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In this article, Sheppard continues his analysis of employee retention credits with an examination of the evolving guidance released by Congress and the IRS, which has led to delayed ERC claims in some instances.

I. Introduction

Congress introduced the employee retention credit way back in March 2020. Some taxpayers are still making ERC claims today, and others can do so until April 2025. This protracted solicitation period has led to questions about the validity of some recent claims. Some ask, for example, why taxpayers with legitimate ERC claims did not file them right away, on their original employment tax returns. One reason is that the IRS did not issue certain guidance until months after Congress enacted the relevant laws. Another is that some of that guidance, which was beneficial to taxpayers, had retroactive effect. This meant that taxpayers were obligated to file amended employment tax returns, sometimes months or years after the fact, to take advantage of favorable modifications to the ERC rules. This article, the latest in a series, analyzes changes that have led to the continued filing of ERC claims.[1]

II. Congressional and IRS Guidance

Readers need to understand the main rules before appreciating how they have morphed. Congress passed four laws in less than two years, and the IRS supplemented them by issuing multiple notices, revenue procedures, and other ERC guidance. An overview follows.

Congress enacted the Coronavirus Aid, Relief, and Economic Security Act in March 2020.[2] It generally provided that an eligible employer could get an ERC against certain employment taxes equal to 50 percent of the qualified wages that it paid to each employee for each quarter, subject to a maximum.[3] An eligible employer in this context meant one that was carrying on a trade or business and also 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 that limited commerce, travel, or group meetings for commercial, social, religious, or other purposes because of COVID-19 (governmental order test).[4]

[1] Readers seeking details about the ERC rules and their evolution should see the following articles by the same author: Hale E. Sheppard, "Employee Retention Credits: Issues Arise as Finger-Point Begins," *Tax Notes Federal*, Sept. 11, 2023, p. 1843; Sheppard, "IRS Clarifies Limited Eligibility of Federal Credit Unions for ERCs," *Tax Notes Federal*, Sept. 4, 2023, p. 1615; Sheppard, "New ERC Guidance About Suspended Operations and Supply Chains," *Tax Notes Federal*, Aug. 28, 2023, p. 1413; Sheppard, "Employee Retention Credits: Analyzing Key Issues for Promoters and Other Enablers," *J. Tax'n* (coming 2023); Sheppard, "Employee Retention Credits: Analyzing Key Issues for Taxpayers Facing IRS Audits," *J. Tax'n* (coming 2023); Sheppard, "Employee Retention Credits: Analyzing Congressional and IRS Guidance From Start to Finish," *J. Tax'n* (coming 2023).

[2] 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 (Apr. 23, 2020); *see also* Notice 2021-20, 2021-11 IRB 922.

[3] CARES Act, section 2301(a).

[4] *Id.*, section 2301(c)(2)(A)(ii)(I).

Second, the employer suffered a significant decline in gross receipts during a particular quarter (reduced gross receipts test).[5]

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. There were two categories of employers: large and small. When 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 governmental order test or the reduced gross receipts test.[6] Alternatively, when an eligible employer had an average of 100 or fewer full-time employees (small eligible employer), qualified wages meant all wages paid during a quarter, whether or not the employees were actually working.[7] In addition to the amounts described above, qualified wages included the qualified health plan expenses paid by the eligible employer, which were allocable to the qualified wages.[8]

Benefits were limited under the CARES Act. In particular, the amount of qualified wages for any one employee could not exceed $10,000 for all applicable quarters combined in 2020. This meant that, after applying the 50 percent limit, the maximum ERC per employee for the entire year was $5,000.[9] Moreover, eligible employers could only seek ERCs for second, third, and fourth quarters of 2020.[10]

Congress then passed the Taxpayer Certainty and Disaster Tax Relief Act (the relief act) in December 2020.[11] That legislation expanded the period during which eligible employers could benefit. They could claim ERCs not only for second, third, and fourth quarters of 2020 (as they could under the CARES Act) but also for first and second quarters of 2021.[12] Eligible employers could get increased amounts of ERCs, too. Under the CARES Act, an eligible employer could only claim ERCs for 50 percent of qualified wages, with a cap of $10,000 per employee for all of 2020. Things changed in two ways thanks to the relief act. The figure increased from 50 percent to 70 percent of the qualified wages paid, *and* the amount was calculated per quarter, not per year. Accordingly, 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 (that is, $7,000 per quarter).[13]

Congress introduced the American Rescue Plan Act in March 2021.[14] That law further expanded the ERC, making it available in third and fourth quarters of 2021.[15]

Things came to a close when Congress enacted the Infrastructure Investment and Jobs Act in November 2021.[16] That legislation announced the end of the ERC, and it retroactively shortened the periods for claiming benefits. Eligible employers, with one narrow exception, could no longer solicit ERCs for fourth quarter 2021. As a result, ERCs for most eligible employers could not exceed $26,000, an amount comprising $5,000 for 2020 in its entirety, plus $7,000 for each of the first, second, and third quarters of 2021. The IRS, often the bearer of bad news for taxpayers, explained that advance ERC payments received by most eligible employers for fourth quarter 2021 constituted "erroneous refunds," which had to be timely repaid.[17]

III. Subsequent and Retroactive Guidance

Eligible employers may request ERCs in several ways. The main one is by filing timely Forms 941, "Employer's Quarterly Federal Tax Return," for each relevant quarter in 2020 and

[5] *Id.*, section 2301(c)(2)(A)(ii)(II).

[6] *Id.*, section 2301(c)(3)(A)(i).

[7] *Id.*, section 2301(c)(3)(A)(ii)(I) and (II). Note that these standards later changed from 100 to 500 full-time employees. *See* Consolidated Appropriations Act, 2021, division EE, section 207; and Notice 2021-23, 2021-16 IRB 1113, Section III.E.

[8] CARES Act, section 2301(c)(3)(C)(i).

[9] *Id.*, section 2301(b)(1); JCT, *supra* note 2, at 38.

[10] CARES Act, section 2301(m); *see also* Notice 2021-20.

[11] Consolidated Appropriations Act, 2021, division EE, section 207; JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021); *see also* Notice 2021-23.

[12] Notice 2021-23, Section III.A.

[13] *Id.*, Section III.D.

[14] ARPA, section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

[15] Notice 2021-49, Section III.A.

[16] P.L. 117-58; *see also* Notice 2021-65, 2021-51 IRB 880.

[17] Notice 2021-65, Section III.B.

2021. Alternatively, they could, and in many instances still can, seek ERCs after the fact by filing Forms 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund."[18] As explained later, filing Forms 941-X was often necessitated by evolving guidance from the IRS, some of which featured retroactive effect back to second quarter 2020, when the ERC began.

A. Aggregating Employers for ERC Purposes

The CARES Act provided that all persons treated as a "single employer" under certain tax provisions will be treated as one employer for ERC purposes, but it lacked details.[19] These were later supplied by the IRS in Notice 2021-20, 2021-11 IRB 922, as follows.[20]

1. What is the general effect of the aggregation rules on ERCs?

Corporations that are members of a controlled group under section 52(a), entities in trades or businesses under common control under section 52(b), members of an affiliated service group under section 414(m), or taxpayers otherwise aggregated under section 414(o) are treated as a single employer when it comes to the ERC. This means that they are considered just one employer for purposes of determining whether they meet the governmental order test or reduced gross receipts test, whether they qualify as a small eligible employer or large eligible employer, and so on.[21]

2. How are ERCs allocated to eligible employers that are members of an aggregated group?

Allocation of ERCs to members of an aggregated group is based on their proportionate share of the qualified wages giving rise to the ERC for each quarter.[22]

3. If the operations of a trade or business of one member of an aggregated group are fully or partially suspended because of a governmental order, are the operations of the other members also considered suspended?

All members of a group that are unified as a single employer under the aggregation rules are treated as such for ERC purposes. Accordingly, if a trade or business is operated by multiple members of an aggregated group, and if the operations of one member are suspended because of a governmental order, then all members are considered to have their operations suspended, even if another member of the group is located in a jurisdiction that is free from governmental orders.[23]

4. For members of an aggregated group, is a significant decline in gross receipts determined based on the entire group?

Yes, if the aggregated group does not satisfy the reduced gross receipts test, then no member of the group may claim ERCs on that basis. Here is an example. Employer B and Employer C are members of a controlled group of corporations and are treated as a single employer under the aggregation rules. Neither meets the governmental order test. Employer B has gross receipts of $1 million in second quarter 2019, and $400,000 in second quarter 2020. For its part, Employer C has gross receipts of $1 million in second quarter 2019, and $750,000 in second quarter 2020. Although Employer B's gross receipts in second quarter 2020 were 40 percent of those in 2019 and thus would meet the reduced gross receipts test by itself, neither Employer B nor Employer C can claim ERCs based on the reduced gross receipts test. This is because the two entities are treated as a single employer for ERC purposes; they had combined gross receipts of $2 million in second quarter 2019 and of $1.15 million in second quarter 2020.[24]

5. How does one determine the maximum ERC when aggregation occurs?

If an employee works for two or more entities treated as a single employer under the

[18] Eligible employers also could have solicited ERCs on an accelerated basis by filing Form 7200, "Advance Payment of Employer Credits Due to COVID-19."

[19] CARES Act, section 2301(d). The relevant provisions are sections 52(a), 52(b), 414(m) and 414(o).

[20] The author has shortened, clarified, paraphrased, or otherwise modified the IRS's original language to make the information more understandable for readers.

[21] Notice 2021-20, Section III.B, Q&A 7.

[22] *Id.*, Q&A 8.

[23] *Id.*, Section III.D, Q&A 21.

[24] *Id.*, Section III.E, Q&A 26.

aggregation rules in 2020, the maximum amount of qualified wages for all quarters that may be taken into account for that employee is $10,000 in the aggregate. Accordingly, an aggregated group treated as a single employer may not claim more than the maximum credit in 2020 of $5,000 for any one individual employed by the members of the aggregated group. For that employee, the amount of the ERC that may be claimed by any particular member is based on its proportionate share of qualified wages giving rise to the ERC during the relevant quarters.

