Board of Directors Information Memo
Downtown College Prep

SUBJECT: Downtown College Prep– Employee Retention Credit

CATEGORY: Finances — Reason for Board Consideration: Contract over $50k
Date: December 19, 2023 — Decision Type: ACTION

Background

We are exploring the possibility of getting an Employee Retention Tax Credit (ERC). The ERC was created by the CARES Act in March 2020 to encourage businesses and non-profits to retain employees. When filed on a refund basis, as would be the case here, a qualifying organization receives direct payments for approved amounts that are deemed uncategorized and unrestricted for accounting purposes.

Originally, the ERC required a significant reduction in revenues. However, the ERC was later expanded to also include eligibility under the condition that a government order at least partially suspended at least part of an organization's operations. We reached out to a tax attorney who has worked with more than 100 California schools (and over 350 schools in more than 20 states) to inquire whether we could seek ERC credits under this newer eligibility requirement.

Due Diligence

We believe this is a novel approach that requires heightened due diligence. In sum, after conducting our due diligence, we believe that the possible financial gain of over $_2,349,000 greatly outweighs the risk that can be mitigated by the payment terms with the attorney.

Michael Williams is a licensed attorney and his firm focuses its practice on tax planning and credits; he is the tax attorney proposing to provide this service.

Rationale

Risk Analysis. Below, we review whether there is any risk to (1) being denied a refund and whether that presents issues of cash flow or charges of frivolous filings, (2) media concerns, and (3) potential costs. In sum, we believe there is minimal to no risk from (1) and (2), and the risk of (3) can be mitigated by cost structure of attorney fees.

Regarding (1), some of the risk is already mitigated because we are seeking a refund. If we had applied for the ERC as many companies did during the early part of the pandemic, we would withhold our requested amount. The danger is if the IRS denied the request, then we would have to pay the money back to the IRS. However, this period is past and now the only option under the ERC is to request a refund. There is less risk here because if the IRS denies a refund from the IRS, there is nothing to pay back. They either send you a check, or deny the request (from which we could appeal if we so chose). If the IRS approves the claim, later audits the claim and overturns it, the organization would have to pay back the credit amount however the attorney would pay his fee back to the organization which mitigates ristk.

There is minimal risk of fraudulent or frivolous filings. This risk is largely borne by the attorney filing the returns, but, regardless, we have done our due diligence with not just the attorney himself, but also I have reviewed the FAQs on eligibility.

Regarding (2), there was some concern by the Board regarding eligibility under the PPP due to media concerns and whether nonprofits were a bona fide recipient of PPP loans. However, the ERC stems from the same CARES Act that gave rise to the PPP, and because it is now settled that nonprofits were eligible under PPP, we should be eligible under the ERC.

Regarding (3), the most significant risk that the attorney has raised is whether our circumstances would warrant a refund, though he thinks it is very likely, under the following circumstances that will be provided to the IRS within the required narrative upon submission:

- *IRS ERC Question 17 Rule: partial shutdown is where a part of the operations is shutdown. IRS ERC Question 18 clarifies that "partial" is "more than a nominal portion of its business" and even if "non-essential."* Here, we completely shut down or substantially modified many of our instructional programs, and other events that help build community and culture throughout our organization. Moreover, we had to shutdown of all in-person marketing and outreach events that connect us with the community and increase visibility of our organization.
- *IRS ERC Question 10 Rule: partial shutdown is where employer is required to reduce its operating hours.* Switching to distance learning for our schools required a critical reduction in instructional time we were able to deliver to our students. During the quarters we were in full or hybrid distance learning mode, we had to offer asynchronous learning for 75% of our operational hours as we navigated the requirements of distance learning.
- *IRS ERC Question 15 Rule: partial shutdown is where an employer is not able to provide comparable services. IRS ERC Question 18 Rule defines a service that is non-comparable as one where "more than a nominal effect" has been placed on the operations.* Instruction and delivery of services had to be drastically revamped, and these inferior means resulted in a dramatic drop in engagement and attendance.

Risk Mitigation. Regarding the risk associated with (3) described above, we can mitigate this in a couple of ways. One, by paying our fees on a contingency basis, we don't pay any fees if we do not get the refund. Two, we can ask our attorney to cover possible appeal and audit costs under this contingency fee arrangement. Thus, the most likely downside risk is not paying anything at all, as if the IRS disagrees with our claim at a later date, we can abate any potential penalties as we can clearly demonstrate that we've done our due diligence and relied on the advice of an experienced tax attorney who has filed a substantial number of claims for nonprofits in California and around the country.

Financial Impact

Contingency Fee. The attorney charges a success-based fee for his services; at our credit size his rate is 8%, which is in line with other schools that we have discussed regarding their ERC filings.

Refund Amount. If all quarters are approved for which we qualify, the total credit would be in excess of $_2,349,000 It is possible that not all quarters receive approval, as each is judged on its own merit. As such, the refund amount will only be known if and when the IRS approves the refund claim.

Recommendation

For board to review and approve the retainer agreement at a 8% contingency fee.

Prepared by:
Pete Settelmayer, CEO

Approved and Recommended: