Current Trends in CARES Act Tax Enforcement

by Kristin M. Lebovic and Vince Farhat

Kristin M. Lebovic

Vince Farhat

Kristin M. Lebovic is a member of the taxation and trusts and estates groups at Jeffer Mangels Butler & Mitchell LLP. Vince Farhat is a former assistant U.S. attorney in the major frauds section of the U.S. attorney's office for the Central District of California. He chairs the white collar defense and investigations group at Jeffer Mangels Butler & Mitchell LLP.

In this article, Lebovic and Farhat examine government enforcement trends with a focus on tax investigations after enactment of the Coronavirus Aid, Relief, and Economic Security Act.

The Coronavirus Aid, Relief, and Economic Security Act (P.L. 116-136) was passed on March 27, and government criminal enforcement bodies took action the following month. This article examines government enforcement trends with a focus on tax investigations. While prosecution activity has been focused on cases of intentional fraud as opposed to unintentional misrepresentations, taxpayers benefiting from the CARES Act are on the IRS's radar.

I. CARES Act Tax Enforcement

The IRS received its own CARES Act relief to the tune of $37 million for enforcement activities, including funding for the Criminal Investigation unit that was specifically created for the CARES Act. The IRS is creating an audit strategy for returns benefiting from the tax relief, and the CI is gearing up to investigate potential criminal violations of the CARES Act.

As taxpayers take advantage of the subsidies offered under the CARES Act, this adds complexity for tax reporting and compliance. For some provisions, amended returns may be required going back five years. For taxpayers, there is certain to be an increase in the number of IRS audits, CI investigations, and criminal prosecutions conducted. The IRS Large Business and International Division has designated the CARES Act as a campaign, stating that its goal is to identify transactions, restructurings, and technical issues as well as to better understand taxpayer behavior under the new law. Taxpayers benefiting from the CARES Act should expect some form of IRS outreach including examinations, soft letters, new and improved practice units, and development of future issue-based campaigns.

First, let's look at how the CARES Act altered the application of some provisions of the IRC.

A. Net Operating Loss Carryback

For some taxpayers, the tax deduction for net operating losses is increased from 80 percent to 100 percent for 2018, 2019, and 2020; the $500,000 limitation on tax-deductible NOLs until 2021 is suspended; and NOLs from 2018, 2019, and 2020 are allowed to be carried back to up to five years.

B. Charitable Contributions

The CARES Act increases the limit of tax-deductible charitable contributions from 10 percent to 25 percent of income for corporations and increases the limit of food inventory from 15 percent to 25 percent of income. The increased limits apply to both individuals and corporations. Also, the CARES Act provides for an above-the-line deduction for charitable cash contributions of up to $300 for taxpayers not itemizing deductions.

C. Deferment of Payroll Tax

Employers can defer payment of their share of Social Security taxes for up to two years. For self-employed workers, payment of the portion of Social Security tax corresponding to the employer's share may also be deferred for up to two years. Payment of these taxes incurred after having a Paycheck Protection Program loan forgiven cannot be deferred, but taxes incurred before the loan forgiveness may continue to be deferred.

D. Employee Retention Tax Credit

The CARES Act provides a tax credit for employers whose operations were suspended or whose revenue has significantly decreased because of COVID-19. The tax credit is equal to 50 percent of qualified wages paid between March 13 and December 31, 2020, and the maximum credit is $5,000 per employee. Qualified wages include the cost of qualified healthcare. Qualified wages don't include wages paid for emergency paid sick leave or emergency family medical leave. A business isn't eligible for the credit if it receives a PPP loan.

E. Interest Expense Deduction Limitation

The Tax Cuts and Jobs Act reduced the limit on the deduction for business interest from 50 percent to 30 percent of adjusted taxable income (income before deductions for interest, taxes, depreciation, and amortization, or EBITDA). The TCJA also eliminated the rule that restricted net interest deduction limits to companies with a debt-to-equity ratio above 1.5. These revisions were adopted in part to reduce profit shifting by multinational corporations (by borrowing in the United States). The CARES Act increases the limit to 50 percent for 2019 and 2020.

