Employee Retention Credits: Analyzing Congressional and IRS Guidance from Start to Finish

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This article, the first in a multi-part series, explores the ERC rules from start to finish.

Introduction

The U.S. economy is humming along, a major disruption occurs, Congress introduces tax incentives to stabilize matters, the Internal Revenue Service ("IRS") provides guidance to implement them, some taxpayers exploit voids and ambiguities to their financial benefit, and the IRS transforms from facilitator to enforcer to halt perceived abuses. This is a timeless tale that has recently centered on the Employee Retention Credit ("ERC").

Given the complexity of the law, the large number of potentially eligible taxpayers, and the pervasiveness of schemes inducing taxpayers to take aggressive or unwarranted positions, battles with the IRS over the ERC will be widespread. Actions by the IRS against those promoting certain ERC claims will abound, too. To understand these inevitable clashes, one must first appreciate the applicable rules. These are complicated, of course, emanating from several laws passed in rapid succession, as well as administrative guidance issued on their heels. This article, the first in a multi-part series, explores the ERC rules from start to finish.

Setting Expectations

Readers should understand a few things before delving into the substance. For starters, this article is *not* intended to

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be a comprehensive treatise; it does not cover every aspect of the ERC or the sources from which it derives. That would be a colossal task, filling many dozens of pages, and inevitably leading most readers down a path of boredom, confusion, and defeat. This article focuses only on key concepts and terminology with broad applicability. Readers with narrower issues are directed to the original sources, where they can get as deep as they like into the proverbial weeds.[1]

Moreover, much of the guidance from Congress and the IRS discussed in this article has been clarified, shortened, paraphrased, or otherwise modified to make it more understandable to readers, particularly those who are not tax professionals. The materials remain dense in many parts despite these efforts; this is an inevitability when dealing with hypertechnical tax matters.

This article discusses each of the four pertinent laws, followed by the corresponding IRS guidance. Some might say the article plods along, and they would be right. This method is necessary, though, for several reasons. For example, definitions, standards and procedures from one piece of legislation often carry over to another, all legislation remains relevant because the rules govern specific quarters in 2020 or 2021, some legislation applies retroactively, and cross-references are plentiful.

Lastly, this article is the first in a long series, and readers will not fully appreciate later installments unless they have this foundation about the origins and development of the ERC.

Evolution of Legislation and IRS Guidance

Congress is no stranger to offering incentives to employers not to fire workers during tough times, particularly in areas negatively impacted by natural disasters. However, dangling financial carrots because of a pandemic, like the Coronavirus, is a rarity. Nobody knew the duration of the disease or its effects on the U.S. economy, which is one reason Congress ending up enacting four laws related to the ERC. These laws, along with some of the corresponding IRS guidance, are explored below.

First Law

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") in March 2020.[2] This was a complicated piece of legislation, which introduced key ERC terms and concepts that evolved over time. Some of them are broken down below.

General Rule

The CARES Act generally provides that an "Eligible Employer" could get an ERC against "Applicable Employment Taxes" equal to 50 percent of the "Qualified Wages" that it paid to each employee for each quarter.[3]

Limitations

The sky was not the limit under the CARES Act. Indeed, it stated that the amount of Qualified Wages for any one employee could not be more than $10,000 for *all* applicable quarters combined. This meant that the maximum ERC per employee was $5,000.[4]

Refunding Excess Credits

The CARES Act also indicated that the ERCs allowed for any particular quarter could not exceed the Applicable Employment Taxes on the wages paid by an Eligible Employer with respect to all employees for such quarter.[5] All was not lost, however. If the amount of ERCs surpassed this cap for any quarter, the excess was treated as an overpayment that would be refunded to the Eligible Employer.[6] Below is an example.

> For a calendar quarter, an Eligible Employer had applicable employment taxes prior to any credits of $10,000 and (1) a credit for research expenditures of a qualified small business of $4,000, (2) a $3,000 credit for paid sick leave under the Families First Coronavirus Response Act and (3) a $5,000 [ERC]. The Eligible Employer's Applicable Employment Taxes are reduced to $0 and it has a $2,000 refundable overpayment.[7]

Definitions

The general rule, explained above, contains three important terms: Eligible Employer, Applicable Employment Taxes, and Qualified Wages. Each is defined below.

Eligible Employer

An Eligible Employer meant an employer that was carrying on a trade or business in 2020, *and* it met one of the following two tests.

First, the employer's operations were partially or fully suspended during a quarter because of an order from an "appropriate governmental authority" limiting commerce, travel, or group meetings for commercial, social, religious, or other purposes due to the Coronavirus ("Governmental Order Test").[8] The following examples clarify this test.

> A restaurant in a state under a statewide order that restaurants offer only takeout service meets the Governmental Order Test, as does a concert venue in a state under a statewide order limiting gatherings to no more than 10 people. Similarly, an accounting firm in a county where accounting firms are among the businesses subject to a directive from public health authorities to cease all activities other than minimum basic operations and that closes its offices and does not require employees who cannot work from home (*e.g.*, custodial employees, mail room employees) to work meets this test.
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> However, a grocery store in a state that generally imposes limitations on food service, gathering size, and travel outside the home, but exempts grocery stores from any [Coronavirus] related restrictions (*e.g.*, because grocery stores are deemed an "essential business" that is excepted from restrictions) would not meet this test.[9]

Second, the employer suffered a significant decline in gross receipts during a particular quarter ("Reduced Gross Receipts Test").[10] The quarter had to fall within the period that *began* the first quarter starting after December 31, 2019, during which the gross receipts for the quarter were less than 50 percent of the gross receipts during the same quarter the previous year, and ended the first quarter after the gross receipts of the employer were greater than 80 percent of the gross receipts the previous year.[11] Here is an illustration:

> If an employer had gross receipts of $100 in each calendar quarter of 2019 and then had gross receipts in the first, second, third, and fourth quarters of 2020 of $100, $40, $90, and $100, respectively, the periods in which such employer is treated as meeting the

[Reduced Gross Receipts Test] are the second and third quarters of 2020.[12]

Applicable Employment Taxes

The term "employment taxes" often refers to three items, namely, (i) federal income taxes paid solely by employees through mandatory withholding done by their employers, (ii) amounts under the Federal Insurance Contributions Act ("FICA"), which are paid partly by employers and partly by employees, and (iii) amounts under the Federal Unemployment Tax Act ("FUTA"), which are paid entirely by employers.[13] When dealing with compensation paid to railroad employees and representatives, the term "employment taxes" also encompasses amounts imposed by the Railroad Retirement Tax Act.[14] The term Applicable Employment Taxes generally meant FICA amounts for purposes of the CARES Act.[15]

Qualified Wages

The notion of Qualified Wages under the CARES Act depended on the number of full-time employees working for an Eligible Employer before things went downhill. Where an Eligible Employer had an average of more than 100 full-time employees ("Large Eligible Employer"), Qualified Wages meant those paid to any employee who was not providing services as a result of the Government Order Test or the Reduced Gross Receipts Test.[16] Various examples follow:

> If a restaurant that had an average of 150 full-time employees during 2019 meets the Governmental Order Test, and the restaurant continues to pay kitchen employees as if they were working 40 hours per week but only requires them to work 15 hours per week, the wages paid . . . for the 25 hours per week with respect to which the kitchen employees are not providing services are Qualified Wages. However, if the same restaurant reduces working hours from 40 hours per week to 15 hours per week and only pays wages for 15 hours per week, no wages paid to the kitchen employees are Qualified Wages.[17]
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> If an accounting firm that had an average of 500 full-time employees during 2019 meets the Governmental Order Test, and during the period in which the governmental order is in place the accounting firm closes its office and does not require custodial and mail room employees to work but continues to pay them their full salaries, wages paid to those custodial and mail room employees for the time they do not work are Qualified Wages. Similarly, if the accounting firm continues to pay administrative assistants their full salaries but only requires them to work two days per week on a rotating schedule, the portion of an administrative assistant's salary attributable to days not worked are Qualified Wages.[18]