For example, Employer E and Employer F are members of an aggregated group treated as a single employer. Employee works for both and receives $10,000 in qualified wages from each during second quarter 2020, for a total of $20,000. Because Employer E and Employer F are treated as a single employer under the aggregation rules, the total amount of qualified wages that may be taken into account for determining the ERCs for Employee in 2020 is limited to $10,000, and the maximum ERC available for qualified wages paid to Employee is $5,000. Employer E and Employer F can each claim their proportionate share of $5,000. Because they paid equal amounts of qualified wages to Employee, they can each claim $2,500 in ERCs. Moreover, because they each paid the maximum amount of qualified wages (that is, $10,000) to Employee during second quarter 2020, Employer E and Employer F are not entitled to the ERCs for additional wages paid to Employee in third or fourth quarters of 2020.[25]

6. For members of an aggregated group, is the average number of full-time employees determined based on the entire group?

Yes, all entities combined under the aggregation rules are treated as a single employer for purposes of determining the average number of employees. For instance, Employer B and Employer C each averaged 75 full-time employees in 2019. They are treated as a single employer under the aggregation rules, so that they had a combined average of 150 full-timers. Because Employer B and Employer C are considered a large eligible employer, each is eligible for ERCs only for wages paid to employees who are not providing services because of either the governmental order test or reduced gross receipts test.[26]

The principles set forth above persevered as Congress and the IRS introduced additional modifications to the ERC rules. The aggregation rules still applied after the relief act changed the limits for small eligible employers and large eligible employers, increasing the threshold from 100 to 500 full-time employees.[27]

B. Third-Party Payers

The CARES Act provided that eligible employers could use third-party payers to assist in claiming ERCs.[28] It also directed the IRS to issue forms, instructions, regulations, and more to elucidate this relationship.[29] Professional employer organizations, certified professional employer organizations, and certain reporting agents are third-party payers in this context.[30] The IRS supplied additional information about third-party payers in Notice 2021-20, some of which is set forth below.[31]

1. Can an eligible employer that uses a third party to report and pay employment taxes get ERCs?

Yes, an eligible employer is entitled to the ERC, regardless of whether it uses a third-party payer to report and pay its federal employment taxes. The third-party payer is not entitled to the ERCs for the wages it remits on behalf of the eligible employer, even if it is considered an employer for other purposes. Different rules apply depending on the type of third-party payer involved.[32]

[25] *Id.*, Section III.F, Q&A 29.

[26] *Id.*, Section III.G, Q&A 32.

[27] Notice 2021-23, Section III.E.

[28] CARES Act, section 2301(h)(3).

[29] *Id.*, section 2301(l)(4).

[30] *Id.*

[31] Notice 2021-20 specified that these rules apply to "eligible common law employers." This article simply refers to them as eligible employers for the sake of consistency and simplicity. The author has shortened, clarified, paraphrased, or otherwise modified the IRS's original language to make the information more understandable for readers.

[32] Notice 2021-20, Section III.M, Q&A 62.

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

If a third-party payer is claiming ERCs on behalf of an eligible employer, it must collect "any information necessary" to accurately do so. This includes information about claims by the eligible employer for certain credits under the Families First Coronavirus Response Act, as well as whether the eligible employer received other tax benefits.[33]

3. May third-party payers rely on data from an eligible employer?

Yes, a third-party payer may rely on information about status as an eligible employer. Either the third-party payer or the eligible employer may maintain all records that substantiate ERC eligibility. However, if the eligible employer does this, the third-party payer must obtain the substantiation and provide it to the IRS upon request. The third-party payer and eligible employer will *each* be liable for any employment taxes due as a result of improper ERC claims.[34]

The relief act fortified the notion that both the third-party payer and the eligible employer will be on the hook when things go wrong. That legislation added language to the effect that any IRS guidance must require that the eligible employer is responsible for "the accounting of" the ERC and for any liability resulting from improper claims. It also mandated that third-party payers have to "accurately report" the ERCs based on the data from the eligible employers.[35] Congress later codified these directives when it enacted ARPA.[36]

C. Full-Time Employees

Under the CARES Act, the definition of qualified wages depended on the number of full-time employees of an employer. Readers might be asking themselves, "What is a full-time employee for ERC purposes?" The CARES Act simply cross-referenced an existing provision of the IRC, which generally labeled those working at least 30 hours per week as full-time employees.[37] The IRS supplied more color in Notice 2021-20. It explained that a full-time employee is one who, during the relevant period, had an average of at least 30 hours of service per week or 130 hours per month.[38]

The rules about qualified wages, including the language about full-time employees, were later codified as section 3134 under ARPA.[39] For its part, the IRS issued Notice 2021-49, 2021-34 IRB 316, which displayed some flexibility. It indicated, for instance, that taxpayers can omit "full-time equivalents" when calculating the average number of full-time employees for purposes of seeing whether they are small eligible employers or large eligible employers. It further said that, for purposes of identifying qualified wages, a worker's status as a full-time employee is "irrelevant," and wages paid to an employee who is not full time may still constitute qualified wages if all other requirements are satisfied.[40]

D. Qualified Wages and Tips

Congress and the IRS initially devoted lots of time to the concept of qualified wages. They did not, however, pay attention to the role of tips until later. The IRS originally explained in Notice 2021-20 that qualified wages consisted of wages as defined in section 3121(a), compensation as defined in section 3231(e), and qualified health plan expenses. Notice 2021-49 later clarified that if an employee receives $20 or more in tips during a month, then those tips should be treated as compensation from the employer for ERC purposes.[41] The effect was that qualified wages, and thus the number of corresponding ERC claims, grew.

