

Tax Notes

Employee Retention Credit: IRS Issues Guidance as Congress Considers Shortening Its Lifespan

By Christopher Migliaccio, JD, Senior Manager, Employee Retention Credit Leader

Ever since the employee retention credit (ERC) became available to a far wider range of businesses in December, both employers and practitioners have found themselves frustrated by the uncertainty that came with a new piece of the tax law. This has been magnified for the ERC because of the significant financial implications for employers. With a maximum credit of \$5,000 per employee in 2020 and \$28,000 in 2021, it could provide big help to struggling businesses and nonprofits.

While there was great excitement when the Consolidated Appropriations Act made the ERC available for PPP borrowers, numerous key issues have remained unsolved mysteries, and the IRS was asked to step in and provide guidance. On August 4, the IRS issued Notice 2021-49, which weighed in on many open questions, and then followed on August 10 with Revenue Procedure 2021-33, answering one of the biggest ERC questions. The news is decidedly mixed for employers.

This article summarizes the most important news from the IRS Notice and Revenue Procedure, and also looks at current legislation in the Senate that would end the ERC earlier than currently expected.

If you're new to the ERC, check out our [primer](#) and [Q&A](#).

Great News for Restaurants

One positive piece of news is that the IRS confirmed that tips included in taxable wages are qualified wages for the ERC. In addition, the tip credit available for income tax purposes may be claimed along with the ERC on the same wages. This means that restaurants and other tip-based businesses can claim the ERC with confidence that it will not negatively affect their income tax position as it relates to tips.

It should also be noted that for those restaurants that received Restaurant Revitalization grants, wages paid with those funds are not eligible for the ERC. However, Restaurant Revitalization grants can be used for a wide range of expenses, not just wages. The same is true of Shuttered Venue Operator grants for live venue operators and other entities in the performing arts industry.

The PPP Forgiveness Question

Many have wondered whether PPP forgiveness should be included in gross receipts when determining whether a business has a significant decline in gross receipts. If included, depending on the timing of forgiveness and the corresponding inclusion, qualification based on a decline in gross receipts in a quarter would be affected. Revenue Procedure 2021-33 allows a taxpayer to elect to exclude the proceeds from PPP forgiveness, as well as Restaurant Revitalization grants and Shuttered Venue Operator grants, as long as they do so consistently. This should provide great comfort to employers in determining their ERC qualification, particularly in 2021. Note that the Revenue Procedure says that for all other purposes of the Code, the excluded amounts are treated as gross receipts, although they are not taxable. Thus, they could impact calculations where gross receipts totals matter (such as whether a business needs to use the accrual method of accounting).

The Owner-Employee Conundrum

Among the more frequently asked ERC questions has been the treatment of wages paid to more than 50% (majority) owners of businesses. It has been quite clear that wages paid to people related to majority

owners were not eligible for the ERC – i.e., the wages of the son of the owner did not qualify. Prior IRS guidance did not mention the majority owners themselves. While a restriction on majority owners getting credits for wages paid to themselves seemed reasonable, many asked – if that was the intention, why wouldn't the IRS just come out and say that? Now, the IRS has ended the debate, and the answer will surprise many.

The rules relating to the ERC and other employment credits reference the constructive ownership attribution rules of Section 267(c) which are quite broad. Under those rules, an owner's parents, siblings and children are all treated as owners themselves. The IRS notice takes the position that because those related persons are owners, wages paid to a majority owner are disqualified from the ERC as wages paid to someone related to a majority owner. But what happens if the majority owner does not have a living parent, sibling or child? Well, because there's no related person who's an owner under the constructive ownership rules, wages paid to the owner do qualify for the ERC. While this is a reasonable reading of the law in a literal sense, we are faced with a very strange situation, where an owner without family is treated differently for purposes of the ERC than an owner with family. As if you didn't already have enough reasons to be annoyed at your brother...

Many businesses, owing to the uncertainty in this area, may have already filed ERC claims including a majority owner's wages that should have been disqualified. The Notice does clarify that if any additional tax is due on amended returns relating to this clarification, any penalties for failure to timely pay or deposit tax will not apply if the taxpayer can show reasonable cause and not willful neglect of the rules.

Reflecting the ERC on Income Tax Returns

The Notice confirms that ERC credits must be reflected on the tax return for the year in which the wages were paid. Thus, regardless of when an ERC claim for 2020 wages was filed (likely in 2021), the credit must reduce wages on the income tax return for 2020. Since this will decrease deductions, it is possible this will increase tax due. For taxpayers that completed their 2020 returns before determining their ERC eligibility, an amended return will be required.

Note that for non-profit recipients of the ERC, the American Institute of Certified Public Accountants (AICPA) nonprofit members have expressed that the ERC should be treated as grant revenue and not a reduction in wages. The Notice does not address this point, but since the Form 990 is reported on the same method of accounting as the books and records of the organization, the grant revenue will be reported in the same fiscal year that the credit is reported in the organization's financial statements.

Other Clarifications

The Notice also made explicit that:

- For 2021, a company will qualify for a quarter if there is a significant decline in gross receipts in either that quarter or the immediately preceding one. Some have asked whether the same quarter can be used twice – i.e., does a decline in Q1 2021 automatically qualify you for Q2 2021? The IRS has confirmed it does.
- In the calculation of employee count in 2019 for determining whether an entity is a small or large employer, there is no consideration of "full-time equivalents" (FTEs) – only the average monthly full-time *employees* (those working >30 hours/week or >130 hours/month) is relevant. However, there is no restriction on applying the credit to part-time employees if a business qualifies for the ERC.

Will There Be a 4th Quarter ERC?

The text of The Bipartisan Infrastructure Investment and Jobs Act, currently being debated in the Senate, has very few tax provisions. However, one key provision is that it would end the ERC after the third quarter of 2021, instead of at the end of the year. It is estimated that this would save the government approximately \$8 billion dollars that could be put toward infrastructure projects. The bill has undergone many permutations, so it's hard to predict if the bill will be passed or if the ERC provision will end up in the final version if it does. However, it's certainly worth keeping an eye on the status of this proposed legislation if your business believes it will qualify for the ERC in the fourth quarter of 2021.

What Now?

This is an excellent time to review your business' ERC position in light of this additional guidance. Perhaps this guidance gives you certainty to make a claim that you have put off. If you've already made a claim, it's worth reviewing to see if perhaps it was overstated (particularly as it relates to majority owner compensation), as well as to confirm whether it was reflected on the appropriate tax return.

Contact Us

Our team has expertise in determining eligibility for and calculating the ERC across a variety of industries. If you are interested in learning more about our services, contact your client service partner or:

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