Tax Notes

The Employee Retention Credit Q&A

By Christopher Migliaccio, JD, Senior Manager

By now, many businesses have become aware of the Employee Retention Credit (ERC) that it was enacted as part of the CARES Act but initially considered an afterthought. That changed when the Consolidated Appropriations Act that was passed in December not only eliminated the rule that prevented PPP borrowers from receiving the ERC but also significantly expanded the credit for 2021. Most recently, the American Rescue Plan Act extended the ERC through the end of 2021 and, given that the credit is up to $7,000 per employee per quarter, it's hard not to get excited about its potential benefit.

Given the completely new nature of many of the provisions of the ERC, it is understandable that questions abound about qualification and calculation of the credit. This article provides answers to some of these questions and clears up misunderstandings; it is based on our current understanding of these issues and reflects the IRS' recent release of guidance on a number of points in Notice 21-20 and Notice 21-23.

"My friend who knows an accountant heard everyone qualifies for this – are they right?"

No – although the rules for qualification are expansive, they are not all encompassing. Businesses qualify for the ERC based on either a full or partial shutdown by a government order OR a significant decline in gross receipts; you'll need to review your specific situation to see if you qualify.

"Government orders affect everyone, Chris! We qualify."

While government orders have affected businesses since March of 2020 and continue to do so, there are several factors that determine whether the government order qualifies a business for the ERC, including:

- First, if a business was deemed essential and had no restrictions placed on it, it can qualify only if a government order shut down its suppliers.
- Even if a business was deemed non-essential and was forced to close its workplace, it qualifies only if it was unable to effectively transition to telework. Recent IRS guidance indicates that this is based on an analysis of the nature of the business' work, how important its workspace is to its operations and how many employees' work was portable to a virtual environment.
- If a business was deemed essential but had restrictions placed on its operations, or was allowed to open with restrictions (as most businesses were after an initial shut down period), it must show that the restrictions have a greater-than-nominal impact, which the IRS has defined as a 10% impact on gross receipts, hours worked or the ability to provide services.

Of course, if a government did not create a full or partial shutdown, qualification for the credit can be considered via a significant decline in gross receipts.

"My business definitely was shut down by a government order. Do I qualify through the end of 2021?"

Qualification by government order lasts only for as long as the order is in place. So, if the order was put in place on March 17, 2020 and lifted on July 15, 2020, that is your business' qualification period. Qualification for any other period would need to be based on the significant decline in gross receipts.

"Okay, let's talk about this decline in gross receipts. What is this a decline from?"

A significant decline in gross receipts is based on a comparison of calendar quarters in 2020 or 2021 against the same calendar quarter in 2019. (Alternate rules exist for businesses that were not yet opened

during some quarters in 2019 or 2020, but if your business existed in all quarters of 2019, the same quarter in 2019 is always the base quarter). To qualify for the credit, a 20% decline in gross receipts is required in 2021; a 50% decline was required in 2020. Qualification in one quarter generally will qualify a business in the next quarter as well – see for details.

"Are gross receipts for these purposes simply operating revenues?"

No. For businesses other than those that are tax exempt, gross receipts include both operating revenues and investment income. For non-profit organizations, gross receipts include everything shown on Form 990, including contributions, pledges and gross amounts received from sales of investments. These articles (ERC for Independent Schools and Enhancements and Extensions to the ERC) provide additional information. Gross receipts are determined based on the taxpayer's method of accounting for tax filing, either cash or accrual.

"My business qualifies! Show me the money for all 800 of my employees!"

The credit is restricted based on number of a business' employees. For businesses with fewer than 100 full-time employees during 2019, the credit can be taken in 2020 for all employees during the qualification period; for businesses with more than 100, the credit can be taken only for wages paid for time not worked. In 2021, that number increases to 500 employees, but it is still based on full-time employees (>30 hours/week or >130 hours/month) in 2019. An important note for seasonal employers: the count is based on a monthly average so it factors in both high and low seasons.

"That's fine, this business has 80 employees. I can take the full credit for this and my six other businesses!"

Not so fast. When one person or a group of people own 50% or more of two or more businesses, the businesses must be aggregated for purposes of the employee count, the gross receipts test and considering whether the business has experienced a partial shutdown. Businesses with significant management overlap may also be required to aggregate.

"No one was really working hard when our office was shut down. I'll just take 80% of everyone's wages."

IRS guidance has made clear that if your business can take the credit only for payments on time not worked, it must be able to show that it was genuinely unworked time and not simply lower productivity. The best way to prove this is with time sheets, but if the business does not have these (and who knew recording this unworked time might translate into tax credits?) it is sufficient to work with employees' managers to try and identify this time. However, the key is that you need support for this calculation should your business be subject to an IRS audit in the future.

"I've got a small business, Chris – just one employee and me. We don't have to worry about restrictions, right?"

Qualified wages do not include self-employment income; thus, sole proprietors or partners in a partnership cannot take the ERC on wages paid to them. Wages paid to owner-employees of an S Corporation do appear to qualify, however. The wages paid to that one employee would not be qualified if that employee is a close relative of an owner with a share of the business greater than 50%.

"Is it just salary that qualifies for the ERC?"

Qualified wages also include employer paid health plan expenses and employer contributions to HRA/FSA plans. They do not include employer contributions to HSA/MSA plans, retirement contributions or other expenses. Eligible health plan expenses must be allocated by employee. For those with self-insured plans, IRS guidance indicates a reasonable method must be used to allocate.

"I received a PPP loan and already filed my forgiveness application. Can I use any wages claimed on the application for the ERC?"

While the same payroll dollars cannot be used for both the ERC and PPP forgiveness, recent IRS guidance has been taxpayer-friendly. Many businesses filed PPP forgiveness applications before the ERC became available to them, with wages far in excess of the amount needed for forgiveness. The IRS has

said that any wages claimed on the application but not needed for forgiveness are available for the ERC if they are also qualified wages. In other words, if a business had a PPP loan of $70,000 and covered period wages of $200,000, the $130,000 difference is potentially ERC eligible. If that business had an additional $10,000 of non-payroll expenses claimed on the PPP forgiveness application, $140,000 of wages are potentially ERC eligible. However, PPP forgiveness applications cannot be amended to add non-payroll costs or change the covered period.

"Are these credits taxable?"

No; however, the amount of the credit does decrease the tax deduction for wages for taxable businesses. For accrual method taxpayers, the reduction is for the year the wages were paid; for cash basis taxpayers, it is currently not clear whether the reduction would be for the year the wages were paid or the year the credit payment is received from the IRS.

"Okay, this is all great. I believe I qualify and have qualified wages to claim. How do I apply?"

Unlike the PPP loan program, the ERC isn't applied for – it's simply claimed on a taxpayer's quarterly employment tax return (Form 941 or similar). For prior quarters, amended payroll tax returns can be filed up to three years after the date of the original filing. An advance credit can be requested before the end of a quarter by filing Form 7200 (for businesses with fewer than 500 employees), although the credit would still need to be reported on Form 941 at the end of the quarter.

"Is the IRS going to audit me?"

Unlike with PPP forgiveness, we haven't received clear guidance on audit procedures or thresholds from the IRS. That's why we're encouraging clients to prepare detailed support for their ERC qualification and credit calculations. The IRS has five years, instead of the standard three years, to audit ERC claims after filing.

Join Us!

Monday, April 19th, we'll be hosting a webinar on the American Rescue Plan Act, including a full discussion of the ERC. Part of the webinar will provide a focus on your specific industry to help explain the issues that impact you. Register here.

Contact Us

If you have questions about the Employee Retention Credit, contact your client service partner or:

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