The tax treatment was slightly better when it came to smaller businesses. Where an Eligible Employer had an average of 100 or less full-time employees ("Small Eligible Employer"), Qualified Wages meant *all* those paid during the relevant period or quarter.[19] Below are examples of this more flexible rule:

> If a restaurant that had an average of 45 full-time employees during 2019 meets the Governmental Order Test, and the restaurant continues to pay kitchen employees wages as if they were working 40 hours per week but only requires them to work 15 hours per week, *all* of such wages paid during the period to which the governmental order applies are Qualified Wages.
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> If the same restaurant responds to the governmental order by reducing the hours of kitchen employees who had previously worked 40 hours per week to 15 hours per week and only pays wages for 15 hours per week, such wages paid during the period to which the governmental order applies are Qualified Wages.[20]
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> If a grocery store that had an average of 75 full-time employees during 2019 meets the Reduced Gross Receipts Test for the second and third calendar quarters of 2020, all wages paid by the grocery store during those quarters are Qualified Wages.[21]

In addition to the amounts described above, Qualified Wages also included so much of the "Qualified Health Plan Expenses" of the Eligible Employer that are allocable thereto.[22]

The CARES Act placed a limit on Qualified Wages. It stated that they could not exceed the amount that an employee would have been paid for actually working an equivalent duration during the 30 days immediately preceding the relevant period.[23] The following examples show that this cap was designed to avoid rate manipulation.

> If an Eligible Employer subject to this rule paid an employee $15 per hour for

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1 Among other things, this article does *not* address special rules related to deferral of employment tax payments, tax-exempt organizations, government instrumentalities, tribal governments, employers in U.S. territories, aggregated entities treated as a single employer, qualified health plan expenses, and Paycheck Protection Program loans.

2 Public Law 116-126; U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020).

3 Public Law 116-126, Section 2301(a).

4 Public Law 116-126, Section 2301(b)(1); U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 38.

5 Public Law 116-126, Section 2301(b)(2).

6 Public Law 116-126, Section 2301(b)(3)(A).

7 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pgs. 38-39. The tax is reduced by the $4,000 research expenditures credit, $3,000 credit under the Families First Coronavirus Response Act, and $3,000 of the $5,000 ERC. The $2,000 excess ERC is treated as refundable.

8 Public Law 116-126, Section 2301(c)(2)(A)(ii)(I).

9 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 39.

10 Public Law 116-126, Section 2301(c)(2)(A)(ii)(II).

11 Public Law 116-126, Section 2301(c)(2)(B).

12 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 40.

13 Section 3101, Section 3111, Section 3301, and Section 3401.

14 Section 3221.

15 Public Law 116-126, Section 2301(c)(1). These consist of Social Security and Medicare taxes.

16 Public Law 116-126, Section 2301(c)(3)(A)(i).

17 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 40.

18 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 41.

19 Public Law 116-126, Section 2301(c)(3)(A)(ii)(I) and (II).

20 U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 41.

21 *Id.*

22 Public Law 116-126, Section 2301(c)(3)(C)(i).

23 Public Law 116-126, Section 2301(c)(3)(B).

all hours worked prior to meeting the Governmental Order Test, but during the period when the Eligible Employer meets the Governmental Order Test pays the same employee $10 per hour for hours when the employee is providing services and $20 per hour for hours when the employee is not providing services, only $15 per hour of wages paid when the employee is not providing services are Qualified Wages.

If an Eligible Employer subject to this rule paid an employee $15 per hour for all hours worked prior to meeting the Governmental Order Test, but during the period when the Eligible Employer meets the Governmental Order Test pays the same employee $20 per hour (both for hours when the employee is providing services and for hours when the employee is not providing services), only $15 per hour of wages paid when the employee is not providing services are Qualified Wages.[24]

Electing Out of the ERC

Eligible Employers had the right to elect out of ERC treatment for any quarter.[25]

Waiver of Penalties

The CARES Act indicated that the IRS "shall waive" any failure-to-deposit penalties under Section 6656 related to Applicable Employment Taxes if the Eligible Employer's failure to remit certain amounts was due to "reasonable anticipation" of receiving an ERC.[26]

IRS Guidance

Congress instructed the IRS to issue "such forms, instructions, regulations and guidance as are necessary" to accomplish a long list of things related to the ERC. [27] These included guidance on how to meet the Reduced Gross Receipts Test and how to prevent abuse by taxpayers. [28]

Effective and Applicability Dates

Coverage of the ERC changed several times later, but it originally applied to wages paid after March 12, 2020, and before January 1, 2021. In other words, the CARES Act originally had the ERC benefitting Eligible Employers during the second, third, and fourth quarters of 2020. [29]

Form 7200

Within just a few days of Congress enacting the CARES Act, in March 2020, the IRS released one of the first documents to implement it. Specifically, the IRS published Form 7200 (Advance Payment of Employer Credits Due to COVID-19).[30] It instructed Eligible Employers to "retain an amount of employment taxes" equal to their ERCs instead of depositing such amount with the IRS. If there were not enough Applicable Employment Taxes to fully cover the ERCs, then taxpayers were supposed to complete and file a Form 7200 to seek advanced payment from the IRS. Form 7200 offered the following example:

> If an employer is entitled to an [ERC] of $10,000 and was required to deposit $8,000 in employment taxes, the employer could retain the entire $8,000 of taxes as a portion of the refundable tax credit it is entitled to and file a request for an advance payment for the remaining $2,000 using Form 7200.

Notice 2021-20

The IRS released additional administrative guidance in March 2021. Notice 2021-20 specifically said that it *only* applied to the periods contemplated by the CARES Act; that is, second, third and fourth quarters of 2020.[31] The IRS guidance in Notice 2021-20 was, in a word, massive. The meat of Notice 2021-20 came in the form of frequently asked questions ("FAQs"), divided into various topics. Some of these FAQs are examined below.[32]

Eligible Employers

What is a "trade or business" for purposes of the ERC?

The term "trade or business" generally has the same meaning as it does under Section 162. According to that provision, an activity does not qualify as a trade or business unless its primary purpose is to make a profit, and it is carried on with regularity and continuity. However, a taxpayer does not necessarily need to make a profit in a particular year to be in a trade or business, as long as a good faith profit motive exists.[33]

Are self-employed individuals eligible for the ERC?

No, self-employed individuals are not eligible for the ERC when it comes to their own earnings, but those who employ other individuals in their trades or businesses and otherwise meet the requirements to be Eligible Employers are eligible with respect to Qualified Wages that they pay their employees.[34]

Are household employers eligible for the ERC?

Household employers are not considered to operate a trade or business; therefore, they generally are not eligible for the ERC with respect to their household employees.[35]

Governmental Orders

What orders from an "appropriate governmental authority" count for purposes of determining eligibility for the ERC?

Orders, proclamations, or decrees from the federal, state or local government may be considered "orders from an appropriate governmental authority," provided that they limit "commerce, travel, or group meetings (for commercial, social, religious, or other purposes)" due to the Coronavirus and they relate to the suspension of an employer's operation of its trade or business. However, if such directives come from a state or local government (as opposed to the federal government), it must be one that has jurisdiction over the employer's operations. Whether an item constitutes an acceptable order for purposes of the ERC is determined without regard to if, or to what extent, a government is actually enforcing the order.

Statements from a governmental official, including comments made during press conferences or in interviews with the media, do not rise to the level of a governmental order for purposes of the ERC. Additionally, the declaration of a "state of emergency" by a governmental authority does not constitute an order if it does not limit commerce, travel, or group meetings in any manner. A declaration that limits commerce, travel, or group meetings, but does so in a manner that does not relate to the suspension of an employer's trade or business, does not count. Moreover, a statement by a mayor of a city encouraging residents to practice social distancing does not make the cut. Finally, an order issued to a restaurant by a local health department to close because of a health code violation is unrelated to the Coronavirus and thus irrelevant for ERC purposes.