[33] *Id.*, Q&A 66.

[34] *Id.*, Q&A 67.

[35] Consolidated Appropriations Act, 2021, division EE, section 207(h); JCT, *supra* note 11, at 69.

[36] ARPA, section 9651(a); H.R. Rep. No. 117-7 at 775 (2021).

[37] CARES Act, section 2301(c)(3)(A)(i) and (ii) (citing section 4980H(c)(4)(A)); *see also* JCT, *supra* note 2, at 40 n.145.

[38] Notice 2021-20, Section III.G, Q&A 31.

[39] ARPA, section 9651(a); *see* section 3134(c)(3)(A).

[40] Notice 2021-49, Section IV.A.

[41] *Id.*, Section IV.B.

E. Decreased Federal Income Tax Deductions

The corollary effects of claiming ERCs received little fanfare, at least initially. This is understandable given that the CARES Act merely stated, obliquely, that rules similar to those in section 280C(a) apply in the ERC context.[42] It appears that few took the initiative to review the provision referenced by Congress. If they had done so, they would have discovered that it serves to disallow the wages-paid deduction for income tax purposes when taxpayers receive certain credits, like ERCs. The IRS explained it in the following manner in Notice 2021-20: "An employer's deduction for Qualified Wages, including Qualified Health Plan Expenses, is reduced by the amount of the [ERC]."[43]

Being aware of the mandatory decrease in the wages-paid deduction is one thing, knowing when to effectuate it is another. This question confused some eligible employers until the IRS eventually addressed it in Notice 2021-49. The IRS pondered a scenario in which an eligible employer filed Forms 941-X to claim ERCs for earlier quarters after it had already filed its income tax return covering the same quarters. The IRS offered the following instructions on timing:

> When a taxpayer claims the [ERC] because of the retroactive amendment of [the law] or otherwise files [a Form 941-X] to claim the [ERC], the taxpayer should file an amended federal income tax return or administrative adjustment request (AAR), if applicable, for the taxable year in which the Qualified Wages were paid or incurred to correct any overstated deduction taken with respect to those same wages on the original federal tax return. [The CARES Act] generally provides, in relevant part, that rules similar to the rules of Section 280C(a) shall apply [and that provision] requires tracing to the specific wages generating the applicable credit. To satisfy this tracing requirement, the taxpayer must file an amended return or AAR, as applicable.[44]

F. Related Parties

The CARES Act enigmatically said that "rules similar to those of Section 51(i)(1)" shall apply in the ERC context.[45] It is a safe bet that many taxpayers, as well as their advisers, did not understand this reference and did not take the time to investigate further.

Fortunately, the IRS provided some more flavor in Notice 2021-20. It explained that compensation paid to "related individuals" may not be taken into account when determining qualified wages for ERC purposes.[46]

After receiving multiple inquiries, the IRS supplied a hefty dose of additional direction in Notice 2021-49.[47] This administrative guidance focused on whether wages paid to an employee who owns more than 50 percent of a corporation, or to that person's spouse, are considered qualified wages for ERC purposes. The IRS began by explaining that under the tax provision cited in the CARES Act, section 51(i)(1), wages are not taken into account when (1) the taxpayer is a corporation and the individual owns, directly or indirectly, more than 50 percent of the value of the outstanding stock of the corporation, or (2) the taxpayer is an entity other than a corporation and the individual owns, directly or indirectly, more than 50 percent of the capital and profits interest in the entity. The IRS went on to clarify that the rules under section 267(c), commonly called the attribution rules or constructive ownership rules, apply in determining an individual's ownership interest in a particular entity.

Before looking to the attribution rules, the IRS indicated in Notice 2021-49 that payments to anyone having any of the following relationships to the majority owner of an entity are not qualified wages: (1) child, or a descendant of a child; (2) brother, sister, stepbrother, or stepsister; (3) father or mother, or an ancestor of either; (4) stepfather

[42] P.L. 116-136, section 2301(e).

[43] Notice 2021-20, Section II.F and Section III.K, Q&A 60.

[44] Notice 2021-49, Section IV.C.

[45] P.L. 116-36, section 2301(e); JCT, *supra* note 2, at 42.

[46] Notice 2021-20, Section II.F.