F. Deductibility of Expenses

A PPP loan provides government funding for payroll, utilities, rent, and interest on prior loans. However, no deduction is allowed for an expense that is otherwise deductible if both (1) the payment of the expense results in forgiveness of a loan made under the PPP, and (2) the income associated with the forgiveness is excluded from gross income under the CARES Act.

G. Individuals

Individual taxpayers meeting specific criteria received cash payments in 2020 and saw changes to special rules for use of retirement funds, allowance of a partial above-the-line deduction for charitable contributions, and modifications for losses.

The CARES Act set the stage for another phase of proposals that have been the subject of discussion leading into the Novevember 3 election, which if passed would make it the fourth act of 2020: a series of bills and proposals collectively referred to as the Health, Economic Assistance, Liability Protection, and Schools (HEALS) Act and the Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act.

While there are many differences between the HEALS Act and the HEROES Act, they do have one thing in common: They address several issues that weren't addressed in the CARES Act, and those that were addressed but that could be enhanced by future legislation or regulatory action. Changes with tax impact include increasing employee retention tax credits, expanding paid leave tax credits, creating investment tax credits for personal protective equipment manufacturing, increasing business deductions for business meals, eliminating the limitation on state and local tax deductions, and addressing the NOL provisions.

While it is unclear what a final fourth act would look like or even whether it would pass, it is clear that there would be changes to provisions in the TCJA and the CARES Act, which brings along additional complexity regarding reporting and compliance that taxpayers should watch out for.

II. Current Enforcement Trends

Along with the taxpayer benefits, there is also no shortage of oversight and enforcement built into the CARES Act, which established several new law enforcement bodies. These new oversight bodies will partner with established law enforcement agencies such as IRS-CI, the FBI, and state attorneys general, who have also pledged to police potential fraud and abuse associated with COVID-19. They are as follows:

- Inspector General for Pandemic Recovery: The Senate confirmed Special Inspector General Brian Miller, who is tasked with coordinating audits and investigations relating to loans and other investments made by the Treasury secretary.
- Congressional Oversight Commission: This body conducts oversight of various agencies' implementation of the CARES Act. The commission has the power to hold hearings and compel the production of documents and witness testimony and is required to furnish regular reports to Congress, addressing the effectiveness of the stimulus programs.
- Pandemic Response Accountability Committee (PRAC): The PRAC has the broadest oversight and enforcement powers of the three bodies established by the CARES Act. It is tasked with helping inspectors general safeguard CARES Act funds to "detect and prevent fraud, waste, abuse, and mismanagement" and "determine whether wasteful spending, poor contract or grant management, or other abuses are occurring," as well as referring matters to the inspectors general or Justice Department as appropriate.

In addition, the IRS has been given an additional $37.2 million for enforcement activities. We can expect oversight investigations not only from CI and the FBI but also from political branches of federal and state governments not typically associated with anti-fraud enforcement. Also, when the IRS establishes its audit approach, taxpayers can be assured there will be increased audit activity, which may lead to the discovery of additional fraud.

Enforcement actions regarding the receipt of stimulus funds has already begun. Businesses should expect significant oversight and enforcement activity involving CARES Act funds for years after the COVID-19 pandemic ends. Hundreds of federal civil and criminal actions have been filed. In fact, the U.S. Attorney General directed all U.S. attorneys to prioritize investigation and prosecution of coronavirus-related fraud schemes, and each U.S. attorney was directed to appoint a coordinator to serve as legal counsel on coronavirus matters, to direct prosecution of coronavirus-related crimes, and to conduct outreach.

The IRS-CI is partnering with other law enforcement agencies to investigate and prosecute suspected CARES Act fraud. IRS-CI investigates potential criminal violations of the IRC and related financial crimes, including tax and money laundering violations involving fraud against banks and other financial institutions and criminal identity theft associated with tax and financial fraud schemes.