Acceptable governmental orders for ERC purposes include (i) an order from the city's mayor stating that all non-essential businesses must close for a specified period,

(ii) an emergency proclamation by a state that residents must shelter in place for a specified period, other than residents who are employed by an "essential business" and who may travel to and from their workplace, (iii) an order from a local official imposing a curfew on residents that impacts the operating hours of a trade or business for a specified period, and (iv) an order from a local health department mandating a workplace closure for cleaning and disinfecting.[36]

Partial or Full Suspension of Operations

If a governmental order requires non-essential businesses to suspend operations, but allows essential businesses to continue operations, is an essential business considered to have a suspension of operations?

An employer that operates an essential business is not considered to have a partial or full suspension of operations if the governmental order allows its operations to remain open. However, an employer that operates an essential business may be considered to have a partial suspension of operations if, under the facts and circumstances, more than a "nominal portion" of its business operations are suspended. For example, an employer that maintains both essential and non-essential business operations, each of which constituting more than a nominal portion, may have a partial suspension if a governmental order restricts only operations of the non-essential portion. In addition, an essential business that is permitted to continue operating may be considered to have a partial suspension nonetheless, if a governmental order requires it to close for a period of time during normal working hours.

For purposes of the ERC, a portion of an employer's business operations will constitute more than a "nominal portion" if either (i) the gross receipts from that portion of the business operations are not less than 10 percent of the total gross receipts, or (ii) the hours of service performed by employees in that portion of the business are not less than 10 percent of the total number of hours of service performed by all employees in the business.[37]

If a governmental order causes suppliers to a business to suspend their operations, is the affected business considered to have a suspension of operations due to a governmental order?

An employer may have a partial or full suspension of operations due to a governmental order if, under the facts and circumstances, its suppliers are unable to make deliveries of critical goods or materials due to a governmental order. For instance, a company operates a manufacturing business, its normal supplier of raw materials had to suspend operations due to a governmental order, the company cannot procure materials from an alternate supplier, and the employer cannot function for a period of time. The company would be an Eligible Employer during such period because its own operations have been halted as a result of the governmental order that suspended operations of its supplier.[38]

If a governmental order causes a reduction in demand for products or services, and a business responds to the lack of demand by suspending some or all of its operations, is the business considered to have a suspension of operations?

An employer that suspends some or all of its operations because its customers are subject to a governmental order requiring them to stay at home or otherwise causing a reduction in demand for its products or services is *not* considered to have a suspension of its operations due to a governmental order. For example, a car repair company is an essential business that is allowed to remain operating, a governmental order generally requires residents to remain at home, demand for the company's services plummets, and it decides to halt operations. The company is not considered to have a suspension due to a governmental order.[39]

If an employer voluntarily suspends operation of a trade or business or reduces hours due to the Coronavirus, does the employer qualify for the ERC?

No, an employer that voluntarily suspends operation of a trade or business or reduces hours is not eligible for the ERC.[40]

If a governmental order requires an employer to close its workplace, but it is able to continue comparable operations by teleworking, is the employer considered to have a suspension of operations?

If an employer's workplace is closed by a governmental order, but it can continue operating, including operating remotely, its operations are not considered to have been partially or fully suspended as a consequence of a governmental order. However, it might qualify if closure of the workplace causes the employer to suspend business operations for certain purposes but not others. The IRS provides three illustrations on this point.

1. Say a software development company maintains an office in a city where the mayor has ordered that only essential businesses may operate. The company is not an essential business, so it must close the workplace. Before the order, all employees worked remotely one or two times per week, and client meetings were held at various locations. After the order, the company required full-time remote work for all employees and made all client meetings by phone or video conference. The company is not considered partially or fully suspended because it managed to continue its operations after the order in a comparable manner.
2. Another example involves a physical therapy facility located in a city whose mayor has ordered that only essential business can operate. The facility is not among this group. Before the order, all appointments occurred at the facility. Things changed after the order. In particular, the facility moved to an online format, only some clients can be serviced, and employees cannot access all the equipment and tools they normally use during therapy. The operations of the facility are partially suspended due to the order because they could not continue in a comparable manner.
3. The third example centers on a scientific company that conducts research in a laboratory and through the use of computer modeling. The mayor ordered all but essential businesses to cease operations, and the company is not deemed essential. Before the order, the employees doing lab-based research had to work onsite, while those doing computer modeling often worked remotely. After the order, the lab employees could not work, but the others continued in a comparable manner. The company's business operations are considered partially suspended due to the governmental order.[41]

What factors should be considered in determining whether an employer can continue operations comparable to those

before a closure caused by a governmental order?

The IRS will consider a non-exhaustive list of factors in deciding if an employer is able to continue comparable operations. The IRS will assess whether an employer has adequate information-technology and other support to continue operations from another location. Moreover, the IRS will gauge the amount of work that is portable or otherwise susceptible to being performed remotely. The IRS will also analyze the role that an employer's workspace plays in its trade or business; is it necessary, beneficial but not necessary, or just convenient? If the workspace is so critical that operations cannot be performed remotely, "this factor alone indicates that the employer is not able to continue comparable operations." This might be true in situations involving laboratories or manufacturing using special equipment. Finally, the IRS will check the extent to which an employer allowed teleworking before the governmental order was issued. If it permitted no or minimal teleworking, then the employer's business might be deemed partially suspended during a reasonable period required to implement policies, obtain and provide employees with appropriate equipment, and otherwise transition to remote work.[42]

If a governmental order requires an employer to close its workplace for certain purposes, but it can remain open for other purposes, does it have a suspension of operations?

If an employer's workplace is closed due to a governmental order for certain purposes, but it can remain open for other purposes, operations would be considered partially suspended if, under the facts and circumstances, the operations that are closed constitute more than a "nominal portion" and they cannot be performed remotely in a comparable manner. Likewise, if all, or all but a nominal portion, of the business operations can continue, but they must be modified because of a governmental order, such modification is considered a partial suspension if it has more than a "nominal effect" on the operations. The IRS offered the following six scenarios to clarify.

1. A restaurant must stop onsite dining because of a governmental order, but it can continue sales on a carry-out, drive-through, or delivery basis. Because onsite dining represents more than a nominal portion of the restaurant's business, its operations are considered partially suspended.
2. A restaurant must stop onsite dining because of a governmental order, but it can continue food sales on a carry-out, drive-through, or delivery basis. Two months later, a subsequent order allows onsite dining in outdoor spaces, like patios, but continues to preclude indoor dining. Because indoor dining represents more than a nominal portion of the restaurant's business, its operations are considered partially suspended. Another order is issued the following month, this time allowing indoor dining, as long as tables are placed at least six feet apart. This spacing constraint has more than a nominal effect on the restaurant's operations. Therefore, even though the restaurant has resumed all categories of business (*i.e.,* indoor dining, outdoor dining, and food sales on a carry-out, drive-through, or delivery basis), its operations are partially suspended.
3. A retail business must close its storefront locations because of a governmental order. However, the business also maintains a website through which it continues fulfilling online orders unaffected. Because store sales constitute more than a nominal portion of total operations, the business is considered partially suspended.
4. A hospital is considered an essential business under a governmental order, but only with respect to its emergency room and intensive care unit. Other aspects of its medical operations, such as elective procedures, are not deemed essential and cannot continue. The non-essential aspects represent more than a nominal portion of the hospital's operations. Therefore, although the hospital is an essential business, it has suffered a partial suspension.
5. A governmental order allows a grocery store to operate as an essential business and it can sell prepackaged goods, but must stop self-serve offerings, like the salad bar. Self-serve offerings do not represent more than a nominal portion of the store's operations, and halting them does not trigger more than a nominal effect. Accordingly, the store's operations are not partially suspended.
6. A large retailer must close its storefront location due to a governmental order, but customers can continue ordering items online or by phone and then pick them up curbside. Storefront operations represented more than a nominal portion of the overall operation; therefore, the retailer was partially suspended during this period. Two months later, another order was issued, and it allowed the retailer to reopen its store, under certain conditions. In particular, the store had to enforce social distancing guidelines, which resulted in some customers having to wait in line outside for short periods during peak times. The second order did not have more than a nominal effect on the retailer's operations, despite the modification. Accordingly, the retailer did not suffer a partial suspension.[43]

What factors should be taken into account in determining whether a modification required by a governmental order has more than a "nominal effect" on business operations?

