The Truth About Supply Chain Disruptions and the Employee Retention Tax Credit

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ADVISORY NOTICE:

Taxes are complicated, tax law is complicated, and the Employee Retention Tax Credit has gotten really complicated. Our legal analysis contained in this guide is meant to be helpful and informative, but it is not a substitute for the real thing and is not intended to be used as tax advice in any particular situation. This analysis is current as of the date published and is also subject to change based on updates in guidance or in the law.

When determining whether or not you qualify for the Employee Retention Tax Credit, we ask that you do the responsible thing and have a qualified tax attorney review your situation. We do not fix the engines in our cars or perform open heart surgery based on what we can Google, so why should the qualification for a complex and nuanced tax credit be any different? Ultimately, the credit involves a legal analysis to determine eligibility, so get a lawyer.

TAX ADVICE NOTICE:

To ensure compliance with the requirements imposed by the United States Treasury and the IRS, we inform you that any federal tax advice contained in this communication (including attachments) is not intended or written to be used, and cannot be used for the purpose of: (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another person any transaction or matter addressed herein.

INTRODUCTION:

There has been a lot of commentary surrounding how a business can qualify for the Employee Retention Tax Credit (ERC) based on a supply chain disruption to its operations. In its relevant parts, IRS Notice 2020-21 states that a business can have a suspension of its operations due to a governmental order if a governmental order causes the suppliers of a business to suspend their operations.[1] The guidance reads:

Question 12:

If a governmental order causes the suppliers to a business to suspend their operations, is the business considered to have a suspension of operations due to a governmental order?

Answer 12:

An employer may be considered to have a full or partial suspension of operations due to a governmental order if, under the facts and circumstances, the business' suppliers are unable to make deliveries of critical goods or materials due to a governmental order that causes the supplier to suspend its operations. If the facts and circumstances indicate that the business' operations are fully or partially suspended as a result of the inability to obtain critical goods or materials from its suppliers because they were required to suspend operations, then the business would be considered an eligible employer for calendar quarters during which its operations are fully or partially suspended and may be eligible to receive the Employee Retention Credit.

Example:

Employer A operates an auto parts manufacturing business. Employer A's supplier of raw materials is required to fully suspend its operations due to a governmental order. Employer A is unable to procure these raw materials from an alternate supplier. As a consequence of the suspension of Employer A's supplier, Employer A is not able to perform its operations for a period of time. Under these facts and circumstances, Employer A would be considered an eligible employer during this period because its operations have been suspended due to the governmental order that suspended the operations of its supplier.

1 See Notice 2021-20, Section III.D, Question 12; https://shorturl.at/celnW

While this example establishes a supply chain pathway toward qualifying for the ERC, there was no further guidance or commentary from the IRS until July 21, 2023, more than two years after IRS Notice 2020-21 was released. Then the IRS Office of Chief Counsel issued a General Advice Legal Memorandum (GLAM), AM 2023-005. The GLAM goes through five hypothetical examples on whether or not a taxpayer can qualify for the ERC due to a supply chain disruption, and in each instance finds that the taxpayer does not qualify based on the facts and circumstances.[2]

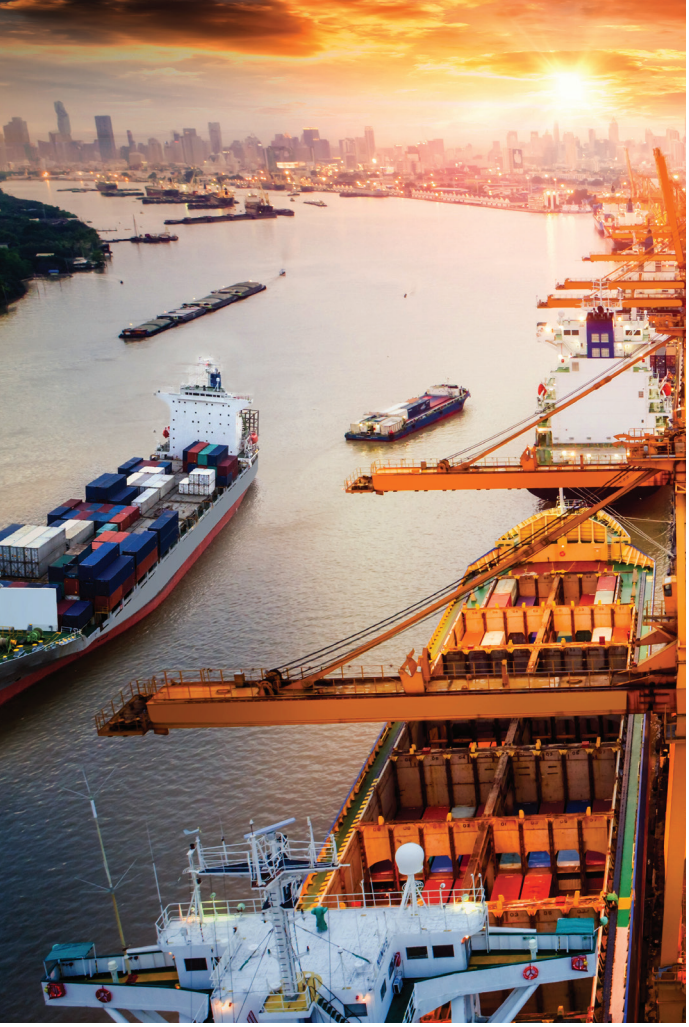
News articles and commentary were quick to jump to the conclusion that taxpayers should not use supply chain disruptions as a means for qualifying for the ERC with some sensational headlines such as "IRS Shuts Down ERC 'Supply Chain' Theory" and "Supply Chain Snags Don't Trigger Employee Retention Tax Credit: IRS."[3] However, an analysis of much of the news and legal commentary on this issue has found it to be misleading and unhelpful for taxpayers trying to determine their eligibility for the ERC.

So, Brotman Law decided to examine each scenario from the GLAM individually and add our own thoughts to the analysis as a tool for really understanding what the IRS is saying (and where the shortfalls are in their analysis).

It is first important to note what the GLAM is and what it is not. The GLAM is meant to be general legal advice for the IRS to use internally in looking at factual scenarios. It is not meant to be legal authority, very clearly stating that, "This GLAM may not be used or cited as precedent." As you will see, the examples in the GLAM are very narrow and are not representative of the complexity of a taxpayer's factual situation. Rather, they are illustrative examples meant to provide a basis for comparison to taxpayer factual situations.

So, let us move forward to the analysis itself.

2 See AM 2023-005; https://www.irs.gov/pub/lanoa/am-2023-005-508v.pdf
3 See "IRS Shuts Down ERC 'Supply Chain' Theory"; https://shorturl.at/psyEQ and "Supply Chain Snags Don't Trigger Employee Retention TaxCredit: IRS"; https://shorturl.at/erQZ7



GLAM SCENARIO 1:

Employer A was not subject to any government orders limiting commerce, travel, or group meetings due to COVID-19 at any time. However, during 2020 and 2021, Employer A experienced several delays in receiving critical goods from Supplier 1. At all times during 2020 and 2021, Employer A continued to operate because Employer A had a surplus of the critical goods normally provided by Supplier 1.

Employer A assumed that Supplier 1's delay in delivering critical goods was caused by COVID-19. Employer A inquired and Supplier 1 vaguely confirmed that the delay was due to COVID-19. Supplier 1 did not provide a governmental order from an appropriate governmental authority and Employer A was unable to locate one.