[47] Notice 2021-49, Section IV.D.

or stepmother; (5) niece or nephew; (6) aunt or uncle; (7) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; and (8) an individual, other than a spouse, who has the same principal abode as the taxpayer and is a member of the household. Notice 2021-49 then got downright byzantine when it analyzed the effect of the attribution rules in the family context. Delving into that complexity is unnecessary in this article. It is enough to view four examples provided by the IRS.[48]

Corporation A is owned 80 percent by Individual E and 20 percent by Individual F. Individual F is the child of Individual E. Corporation A is an eligible employer for first quarter 2021. Both Individual E and Individual F are employees of Corporation A. Under the attribution rules, both Individual E and Individual F are treated as 100 percent owners of Corporation A. Accordingly, Corporation A may not treat as qualified wages any wages paid to either Individual E or Individual F because both are related for ERC purposes.[49]

Corporation B is owned 100 percent by Individual G. Individual H is the child of Individual G. Corporation B is an eligible employer for first quarter 2021. Individual G is an employee of Corporation B, but Individual H is not. Under the attribution rules, Individual H is attributed 100 percent ownership of Corporation B, and both Individual G and Individual H are treated as 100 percent owners. Therefore, Corporation B may not treat as qualified wages any wages paid to Individual G because he is a related individual.[50]

Corporation C is owned 100 percent by Individual J. Corporation C is an eligible employer for first quarter 2021. Individual J is married to Individual K, and they have no other family members. Individual J and Individual K are both employees of Corporation C. Under the attribution rules, Individual K is attributed 100 percent ownership of Corporation A, and both Individual J and Individual K are treated as 100 percent owners. However, Individual J and Individual K do not have any of the relationships to each other described in section 51(i)(1). Consequently, wages paid to Individual J and Individual K are qualified wages.[51]

Corporation D is owned 34 percent by Individual L, 33 percent by Individual M, and 33 percent by Individual N. They are siblings. Corporation D is an eligible employer for first quarter 2021. All the siblings are employees of Corporation D. Under the attribution rules, each of the three siblings is treated as a 100 percent owner. The siblings have one of the relationships described in section 51(i)(1). Corporation D, therefore, may not treat as qualified wages those paid to any of the siblings.[52]

G. Interplay Between ERCs and Other Tax Benefits

The CARES Act initially provided that an eligible entity that received loans to cover payroll costs under the Paycheck Protection Program would not be entitled to ERCs.[53]

The second law, the relief act, made significant changes. Among other things, it eliminated the rigid rule preventing recipients of PPP loans from also accessing ERCs.[54] It explained that "payroll costs" for PPP purposes generally would not include qualified wages taken into account by employers when determining their eligibility for ERCs.[55] However, the relief act granted employers the option to elect to exclude some or all of their qualified wages for ERC purposes, so that they might be able to benefit from both the PPP and ERC to varying degrees.[56] The relief act also indicated that these changes were retroactive; that is, they applied as if Congress had originally included them in the CARES Act in March 2020.[57]

The IRS issued guidance regarding the interplay between the PPP and ERC, primarily via

[48] The author has shortened, clarified, paraphrased, or otherwise modified the IRS's original language to make the information more understandable for readers.

[49] Notice 2021-49, Section IV.D, Example 1.

[50] *Id.*, Example 2.

[51] *Id.*, Example 3.

[52] *Id.*, Example 4.

[53] CARES Act, section 2301(j) (referencing section 1102); JCT, *supra* note 2, at 42.

[54] Consolidated Appropriations Act, 2021, division EE, section 206(c)(2)(B).

[55] *Id.*, section 206(c)(1).

[56] *Id.*, section 206(c)(2); JCT, *supra* note 11, at 67.

[57] Consolidated Appropriations Act, 2021, division EE, section 206(e)(1).

Notice 2021-20.[58] It explained that an eligible employer could elect not to take into account certain qualified wages for ERC purposes. It made the election by not claiming ERCs for those amounts on its Forms 941. Even if it did not make an affirmative election, an eligible employer that received a PPP loan was deemed to have made the election for all qualified wages that it characterized as payroll costs on its PPP loan forgiveness application. Notwithstanding a deemed election, if an eligible employer reported any qualified wages as payroll costs on a PPP loan forgiveness application, but the loan was not forgiven, those qualified wages could later be taken into account for ERC purposes. Moreover, if an eligible employer obtained forgiveness of only a portion of the PPP loan, then it was deemed to have made an election for only part of the qualified wages labeled as payroll costs on the PPP loan forgiveness application.

1. Examples.

Notice 2021-20 offered several examples illustrating the preceding guidance.[59]

Employer A received a PPP loan of $100,000. Employer A is an eligible employer and paid $100,000 in qualified wages that would qualify for the ERC during second and third quarters of 2020. To receive forgiveness of the PPP loan in its entirety, Employer A was required to report a total of $100,000 of payroll costs and other eligible expenses. Employer A submitted a PPP loan forgiveness application reporting all $100,000 of qualified wages as payroll costs. Employer A received a decision in first quarter 2021 forgiving the entire PPP loan. Employer A is deemed to have made an election not to take into account $100,000 of the qualified wages for ERC purposes, which was the amount included in the payroll costs reported on the PPP loan forgiveness application.[60]

