MEMORANDUM

DATE: July 28, 2021
TO: File
FROM: Wendy J. Manson, CPA and William J. Palazzolo, Esq
RE: Employee Retention Tax Credit Rules for First and Second Quarter 2021

The Consolidated Appropriations Act, 2021 ("CAA") provides relief to individuals, businesses, health care providers, and others impacted by the COVID-19 pandemic. A key opportunity for businesses in the CAA is an expansion of the Employee Retention Credit ("ERC"), which was first established in the CARES Act. The CAA made several enhancements to the ERC and the important points are as follows:

Eligible Employer

The employer must be carrying on a trade or business and meet one of the following two criteria:

- Full or Partial Suspension Due to Government Order
- Significant Decline in Gross Receipts

Significant Decline in Gross Receipts

For 2020 ERC, the quarterly revenue decline needs to be more than 50%. To determine this, employers would compute their 2020 quarterly revenue and compare it to the same quarter for 2019.

For 2021 ERC, the quarterly revenue decline needs to be more than 20%. Employers would compare their 2021 quarterly revenue to the same quarter for 2019.

A special rule for 2021 ERC allows the business to look to the previous quarter to determine a revenue decline greater than 20%. For example, during the first quarter of 2021, the fourth quarter revenue of the previous year could be used (Quarter 4 of 2020 vs. Quarter 4 of 2019). This special rule would be used if Quarter 1 2021 revenues had not declined more than 20% from Quarter 1 2019 revenues.

For a business that started in 2019, the quarter the business began should be the base of determining the quarterly decline, until the business reaches a year of operations. For example, a new business that started in the second quarter of 2019 would use that quarter as the base to determine revenue decline for either first quarter 2020 or second quarter 2020. If a business started in the middle of a quarter in 2019, an estimate of that period's gross receipts can be used.

ERC Claim Period

The period depends on whether the business qualifies under the full or partial suspension of operations or from a revenue decline.

Partial or Full Suspension of Operations: For the period that the full or partial shutdown was in effect.

Revenue Decline: For the entire quarter, which first sustained the significant decline in gross receipts ("initial quarter"), and for at least the following quarter ("subsequent quarter"). Therefore, at least two quarters of wages will be able to be claimed. Note: it is only when "subsequent quarter's" revenues are more than 80% of the previous year that the ERC would not be available for the NEXT quarter.

Employees that can be Claimed for the ERC

If you are a small employer, the ERC can be claimed on ALL employee wages (see employee wage limits below, and subject to family restrictions described next). See below for a further description of a small employer.

If you are not a small employer, the ERC can ONLY be claimed on wages paid to employees for not working. The definition of employees "not working" should be carefully reviewed with your professional advisors. Additional guidance is necessary to determine if employees are considered "not working" for purposes of their wages being eligible for the ERC.

Wages paid to certain related parties and owners are limited (under rules similar to Section 51(i)). Family members such as siblings, children, parents, grandparents, etc. are ineligible for this credit. IRS FAQ #59 lists the ineligible relationships:

- A child or a descendant of a child;
- A brother, sister, stepbrother or stepsister;
- The father or mother or an ancestor of either;
- A stepfather or stepmother;
- A niece or nephew;
- An aunt or uncle;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law.

Ineligible wages also include wages paid to an employee with an ineligible relationship from above to someone considered to indirectly own 50% or more of the business through a constructive ownership (under §267(c)). Spouses, brothers, sisters, ancestors, and descendants are considered to have indirect ownership. Indirect ownership can also occur from ownership in other business entities such as corporations, partnerships, and trusts.

The self-employment earnings of self-employed individuals are not considered qualified wages.

Small Employer

A small employer is defined as having 100 or fewer full-time equivalents (FTE) when claiming the 2020 ERC. A small employer is defined as having 500 or fewer FTEs in order to claim the 2021 ERC. In both cases, the reference period is 2019 employment. In other words, for 2021 ERC, the reference period is NOT 2020 FTEs. Affiliation rules also must be analyzed in computing the FTEs.

The specific rules for computing FTEs are provided under Section 4980H (enacted in 2010 as part of the Affordable Care Act (ACA)). A full-time employee for any calendar month is an employee, who has on average at least 30 hours of service per week during the calendar month or at least 130 hours of service during that month.

Amount of Eligible Wages

This is generally gross wages plus employer health insurance costs. The maximum qualified wages are $10,000 per year, per employee for 2020 and $10,000 per quarter, per employee for 2021.

Previously under the CARES Act, if an employer obtained a PPP loan, it could not benefit from the ERC employee at all. The CAA law changed this rule retroactively for 2020 and 2021 to require both PPP and ERC not be used on the exact same wages. Therefore, wages claimed on the PPP loan cannot be claimed for ERC.

Similarly, wages claimed for emergency paid sick leave and emergency paid family and medical leave under the Families First Coronavirus Response Act (FFCRA) are not qualified wages.

Wages and health insurance benefits claimed to generate the ERC cannot be claimed to generate certain other credits, such as:

Section 41 – Research & Development Credit

Section 51 – Work Opportunity Tax Credit

Section 45A – Indian Employment Credit

Section 45P – Employer Wage Credit for Active Duty Members

Section 45S – Employer Credit for Paid Family and Medical Leave

Section 1396 – Empowerment Zone Employment Credit

Amount of ERC

For 2020, the credit amount is 50% of qualified wages up to $10,000. This includes the entire year. Thus, for 2020, the maximum credit per employee is $5,000 ($10,000 x 50%).

For 2021, the credit amount is 70% of qualified wages up to $10,000 per quarter. An important difference here is that for 2021, the credit is limited to 70% of qualified wages each calendar quarter.

ERC is Taxable

The ERC is subject to income tax. Wages on the claimed credit must be reduced by the amount of the credit, which results in the credit being taxable income. The reduction in wages may also impact Section 199A eligible wages for purposes of the 20% qualified business income deduction. If the credit is claimed on 2020 payroll taxes after the income tax return has been filed, an amended income tax return may be required to accurately exclude wages reduced for the employee retention credit. For passthrough entities, owners' returns will also need to be amended.