IRS ANALYSIS:

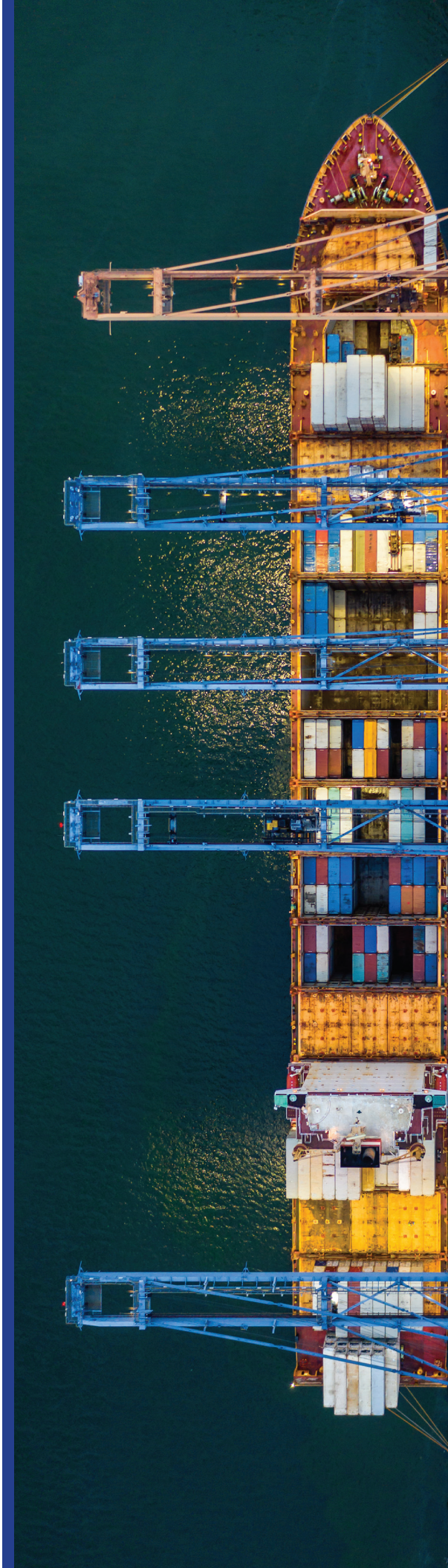
Employer A does not meet the definition of eligible employer provided under section III.D., Q/A-12 of Notice 2021-20 because Employer A cannot demonstrate that a governmental order applicable to Supplier 1 fully or partially suspended Supplier 1's trade or business operations. Even if Employer A received or could locate the governmental orders applicable to Supplier 1, Employer A did not have to cease operations because Employer A had a reserve of critical goods allowing Employer A to continue operations; thus, Employer A did not experience a full or partial suspension of operations due to an inability to obtain Supplier 1's critical goods.

The relevant inquiry is whether Employer A's trade or business operations could continue; since Employer A was able to continue its own business operations despite the supply chain disruption, it was not subject to a full or partial suspension of operations.

BROTMAN LAW ANALYSIS:

We agree, but have issues with the facts presented. In order to qualify for the ERC, you must be able to 1) cite to a governmental order, 2) have a more than nominal impact to the business, and 3) show the link between that order and a suspension or more than nominal modification to the business' operations. Because the business in Scenario 1 cannot identify a specific governmental order, we believe this would prove fatal to their case.

Additionally, the example cites that **at all times during 2020 and 2021**, Employer A had a surplus of critical goods normally provided by Supplier 1. This speaks to the fact that even if a governmental order caused the supply chain disruption, Employer A did not suffer a more than nominal impact to its business' operations. However, what does the IRS's example really say here? First, it is important to note that the IRS's example highlights a business that had a surplus of all critical goods at all times during 2020 and 2021, which suggests there was NO impact on the business. In reality, very few businesses that rely on critical goods maintain a two-year inventory reserve that would have carried them completely through the pandemic without interruption.



As the IRS states, "The relevant inquiry is whether Employer A's trade or business operations could continue [as normal]," so the inference here is that if the business' operations were more than nominally impacted by a governmental order then they may qualify based on a supply chain disruption.