Employer B received a PPP loan of $200,000. Employer B is an eligible employer and paid $250,000 of qualified wages that would qualify for the ERC during second and third quarters of 2020. To receive forgiveness of the PPP loan in its entirety, Employer B was required to report a total of $200,000 of payroll costs and other eligible expenses. Employer B submitted a PPP loan forgiveness application reporting the $250,000 of qualified wages as payroll costs. Employer B received a decision in the first quarter of 2021 forgiving the entire PPP loan amount of $200,000. Employer B is deemed to have made an election not to take into account $200,000 of the qualified wages for purposes of the ERC, which was the amount included as payroll costs on the PPP loan forgiveness application. It may not treat that amount as qualified wages for ERC purposes. Employer B is not treated as making a deemed election for $50,000 of the qualified wages (that is, $250,000 reported on the PPP loan forgiveness application, minus $200,000 of loan forgiveness), and it may treat that amount as qualified wages for ERC purposes.[61]

Employer C received a PPP loan of $200,000. Employer C is an eligible employer and paid $200,000 of qualified wages that would qualify for the ERC during the second and third quarters of 2020. Employer C also paid other eligible expenses of $70,000. To receive forgiveness of the PPP loan in its entirety, Employer C was required to report a total of $200,000 of payroll costs and other eligible expenses. Employer C submitted a PPP loan forgiveness application reporting the $200,000 of qualified wages as payroll costs but did not report the other eligible expenses of $70,000. Employer C received a decision in first quarter 2021 forgiving the entire PPP loan amount of $200,000. Employer C is deemed to have made an election not to take into account $200,000 of qualified wages for ERC purposes, which was the amount included as payroll costs on the PPP loan forgiveness application. Although Employer C could have reported $70,000 of other eligible expenses and $130,000 of payroll costs, it reported $200,000 of qualified wages as payroll costs on the PPP loan forgiveness application. As a result, no portion of the qualified wages reported as payroll costs may be treated as qualified wages for ERC

[58] Notice 2021-20, Section III.I; *see also* IRS, "Lesson 3: Tax Credit for Employee Retention," at 3-51 through 3-56, COVID Credits & Deferrals for Employment Tax, Student Guide (revised July 2022).

[59] The author has shortened, clarified, paraphrased, or otherwise modified the IRS's original language to make the information more understandable for readers.

[60] Notice 2021-20, Section III.I, Example 1.

[61] *Id.*, Example 2.

purposes. Employer C cannot reduce the deemed election by the amount of the other eligible expenses that it could have reported on its PPP loan forgiveness application.[62]

Assume the same facts as above, but suppose Employer C submitted a PPP loan forgiveness application reporting the $200,000 of qualified wages as payroll costs, as well as the $70,000 of other eligible expenses. Employer C received a decision in first quarter 2021 forgiving the entire PPP loan amount of $200,000. In this case, Employer C is deemed to have made an election not to take into account $130,000 of qualified wages for ERC purposes, which was the amount of qualified wages included as payroll costs on the PPP loan forgiveness application up to the minimum amount of payroll costs, together with the $70,000 of other eligible expenses, sufficient to support the amount of the loan that was forgiven. As a result, $70,000 of the qualified wages reported as payroll costs may be treated as qualified wages for ERC purposes.[63]

Employer D received a PPP loan of $200,000. Employer D is an eligible employer and paid $150,000 of qualified wages that would qualify for the ERC during the second and third quarters of 2020. In addition to the qualified wages, Employer D had $100,000 of other payroll costs that are not qualified wages, and $70,000 of other eligible expenses. To receive forgiveness of the PPP loan in its entirety, Employer D was required to report $200,000 of payroll costs and other eligible expenses. Employer D submitted a PPP loan forgiveness application reporting $130,000 of payroll costs and $70,000 of other eligible expenses. Employer D can demonstrate that the payroll costs reported on the PPP loan forgiveness application consist of $100,000 of payroll costs that are not qualified wages and $30,000 of payroll costs that are qualified wages. Employer D received a decision in first quarter 2021 forgiving the entire PPP loan amount of $200,000. Employer D is deemed to have made an election not to take into account $30,000 of qualified wages for ERC purposes, which was the amount of qualified wages included as payroll costs on the PPP loan forgiveness application. Employer D is not deemed to have made an election regarding the $120,000 of qualified wages that are not included as payroll costs on the PPP loan forgiveness application. Accordingly, Employer D may take into account the $120,000 of qualified wages (that is, $150,000 of qualified wages paid, minus $30,000 of qualified wages included as payroll costs reported on the PPP loan forgiveness application) for ERC purposes.[64]

Assume the same facts as above, but suppose the PPP loan was not forgiven. Employer D may treat the full $150,000 as qualified wages (that is, the $30,000 of qualified wages included as payroll costs reported on the PPP loan forgiveness application, plus the additional $120,000 of qualified wages not included as payroll costs) as qualified wages for ERC purposes.[65]

Notice 2021-49 slightly added to the discourse. It confirmed that the rules related to the interaction between PPP loans and the ERC found in Notice 2021-20 continued to apply in third and fourth quarters of 2021.[66]

2. Safe harbor.

Radical changes occurred when the IRS released Rev. Proc. 2021-33, 2021-34 IRB 327, in August 2021, nearly one and a half years after the rules were created by the CARES Act. Looking to the existing laws and guidance, Rev. Proc. 2021-33 summarized the situation as follows:

> An employer that receives a PPP loan may claim the [ERC] available to it for the quarter, subject to the restriction that the Qualified Wages may not be counted both for the [ERC] and as payroll costs that are paid during the covered period, to the extent that the payroll costs qualify the Eligible Employer for forgiveness under the PPP.[67]

[62] *Id.*, Example 3.

