IRS ISSUES ADDITIONAL GUIDANCE ON EMPLOYEE RETENTION TAX CREDIT; CONSISTENCY WITH CONGRESSIONAL INTENT AGAIN QUESTIONED

Hodgson Russ Federal-International Tax Alert
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This is an update to our April 14, 2020 alert which discussed, in part, the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") employee retention credit ("ERC") for certain employers subject to closure due to COVID-19. On April 29, 2020, the Internal Revenue Service ("IRS") released additional Frequently Asked Questions ("FAQs") on the ERC. The ERC is not available to business that took advantage of the Paycheck Protection Program ("PPP"). Recent frustration and open questions surrounding the availability of and qualifications for the PPP loan has given way to renewed interest in the ERC for some businesses.

Executive Summary

- The IRS has instructed that business operations are considered to have been "partially or fully suspended" only when operations in some or all of the jurisdictions in which the business operates are suspended due to a governmental order limiting commerce, travel, or group meetings due to COVID-19 in a manner that affects an employer's operation of its trade or business, meaning that operations are not suspended for ERC purposes if an employer can continue operations (*e.*, telework) at a "comparable" level to its pre-suspension operations.
- When an employee is paid a larger portion of their normal wages than relates to their typical amount of hours worked, the surplus is qualified wages paid for non-work eligible for the ERC.
- Although there has been a recent call for the Treasury Department to reconsider this position, the FAQs provide that while qualified health plan expenses are generally qualified wages for ERC purposes, no portion of health plan expenses can be treated as qualified wages if an employer is not paying employee wages (other than health care coverage).

The ERC, Generally

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As a reminder, the ERC (with certain qualifications) makes available a refundable payroll tax credit for 50 percent of qualified wages paid or incurred by employers to employees from March 13, 2020 through December 31, 2020. The credit is limited to the first $10,000 of compensation, including health benefits, paid to an employee during such period. The credit is generally available to employers (1) whose operations were suspended in full or in part due to a COVID-19 related shut-down order, or (2) whose gross receipts declined by more than 50 percent when compared to the same quarter in the prior year. For employers with a 2019 average of more than 100 full-time employees, qualified wages are wages paid to employees who are not providing services due to COVID-19 related full or partial shut-down orders. For smaller employers, all wages qualify for the credit, regardless of whether the employee is providing services for which the wages are paid. Special rules apply to tax-exempt entities, and otherwise eligible employers are denied the credit if they receive a PPP loan.

Summary of Select Issues Covered By April 29, 2020 IRS FAQs

Before the IRS released the most recent guidance, there were various open questions about the ERC. While the FAQs do not conclusively answer many of these questions, they do provide some additional insight into the function of the credit.

1. Determining When Business Operations Have Been "Partially or Fully Suspended"

As noted above, employers eligible for the ERC include employers who have had their operations "fully or partially suspended . . . due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes)" due to the COVID-19. Many employers had questions about what this meant in practice. For instance, does a decrease in customer demand due to the lockdown constitute a partial suspension of business? What constitutes an "appropriate governmental authority"?

Update: The FAQs (specifically FAQs 28-29 and 31-38, found here and here respectively) provide additional helpful guidance to aid employers in determining whether their operations have been partially or fully suspended due to an order from an appropriate governmental official under the meaning of the ERC.

First, the FAQs note that orders from the Federal government, or the State or local government in which the employer operates, are "orders from an appropriate governmental authority" if they limit commerce, travel, or group meetings due to COVID-19 in a manner that affects an employer's operation of its trade or business, including orders that limit hours of operation. Orders such as statements from government officials made during press conferences or media interviews are not sufficient orders for ERC purposes. Similarly, the declaration of a state of emergency is not a sufficient governmental order if it does not limit commerce, travel, or group meetings in a manner that does not affect the employer's operation of its trade or business.

Second, the FAQs provide that employers who have their workplace closed but can "continue operations comparable to its operations prior to the closure by requiring its employees to telework" are not considered to have been fully or partially suspended. Clearly, there is some interpretation required to determine what is meant by the word "comparable," and the IRS provides little to clarify the meaning of the term. FAQ 33 provides an example, but it does little to elucidate the standard by which comparability will be measured for the purposes of the ERC.

Finally, the FAQs provide some guidance for employers with operations in multiple jurisdictions. With some states beginning to ease stay-at-home orders, questions have begun to arise regarding whether an employer with some fully operational branches in open jurisdictions but other branches that remain closed due to governmental orders may take advantage of the credit. The FAQs confirm that employers that operate a trade or business in multiple locations and are subject to State and local governmental orders limiting operations in some, but not all, jurisdictions are considered to have a partial suspension of operations.

2. Calculating "Qualified Wages" for Employees Working Reduced Hours

As discussed above and in our prior alert, the calculation of ERC "qualified wages" varies based on employer size. Specifically, employers with a 2019 average of more than 100 full-time employees include wages paid to employees who are not working due to COVID-19 related shut-down orders as "qualified wages." For smaller employers, all wages qualify for the credit, not just those paid for non-workers. An employer who opened their business in 2020 uses the above test, but applies it to the calendar months the business was open in 2020 instead of 2019.

Update: An open question concerning the calculation of ERC qualified wages is whether the ERC is scalable. That is, what if an employer is paying 100 percent of an employee's salary but due to a partial shut-down order the employee is only working 50 percent of the hours they usually would. How much, if any, of these wages are qualified wages for ERC purposes?

