IRS issues even more Employee Retention Credit guidance

This latest notice provides specific reporting guidance for the first and second quarters of 2021.

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The Employee Retention Credit (ERC) has emerged as one of the biggest and most confusing COVID-19–related tax provisions. Before we delve into the latest IRS guidance, let's set the stage for the three sets of rules that apply to the ERC. Each set of rules depends on which period the employer paid wages eligible for the credit.

- Rule set #1: Applies to wages paid from March 12, 2020, and before January 1, 2021 (the second, third, and fourth quarters of 2020). Rule set #1 is governed by the CARES Act §2301, as amended by the Taxpayer Certainty and Disaster Tax Relief Act (TCDTRA) §206. Supplemental guidance was issued in IRS Notice 2021-20.
- Rule set #2: Applies to wages paid from January 1, 2021, and before July 1, 2021 (the first and second quarters of 2021). Rule set #2 is governed by the CARES Act §2301, as amended by the TCDTRA §207. Supplemental guidance was issued in IRS Notice 2021-23. Rule set #2 is the subject of this article.
- Rule set #3: Applies to wages paid from July 1, 2021, and before January 1, 2022 (the third and fourth quarters of 2021). Rule set #3 is governed by the American Rescue Plan and is discussed in more detail in "Payroll credits modified by the American Rescue Plan" in this issue of *Spidell's Federal Taxletter®*. Supplemental guidance will be issued in a later IRS notice.

Gross receipts test

Employers are eligible for the ERC if they are subject to a full or partial suspension of their operations, or if they experience a significant decline in gross receipts.[1] For a detailed discussion of what qualifies as a "partial suspension," see "New Employee Retention Credit guidance" in the April 2021 issue of *Spidell's Federal Taxletter®*. There is no change in the definition of "partial suspension" for credits claimed in 2021.

For the first and second quarters of 2021, employers must demonstrate at least a 20% reduction in gross receipts to qualify for the credit. An employer meets this test if their gross receipts for the quarter they are claiming the credit for are less than 80% of their gross receipts for the same calendar quarter of 2019.[2] If the employer was not in existence as of the beginning of the same calendar quarter in 2019, then the same 2020 calendar quarter must be used.[3]

Example of using 2020 gross receipts: ScotCo began business on January 10, 2019. When determining whether its first quarter 2021 gross receipts are eligible for the ERC, it ordinarily must determine whether the first quarter 2021 gross receipts are less than 80% of its first quarter 2019 gross receipts. Because ScotCo was not in existence at the beginning of the first quarter of 2019 (January 1, 2019), it must use its first quarter 2020 gross receipts as its comparison quarter.

Instead of comparing gross receipts for the current quarter with gross receipts from the same quarter in 2019, employers can elect to use an alternative quarter to calculate gross receipts.[4] Under this election, an employer compares the calendar quarter prior to the quarter they are claiming the credit for to the same calendar quarter in 2019 to determine if there is a significant decline in gross receipts.

Example of alternate gross receipts election: Sani, Inc. has the following gross receipts for 2019 through 2021:

	2019	2020	2021
Q1	$105,000	$90,000	$90,000
Q2	$115,000	$95,000	N/A
Q3	$110,000	$90,000	N/A
Q4	$125,000	$80,000	N/A

Sani wants to claim the ERC for wages paid in the first quarter of 2021.

Sani's 2021 Q1 gross receipts are 86% of 2019 Q1 gross receipts ($90,000 ÷ $105,000 = 86%), so Sani doesn't qualify for the ERC under the general comparison rule.

However, Sani can elect to compare its previous quarter (2020 Q4) gross receipts to its 2019 Q4 gross receipts. Under this election, Sani's 2020 Q4 gross receipts are 64% of its 2019 Q4 gross receipts ($80,000 ÷ $125,000 = 64%); therefore, it qualifies for the ERC for the first quarter of 2021.

Note: If Sani was not in existence as of the beginning of the fourth quarter of 2019, then the alternative election is not available.

There is no specific election statement or form required to make this election, and the election can be made on a quarter-by-quarter basis.

Maximum ERC

For the first and second calendar quarters of 2021, the maximum ERC is 70% of qualified wages (including allocable qualified health plan expenses) paid by the employer.[5] The maximum wages per employee are $10,000 per calendar quarter; therefore, the maximum credit per employee is $7,000 ($10,000 maximum wages per employee × 70%) per calendar quarter.

This is an increase over the rules applicable for wages paid in 2020 where the maximum ERC credit was 50% of qualified wages paid, up to $10,000 in *annual* wages per employee.

Eligible employers

For wages paid in the first and second quarters of 2021, an eligible employer must have been carrying on a trade or business during the calendar quarter for which the ERC is claimed.[6] Generally, governmental employers are not eligible for the ERC, but for wages paid in the first and second quarters of 2021, any governmental entity that is a college or university, or whose principal function is providing medical or hospital care, is treated as an eligible trade or business.[7]

Small employers expanded

For the first and second calendar quarters of 2021, the employee threshold to determine whether an employer is a small employer or a large employer is expanded from 100 full-time employees to 500 full-time employees.[8] When determining the number of full-time employees, an employer must use the 2019 calendar year.

An employee is counted as a full-time employee if he or she had an average of at least 30 hours of service per week for any month in 2019 or 130 hours of service in any month in 2019.[9] Only full-time employees are counted for purposes of this threshold. There is no full-time equivalent employee computation.

So, an employer whose average number of full-time employees in 2019 was 500 or less can claim the ERC for the first and second quarters of 2021 for eligible wages paid to each employee, whether the employee was actually working or not. Employers with an average of more than 500 full-time employees in 2019 can only claim the ERC for the first and second quarters of 2021 for wages paid to employees who are not actually working.