The types of modifications contemplated in the preceding segment are those mandated by a governmental order as a condition to reopening a workplace to the public. Examples of such modifications include limiting occupancy to create social distancing, requiring that services be performed on an appointment-only basis by businesses that previously allowed walk ins, making employees and customers wear face masks, or changing the format of service, like allowing the sale of carry-out or prepacked food, but not sit-down dining.

The fact that an employer must modify its operations because of a governmental order does not result in a partial suspension for ERC purposes, unless it has more than a "nominal effect" on operations. This determination is based on the particular facts and circumstances of each situation, but generally a decrease of less than 10 percent of an employer's ability to provide goods or services is considered nominal.[44]

Are operations considered to be partially suspended if an employer must reduce its operating hours by a governmental order?

Yes, an employer that diminishes its operating hours due to a governmental order has been partially suspended. For instance, a company runs a food-processing facility that normally operates 24 hours a day, the local health department demands that such facility do a deep-clean once a day to prevent the spread of the Coronavirus, and the company reduces the workday to 19 hours to accommodate the obligatory cleaning. The company is considered to have partially suspended work because of a governmental order.[45]

Is an employer that operates in multiple locations and is subject to a governmental order requiring suspension of operations in only some jurisdictions considered to have a partial suspension?

Yes, employers that operate a trade or business in multiple locations and get hit with governmental orders forcing them to cease activities in some, but all not, locations are considered partially suspended for ERC purposes. To operate in a consistent manner on a national or regional basis, these employers might set policies that comply with both local governmental orders and national recommendations from, say, the Department of Homeland Security and Centers for Disease Control. Under these circumstances, even though the employer may not be subject to a governmental order to stop operations in certain locations, and even though it may be merely following guidelines from federal organizations, the employer would still be considered partially suspended in such locations.

If an employer is subject to a governmental order to suspend its business operations and such order is later lifted in the middle of a quarter, is the employer an Eligible Employer for the entire quarter?

An employer with business operations that are suspended, fully or partially, due to a governmental order for a portion of a quarter is an Eligible Employer for the entire quarter. However, only wages paid with respect to the period during which the employer's operations are suspended may be considered Qualified Wages.

For example, a state issued a governmental order for all non-essential business to close from March 10, 2020, through April 20, 2022. The company thus closes. It was a Large Eligible Employer during the first quarter and second quarter 2020, but it may only claim the ERC for wages paid from March 13, 2020 (*i.e.,* the date on which the CARES Act first took effect) through April 20, 2020, for employees who were not providing services during this period because of the order. The company could not claim the ERC for the rest of the second quarter, from April 21, 2020, through June 30, 2020.[46]

Reduction in Gross Receipts Test

How is the period during which there is a significant decline in gross receipts determined?

The period during which a significant decline in gross receipts exists is determined by identifying the first quarter in 2020, if any, in which an employer's gross receipts are less than 50 percent of its gross receipts for the same quarter in 2019. The period ends January 1, 2021, or the quarter after the quarter in which the employer's gross receipts are more than 80 percent of its gross receipt for the same quarter in 2019, which happens earlier.

The IRS supplied the following example. A company's gross receipts were $100,000 in first quarter 2020, $190,000 in second quarter 2020, and $230,000 in third quarter 2020. By comparison, its gross receipts were $210,000 in first quarter 2019, $230,000 in second quarter 2019, and $250,000 in third quarter 2019. Accordingly, the company's gross receipts in the first, second, and third quarters of 2020 were 48 percent, 83 percent, and 92 percent of its gross receipts in the same quarters of 2019. This means that the company experienced a significant decline in gross receipts *starting* the first day of the first quarter of 2020 *(i.e.,* the quarter during which gross receipts were less than 50 percent of those in the same quarter of 2019) and *ending* on the first day of the third quarter of 2020 (i.e., the quarter after the first quarter in which the gross receipts were more than 80 percent of those in the same quarter of 2019). Consequently, the company was an Eligible Employer for the first and second quarters

NOTES

[24] U.S. Joint Committee on Taxation. Description of the Tax Provisions of Public Law 116-136, The Coronavirus Aid, Relief, and Economic Security Act. JCX-12R-20 (April 23, 2020), pg. 41.
[25] Public Law 116-126, Section 2301(g).
[26] Public Law 116-126, Section 2301(k).
[27] Public Law 116-126, Section 2301(l).
[28] *Id*.
[29] Public Law 116-126, Section 2301(m).
[30] Internal Revenue Service. Instructions for Form 7200 (March 2020), pg. 2. Taxpayers could also request credits for appropriate amounts paid under the FFCRA.
[31] Notice 2021-20, Section I.
[32] Notice 2021-20, Section III.
[33] Notice 2021-20, Section III, FAQ 1.
[34] Notice 2021-20, Section III, FAQ 5.
[35] Notice 2021-20, Section III, FAQ 6.
[36] Notice 2021-20, Section III, FAQ 10.
[37] Notice 2021-20, Section III, FAQ 11. Taxpayer must do the gross receipts calculation and hours of service calculation using the figures from the same quarter in 2019.
[38] Notice 2021-20, Section III, FAQ 12.
[39] Notice 2021-20, Section III, FAQ 13. The IRS notes that the company might meet the alternative test, the Reduced Gross Receipts Test, depending on the circumstances.
[40] Notice 2021-20, Section III, FAQ 14.
[41] Notice 2021-20, Section III, FAQ 15.
[42] Notice 2021-20, Section III, FAQ 16.
[43] Notice 2021-20, Section III, FAQ 17.
[44] Notice 2021-20, Section III, FAQ 18.
[45] Notice 2021-20, Section III, FAQ 19.
[46] Notice 2021-20, Section III, FAQ 22.
[47] Notice 2021-20, Section III, FAQ 23.
[48] Notice 2021-20, Section III, FAQ 24.
[49] Notice 2021-20, Section III, FAQ 27.
[50] Notice 2021-20, Section III, FAQ 28.
[51] Notice 2021-20, Section III, FAQ 29.
[52] Notice 2021-20, Section III, FAQ 30.
[53] Notice 2021-20, Section III, FAQ 31.
[54] Notice 2021-20, Section III, FAQ 33.
[55] Notice 2021-20, Section III, FAQ 34.
[56] Notice 2021-20, Section III, FAQ 35.
[57] Notice 2021-20, Section III, FAQ 38.
[58] Notice 2021-20, Section III, FAQ 39.
[59] Notice 2021-20, Section III, FAQ 50.
[60] *Id*.
[61] Notice 2021-20, Section III, FAQ 57.
[62] Notice 2021-20, Section III, FAQ 60.
[63] Notice 2021-20, Section III, FAQ 62.
[64] Notice 2021-20, Section III, FAQ 66.
[65] Notice 2021-20, Section III, FAQ 67.
[66] Public Law 116-260, Division EE (Dec. 27, 2020). The Relief Act was one portion of the larger Consolidated Appropriations Act of 2021.
[67] *See, generally*, U.S. Joint Committee on Taxation. Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security. JCX-3-21 (Feb. 8, 2021), pgs. 66-70.
[68] Public Law 116-260, Division EE, Section 207(a) (Dec. 27, 2020).
[69] Public Law 116-260, Division EE, Section 207(b) (Dec. 27, 2020)
[70] Public Law 116-260, Division EE, Section 207(c) (Dec. 27, 2020).

of 2020 under the Reduced Gross Receipts Test.[47]

What are "gross receipts" for an employer?

