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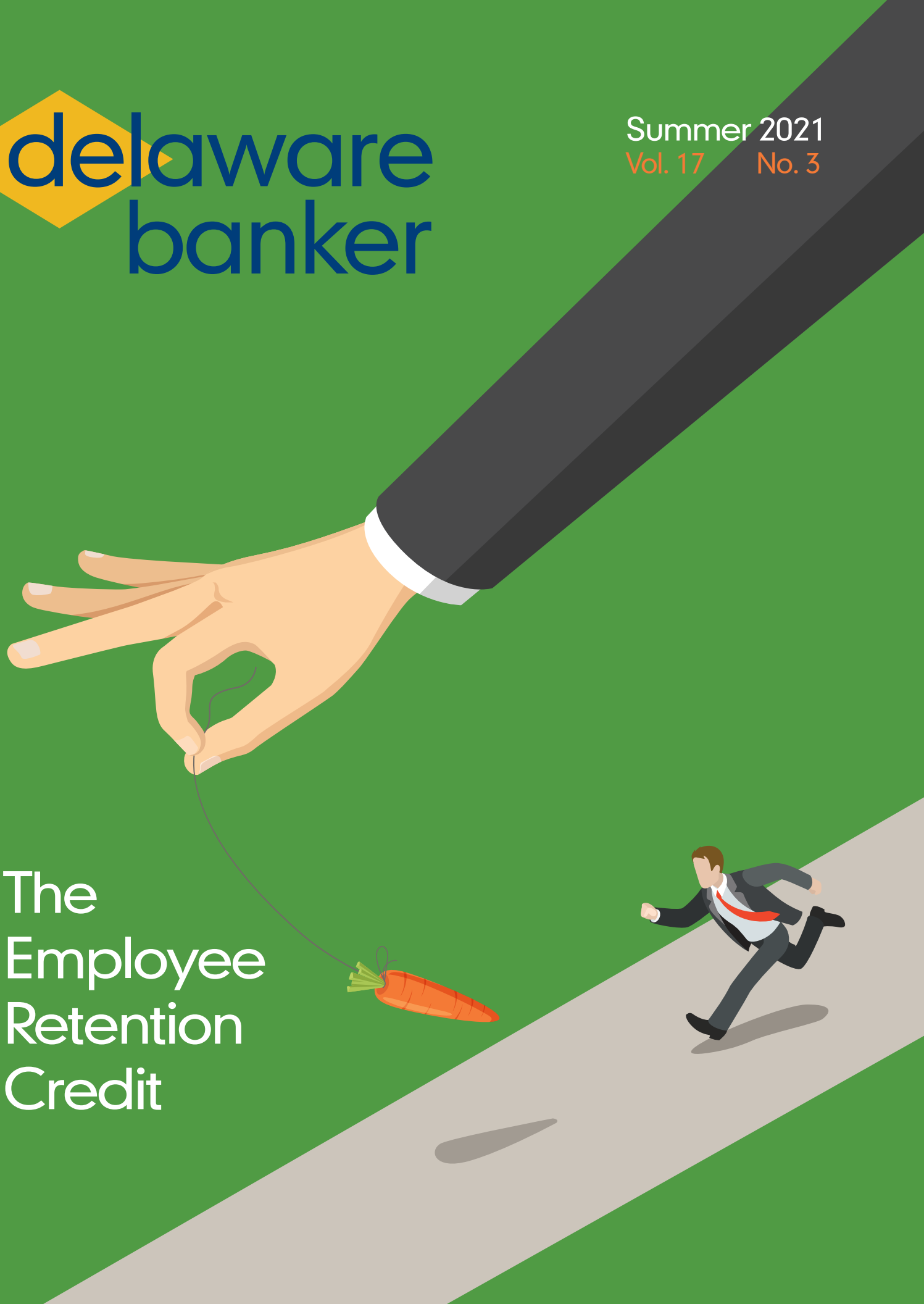

The Employee Retention Credit

The Employee Retention Credit

A Little Known, but Powerful Tax Credit

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Have you heard about a little-known tax credit that could generate savings for your business and most nonprofit clients of $5,000 per employee in 2020 or $28,000 per employee in 2021? Powerful, right? Well, we are getting a little ahead of ourselves so let us start from the beginning.