Advanced payments of credit

For 2021, only small eligible employers can request advanced payments of the ERC on Form 7200, Advance Payment of Employer Credits Due to COVID-19 (although all employers can still reduce the amount of their payroll deposits).[10]

Small eligible employers (employers with 500 or fewer full-time employees) can elect to receive an advance payment of the ERC up to 70% of the average quarterly wages paid in calendar-year 2019 (the 70% advance rule). **Note:** There was no limit on advance payments for credits claimed in 2020.

Pursuant to Notice 2021-23, the IRS has determined that a small eligible employer determines its average quarterly wages by calculating the average amount of wages required to be reported on all of its Forms 941, Employer's Quarterly Federal Tax Return, on line 5c (Taxable Medicare wages and tips), for the 2019 calendar year.

Employers that file annual payroll tax returns must use the following payroll tax return lines instead of Form 941, line 5c:

- If Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, was used in 2019, then use line 4;
- If Form 944, Employers Annual Federal Tax Return, was used in 2019, then use line 4c;
- If Form CT-1, Employer's Annual Railroad Retirement Tax Return, was used in 2019, then use the sum of the amounts in the compensation columns of line 2 and line 9.

Additional rules for seasonal employers are also provided in Notice 2021-23.

Employee Retention Credit Comparison Chart

Issue	CARES Act/TCDTRA (Q2–Q4 2020)	CARES Act/TCDTRA (Q1 and Q2 2021)	American Rescue Plan (Q3 and Q4 2021)
Eligible employers	Trade or business experiencing: ● A full or partial shutdown; or ● Significant decline in gross receipts, which means a 50% decline in gross receipts from same calendar quarter in 2019 and continues through end of first quarter for which business's gross receipts are greater than 80% of comparable 2019 calendar quarter Nonprofits are eligible, but governmental entities are not Originally PPP loan recipients could not receive credit. This was changed retroactively by TCDTRA	Trade or business experiencing: ● A full or partial shutdown; or ● Significant decline in gross receipts, meaning a 20% decline in gross receipts compared to comparable 2019 calendar quarter. Taxpayers may elect to use prior calendar quarter rather than current calendar quarter to determine if there was a significant decline in gross receipts Governmental entities that are colleges or universities, or whose principal function is providing medical or hospital care are eligible for credit	Same as 2021 Q1 and Q2 criteria, plus: Recovery startup businesses, which is any employer that began trade or business after February 15, 2020, with gross receipts of less than $1 million

Employee Retention Credit Comparison Chart (continued)			
Issue	**CARES Act/TCDTRA (Q2–Q4 2020)**	**CARES Act/TCDTRA (Q1 and Q2 2021)**	**American Rescue Plan (Q3 and Q4 2021)**
Amount of credit	50% of qualified wages	70% of qualified wages	70% of qualified wages
Maximum amount of qualified wages/ credit	$10,000 per employee for the year (credit capped at $5,000 per employee for the year)	$10,000 per employee per calendar quarter (credit capped at $7,000 per employee per quarter)	$10,000 per employee per calendar quarter (credit capped at $7,000 per employee per quarter)
Qualified wages	Includes health plan expenses paid on behalf of employee if excluded from employee's gross income For small employers (defined as 100 or less full-time employees), qualified wages include wages paid to all employees For large employers (defined as more than 100 full-time employees), qualified wages limited to wages paid to employees who are not working. Does not include wages paid: • For which FFCRA credits claimed; or • With PPP forgiven loans	Same as 2020 credit, except definition of "small employer" modified to apply to employers with 500 or fewer full-time employees	Same as 2021 Q1 and Q2 credit, however severely financially distressed employers may claim credit for wages paid to all employees even if the employer has more than 500 employees A severely financially distressed employer is any employer whose gross receipts declined more than 90% in a 2021 calendar quarter compared to same quarter in 2019
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Employee Retention Credit Comparison Chart (continued)			
Issue	**CARES Act/TCDTRA (Q2–Q4 2020)**	**CARES Act/TCDTRA (Q1 and Q2 2021)**	**American Rescue Plan (Q3 and Q4 2021)**
Claiming credit	Claimed on Form 941 Employers may receive advance credit by: • Reducing payroll deposits; and/or • Claiming advance credit payment on Form 7200	Same as 2020 credit except that advance credit payments are limited to small eligible employers (500 or fewer full-time employees), and the amount of advance is limited to 70% of the average quarterly wages paid in calendar-year 2019	Same as 2021 Q1 and Q2 credits
Wage deduction	Wage deduction must be reduced by amount of credit claimed	Wage deduction must be reduced by amount of credit claimed	Wage deduction must be reduced by amount of credit claimed
Statute of limitations period to review credit claimed on return	Three years	Three years	Five years

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1 CARES Act §2301(a)

2 Notice 2021-23; CARES Act §2301(c)(2)(A)(ii)(II) as amended by TCDTRA §207(d)(1)(A)

3 Notice 2021-23; CARES Act §2301(c)(2)(A) as amended by TCDTRA §207(d)(1)(B)

4 Notice 2021-23; CARES Act §2301(c)(2)(A) as amended by TCDTRA §207(d)(2)

5 Notice 2021-23; CARES Act §2301(a) as amended by TCDTRA §207(b)

6 Notice 2021-23; CARES Act §2301(c)(2)(A)(i) as amended by TCDTRA §207(a)(2)

7 Notice 2021-23; CARES Act §2301(f) as amended by TCDTRA §207(d)(3)(A)

8 Notice 2021-23; CARES Act §2301(c)(3)(A)(i) as amended by TCDTRA §207(e)(1)

9 Notice 2021-20; IRC §4980H(c)(4)

10 Notice 2021-23; CARES Act §2301(j) as amended by TCDTRA §207(g)