For purposes of the ERC, the term "gross receipts" has the meaning set forth in an unrelated provision, Section 448(c). It includes total sales (net of returns and allowances), all amounts received for services performed, and any income from investments, incidentals, or outside sources. For instance, gross receipts encompasses interest, dividends, rents, royalties, and annuities, regardless of whether they derive from a taxpayer's trade or business. Gross receipts normally are not reduced by cost of goods sold, but they are lowered by a taxpayer's adjusted basis in certain business property or capital assets sold. Finally, loan repayments and certain sales taxes imposed on purchasers (but collected and remitted by the seller) are not part of gross receipts.[48]

How does an employer that started its business in 2019 determine whether it experienced a significant decline in gross receipts?

The answer varies depending on which quarter in 2019 the business began. An employer that started its business in *first* quarter 2019 should use gross receipts for the applicable quarter of 2019, described below, for comparison to gross receipts for the same quarter in 2020 to determine whether it experienced a significant decline in gross receipts in 2020. An employer that started its business in *second* quarter 2019 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for the first and second quarters of 2020, and should use the third and fourth quarters of 2019 for comparison to the third and fourth quarters of 2020. An employer that started its business in *third* quarter 2019 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for the first, second, and third quarters of 2020, and should use the *fourth* quarter of 2019 for comparison to the fourth quarter of 2020. An employer that started its business in the fourth quarter 2019 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for any quarter in 2020. If an employer started business in the *middle* of a quarter in 2019, it should estimate the gross receipts it would have had for the entire quarter based on the gross receipts for the portion of the quarter that the business was in operation. The employer may use "any reasonable method" to calculate this amount, including extrapolating based on the gross receipts for the number of days its business was operating during the quarter.[49]

How does an employer that acquires a trade or business during 2020 determine if it experienced a significant decline in gross receipts?

To determine whether it experiences a significant decline in gross receipts, an employer that acquires (through an asset purchase, stock purchase, or any other form of acquisition) a trade or business during 2020 must include gross receipts from the acquired business in its gross receipts computation for each quarter that it owns and operates the acquired business. Solely for purposes of the ERC, when an employer compares its gross receipts for a quarter in 2020 when it owns an acquired business to its gross receipts for the same quarter in 2019, the employer may, to the extent the information is available, include gross receipts of the acquired business in its gross receipts for the quarter in 2019. Under this "safe harbor" approach, the employer may include these gross receipts regardless of the fact that it did not own the acquired business during that quarter in 2019.

An employer that acquires a trade or business in the middle of a quarter in 2020 and that chooses to use this safe harbor approach must estimate the gross receipts it would have had from that acquired business for the entire quarter based on the gross receipts for the portion of the quarter that it owned and operated the acquired business. However, an employer that elects not to use this safe harbor approach only needs to include gross receipts from the acquired business for the portion of the quarter that it owned and operated such business.

For instance, a company acquired all the assets of a business in a taxable transaction on January 1, 2020. The gross receipts of the acquired business were $50,000 for the first quarter 2020, and $200,000 for the first quarter 2019. The company has access to the books and records of the prior owner of the acquired business, such that it can calculate the gross receipts attributable to the acquired business for first quarter 2019. For purposes of the ERC, the company must include $50,000 in its gross receipts computation for first quarter 2020 (because the company actually owned the acquired business) and may include $200,000 in its gross receipts computation for first quarter 2019.[50]

Maximum Amount of ERC

How is the maximum amount of the ERC available to an Eligible Employer determined?

The ERC equals 50 percent of Qualified Wages, including allocable Qualified Health Plan Expenses, that an Eligible Employer pays in a quarter. The maximum amount of Qualified Wages that can be taken into account with respect to *each* employee for all quarters in 2020 is $10,000, which means that the largest ERC for an employee in 2020 is $5,000.

For instance, a company pays $8,000 in Qualified Wages to the employee for second quarter 2020, and $8,000 for third quarter 2020. Even though the company paid the employee a total of $16,000, the maximum is $10,000 for the entire year. Therefore, the ERC available to the company is $4,000 for second quarter and $1,000 for third quarter because of the 50 percent limit.[51]

Qualified Wages

What are Qualified Wages?

The circumstances in which payments by an Eligible Employer will be considered Qualified Wages depend, in part, on the average number of full-time employees it had during 2019. For a Large Eligible Employer (*i.e.*, one with more than 100 employees), Qualified Wages are those paid to an employee for time that the employee is not providing services due to either the Governmental Order Test or the Reduction Gross Receipts Test. By contrast, for a Small Eligible Employer *(i.e.,* 100 employees or less), Qualified Wages are those paid to an employee during any quarter in which business operations are partially or fully suspended because of the Governmental Order Test or any quarter in which the company meets the Reduced Gross Receipts Test.[52]

How does an Eligible Employer identify the average number of full-time employees during 2019?

The term "full-time employee" means an employee who, for any calendar month in 2019, had an average of at least 30 hours of service per week, or 130 hours per month. An employer uses a different calculation depending on whether it operated its business for all of 2019, started the business during 2019, or began in 2020.[53]

What may a Small Eligible Employer treat as Qualified Wages?

Small Eligible Employers may treat essentially all wages (other than any wages taken into account under the Families First Coronavirus Response Act) paid after March 12, 2020, and before January 1, 2021, with respect to their employees for any period in the quarter during which their business operations are fully or partially suspended due to the Governmental Order Test, or during a quarter in which they meet the Reduced Gross Receipts Test.[54]

What may a Large Eligible Employer treat as Qualified Wages?

Large Eligible Employers may treat wages (other than any wages taken into account under the Families First Coronavirus Response Act) paid to employees after March 12, 2020, and before January 1, 2021, *only* for the time they are not providing services in the period of the quarter during which the employer's operations are fully or partially suspended due to the Governmental Order Test, or the employer meets the Reduced Gross Receipts Test. Large Eligible Employers may not treat wages as Qualified Wages if they were paid to employees for the time they actually provided services to the employer.

For example, a Large Eligible Employer operating a local chain of restaurants is subject to a governmental order prohibiting indoor food service, but leaving unaffected food sales on a carry-out, drive-through, or delivery basis. The Large Eligible Employer continues to pay the kitchen staff and others who work. These are not Qualified Wages.

As another example, a Large Eligible Employer was forced to suspend operations at the end of first quarter 2020. Its employees performed services at the beginning of the first quarter, but then stopped due to the order. Despite this work stoppage, the Large Eligible Employer paid normal wages for the entire first quarter. Those paid for the period during which the employees were not working were Qualified Wages.[55]

May a Large Eligible Employer claim an ERC for an increase in the amount of wages it paid its employees during the time that they are not providing services?

When it comes to Large Eligible Employers, Qualified Wages paid to an employee may not exceed what the employee would have been paid for working an equivalent amount during the 30 days immediately preceding the start of the full or partial suspension of the operation, or the first day of the quarter in which the employer experienced a significant decline in gross receipts. The amount paid for working an equivalent amount may be determined using "any reasonable method" when it comes to variable-hour employees.

For instance, the company is a Large Eligible Employer operating a chain of grocery stores, which is subject a governmental order that limits store hours. The company, in response to the order, reduces the number of hours its employees work, but increases the hourly rate by $2. Only the amounts paid to employees for time when they are not providing services, and at the prior hourly rate, would be considered Qualified Wages.[56]

May an Eligible Employer treat wages paid to employees pursuant to a pre-existing vacation, sick or personal-leave policy as Qualified Wages?

A Large Eligible Employer may not treat as Qualified Wages amounts paid to employees for paid-time-off for vacations, holidays, sick days, etc. These wages are paid pursuant to existing leave policies, which represent benefits accrued during an earlier period in which the employees provided services and are not wages paid for time during which the employees are not providing services.