The IRS's Scenario 1 further states the supplier confirmed delays were due to COVID-19. Because there is a lack of specificity, Employer A should obtain more information from Supplier 1 or have a trusted tax professional perform research on the applicable governmental orders, proving that the delay is due to governmental orders impacting the supplier's ability to get raw materials, import goods from overseas, or manufacture their product domestically. That is what caused delays, which would remove the fatal flaw in this.

We also point out that the IRS's Employer A lived in the state of "Fantasy Land" during the pandemic because Employer A was not subject to any governmental orders limiting commerce, travel, or group meetings due to COVID-19 at any time. It is our experience that our clients, particularly businesses that are physical location-dependent or rely on a significant workforce, experienced an impact from governmental orders.

Ultimately, IRS's Scenario 1 would have been more helpful if it walked taxpayers through a successful example rather than throwing unrealistic adverse facts against Employer A. For example, assuming Employer A does not have a two-year stockpile of the critical goods, Employer A could have demonstrated qualification for the credit by being able to cite to the specific governmental orders that impacted their supplier and being able to show the more than nominal impact caused to the business as the result of not being able to find a reasonable replacement supplier for any of the critical supplies.

GLAM SCENARIO 2:

Employer B was not subject to any governmental orders limiting commerce, travel, or group meetings due to COVID-19 at any time. However, certain critical goods from Supplier 2 were stuck at port in State X. Employer B assumed the bottleneck at the port was a result of COVID-19.

Employer B could not identify any specific governmental order applicable to Supplier 2 or any specific governmental order that caused the bottleneck at the port. Some news sources stated that COVID-19 was the reason for the bottleneck, while others cited reasons such as increases in consumer spending and aging infrastructure. In addition, Supplier 2 mentioned to Employer B that other critical goods that were not stuck at port would be delayed due to a truck driver shortage. Employer B saw some discussion on social media that the truck driver shortage was because drivers were out sick due to COVID-19.

IRS ANALYSIS:
Employer B does not meet the definition of an eligible employer under section III.D., Q/A-12 of Notice 2021-20 because Employer B cannot demonstrate that a government order applicable to Supplier 2 fully or partially suspended Supplier 2's trade or business operations.

In addition, while COVID-19 may have been a contributing factor to the bottleneck at the port or the truck driver shortage, Employer B could not substantiate that any specific governmental order caused a bottleneck at the port. Even if Employer B could identify governmental orders applicable to the bottleneck, Employer B must substantiate that the bottleneck and thus the suspension of Supplier 2 was due to the orders.

BROTMAN LAW ANALYSIS:
We disagree. Yes, it is true that for the purposes of substantiating the ERC that you need to cite to a governmental order. However, depending on what ports you relied on for supplies, there were multiple local-governmental orders that impacted the ports.

The IRS's example downplays the impact the COVID-19 pandemic had on the ports, thus, is out of touch with the facts which caused the vast majority of supply chain shortages in the United States in 2020 and 2021. For example, in looking at the Ports of Los Angeles and Long Beach, on February 24, 2021, President Biden signed Executive Order (E.O.) 14017, "America's Supply Chains," in which he ordered a review of supply chain issues caused by the pandemic. As the White House noted, "COVID has disrupted workers in key transportation and logistics nodes – the jobs of **1,800 Southern California port workers** were disrupted because of COVID earlier this year."[4] COVID-19 related supply chain disruptions at the ports were well documented by the national news. For example, the L.A. Times wrote that "workforces across the transportation and logistics sector were severely impacted by California-mandated pandemic-related precautions that limited crews and their ability to move cargo between ships, trucks, and trains.

