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Who Actually Qualifies for the Employee Retention Credit?

Even companies that have claimed the ERC may want to review their documentation of qualification for the credit.

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By Christopher Migliaccio.

The Employee Retention Credit (ERC) started out as something of a secret. Originally part of the CARES Act, the ERC was limited in 2020 and only available to organizations which did not receive Paycheck Protection Program (PPP) loans. The Consolidated Appropriations Act, approved in December 2020, retroactively removed the restriction against claiming the ERC if you had received a PPP loan (and expanded the credit in 2021). This went under the radar for many businesses.

Now, in 2022, with no PPP loan program in place, many businesses are starting to look and see if they can retroactively claim the ERC. And, for businesses who haven't researched it themselves, there's likely a company calling to tell them that they qualify for up to \$26,000 in credits per employee. Which would be true – if the company actually qualifies for the ERC in all available periods and the employee earns at least \$10,000 per quarter (discussed further below). But does everyone qualify for the ERC? With IRS audits on the rise, it's an important question for businesses. Even companies that have claimed the ERC may want to review their documentation of qualification for the credit.

How Does an Organization Qualify for the ERC?

The ERC is a credit against payroll taxes owed by an employer on “qualified wages.” To the extent the credit amount exceeds the amount of Social Security tax (Medicare tax for third quarter 2021) due on the wages paid, it is refundable. Businesses are eligible if they were closed (fully or partially) because of a government order related to COVID-19 or have experienced a significant decline in gross receipts. Qualification under the gross receipts test is for full quarters; qualification under the government order test is for the length of the government order. Thus, if a restriction was lifted mid-quarter, qualification ends mid-quarter.

Companies with the same or similar ownership, or that are managed by one central entity, may be required to consider their qualification together under the aggregation rules. Simply filing payroll separately does not mean an entity's ERC qualification can be considered on its own.

How Is the ERC Calculated?

For 2020, the ERC equals 50% of each employee's qualified wages, up to a maximum of \$10,000 of wages for the year, yielding a maximum credit of \$5,000 per employee. In 2021, the ERC equals 70% of each employee's qualified wages, up to a maximum of

\$10,000 of wages *per quarter*, thus yielding a maximum credit of \$7,000 per employee, per quarter. Since the ERC is available for the first three quarters of 2021, the credit is capped at \$21,000 per employee. (There is limited availability of the credit in the fourth quarter of 2021 for “recovery startup businesses” – those beginning after February 15, 2020 that meet certain requirements.) However, please keep in mind that businesses which had over an average of 100 full-time employees during 2019 are only able to claim the 2020 ERC for employees who were being paid for time not worked, and those with over 500 full-time employees in 2019 are subject to the same rule for 2021.

The credit must be calculated with consideration of wages used for PPP loan forgiveness. In addition, wages have to be considered in context of other COVID-era programs, such as the Restaurant Revitalization Fund and Shuttered Venue Operators Grant, receiving other tax credits, or for non-profits, which are paid for directly by grants.

What Does It Mean to be Shut Down by a Government Order?

Qualification using a significant decline in gross receipts test is an objective measure. A business compares its gross receipts in 2020 and 2021 to corresponding quarters in 2019, using the same measure of gross receipts used on its tax return.

Less objective is the meaning of “fully or partially shut down” by a government order. The IRS has issued guidance on qualification via a government order for the ERC. The guidance has mostly been codified in Notices. While Notices do not have the full force of law, they represent the position of the IRS and will certainly be their initial guiding principles on an audit. Businesses that cannot clearly point to how their qualification complies with the Notices may face extended scrutiny, and potentially the requirement to repay the ERC, with penalties and interest.

In the early period of the pandemic (roughly March through June of 2020, although it varies by state and locality), businesses were deemed either essential or non-essential. For some businesses that were deemed not essential (or for whom a significant portion of their business was deemed not essential), and were not able to transition to working virtually, qualification can be relatively clear. Notice 2020-21 provides a four-factor test to analyze whether a business was not able to transition to telework during a period in which their workplace was closed, and thus qualifies for the ERC during that time.

However, for much of the relevant ERC time period, businesses weren't forced to be closed, but were instead subject to restrictions on operations. If a restriction forced a change in operations in some way, does that automatically qualify a business for the ERC? There are those who would point to OSHA guidance as a catch-all to indicate business impact and qualification. But the IRS has indicated that they believe a business facing restrictions on operations only qualifies if the effect of restrictions is more than nominal, defined as 10% of a company's ability to provide goods or services. Setting aside the question of whether 10% is "nominal," the IRS is clearly looking for objective impacts from government orders, not simply a tweak in operations while business continued otherwise as normal, or in some cases, actually increased from pre-pandemic levels.

While some businesses have some objective measures to use (for example, a restaurant may point to capacity restrictions), many businesses do not. However, there are companies telling them they qualify regardless, without any quantifying of impacts on the business. This would be problematic if the IRS audits the business because the IRS is likely to require quantification. A business that does not have quantifiable impacts could be asked to give back the ERC credit, with penalties and interest. We believe the best practice is to ensure you can quantify the impact on your business. If there's no way to do this, you may need to accept that your organization does not qualify for the ERC during a certain time period.

Note that just because the IRS has processed a credit does not mean that they have audited and accepted the claim. The Consolidated Appropriations Act provided five years for the IRS to go back and audit ERC claims, so there's a long available period for them to scrutinize claims.

The Supply Chain Issue

Maybe you've heard that you don't need to show an impact on your business directly; that you can rely on supply chain issues to qualify for the ERC. While the IRS guidance does discuss impact of supply chain issues as a path to qualification, this avenue is much more limited than often portrayed.

First, IRS guidance requires that for a business to qualify as being shut down based on a supply chain issue, the supply chain issue must be because of a shutdown order related to COVID-19. This can be very difficult to prove, as supply chain issues multiplied for a wide variety of reasons in 2020 and 2021.

Moreover, the supply chain issue must cause a partial shutdown of the business. This puts us right back in the discussion of whether the supply chain problem limits the ability to provide goods or services by at least 10%. Again, quantification becomes important, and any claim without that is likely to face scrutiny. It's important not to confuse a supply chain interruption with a simple decline in the volume of business.

What if I've Already Gotten My Credit?

If you're reading this and thinking that perhaps you have claimed the ERC in haste, it's not too late to document your rationale as thoroughly as possible. Review what you have in regard to your qualification and ask yourself a few questions.

If you're relying on a partial shutdown for qualification, did you document the specific, tangible impacts on the organization's ability to provide goods or services? Did you quantify those impacts? If not, now is the time to build your audit file before you're facing IRS document requests and while these issues and your documentation are still relatively fresh.

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