[63] *Id.*, Example 4.

[64] *Id.*, Example 6.

[65] *Id.*, Example 7.

[66] Notice 2021-49, Section III.F.

[67] Rev. Proc. 2021-33, section 2.03(3).

Rev. Proc. 2021-33 then explained that, under the relief act, no amount is included in the gross income of most taxpayers as a result of the forgiveness of a PPP loan.[68] Next, Rev. Proc. 2021-33 turned from gross income to gross receipts. It said that, when it comes to determining whether a taxpayer is an eligible employer under the reduced gross receipts test, the term "gross receipts" means total sales, all amounts received for services performed, investment income, and income from incidental or outside sources, regardless of whether those amounts are included in a taxpayer's gross income.[69] Rev. Proc. 2021-33 then brought it all together when describing the reason for offering a safe harbor. It underscored that, although the amount of PPP loan forgiven is not included in gross income thanks to the relief act, it normally would fall into the broad category of gross receipts. Therefore, unless the IRS were to introduce a solution, an employer must count the loan forgiveness in gross receipts when figuring out whether it qualifies for the ERC using the reduced gross receipts test.[70] Enter the safe harbor.

The IRS reasoned that the PPP and ERC "coordination rules" in the CARES Act and subsequent laws show a congressional intent that employers be able to take advantage of both incentives, provided that there is no overlap in the wages counted. The IRS further reasoned that including the amount of PPP loans forgiven in gross receipts when applying the reduced gross receipts test for ERC purposes would "frustrate this congressional intent." Therefore, Rev. Proc. 2021-33 introduced a safe harbor. It allows employers not to count the amount of PPP loans forgiven when, and only when, calculating ERC eligibility under the reduced gross receipts test.[71] Implementing the safe harbor was easy; an employer simply excluded the loan forgiveness from its gross receipts when affirming eligibility for the ERC on its Forms 941 or Forms 941-X.[72]

[68] *Id.*, section 2.05.

[69] *Id.*, section 2.06.

[70] *Id.*, section 3.01.

[71] *Id.*, section 3.02.

[72] *Id.*, section 3.04.

H. Qualified Health Plan Expenses

The CARES Act says that qualified wages include not only traditional compensation to employees, but also the portion of qualified health plan expenses properly allocable to those qualified wages.[73] For their part, qualified health plan expenses ordinarily are the amounts paid or incurred by an eligible employer to provide and maintain a group health plan.[74] The CARES Act indicated that allocations generally were acceptable if made on a pro rata basis among the employees and the periods of coverage.[75]

The relief act made a couple of changes. Specifically, it substituted the term "certain health plan expenses" for qualified health plan expenses. It also relocated this term, moving it under the broader concept of qualified wages. The relief act did not alter the substance of the rules, though.[76] ARPA, for its part, later brought the rules front and center, codifying them as part of section 3134.[77]

The IRS later added the following detail via Notice 2021-20.[78]

1. What are qualified wages?

Qualified wages normally are limited to certain wages and other compensation paid by an eligible employer to its employees for second, third, or fourth quarters of 2020. They also include amounts paid by an eligible employer to provide and maintain a group health plan, to the extent those amounts are excluded from gross income of employees under the pertinent tax provisions. For these purposes, qualified wages do not include qualified sick leave wages or qualified family leave wages taken into account under the Families First Coronavirus Response Act.

Here is an example. Employer A is a small eligible employer that has had a partial

[73] CARES Act, section 2301(c)(3)(i).

[74] *Id.*, section 2301(c)(3)(ii). The term "group health plan" is defined in section 5000(b)(1) and the employee income exclusion provision is in section 106(a).

[75] *Id.*, section 2301(c)(3)(iii); *see also* Notice 2021-20, Section II.C.

[76] Consolidated Appropriations Act, 2021, division EE, section 206(b).

[77] ARPA, section 9651(a); *see also* H.R. Rep. No. 117-7 at 772; *see* section 3134(c)(4)(B).

[78] The author has shortened, clarified, paraphrased, or otherwise modified the IRS's original language to make the information more understandable for readers.

suspension of its business operations because of a governmental order. Employer A offers its employees various benefits that allow for pretax salary reduction contributions, including a qualified section 401(k) plan, a fully insured group health plan, a dependent care assistance program, and qualified transportation benefits. Employer A also makes matching and nonelective contributions to the qualified section 401(k) plan, and it pays the portion of the cost of maintaining the group health plan. None of these amounts is taken into account for purposes of the credits claimed under the Families First Coronavirus Response Act. Employer A may treat as qualified wages the amounts its employees contribute as pretax salary reduction contributions to the qualified section 401(k) plan for the period of partial suspension because those amounts are wages within the meaning of section 3121(a). Also, Employer A may treat all amounts paid toward maintaining the group health plan (including any employee pretax salary reduction contributions) for the period of partial suspension as qualified health plan expenses, and thus as qualified wages. However, Employer A may not treat as qualified wages the amounts it contributes as matching or nonelective contributions to the qualified section 401(k) plan, nor may it treat as qualified wages any employee contributions toward the dependent care assistance program or qualified transportation benefits. These amounts do not constitute wages within the meaning of section 3121(a), so they are not qualified wages for ERC purposes.[79]

2. Do qualified health plan expenses include both the portion paid by the eligible employer and the portion paid by the employee?