Similarly, warehouses and distribution centers reached capacity and suffered similar impact due to the same pandemic restrictions."[5]

4 https://shorturl.at/nw028
5 https://www.latimes.com/environment/story/2022-10-17/ports-blame-covid-19-for-spike-in-harmful-emissions

The White House elaborates on the situation in further commentary:

These disruptions are not just happening here at home, but all around the world as COVID-19 has led to global shut downs and disruptions. The Chinese Ports of Yantian (Shenzhen) and Ningbo-Zhoushan — two of the top five largest ports in the world — each experienced multi-week partial-terminal closures aimed at curbing COVID-19 outbreaks, slowing global supply chains due to increased dwell times and cancelled sailings. In September, **hundreds of factories closed under lockdown restrictions in Vietnam,** halting production that supports thousands of retailers worldwide. They have been slowly reopening in early October, but must still contend with mounting supply chain issues. These disruptions have made the transportation supply chain more unstable and difficult to predict.[6]

The IRS implies these port disruptions were not due to pandemic-related governmental orders. However, further research would point to California OSHA restrictions mandating quarantines for employees who tested positive or whom were in contact with someone who tested positive for COVID-19, and other related governmental orders, which led to these shortages in labor forces. The IRS also suggests that other mitigating factors could have played an impact on the supply chain issues that occurred at the ports (contrary to all major news sources) and that the taxpayer has the burden of proof to point to a specific governmental order versus other mitigating factors.

It is hard to believe that a court would mandate such a high burden of proof on a taxpayer to demonstrate such granular level of detail when it is commonly accepted that COVID-19 placed a severe burden on the ports, therefore, on the U.S. supply chain. In short, as long as the taxpayer could source goods to a particular port/point of origin, we believe that a tracing analysis along with citations to governmental orders will meet the taxpayer's burden of proof.

6 https://www.whitehouse.gov/briefing-room/statements-releases/2021/10/13/fact-sheet-biden-administration-efforts-to-address-bottlenecks-at-ports-of-los-angeles-and-long-beach-moving-goods-from-ship-to-shelf/

GLAM SCENARIO 3:

Employer C and Supplier 3 are located in a jurisdiction that issued governmental orders suspending both of their business operations for the duration of April 2020.

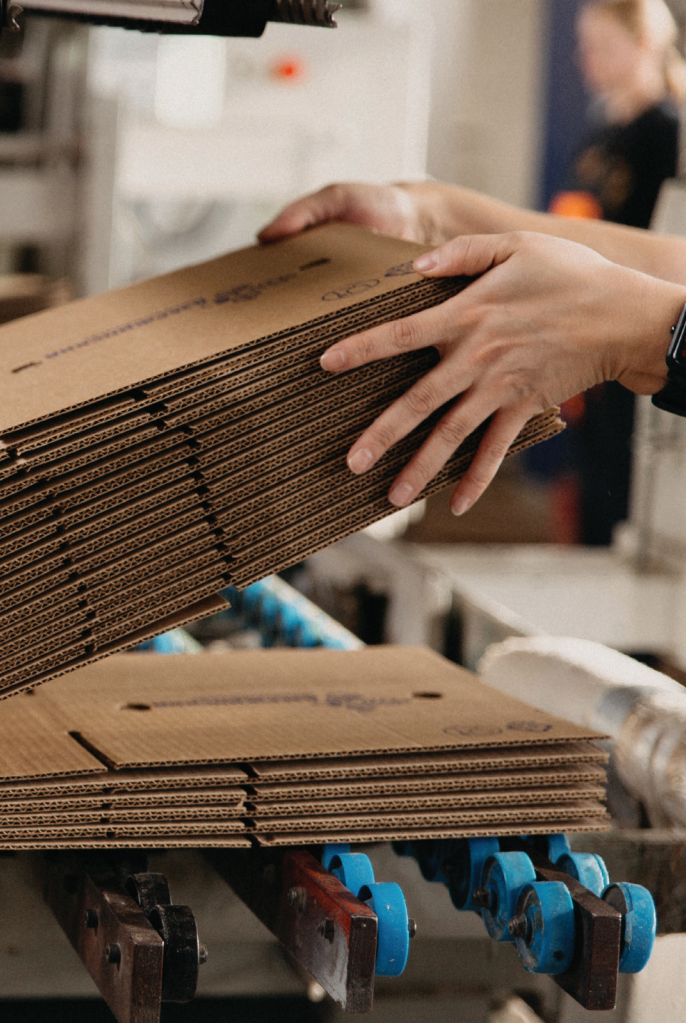
Employer C and Supplier 3's jurisdiction lifted all orders related to COVID-19 in May 2020. For the remainder of 2020 and 2021, Employer C experienced a delay in receiving critical goods from Supplier 3. Supplier 3 does not provide a reason for the delay, but Employer C assumes the delay is due to the governmental order in place in April 2020.

