satisfied: (1) the business must have experienced a substantial decline in gross receipts for the quarter wages were paid compared to the same quarter in 2019 (a more than 50% decline for 2020 quarters, or more than 20% decline for 2021 quarters); or (2) the operations of the business were either fully or partially suspended as a result of a COVID-19-related governmental order. (There are other requirements to claim the ERC, but these are the eligibility thresholds.)

If a business satisfies the gross receipts test – an objective, mechanical test – then it may be eligible for the ERC. However, many businesses are unable to satisfy the gross receipts test. After all, when the U.S.

government injects \$5 trillion into the economy, it stimulates economic activity. Consequently, a business that does not meet the gross receipts test must look to the alternative governmental order test to qualify for the ERC.

Under the governmental order test, a business must demonstrate that a governmental order either fully or partially suspended its operations either because the business was locked down (which was common in the early months of the pandemic) or because a governmental order required modifications to operations, having a more than nominal effect on business (defined in the guidance as a 10% or greater reduction in the business's ability to provide goods and services to its customers).

Initial guidance from the IRS (Notice 2021-20) states that to rely on supply chain disruptions as a basis to claim the ERC, a business must demonstrate that the operations of a critical supplier were suspended due to a COVID-19-related governmental order. For example, if a business required parts from a critical supplier to operate, but that supplier's operations were shuttered due to a government order, and the business was unable to find an alternate supplier, then the business would qualify under the governmental order test. The new legal memo reiterates the IRS's initial guidance. The legal memo sets out five general scenarios involving supply chain issues, each of which concludes that the business is **not** eligible to claim the ERC.

In scenario #1, a supplier told a business that shipping delays were the result of COVID-19, but did not tell the business about a specific governmental order. The memo concludes that such general supply chain disruptions do not rise to the level that would allow the credit. The lesson here is that if a critical supplier's business is suspended by a COVID-19-related governmental order, this should be documented, preferably by a written statement from the supplier and a copy of the specific governmental order that caused its business operations to be suspended.

In scenario #2, a critical supplier explained to a business that deliveries were delayed due to bottlenecks at the port to which the supplies were shipped, and due to a shortage of truck drivers to deliver supplies from the port. The legal memo concludes that the business cannot rely on the governmental order test to claim the credit because it cannot demonstrate the delivery delays were due to a governmental order.

In scenario #3, a critical supplier to a business had its operations suspended by a governmental order in April 2020, but the order was lifted the following month. However, the closure of the supplier's business resulted in delayed deliveries for the remainder of 2020 and 2021. The legal memo concludes that the business was eligible to claim the credit for wages paid in April 2020 during the period the supplier's business operations were suspended due to the governmental order, but not eligible to claim the credit for any periods after April 2020 following the expiration of the governmental order. Thus, supply chain disruptions resulting from residual delays after the expiration of a governmental order that suspended a supplier's operations are not a basis to claim the ERC.

In scenario #4, a supplier was unable to supply critical goods to a business, but the business was able to obtain the critical goods from an alternate supplier, but at a price 35% higher than its regular supplier charged. The legal memo concludes the business cannot use this supply chain disruption as a reason to claim the ERC because it was able to obtain the critical goods from an alternate supplier, even though at a higher price, reducing its profit. Consequently, when filing an ERC claim based on supply chain disruptions, evidence should be gathered (such as emails from suppliers) to demonstrate that there were no alternative suppliers from whom critical goods could be obtained at any price.

In scenario #5, a retail business was unable to obtain certain products due to supply chain disruptions, and had to raise its prices on other products, but it stayed in business notwithstanding these issues. The legal memo concludes that the retail business is not eligible to claim the credit on the basis of supply chain disruptions because the business was unable to demonstrate that the supplier's operations were suspended by a governmental order, and was able to maintain its retail business operations even though it was unable to sell some products.

Note that the legal memo does not address a situation where a supplier's business is located in a foreign country where the foreign government ordered a shutdown of the supplier's business. This is because a governmental order is defined in Notice 2021-20 as an order by the U.S. government, a U.S. state or a local government of a U.S. state. Consequently, an order of a foreign government would not technically qualify as a governmental order. As a result, if an acquired company claimed the ERC on the basis that a supplier was shut down due to a foreign government's order, the business should assume the IRS would disallow the credit on audit, until such time that further guidance clarifies this issue.

Author

This GT Alert was prepared by:

- [Marvin A. Kirsner](#) | +1 954.768.8224 | kirsnerm@gtlaw.com

Albany. Amsterdam. Atlanta. Austin. Berlin.~ Boston. Charlotte. Chicago. Dallas. Delaware. Denver. Fort Lauderdale. Houston. Las Vegas. London.* Long Island. Los Angeles. Mexico City.+ Miami. Milan.» Minneapolis. New Jersey. New York. Northern Virginia. Orange County. Orlando. Philadelphia. Phoenix. Portland. Sacramento. Salt Lake City. San Diego. San Francisco. Seoul.∞ Shanghai. Silicon Valley. Singapore.° Tallahassee. Tampa. Tel Aviv.^ Tokyo.* Warsaw.~ Washington, D.C.. West Palm Beach. Westchester County.

*This Greenberg Traurig Alert is issued for informational purposes only and is not intended to be construed or used as general legal advice nor as a solicitation of any type. Please contact the author(s) or your Greenberg Traurig contact if you have questions regarding the currency of this information. The hiring of a lawyer is an important decision. Before you decide, ask for written information about the lawyer's legal qualifications and experience. Greenberg Traurig is a service mark and trade name of Greenberg Traurig, LLP and Greenberg Traurig, P.A. ~Greenberg Traurig's Berlin office is operated by Greenberg Traurig Germany, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. *Operates as a separate UK registered legal entity. +Greenberg Traurig's Mexico City office is operated by Greenberg Traurig, S.C., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. »Greenberg Traurig's Milan office is operated by Greenberg Traurig Santa Maria, an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ∞Operates as Greenberg Traurig LLP Foreign Legal Consultant Office. °Greenberg Traurig's Singapore office is operated by Greenberg Traurig Singapore LLP which is licensed as a foreign law practice in Singapore. ^Greenberg Traurig's Tel Aviv office is a branch of Greenberg Traurig, P.A., Florida, USA. ¤Greenberg Traurig's Tokyo Office is operated by GT Tokyo Horitsu Jimusho and Greenberg Traurig Gaikokuhojimubengoshi Jimusho, affiliates of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. ~Greenberg Traurig's Warsaw office is operated by GREENBERG TRAUIG Nowakowska-Zimoch Wysokiński sp.k., an affiliate of Greenberg Traurig, P.A. and Greenberg Traurig, LLP. Certain partners in GREENBERG TRAUIG Nowakowska-Zimoch Wysokiński sp.k. are also shareholders in Greenberg Traurig, P.A. Images in this advertisement do not depict Greenberg Traurig attorneys, clients, staff or facilities. No aspect of this advertisement has been approved by the Supreme Court of New Jersey. ©2023 Greenberg Traurig, LLP. All rights reserved.*