On the other hand, a Small Eligible Employer may treat as Qualified Wages all wages paid with respect to employees during the period of full or partial suspension of operations or a quarter during which it

NOTES

71 Public Law 116-260, Division EE, Section 207(e) (Dec. 27, 2020).
72 *Id.*
73 Public Law 116-260, Division EE, Section 207(d) (Dec. 27, 2020).
74 *Id.*
75 Public Law 116-260, Division EE, Section 207(i) (Dec. 27, 2020). This article does not explore all new data provided in Notice 2021-23; it focuses on the most relevant aspects.
76 Notice 2021-23, Section II.
77 Notice 2021-23, Section III, A.
78 Notice 2021-23, Section III, D.
79 Notice 2021-23, Section III, E.
80 *Id.*
81 *Id.*
82 Notice 2021-23, Section III, C.
83 *Id.*
84 *Id.*
85 *Id.*
86 *Id.*
87 Public Law 117-2 (March 11, 2021).
88 Public Law 117-2, Section 9651(a) (March 11, 2021).
89 U.S. House of Representatives. American Rescue Plan Act of 2021. 117th Congress, First Session. Report 117-7 (Feb. 24, 2021), pg. 776.
90 Public Law 117-2, Section 9651(a) (March 11, 2021).
91 *Id.*
92 *Id.*
93 Notice 2021-20 continues to apply to second, third and fourth quarters of 2020, and Notice 2021-23 continues to apply to first and second quarters of 2021. *See* Notice 2021-49, Section I.
94 Notice 2021-49, Section I.
95 Notice 2021-49, Section III, A.
96 Notice 2021-49, Section III, D.
97 *Id.*
98 *Id.*
99 Section 6501(b)(2); Treas. Reg. § 301-6501(b)-1(b); Private Letter Ruling 8510004.
100 Treas. Reg. § 301.6501(b)-1(b).
101 Notice 2021-49, Section III, G. Section 6501(b)(2) has special rules for employment tax returns. It states that if a return for any period ending with or within a calendar year is filed before April 15 of the following year, then it shall be considered field on April 15. In other words, the filing date is pushed until later, thereby creating a longer assessment-period for the IRS.
102 Notice 2021-49, Section III, G.
103 Notice 2021-49, Section IV.
104 *Id.*
105 Revenue Procedure 2021-33, Section 1. *See* Paycheck Protection Program Flexibility Act of 2020, Public Law 116-142.
106 Revenue Procedure 2021-33, Section 3.03.
107 *Id.*
108 Revenue Procedure 2021-33, Section 3.04.
109 Revenue Procedure 2021-33, Section 6.
110 Public Law 117-58 (Nov. 15, 2021).
111 Public Law 117-58, Section 80604(a) (Nov. 15, 2021).
112 *Id.*
113 *Id.*
114 Notice 2021-65, Section III, A.
115 Notice 2021-65, Section III, B.

has a significant decline in gross receipts, even if paid under a pre-existing vacation, holiday, sick and other leave policy.[57]

May an Eligible Employer treat payments to former employees as Qualified Wages?

Payments, including severance and other post-termination payments, made to a former employee are not Qualified Wages for purposes of the ERC. This is because they constitute payments for a prior employment relationship, not one during which an ERC can be claimed. The question of whether employment has terminated is based on all the facts and circumstances.[58]

Claiming the ERC

How does an Eligible Employer claim the ERC?

An Eligible Employer reports its Qualified Wages and the amount of ERCs to which it is entitled on the designated lines of its federal employment tax return, which normally is Form 941 (Employer's Quarterly Federal Tax Return). Eligible Employers can do two things in anticipation of receiving their ERCs. First, they can reduce their deposits up to the amount of the anticipated ERCs. Second, they can request by filing Form 7200 (Advance Payment of Employers Credits Due to COVID-19) an advance payment of the amount by which the ERCs exceed the reduced deposits.[59]

Here is an example from the IRS. The company paid $10,000 in Qualified Wages. It was required to deposit $8,000 in federal employment taxes for all its employees for all wages paid during the same quarter as it paid the Qualified Wages. In anticipation of receiving the ERCs, the company can keep $5,000 of the $8,000 that it was otherwise obligated to deposit with the IRS, and it will not incur a failure-to-deposit penalty for doing so. The company will account for the $5,000 that it retained when it later files its Form 941 for the relevant quarter.[60]

May an Eligible Employer that files quarterly Forms 941 take into account Qualified Wages paid in a prior quarter?

An Eligible Employer may file a claim for refund or make an interest-free adjustment by filing Form 941-X (Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund) for a previous quarter. For instance, the company is an Eligible Employer that paid Qualified Wages during second quarter 2020 but did not claim the ERCs on its corresponding Form 941. If the company later decides to seek the ERCs, it should file a Form 941-X for second quarter 2020 within the appropriate timeframe.[61]

Employees Cannot Exclude Qualified Wages from Income

Can employees characterize Qualified Wages as "qualified disaster relief payments" and thus exclude them from gross income?

Section 139 generally excludes from gross income payments to individuals for expenses they incurred as a result of certain disasters. Qualified Wages are *not* such payments because they constitute what an individual would otherwise earn as compensation, not expenses.

Eligible Employers Must Reduce Income Tax Deductions

Do the ERCs that an Eligible Employer receives reduce the expenses that it can deduct on its federal income tax returns?

Yes. The CARES Act expressly states that rules similar to Section 280C(a) apply for purposes of applying the ERC. This means that an Eligible Employer's income tax deduction for the Qualified Wages it paid, including Qualified Health Plan Expenses, is reduced by the amount of the ERC it receives.[62]

Use of Third-Party Payers

Can an Eligible Employer that uses a third-party to report and pay employment taxes get ERCs?

If a common-law employer is otherwise eligible to receive ERCs, it is entitled to them regardless of whether it uses a third-party payer, such as a reporting agent, payroll service provider, professional employer organization, certified professional employer organization, or Section 3504 Agent. Different rules apply depending on the type of third-party payer utilized.[63]

What information must third-party payers obtain from their client employers to claim ERCs on their behalf?

If a third-party payer is claiming ERCs on behalf of a client-employer, it must collect from the client-employer all information necessary to make an accurate claim. This includes obtaining information with respect to claims for other credits or benefits by the client-employer, as well as whether it received a Paycheck Protection Program ("PPP") loan.[64]

May third-party payers rely on information from their client-employers regarding the ERC?

If a third-party payer is claiming ERCs on behalf of the client-employer, it may rely on the client-employer's information about its eligibility to claim ERCs. Either the third-party payer or the client-employer may maintain all records substantiating eligibility. However, if the client-employer does so, and if the IRS seeks them from the third-party payer, then it is responsible for retrieving the records from the client-employer and supplying them to the IRS. Both the client-employer and the third-party payer will be liable for any employment taxes due because of improper claims for ERCs on returns filed by the third-party payer.[65]

Second Law

Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020 ("Relief Act") in December 2020.[66] It extended and modified the existing ERC law in several ways, some of which are explored below.[67]

Eligible Employers originally could claim ERCs only for second, third, and fourth quarters of 2020. The Relief Act broadened the scope, adding first and second quarters of 2021.[68]

The Relief Act made several changes related to Qualified Wages. For example, it increased the relevant percentage. The CARES Act contemplated an Eligible Employer getting an ERC equal to 50 percent of the Qualified Wages that it paid. The Relief Act raised that to 70 percent.[69] Moreover, the Relief Act favorably adjusted the cap on Qualified Wages. The amount was initially $10,000 per employee for all quarters, creating a maximum ERC of $5,000 per employee in 2020. The Relief Act boosted this to $10,000 for each employee, for each quarter.[70]

The Relief Act also modified the standards for being a Small Eligible Employer and Large Eligible Employer, thereby making it easier to claim ERCs for all wages paid to employees during certain quarters, not just to those who were not providing services.[71]

The last change was that the Relief Act eliminated the earlier rule that the Qualified Wages paid by a Large Eligible Employer

to an employee cannot surpass the amount such employee would have been paid for actually working the same amount during the 30 days immediately before the period when the Governmental Order Test or Reduced Gross Receipts Test was met.[72]