A Little History

The Employee Retention Credit, also known as ERC, was one of many items that came from the Coronavirus Aid, Relief and Economic Security (CARES) Act passed in March 2020. The CARES Act also brought taxpayers the Paycheck Protection Program (PPP) which has been thoroughly covered in the news. It seems like everyone knows about the PPP but for some reason the Employee Retention Credit has not received the same fanfare. One big reason for the lack of coverage is that the CARES Act did not initially allow the Employee Retention Credit to be claimed by employers who also applied for a PPP loan. Because of this, many employers were not allowed to utilize the Employee Retention Credit in the beginning of the pandemic.

The Employee Retention Credit in 2020

In December of 2020, the Taxpayer Certainty and Disaster Tax Relief Act of 2020, a section of the Consolidated Appropriations Act of 2021, was passed which contained a provision that voided this rule and opened the door for many small businesses to claim the credit.

An employer can claim the Employee Retention Credit as a payroll tax credit if the employer pays wages or qualifying health expenses to employees. The credit would reduce the amount of payroll tax withholdings and employer matching amounts that normally would have to be remitted to the government and reported on Form 941 and is calculated on 50% of wages or health expenses paid to employees from March 12, 2020 through December 2020. The maximum annual credit is $5,000 per employee with a maximum annual wage base of $10,000 per employee.

There are a few catches to claiming the Employee Retention Credit. First, employers that averaged more than 100 employees in 2019 would only be eligible for a credit if they paid employees who did not provide services to the employer. Essentially, the government initially wanted to focus on larger employers who closed their doors during the pandemic but still somehow managed to compensate their employees. If an employer had less than 100 employees, the service rule described above did not apply.

Second, eligibility of the Employee Retention Credit could also be derailed depending on the timing and use of the PPP funds. To qualify for full forgiveness of the PPP loan, employers must use a portion of the PPP funding to pay employee payroll costs. The employer reports these payroll costs on a PPP forgiveness application and in most circumstances, these same payroll costs cannot be used for the Employee Retention Credit. However, there are many ways to maximize both the forgiveness of PPP loans and the Employee Retention Credit which go beyond the scope of this article.

Finally, employers could only qualify for the credit in each quarter in 2020 if they demonstrated a 50% drop in gross receipts when comparing to the same quarter in 2019, which is also known as a significant decline in gross receipts. If employers did not demonstrate a significant decline in gross receipts, the employers could still qualify for the Employee Retention Credit if their business operations were fully or partially suspended by the government due to compliance with Covid-19. The suspension of business operations would have to have had more than a nominal impact on business operations. The IRS defines a nominal impact on business operations as something that results in more than a 10% reduction in an employer's ability to provide goods or services in the normal course of the employer's business.

Example Scenario in Notice 2020-21: The partial suspension rule may be difficult to analyze, and the IRS has included examples in Notice 2020-21 to help give additional insight into their thought process. One of the most practical examples offered in the notice focuses on a traditional restaurant that previously offered indoor dining to its patrons before Covid-19. In the example, Covid-19 arrives, and a government reacts to it by issuing an order that no longer allows indoor dining. However, the government order continues to allow restaurants to accept take-out orders and provide outdoor dining to its customers. In the example, the IRS concludes that more than a nominal part of business operations has been shut down and the business is eligible for the credit.

Example Scenario of What I've Seen: I helped clients apply the above example to their situation when they suffered a partial suspension of activities due to governmental orders. Most states, Delaware being one of them, identified and grouped businesses into essential and non-essential categories. It is not uncommon for a business to have essential and non-essential components and the government would shut down the activities of the non-essential components while allowing the essential ones to continue operating.