The amount of qualified health plan expenses taken into account in calculating the amount of qualified wages generally includes both the portion paid by the eligible employer and the portion paid by the employee with pretax salary reduction contributions. Amounts that the employee paid with after-tax contributions, however, are not considered qualified health plan expenses.[80]

3. May a small eligible employer treat its health plan expenses as qualified wages for ERC purposes?

Yes, a small eligible employer can treat as qualified wages its health plan expenses in second, third, or fourth quarter 2020 for any employee during any period for which it meets the governmental order test or reduced gross receipts test. Small eligible employers may treat health plan expenses allocable to the relevant periods as qualified wages, even if the employees are not working and the eligible employer does not pay them any wages for that time.

For instance, Employer A is a small eligible employer subject to a governmental order that partially suspends its business operations. It reduces the hours of all employees by 50 percent in response to the order. Employer A pays wages to the employees only for the time they are actually providing services, but it continues to supply them with full healthcare coverage. Employer A's health plan expenses allocable to wages paid during the period its operations were partially suspended may be treated as qualified wages for ERC purposes.

Likewise, Employer B is a small eligible employer subject to a governmental order. It takes more extreme actions, laying off or furloughing all its employees but not terminating them. Employer B does not pay wages to its employees for the time that work has ceased, but it continues the employees' healthcare coverage. Employer B's health plan expenses allocable to the period its operations were partially suspended may be treated as qualified wages.[81]

4. May a large eligible employer treat its health plan expenses as qualified wages for ERC purposes if they are allocable to a time when employees were not providing services?

A large eligible employer may treat as qualified wages health plan expenses paid or incurred in second, third, or fourth quarter 2020 that are allocable to when employees were not providing services during any period in which it meets the governmental order test or the reduced gross receipts test. A large eligible employer may

[79] Notice 2021-20, Section III.G, Q&A 30.

[80] *Id.*, Section III.H, Q&A 40.

[81] *Id.*, Q&A 41.

not treat as qualified wages, however, health plan expenses allocable to the time employees were providing services. Below are various examples illustrating these rules.

Employer C is a large eligible employer subject to a governmental order that partially suspends its operation. It reduces by 50 percent the hours of all employees and pays wages only for the time they spend actually working, yet it continues to provide all employees with full healthcare coverage. The 50 percent of the health plan expenses that is allocable to the time that the employees were not providing services are qualified wages. Employer C cannot treat the other 50 percent, which is allocable to time when employees were actually working, as qualified wages.

Employer D is a large eligible employer subject to a governmental order that partially suspends its operation. It reduces by 50 percent the working hours of all employees but only decreases their pay by 40 percent. The result is that they get 60 percent of their wages for working 50 percent of their normal hours. Meanwhile, Employer D continues to cover all health plan expenses for the employees. Employer D may treat as qualified wages the 10 percent of the wages that it pays for time the employees are not providing services, plus 50 percent of the health plan expenses because they are allocable to when employees were not providing services.

Employer E is a large eligible employer subject to a governmental order that partially suspends its operation. It lays off or furloughs all its workers but does not fire them. During this downtime, Employer E does not pay the employees, but it continues to cover all health plan expenses for them. Employer E can treat as qualified wages the health plan expenses that are allocable to the time when the employees were not providing services.[82]

Notice 2021-20 went on to provide examples focused on specific issues, namely, appropriate allocation of expenses in situations involving fully insured group health plans and self-insured group health plans and eligibility of expenses related to health savings accounts, Archer medical savings accounts, high-deductible health plans, health reimbursement arrangements, health flexible spending arrangements, and more.[83]

I. Other Delayed IRS Revelations

The IRS also released guidance, often well after the rules were conceived in the CARES Act in March 2020, concerning several other topics. For instance, the IRS offered belated details about the relationship between disruptions in the supply chain and the governmental order test.[84] It also discussed ERC claims by federal credit unions for the first time — more than three years after the relevant legislation took effect.[85]

IV. Conclusion

With four laws enacted by Congress in rapid succession, a series of directives released by the IRS to implement evolving legislative mandates, multiple rules introduced with retroactive and prospective applicability, various sources taking inconsistent positions on key ERC issues, piecemeal guidance released by the IRS to tackle new issues as they inevitably arise, and big money at stake, it is understandable that taxpayers continue to file ERC claims now, long after the relevant quarters have passed. Are these claims legitimate? That is a question with which taxpayers, the IRS, and the courts will be wrangling for many years to come. ■

[82] *Id.*, Section III.H, Q&A 42.

[83] *Id.*, Section III.H, Q&A 43 through 48.

[84] AM 2023-005; IRS, "Frequently Asked Questions about the Employee Retention Credit" (July 27, 2023).

[85] ILM 202333001; Fred Stokeld, "IRS Clarifies Availability of Retention Credit for Credit Unions," *Tax Notes Federal*, Aug. 28, 2023, p. 1524.