For example, the owner of a Florida talent management company and four others were charged in criminal complaints unsealed in August for their alleged participation in a scheme to file fraudulent loan applications seeking more than $24 million in forgivable PPP loans guaranteed by the Small Business Administration under the CARES Act.[1] The defendants allegedly participated in an extensive nationwide scheme to file at least 90 fraudulent applications for millions of dollars in PPP loans in exchange for illegal kickbacks of portions of the loan proceeds. This case is being investigated by the IRS-CI Cincinnati and Miami field offices, the FBI, and the SBA's inspector general.

On August 20, a couple from Gilmer, Texas (Dalton Brewer and Emilee Fenton) were charged with conspiracy to unlawfully transfer, possess, and use a means of identification.[2] Fenton was also charged with theft of government money and aggravated identity theft for her role in obtaining two economic impact payments (EIPs) using the identities of other persons. In its $2 trillion in relief programs, the CARES Act authorized about $560 billion for benefits to individuals, including an estimated $300 billion allocated for EIPs. Under the CARES Act, qualifying individuals may

[1] Department of Justice, "Nine Charged With $24 Million COVID-Relief Fraud Scheme," Release No. 20-751 (Aug. 6, 2020).

[2] U.S. Attorney's Office, "Upshur County Couple Indicted for Identity Theft in Connection With CARES Act Economic Impact Payments" (Aug. 20, 2020).

receive up to $1,200 in EIPs per adult, up to $2,400 for married couples filing jointly, and $500 per child under 17 years old. Individuals with income exceeding $99,000 or joint filers whose income exceeds $198,000 do not qualify for any payment. If convicted, Brewer and Fenton face up to 15 years in federal prison. This case is being investigated by IRS-CI, the Postal Inspection Service, and Treasury Inspector General for Tax Administration.

In addition to IRS-CI investigations, TIGTA is actively investigating CARES Act fraud schemes involving falsified tax information. For example, on September 29, a North Carolina man was charged with fraudulently seeking more than $6 million in PPP loans, including charges of wire fraud, bank fraud, and engaging in unlawful monetary transactions.[3] The government alleges that Tristan Pan submitted numerous fraudulent PPP loan applications, including on behalf of entities named Pan Insurance Agency, White Walker, Khaleesi, and The Night's Watch. The government alleges that, in support of the fraudulent PPP loan applications, Pan made false statements about the companies' employees and payroll expenses. The PPP loan applications were supported by false documents, including allegedly falsified tax filings. According to the indictment, Pan allegedly submitted 14 PPP loan applications seeking in excess of $6.1 million and received more than $1.7 million in benefits following approval of the Pan Insurance Agency and White Walker PPP loan applications. This case is being investigated by TIGTA, the FDIC inspector general, and the FBI, with the assistance of the SBA inspector general.

III. Taxpayer Risks

A. Past and Future Compliance

When a taxpayer files an amended return to take advantage of provisions in the CARES Act, an examination by the IRS may not be far behind. If the IRS determines that the return requires a closer review, an examination may expand its focus to items beyond the CARES Act, and the examination can extend to taxpayer financial transactions for all years open within the statute of limitations.

B. Loan Process

Any inaccuracy on an employer's loan application could create potential enforcement liability, including with the IRS or under the federal civil False Claims Act. Have an adviser review the entire submission for errors or inconsistencies before formally submitting it.

C. Stay Up to Date

The legislation and compliance requirements continue to evolve. Ensuring compliance means having a plan in place, whether it's an adviser or news source you check often to stay current with changes or new policies.

The U.S. government will be aggressive in pursuing misconduct or fraud by recipients of CARES Act funds. It will also be actively auditing amended and filed returns for taxpayers benefiting from the tax provisions of the act, which could lead to a visit from IRS-CI.

Entities applying for and receiving CARES Act loans should be aware of the risks related to noncompliance with all applicable laws and regulations and stay up to date on published guidance by all government agencies. If a taxpayer incorrectly double-dips on tax benefits, this mistake, at best, could lead to a time-consuming and expensive civil investigation and audit. It could also open the door for a broader examination of financial dealings if a problem is discovered. ■

[3] Department of Justice, "North Carolina Man Charged With Fraudulently Seeking Over $6 Million in COVID Relief Funds," Release No. 20-1019 (Sept. 29, 2020).