The IRS addresses this issue with two FAQs, for both hourly and salaried employees. FAQ 54 and 55 provide that employers may use any reasonable method to determine the number of hours that a salaried employee is not providing services, but for which the employee receives wages either at the employee's normal wage rate or at a reduced wage rate, and include the surplus wages as qualified wages. FAQ 55, Example 1 provides the following:

Employer V, a large fitness club business that employed an average of more than 100 full-time employees in 2019, closed all of its locations in City B by order of City B's mayor. Employer V continues to pay its exempt managerial employees their regular salaries. While the clubs are closed and there is not sufficient administrative work to occupy the managerial employees full-time, they continue to perform some accounting and similar administrative functions. Employer V has determined, based on the time records maintained by employees, that they are providing services for 10 percent of their typical work hours. In this case, 90 percent of wages paid to these employees during the period the clubs were closed are qualified wages.

As such, when an employee is paid a larger portion of their normal wages than relates to their production or hours worked, the surplus is qualified wages paid for non-work. The Joint Committee on Taxation ("JCT") agrees with this conclusion, and provides additional examples in their CARES Act explanation (here). Of course, these fractions are far more easily computed for an hourly employee than someone on salary. Because the ERC is only available to larger employers when a wage payment is made for non-production, the credit is less attractive to many businesses.

As noted above, the FAQs discuss how an employer with more than 100 full-time employees in 2019 may calculate qualified wages. The FAQs provide that employers may use any "reasonable" method to determine the number of hours that a salaried employee is not providing services, but still receives wages. The term reasonable method includes "the method that the Eligible Employer would use to determine the employee's entitlement to leave under the Family and Medical Leave

Act" as well as "the method(s) that the Department of Labor has prescribed to determine the number of hours for which an employee with an irregular schedule is entitled to paid sick leave under the FFCRA." It is not reasonable, however, for an employer to treat an employee's hours as having been reduced based on an assessment of the employee's productivity levels during the hours the employee is working.

Interestingly, the IRS has taken the position that wages paid to related individuals (including children and children-in-law, siblings, parents, etc.) are not taken into account for the ERC. The FAQs include attribution for the purposes of this rule, meaning that an employee who has the above-noted relationship to a 50 percent shareholder or partner of the employer also cannot have their wages included for ERC purposes.

Finally, the FAQs also note that if wages are increased during a period in which the employee is not providing services, the increase will not constitute qualified wages for ERC purposes.

3. When Is Health Care Coverage "Qualified Wages" for ERC Purposes?

Generally, the ERC provides that "qualified wages" includes "qualified health plan expenses" paid or incurred by the employer. A qualified health plan expense is an "amount paid or incurred by the eligible employer to provide and maintain a group health plan," but only to the extent that such amounts are excluded from the employees' gross income.

Update: IRS FAQs 62-72 (found here) confirm that qualified health plan expenses are qualified wages as outlined above. They also provide additional insight into how such expenses are factored into qualified wages in circumstances where an employee is laid off or furloughed, but still is receiving health care coverage from his/her employer. Specifically, the FAQs provide that if an employer is not paying employee wages (other than health care coverage), then no portion of the health plan expenses can be treated as qualified wages for ERC purposes. The reasoning provided by the IRS is that, because no wages are paid to a laid off or furloughed employee, no portion of the health plan expenses is allocable to wages paid to the employee.

Conflict Between IRS FAQs and Joint Committee on Taxation Interpretation

Unfortunately, there are some discrepancies between IRS guidance (including the recently released ERC FAQs discussed above) and the JCT interpretation of COVID-19 tax credits. For example, while the IRS FAQs only include full-time employees to determine whether an employer has 100 workers for determining "qualified wages" under the ERC, the JCT interpretation focused on both full-time and "full-time equivalent" employees.

Despite the conflict between the interpretations, IRS officials have stood behind the stances taken in its guidance. While the FAQs issued on the ERC do not carry the force of law, they are likely the most accurate interpretation of the IRS stance on the credit. It is not currently known how much (if any) of the information provided in the FAQs will eventually make its way into Treasury regulations.

Conflict Between IRS FAQs and Expressed Congressional Intent

Last week we saw the IRS espouse its position that expenses paid with PPP loan proceeds are not tax deductible, followed quickly by Senator Grassley's and House Ways and Means Committee Chair Richard Neal's rebuke suggesting that the legislative intent was to allow deductibility (followed shortly thereafter this week by Treasury Secretary Mnuchin's expressed support for the IRS position).

Similarly, congressional intent appears to be frustrated with regard to the above-discussed exclusion of the ERC benefit for health care expenses paid to furloughed employees not otherwise being paid wages. In a May 4th letter to the Secretary of Treasury, Senator Grassley, Representative Neal, and Senator Wyden jointly expressed their frustration that this position in the FAQ is inconsistent with congressional intent and requested the Treasury Department to reconsider its position.

Conclusion

Generally, the usefulness of the ERC likely varies by employer size due to the credit's calculation of "qualified wages" becoming less useful for many employers with more than 100 full-time employees. Still, given the real issues with the administration of the Federal PPP program, a renewed focus on the ERC may be warranted for some businesses.

Please contact Brad Birmingham (716.848.1511) or Joe Rekrut (716.848.1715) with any questions you may have regarding the ERC or the above IRS guidance.

Please check our Coronavirus Resource Center and our CARES Act page to access information related to both of these rapidly evolving topics.

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