The standards for meeting the Reduced Gross Receipts Test were lowered under the Relief Act, which made achieving Eligible Employer status easier. Instead of gross receipts having to fall below 50 percent of the previous mark, they only had to be less than 80 percent during the same quarter in 2019.[73]

The Relief Act also gave employers the power to elect, in determining whether they meet the Reduced Gross Receipts Test, to compare the gross receipts of the immediately preceding quarter to those for the corresponding quarter in 2019, instead of using the quarter for which the ERC is claimed.[74]

Finally, the Relief Act mandated that the IRS carry out a "public awareness campaign," in conjunction with the Small Business Administration, to ensure that potential Eligible Employers were aware of the ERC. The IRS had to swiftly notify relevant employers and supply them "educational materials."[75]

Notice 2021-23

The IRS needed to provide yet more administrative direction. This time, it came in the form of Notice 2021-23. The new guidance generally did *not* change the information that the IRS previously issued in Notice 2021-20, which only concerned the CARES Act. Rather, Notice 2021-23 "amplified" its earlier guidance, taking into account changes that Congress made in the Relief Act.[76]

Expansion of ERC

Notice 2021-23 starts with scope, confirming that an Eligible Employer might be able to claim ERCs not only for the second, third and fourth quarters of 2020 (as it could under the CARES Act), but also for the first and second quarters of 2021.[77]

Increase of Maximum Amount of ERCs

Notice 2021-23 reminded taxpayers that for second, third and fourth quarters of 2020 an Eligible Employer could claim ERCs for 50 percent of Qualified Wages, up to a maximum of $10,000 per employee for all of 2020. Simple math shows that Eligible Employers could get no more than $5,000 per employee that year.

Things changed in two ways for first and second quarters of 2021 thanks to the Relief Act. The percentage increased from 50 to 70, *and* the amount was calculated per quarter, not per year. As a result, if an Eligible Employer were to pay an employee $10,000 in Qualified Wages in each of the first and second quarters of 2021, then the ERCs would total $14,000 (i.e., $7,000 per quarter).[78]

New Small and Large Eligible Employer Standards

Notice 2021-23 explained that whether amounts paid by an Eligible Employer will constitute Qualified Wages depends, in part, on the average number of full-time employees. The standards changed pursuant to the Relief Act.

Notice 2021-23 began by summarizing the original rules. For purposes of the ERC for 2020, for an Eligible Employer with an average of more than 100 full-time employees in 2019 ("2020 Large Eligible Employer"), Qualified Wages were those paid to employees for the time that they were not providing any services because of the Governmental Order Test or the Reduction in Gross Receipts Test. By contrast, for an Eligible Employer with 100 or fewer full-time employees in 2019 ("2020 Small Eligible Employer"), Qualified Wages were those paid to any employee (regardless of whether they were providing services or not) during any quarter that business operations were partially or fully suspended because of the Governmental Order Test or when the employer met the Reduced Gross Receipts Test.[79]

The Relief Act modified the figures regarding full-time employees. In particular, Large Eligible Employers became those whose average number of full-time employees during 2019 was more than 500 ("2021 Large Eligible Employer"), while Small Eligible Employers were those with an average of 500 or less ("2021 Small Eligible Employer").[80]

Abolishing Limit for Large Eligible Employers

Notice 2021-23 explained that, under the CARES Act and earlier Notice 2021-20, the Qualified Wages for 2020 Large Eligible Employers could not exceed what an employee would have been paid for actually working an equivalent amount during the 30 days immediately preceding the start of the suspension because of the Governmental Order Test or when the employer met the Reduced Gross Receipts Test. The Relief Act abolished that limit, such that it did not apply for determining Qualified Wages for first and second quarters of 2021.[81]

Reduced Gross Receipts Test Easier to Meet

Among the issues that will likely be hotly contested with the IRS is whether an employer meets the Reduced Gross Receipts Test for particular quarters. Notice 2021-23 elaborates on this subject.[82] It explained that, under the CARES Act and the earlier Notice 2021-20, the period during which an employer experienced a significant decline in gross receipts was generally determined by identifying the first quarter in 2020, if any, in which its gross receipts were less than 50 percent of its gross receipts for the same quarter in 2019. Moreover, the period ended on January 1, 2021, or the quarter after the quarter in which the employer's gross receipts in 2020 exceeded 80 percent of its gross receipts for the same quarter in 2019, whichever occurred first.

The Relief Act introduced changes. Specifically, that legislation provided that an employer is an Eligible Employer for any quarter during which its gross receipts were less than 80 percent of its gross receipts for the same quarter in 2019. Thus, when it comes to the ERC for the first and second quarters of 2021, the determination of Eligible Employer status is made separately for each quarter and it is based on a threshold of 80 percent.[83]

Notice 2021-23 underscored other changes found in the Relief Act focused on what quarters should be compared in determining whether the Reduced Gross Receipts Test is met in situations where employers started operations at different times. It explained that, with respect to an employer for any quarter, if the employer was not in existence as of the beginning of the same quarter in 2019, then the rule should be applied by substituting 2020 for 2019. The result is that if any employer did not exist at the beginning of the first quarter of 2019, then it ordinarily compares

its gross receipts from first quarter 2021 to those in first quarter 2020. Similarly, if an employer did not exist at the start of second quarter of 2019, then it normally compares gross receipts from the second quarter 2021 to those from second quarter 2020.[84]

Election by Employers of Measurable Quarters

Notice 2021-23 pointed out that the Relief Act permits an employer to elect to use an alternative/different quarter to calculate gross receipts. With this election, an employer generally determines whether the Reduced Gross Receipts Test is met for a quarter in 2021 by comparing its gross receipts from the immediately preceding quarter with those for the corresponding quarter in 2019 (and by substituting 2020 for 2019 if the employer did not exist at the start of that quarter in 2019). For instance, for the first quarter 2021, an employer could elect to use its gross receipts from fourth quarter 2020 and compare them to those from fourth quarter 2019. In situations where an employer did not exist as of the start of fourth quarter 2019, an alternative election would not be available for first quarter 2021. When it comes to second quarter 2021, an employer could elect to compare gross receipts from first quarter 2021 to those of first quarter 2019. If, however, an employer did not exist at the beginning of first quarter 2019, the employer could elect to measure the decrease for second quarter 2021 by comparing gross receipts for first quarter 2021 with those from first quarter 2020.[85]

Warnings of Enforcement

The IRS cautioned employers in Notice 2021-23 that audits regarding the Reduced Gross Receipts Test were likely. It did so by warning all employers that they "must maintain documentation to support the determination," including any alternative quarter they elect to use for the sake of comparison.[86]

Third Law

Congress passed the American Rescue Plan Act of 2021 ("ARP Act") in March 2021.[87] Importantly, it codified the ERC, making it Section 3134 of the Internal Revenue Code.

The ARP Act further expanded the ERC, allowing Eligible Employers to claim benefits for the third and four quarters of 2021.[88] Thus, at that point, the ERC was available with respect to the second, third, and fourth quarters of 2020 (under the CARES Act), first and second quarters of 2021 (under the Relief Act), and third and fourth quarters of 2021 (under the ARP Act). Why did Congress prolong the ERC period by two additional months? According to the legislative history, the U.S. economy had lost about 10 million jobs, the financial slowdown from the Coronavirus persisted, and many individuals count on their jobs not only for wages, but also for healthcare, retirement savings, childcare, and other benefits.[89]

The ARP Act added special rules for "Recovery Startup Businesses," which are those that began carrying on a trade or business *after* February 15, 2020, and whose average annual gross receipts during the relevant period did not exceed $1 million.[90]

The ARP Act inserted new rules about "Severely Financial Distressed Employers," too. These are employers whose gross receipts during the relevant quarter were less than 10 percent of those in the previous comparable quarter. For this narrow category of struggling businesses, the term Qualified Wages means all wages paid to employees during all relevant quarters.[91]

In what will be terribly important to the IRS as its enforcement of ERC issues intensifies, the ARP Act granted the IRS more time to audit taxpayers who might be misbehaving. In particular, the ARP Act created an exception to the general three-year rule on assessments; it allowed the IRS five years from the date on which the relevant Form 941 is filed or treated as filed to audit, propose additional taxes and penalties, and issue a final notice.[92]

Notice 2021-49

Notice 2021-49 was the next in the series of IRS guidance. It retained and "amplified" the earlier information in Notice 2021-20 (relating to the CARES Act) and Notice 2021-23 (relating to the Relief Act).[93] It also supplied new data concerning the ARP Act, its expansion of the ERC to third and fourth quarters of 2021, and its introduction of Section 3134.[94] Certain aspects of Notice 2021-49 are explored below.

