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Employee Retention Tax Credits – New IRS Q&As Shed Light on Gray Areas

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The Internal Revenue Service (IRS) recently released new guidance, in the form of Q&As posted on its website, on the Employee Retention Tax Credit (ERTC) provisions contained in Section 2301 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

This alert reviews some highlights from the Q&As as posted by the IRS on April 29, 2020. Unfortunately, some of the guidance is more restrictive than anticipated. This alert also discusses the legal significance of the Q&As, which is not very clear.

As discussed below, some employers may face difficult decisions in relation to the claiming of the tax credits.

ERTC Overview

To set the stage for the discussion, here is a quick synopsis of the ERTC.

Eligible Employers. Any business that either:

- Has a full or partial suspension of operations during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel or group meetings (for commercial, social, religious or other purposes) due to coronavirus disease 2019 (COVID-19), or
- Experiences a significant decline in gross receipts during the calendar quarter (less than 50% of its gross receipts for the same calendar quarter in 2019)

The Tax Credit. Fifty percent of the "qualified wages" and "allocable qualified health plan expenses" that an eligible employer pays for its employees after March 12, 2020, and before January 1, 2021.

The maximum amount of qualified wages taken into account with respect to each employee for all calendar quarters is US$10,000. Thus, the maximum tax credit for an eligible employer for qualified wages paid to any employee is US$5,000.

The new Q&As provide information on a wide range of topics, including which employers are eligible for the tax credit, what it means for an employer's operations to be suspended, when and how the tax credit may be claimed, and special considerations for essential businesses. The following are selected highlights.

Defining a Shutdown

In General. Most employers will want to qualify under the "suspended operations" test rather than the "decline in gross receipts" test, as it is less technical and can be determined without needing to run numbers. In a sense, the 50% decline in gross receipts is a backup test for employers whose operations are not suspended, but whose businesses are still impacted by coronavirus fallout.

Q&As 29-38 set forth the current IRS interpretation of what it means for operations to be "suspended due to a government order." These Q&As do not purport to be comprehensive. There are unfortunately many inconsistencies within the Q&As, and there may be other circumstances not covered by the Q&As that also constitute a partial suspension of operations.

The IRS backstopped its interpretations of the shutdown tests with a reminder that even if a taxpayer's business is not considered suspended, the employer may still be eligible for the tax credit under the gross receipts test.

Essential Businesses. Q&A 30 states that in general, an essential business – one that is permitted to remain open during a government shutdown order – will not be considered to have had a suspension in operations. Thus, an essential business generally cannot claim the tax credit unless it experiences a significant decline in gross receipts.

However, Q&A 31 also states that under certain circumstances, a supply chain interruption caused by a government order affecting a business' suppliers is sufficient grounds to consider the business suspended due to a government order – an **indirect** suspension, so to speak. Thus, even if an essential business is not directly shut down by a government order, it might still be considered to have been shut down due to supply chain disruptions.

Reduced Hours. Q&A 36 provides that if an employer is required to reduce its business hours pursuant to a governmental order, it may be considered to have had its operations partially suspended.

Multiple Locations. Q&A 36 provides that if a business operates in multiple locations, a suspension of the business due to a governmental order that occurs in one location constitutes a partial suspension of the entire business. If that business then closes other locations to operate in a consistent manner in all jurisdictions, the employer would still be considered to have partially suspended operations at all locations.

Controlled Groups. Similarly, Q&A 37 provides that for a group of companies under common control, a suspension of operations at one company will be deemed to occur with respect to all of the companies within the controlled group.

Voluntary Suspensions. Q&A 29 provides that if an employer is not subject to a governmental order that restricts its operations, but voluntarily suspends operations or reduces hours, the employer is not eligible for the ERTC on the basis of a full or partial suspension of its operations due to a governmental order. However, it may qualify under the gross receipts test (see below).

Reductions in Customers. Similarly, Q&A 32 states that if the employer is an essential business that is not required to close its physical locations or to otherwise suspend its operations, it is not considered to have a full or partial suspension of its operations for the sole reason that its customers are subject to a government order requiring them to stay at home. Nonetheless, it may qualify under the gross receipts test.

Teleworking. Finally, among the less-friendly interpretations are those related to telework. Q&A 35 states that if a business is forced to close its physical locations, but is "able to" continue operations comparable to its operations prior to the closure by requiring its employees to telework, it will not be considered to have incurred a suspension of operations.

It is not clear when a business is "able to" continue operations telephonically. Nor is it clear whether a suspension may occur if a business continues portions of its operations by telework, but voluntarily suspends other aspects of its operations.

The Gross Receipts Test

In General. Q&As 39-47 provide information regarding the gross receipts test. The test for this purpose adopts the gross receipts test used under section 448(c) of the Internal Revenue Code (the Code).