For example, eye doctors perform essential and non-essential services. They may perform emergency eye surgeries but also may offer non-essential services like elective surgeries or basic eye exams. When Covid came, Delaware issued an order restricting non-essential businesses from operating. In this example, a "non-essential" portion of their business operations was suspended. Since the non-essential services comprised more than a nominal portion of business activities, my client claimed an Employee Retention Credit on the wages paid during the period of shutdown. One of my clients only had a 48% drop in gross receipts and barely missed qualifying for the credit under the significant drop in gross receipt test. The partial suspension rule allowed them to still claim a credit.

It is important to note one key difference between a substantial drop in gross receipts versus a full or partial suspension of business activities. If a business has a significant decline in gross receipts in a given quarter, wages or health expenses paid during the entire quarter could be eligible for the credit (subject to the $5,000 cap) while only wages or health expenses paid during an actual full or partial shutdown period would qualify for the credit.

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Employee Retention Credit

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How the Employee Retention Credit Progressed in 2021

The Employee Retention Credit rules were liberalized in 2021 but still contain the same potential complications related to the interaction with the PPP program. So, if an employer received a PPP#2, they may need additional professional analysis to ensure maximization of PPP forgiveness and the Employee Retention Credit.

In 2021, the 100-employee test increased to 500-employees, opening the door for larger employers to apply for the credit. The $5,000 annual cap per employee is increased to $7,000 per employee per quarter and is based on 70% of wages paid to an employee instead of the 2020 rule which only allowed 50%. This essentially allows an eligible employer to apply for a $28,000 credit per employee for the entire year, a potential windfall for many employers which gets magnified if the employer has a large amount of employees.

An employer must demonstrate a 20% drop in gross receipts in any quarter in 2021 when compared to the same quarter in 2019. This is substantially much easier to accomplish compared to the 50% reduction which is the 2020 standard. The full or partial suspension test is still available in 2021 but is less likely to be utilized since the country began to open more in 2021.

How to Claim the Employee Retention Credit & Additional Considerations

The Employee Retention Credit is claimed on payroll tax returns. For payroll tax returns filed in 2020, it is likely an employer will have to amend the payroll tax return to claim the credit since the returns have already been filed. In 2021, an employer could request an advance of the credit and reconcile any differences at the end of the quarter when the payroll tax return is filed. Unfortunately, for the amended returns, the IRS has been extremely slow to process them which is not ideal for businesses that desperately need these funds.

One downfall of the credit is that it reduces the tax deduction for the wages and qualifying health expenses on the income tax return essentially making the credit fully taxable at the federal level. The deduction is lost in the year when the wages are paid. The state income tax rules would have to be examined to determine the tax impact at the state level. In other words, your client's income tax liability might be increased, causing them to pay higher taxes on their 2020 or 2021 income tax return depending on the year the wages related to the credit were paid.

In Summary

The Employee Retention Credit is an extremely powerful credit that could provide immense savings for your clients. The next time you speak to your clients, check with them to see if they are aware of the Employee Retention Credit. Even if they say they know about the Employee Retention Credit and think they do not qualify, I recommend the client take the time to gather a second opinion as the rules of eligibility have been constantly evolving. It could potentially be a wonderful opportunity for them, and they surely will not forget the fact that you proactively asked about their Employee Retention Credit situation.

Michael Kelly has over ten years of experience focusing on taxes while working with various types of industries including medical practices, optometrists, law firms, franchises, family-owned businesses, and construction companies. Michael specializes in individual and business taxation, trust and estate taxation, state and local taxation, and nonprofit advisory. He frequently assists clients with their accounting questions and has a strong understanding of QuickBooks and other bookkeeping software. Continuously thinking of creative solutions to minimize taxes for his clients and increase client efficiency are two of the many areas where Michael excels. He also enjoys the challenge of researching uncertain or unusual federal and state income tax issues, including being heavily involved with his clients on the PPP loan and forgiveness application process.