Expansion of ERC

Notice 2021-49 confirmed that, under Section 3134, an Eligible Employer can claim ERCs for third and fourth quarters of 2021.[95]

Recovery Startup Businesses

Notice 2021-49 explained that the ARP Act inserted a new type of Eligible Employer, the so-called Recovery Startup Business. That is an employer (i) that begins operating a trade or business after February 15, 2020, (ii) has average annual gross receipts of not more than $1 million during the relevant period, and (iii) does not otherwise qualify as an Eligible Employer under the Governmental Order Test and the Reduced Gross Receipts Test.[96]

The ARP Act also created a cap on the amount of ERCs that Recovery Startup Businesses can claim; they cannot exceed $50,000 for each of third and fourth quarter 2021. Interestingly, Notice 2021-49 explained that the analysis of whether an employer is a Recovery Startup Business must be done separately for each quarter.

For example, if an eligible employer is a Recovery Startup Business in the third quarter 2021, but is not a Recovery Startup Business in the fourth quarter 2021 because it is an Eligible Employer due to a full or partial suspension or a decline in gross receipts during the fourth quarter 2021, the $50,000 limitation applies to the third quarter 2021 but does not apply to the fourth quarter 2021.[97]

Severely Financially Distressed Employers

The ARP Act introduced the notion of "Severely Financially Distressed Employers." According to Notice 2021-49, for purposes of the ERC for third and fourth quarters of 2021, an Eligible Employer with gross receipts that are less than 10 percent (instead of 80 percent) for the same quarter in 2019 (or 2020, if the employer did not exist in 2019) is considered a Severely Financially Distressed Employer. The earlier restriction on Qualified Wages for Large Eligible Employer disappears in these instances. Thus, for third and fourth quarters of 2021, a Severely Financially Distressed Employer, which is also a Large Eligible Employer, can treat *all* wages paid to its employees as Qualified Wages while it

maintains this status, not just to those employees who are not working.[98]

Expanded Assessment Period

Readers need some background on timing issues in order to understand certain changes explained in Notice 2021-49. Forms 941 are not due until the following April 15 for purposes of the running of the assessment-period.[99] Forms 941 for all four quarters of a particular year, therefore, are deemed filed on April 15 of the succeeding year. For example, Form 941 for second quarter 2020 must be filed by July 31, 2020 (*i.e.*, the last day of the month following the end of the relevant quarter), but is deemed to be filed on April 15, 2021. The general assessment-period of three years for such Form 941 would not expire until April 15, 2024.[100]

Notice 2021-49 clarified the special, extended assessment-period in the context of the ERC. It says that the assessment-period for any amount attributable to an ERC will not expire before the date that is five years (instead of three years) after the date on which the original Form 941 that includes the quarter with respect to which the ERC is determined or filed, or the date on which such return is deemed to have been filed, whichever is later.[101] Applying the special assessment-period to the example from the previous paragraph yields the following result: If an Eligible Employer files a timely Form 941 for third quarter 2021 claiming ERCs, such Form 941 is deemed to have been filed on April 15, 2022, and the assessment-period stays open until April 15, 2027.

Importantly for taxpayers, Notice 2021-49 indicates that the extended assessment-period applies to ERC claims for third and fourth quarters of 2021 under the ARP Act, but does *not* affect ERC claims for earlier quarters under the CARES Act or Relief Act.[102]

Guidance Applicable to All Quarters

Notice 2021-49 also contained some general clean up, if you will, offering supplemental guidance on different issues that had arisen since Congress first introduced the ERC and the IRS started implementing it.[103] This information generally applied to *all* quarters covered by the ERC under *all* legislation, spanning second quarter 2020 through fourth quarter 2021. Specifically, Notice 2021-49 answered questions regarding the definition of full-time employees, treatment of tips, special rules for related parties, inconsistent quarter elections for calculating gross receipt comparisons, and unique rules in cases where employers acquire a business.[104]

Revenue Procedure 2021-33

Revenue Procedure 2021-33 created a "safe harbor" that allows taxpayers to exclude certain items from gross receipts when calculating that figure for ERC purposes, including loans forgiven under the PPP.[105] Revenue Procedure 2021-33 says that an employer can ignore various things, among them any PPP loan forgiveness, when analyzing its eligibility to claim ERCs for a particular quarter, as long as the employer "consistently applies" this safe harbor.[106] This means that the employer must disregard the loans for *all* relevant quarters, and not include and exclude amounts at its whim with the goal of satisfying a particular standard or percentage.[107] Making the election to apply this safe harbor was rather easy; an employer simply needed not to take into account the forgiven PPP loan when calculating its gross receipts for purposes of evaluating whether it was an Eligible Employer that satisfied the Reduced Gross Receipts Test.[108]

The safe harbor applied to *all* periods relevant to the ERC, namely, second quarter 2020 through fourth quarter 2021.[109]

Fourth Law

Things came to an unexpected close when Congress enacted the Infrastructure Investment and Jobs Act ("IIJA") in November 2021.[110] That legislation announced the end of the ERC, and to the surprise of many, *retroactively* shortened the periods for which Eligible Employers could claim benefits. Just nine months earlier, Congress underscored several lofty reasons for expanding the ERC to cover 2021 in its entirety. It changed course with the IIJA, though, generally eliminating fourth quarter 2021. As a result, ERC claims were limited to the second, third and fourth quarters of 2020, and the first, second and third quarters of 2021.[111]

Recovery Startup Businesses were saved from the chopping block; they, and only they, could continue to claim ERCs for fourth quarter 2021.[112] Congress made it easier for taxpayers to qualify as Recovery Startup Businesses, too. It removed the requirement that an employer could not otherwise qualify as an Eligible Employer pursuant to the Governmental Order Test or Reduced Gross Receipts Test.[113]

Notice 2021-65

The IRS issued Notice 2021-65 to clarify the IIJA. It started, of course, with confirmation that Eligible Employers, other than Recovery Startup Businesses, could not claim ERCs for fourth quarter 2021.[114] The next logical step for the IRS was recouping funds. It did so by explaining that advance ERC payments received by most Eligible Employers for fourth quarter 2021 constitute "erroneous refunds," they must be repaid in a timely manner, and delinquencies would be penalized.[115]

Conclusion

This article shows that understanding the ERC is a major challenge. How could it *not* be? The situation features four laws applying different rules to different quarters over a two-year period, a scarcity of legislative history revealing the intentions of Congress, a series of Notices and other IRS guidance full of complicated explanations and examples, rules that govern and then later get modified or eliminated altogether, standards that change multiple times, cross-references, and rules that apply currently, prospectively, or retroactively. To top it off, you have lots of people still suffering negative financial effects from the Coronavirus, the IRS notifying all employers about the existence and benefits of the ERC pursuant to a congressional mandate, and aggressive promoters (for lack of a better word) telling employers that they are eligible to claim large amounts of ERCs, often using dubious interpretations of the law. Common sense indicates that these factors will lead to widespread non-compliance by taxpayers, matched by significant enforcement actions by the IRS. When that occurs, employers *and* those on whom they relied in claiming ERCs would be wise to use this article as a foundation, seek out other articles in this multi-part series, and contact tax defense counsel experienced with ERC issues. ●