As an initial matter, Q&A 41 states that the employer is not required to show that the significant decline in gross receipts is related to COVID-19. It is an objective test.

Additionally, for a controlled group of companies, the gross receipts test is based on the gross receipts of all members of the controlled group.

Determining Gross Receipts. Under the Code section 448(c) test, "gross receipts" generally include total sales and all amounts received for services. However – and of particular relevance to taxpayers wishing to claim the ERTC under this test – the section 448(c) test for gross receipts **also** includes income from investments, regardless of whether such income is derived in the ordinary course of the taxpayer's trade or business.

Q&A 40 states that sales outside a business' ordinary course of business are still included in the gross receipts test. Including sales outside the ordinary course of business in the gross receipts test means that businesses selling long-term investments to fund immediate needs may jeopardize their eligibility for the ERTC.

For example, if a business sells stock (that it otherwise would have held) to fund employee wages, then any gain realized on such sale is included in 2020 gross receipts. It is not clear whether including sales outside the ordinary course of business in the gross receipts test was congressional intent or congressional oversight – it seems as though businesses should be permitted to make sales outside the ordinary course of business to fund business operations without risking their eligibility for the ERTC.

Qualified Healthcare Expenses

Section 125 Plan Contributions. Q&A 63 provides that the term "qualified health plan expenses" include any amounts paid by employees on a pre-tax basis under a Code Section 125 "cafeteria plan."

Allocating Qualified Health Plan Expenses. On May 8, 2020, the IRS revised its earlier guidance published April 29, 2020, with respect to Q&As 64 and 65, and changed course stating employers **can** claim the ERTC for qualified healthcare expenses, **regardless** of whether the employee is paid qualified wages. In general, we believe that the IRS's new interpretation of how qualified healthcare expenses are treated for purposes of the ERTC is more consistent with congressional intent than its previous interpretation.

The revised Q&As clarify this new interpretation with five examples – in each example, qualified healthcare expenses paid to furloughed employees are considered qualified wages for purposes of the ERTC. Following are two of the examples that we believe best clarify an employer's ability to utilize the ERTC when paying an employee's health care expenses.

Example: Over 100 Employees, Reduced Hours, Reduction in Wages, 100% Healthcare Expenses Paid For

Example 2 in Q&A 64 provides a detailed interpretation of how the qualified wage rules work for large employers. In this example, an employer that averaged over 100 employees in 2019 is subject to a government order that causes a partial suspension of operations. The employer is forced to reduce employee hours by 50%, but continues paying employees 60% of their wages and 100% of their qualified healthcare expenses. The example states that amounts paid with respect to periods when the employee is not providing services are qualified wages; thus, 10% of the wages paid and 50% of qualified healthcare expenses may be treated as qualified wages.

Example: No Wage Payment, 100% Healthcare Expenses Paid For

Example 3 in Q&A 65 further clarifies that if an employer ceases paying wages to employees altogether, but continues paying such employees' healthcare expenses, then the employer may still treat the healthcare expenses as qualified wages. In this example, the employer furloughed or laid off the employees, but continued paying their healthcare expenses. The example states that the healthcare expenses can be treated as qualified wages, even though the employees are furloughed.

Legal Significance of the Q&As

As a legal matter, only IRS guidance included in an official IRS Bulletin is considered legal authority, and most of the Q&A documents related to the CARES Act are not included in an IRS Bulletin. Thus, the Q&A documents have a disclaimer stating that the "information" provided in the Q&As cannot be used to support a legal argument in a court case.

Nevertheless, any interpretation of the IRS will be persuasive on audit and should carry some weight in a court proceeding. Thus, employers would be wise to generally follow the Q&As as a legal guidepost. In certain instances, there may be other legal authorities that can be relied upon to challenge the IRS' interpretation taken in a Q&A. However, employers will need to be cautious in taking any positions that might be directly contrary to the Q&As.

Claiming the ERTC

In general, an employer will claim the ERTC on its quarterly filings made to report income tax and employment tax withholding and payments (IRS Form 941).

The Form 941 has not yet been revised to reflect how the ERTC and other new tax credits may be claimed. Thus, at this point, it is unclear to what extent an employer may need to provide a detailed description of the reasons for its determination that it is eligible for the ERTC.

It is not anticipated that any detailed description of ERTC eligibility will be required on the Form 941 filing. Accordingly, employers will need to be sure to internally document in their files the rationale for claiming the ERTC, and any calculations of qualified wages and allocable amounts of qualified health plan expenses.

Please contact us if you need any assistance in determining your eligibility for the ERTC, the amount of the ERTC and appropriate documentation requirements.

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