IRS ANALYSIS:
Employer C is an eligible employer in the second calendar quarter of 2020 because its business operations were fully or partially suspended due to a government order. However, only wages paid with respect to the period during which Employer C is fully or partially suspended due to a governmental order may be considered qualified wages. See section III.D., Q/A-22 of Notice 2021-20. Employer C does not meet the definition of an eligible employer under section III.D., Q/A-12 of Notice 2021-20 for any subsequent calendar quarter in 2020 or 2021 because Employer C cannot demonstrate that a government order applicable to Supplier 3 fully or partially suspended Supplier 3's trade or business operations. The residual delays caused by a government order in place during a prior calendar quarter will not constitute a government order in subsequent calendar quarters once the order has been lifted.

BROTMAN LAW ANALYSIS:
We disagree. Section III.D., Q/A-22 of Notice 2021-20 makes clear that qualified wages are wages paid in the period where the business is fully or partially suspended due to a governmental order, regardless of whether the governmental order is still in effect. Under the IRS logic, as soon as the governmental order is lifted, Employer C would not meet the definition of an eligible employer. If someone hits you in the arm, even if they stop hitting you, it will still hurt, and you will still feel the effects long after. Assuming that Employer C could show that Supplier 3's delay in production of critical goods was a lingering effect of the governmental order lifted in May 2020, we see no issue in the qualification.

The IRS's analysis is misleading because it states that residual delays in a prior calendar quarter will not qualify a business once an order has been lifted. However, there is no reference to that in Section III.D., Q/A-12 of Notice 2021-20. Rather, Q/A makes clear that if the business' suppliers are unable to make deliveries of critical goods or materials due to a governmental order that causes the supplier to suspend its operations, that business is eligible.

Although the burden would be on the taxpayer to prove causation between the delays in receiving critical goods in 2021 to the April 2020 order, there should be no other barrier in qualifying the taxpayer. Furthermore, supply chain issues are latent. Once the governmental orders were lifted, it is unlikely the supply chain resolved itself the next day or even the next month. Supply chain delays were often weeks and months past the date governmental orders were lifted, assuming they were lifted at all. Therefore, we do not agree with the IRS's position on this issue and find it implausible that a court would concur with their analysis.



GLAM SCENARIO 4:

Employer D was not subject to any governmental orders limiting commerce, travel, or group meetings due to COVID-19 at any time. During 2020 and 2021, Employer D could not obtain critical goods from Supplier 4. However, Employer D was able to obtain the goods from an alternate supplier. The critical goods from the alternate supplier cost 35% more than those from Supplier 4. Employer D could continue to operate its trade or business even though it was not as profitable as in 2019.

IRS ANALYSIS:

Employer D does not meet the definition of an eligible employer under section III.D., Q/A-12 of Notice 2021-20 because Employer D could continue to operate its trade or business. Employer D was not prevented from operating its trade or business at any point during 2020 or 2021. Incurring a higher cost for critical goods does not result in a full or partial suspension of operations.

BROTMAN LAW ANALYSIS:

We agree, but have concerns about the facts presented.

It is true that paying a higher cost for critical goods does not, by itself, rise to the level of an operational impact. However, assuming the utilization of an alternate supplier was not as seamless as the IRS presents, the disruption caused business operations during the period of sourcing alternate suppliers to rise to the level of a more than nominal impact. Per the IRS safe harbor definition, they consider "more than a nominal effect" to be at least a 10% reduction in your ability to provide goods or services in the normal course of your business.[7]

It is also important to note that due to governmental order, this Employer D did not experience any other reduction in ability to provide goods or services and this isolated impact was the only impact it experienced. This is uncommon with most real-world scenarios involving supply chain disruptions.

7 See Notice 2021-20, Section III.D, Questions 11, 17, and 18; https://www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit#supply.

GLAM SCENARIO 5:

Employer E operates a large retail business selling a wide variety of products. Employer E was not subject to any governmental orders limiting commerce, travel, or group meetings due to COVID-19 in 2021. Due to various supply chain disruptions, Employer E was not able to stock a limited number of products and was forced to raise prices on other products that were in limited supply. However, at no time did the product shortage prevent Employer E from continuing to fully operate as a retail business during 2021.

IRS ANALYSIS:

Employer E does not meet the definition of an eligible employer under section III.D., Q/A-12 of Notice 2021-20 during calendar year 2021 because Employer E cannot demonstrate that a governmental order applicable to a supplier of critical goods or materials caused the supplier to suspend operations and that Employer E was unable to obtain critical goods and materials causing a full or partial suspension of Employer E's business operations.

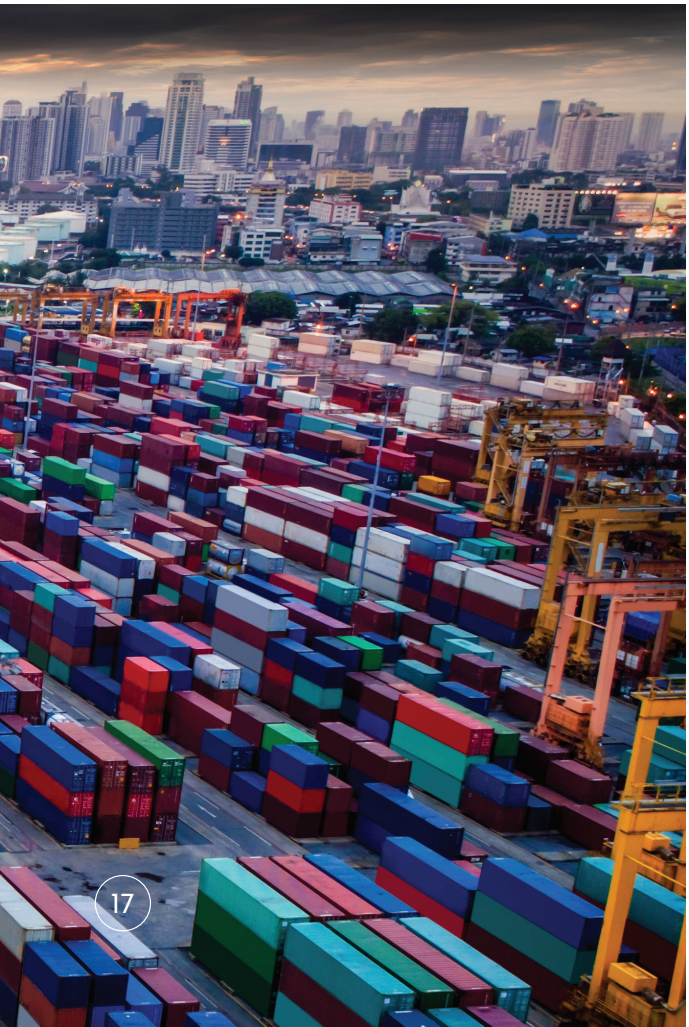
At all points during 2021, Employer E was able to operate its retail business. While a limited number of products were not available, Employer E was still able to offer a wide variety of products to its customers and Employer E was not forced to partially suspend operations.

BROTMAN LAW ANALYSIS:

We agree, but equally do not find the facts of this scenario to be particularly realistic. Employer E operates a large retail business with presumably a large number of employees. It would be uncommon for such a business to not be subject to any governmental orders limiting commerce, travel, or group meetings due to COVID-19.

However, presuming this is true, we note that the word "limited" is not defined in this example. If the shortage of products, caused by governmental order-related supply chain disruptions, constituted 10% or more of Employer E's sales, then we believe this would qualify Employer E for ERC.

Raising prices on other products was presumably not related to governmental orders, so we equally agree that this would not qualify the business.



CONCLUSION:

In many respects, the IRS Chief Counsel Memorandum does not really clarify the issue of supply chain disruptions and eligibility for ERC. The examples provided are hyper-limited and we believe are not an accurate depiction of what most employers faced during the COVID-19 pandemic. In other instances, we believe that the IRS overextends its analysis, and its interpretation is not consistent with other guidance and the legislative intent of the ERC.

Furthermore, the IRS presented each scenario in a negative or opposing manner in some respect. We feel taxpayers would have been better served by the IRS illustrating what they believe would qualify an employer for the ERC due to a supply chain disruption or by clarifying the level of substantiation needed to pass muster. Examples that were clearer and more analogous to the real-world fact patterns that our clients experienced during the pandemic would have provided better guidance.

As noted previously, this Chief Counsel Memorandum is the IRS's litigation position. It is not binding authority, cannot be cited, and its application is extremely limited to the factual scenarios presented. While an indicator of how the IRS may respond to a particular factual scenario, you should speak with a qualified tax attorney about your specific circumstances and to determine your eligibility for the credit.

Only a tax attorney can properly assess your facts and circumstances and advise you as to whether or not you should claim the credit.

About Brotman Law:

Brotman Law represents clients nationwide as a boutique tax law firm founded in 2013 and was recognized in 2018 by the Law Firm 500 as the 14th fastest-growing law firm in the United States. Today, Brotman Law has nine attorneys and has offices in San Diego, Los Angeles, and Chicago. The Firm's practice areas relate to tax controversy, tax compliance, tax optimization, and tax credit work for businesses and individuals in different jurisdictions across the United States and internationally.

Brotman Law has developed into one of the leaders in Employee Retention Tax Credit compliance work. The Firm has helped its clients and others file for hundreds of millions of dollars in Employee Retention Tax Credits and focuses on larger, more technical, and more complex credit work. Our background in tax controversy, representing taxpayers in hundreds of audits, and saving them many millions of dollars in potential penalties, informs our judgement on the credit.

The Firm's primary objective when representing a client with respect to the Employee Retention Tax Credit is to try and maximize their credit, but first and foremost to keep them safe. We make sure that the Employee Retention Tax Credit is done the right way for businesses across the United States.

The Firm equally represents Employee Retention Tax Credit companies and other mid-size and larger organizations with their tax credit compliance. Mr. Brotman conducts weekly trainings for lawyers and is a frequent speaker on the subject. Mr. Brotman has been recognized as a "Super Lawyer - Rising Star," a distinction awarded to the top 2.5% of lawyers nationwide every year for the last six years, to the San Diego's "Best of the Bar" list of recommended attorneys and was most recently named a "Leader in Law" by the San Diego Business Journal for 2023.

Mr. Brotman has been quoted by the Wall Street Journal, the New York Times, the Los Angeles Times, The Sacramento Bee, Fox News, and by many other publications and news outlets.

At Brotman Law, our Firm has a practical approach to problem solving that differs from other law firms, putting client goals and objectives, tax and non-tax, into a framework of making decisions in the best interest of the client.

We draw on a wide range of interdisciplinary skills and business knowledge to help the client make the best decision from a business perspective with to their tax challenge, rather than simply solving their problem. Our Firm meets clients where they are and gets them to where they want to be.

Bottom line: Tax is complicated enough, so we keep things simple and our advice straightforward to help you make the best decisions for you and your business.

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