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Episode 14: Retention Credit Opportunities

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Audio Transcript:
David Rogers: Welcome to another episode of Winston & Strawn's Benefits Blast podcast. My name is David Rogers and I'm joined today by my former colleague, Ruth Wimer. During this episode, we will discuss a tax credit available to many organizations. We will cover what the retention credit is, which employers are eligible, how to calculate the retention credit, and the implications of a PPP loan and other tax credits that you may have already taken advantage of. So we'll get right into it and start, Ruth, with a broad description of what is the retention credit and how can companies apply for it for 2020 and 2021?

Ruth Wimer: Well, thank you. We'll be providing a lot more detail in this podcast, but in general, the employee retention credit is refundable tax credit against certain employment taxes for employers experiencing difficulties related to the COVID-19 pandemic under either one of two criteria.

David Rogers: And let's start first with 2020. What amount of retention credit is available for?

Ruth Wimer: Well, the employee retention credit is a refundable tax credit against certain employment taxes equal to 50% of the qualified wages an eligible employer paid to employees after March 12th, 2020, and before January 1, 2021. The qualified wages are equal to $10,000 per employee for the entire year. And thus, the maximum cash to the employer is $5,000 per employee for calendar year 2020. So by way of example, an employer has 20 employees and the retention credit is $100,000, that employer will receive $100,000 from the IRS following IRS procedures for 2020.

David Rogers: And I know the calculations are different for 2021. So let's go now and discuss the amount of retention credit for 2021.

Ruth Wimer: The employee retention credit for 2021 is a refundable tax credit against certain employment taxes equal to 70% of the qualified wages an eligible employer pays to employees between January 1, 2021 and July 1, 2021. But, then the American Rescue Plan extended the retention credit, so now it goes through December 31st, 2021, so that as you can get the retention credit for all four quarters of this year. Qualified wages for 2021 are equal to $10,000 per employee per quarter, and thus the maximum cash to the employer is $28,000 in 2021. You get to this number by multiplying 70,000 times $10K per quarter times four quarters to equal $28,000 in 2021, per employee.

David Rogers: So we have a $5,000 credit for 2020 and an up to $28,000 credit for 2021. So part of what you just indicated was that this is based upon what wages are qualified. So let's go through the definition of wages and also whether or not this is available to employers who have independent contractors as well.

Ruth Wimer: Sure. This one is easy. Qualified wages are generally your employee's FICA wages. So whatever you're paying employees that are subject to FICA taxes, plus the healthcare expenses, are eligible for the credit. Since qualified wages are generally those wages subject to FICA tax, independent contractors are not included.

David Rogers: To our listeners, we have a PDF of this PowerPoint presentation available as well because some of these calculations get a little complicated. So now let's talk a little bit about who's an eligible employer first for 2020, and then for 2021.

Ruth Wimer: This is probably the most complicated part of analyzing whether an employer, and how much an employer, can get by way of the retention credit. Employers are eligible for the credit if they operated a trader business during calendar year 2020, and experienced either a full or partial shutdown of the operation of the trader business drawing any calendar quarter because of government orders limiting commerce travel, or group meetings due to COVID-19, and this is called the government orders test. Or alternatively, an employer can meet the test regarding gross receipts. For 2020, that test is a significant decline in gross receipts defined as more than a 50% reduction in gross receipts as compared to the same quarter in 2019 – that's the gross receipts test.

David Rogers: Anything else you want to talk about in terms of the gross receipts test for 2020, any further detail?

Ruth Wimer: Yes. For 2020, again, it's requiring a more than 50% decline in gross receipts. And so the period during which the retention credit may be obtained begins with that quarter when there was more than a 50% decline and ends with the quarter in 2020 in which gross receipts are more than 80% of its gross receipts. So once you get that 50%, if the next quarter is 60%, you're still in the period for which you can get the retention credit all the way through the quarter in which you have more than 80% of gross receipts as compared to 2019.

David Rogers: So that's the 2020 test. Now we're going to talk about who's an eligible employer for 2021, and you'll see that the standards or the requirements are again different for 2021.

Ruth Wimer: In general, I would note in 2021, it's much, much easier to meet the gross receipts test. The government order tests, where you had a full partial shutdown due to government orders, is exactly the same as for 2020. However, the gross receipts test is far simpler to meet. The gross receipts test is where there's been a more than 20% reduction in gross receipts for the quarter when compared to the same quarter in 2019, or a 20% reduction in gross receipts calculated by using the prior quarter receipts as compared to the same quarter in 2019. So you have a choice there. And I would note, again, the reduction only needs to be more than 20%, and also you can look back at the prior quarter for meeting that test.

David Rogers: So that is another distinction, 2021 versus 2020. Obviously Congress is trying to provide additional relief for those employers who are still suffering from the pandemic. Okay, so a little bit more about the gross receipts test for 2021.

Ruth Wimer: For 2021, the gross receipts test looks at a significant decline of gross receipts, which begins on the first day of the first quarter of 2021, for which an employer's gross receipts are less than 80% of its gross receipts as compared to the same quarter in 2019, and ends on the first day of the first calendar quarter during the same year in which the gross receipts are more than 80% of its gross receipts as compared to the same calendar quarter in 2019.

David Rogers: We've talked about which employers are eligible for the retention credit for 2020 and 2021. Now let's talk about what wages are eligible for both years.

Ruth Wimer: As mentioned previously, basically the qualified wages eligible for those defined as FICA wages under Section 3121 A, and also you add to that the qualified health plan expenses. Now, for 2020, an employer cannot claim a credit under Section 45 S of the code, which is the employer credit for family and medical leave for qualified wages for which a client claimed the retention credit, and in the first half of 2021, in addition to the Section 45 S, credit employers must exclude from qualified wages any wages taken into account under Section 4145 A and several other provisions of the code, which provide for credits. So the way that these rules can be summarized is an employer cannot double dip and get different credits under the internal revenue code for the same wages paid to employees.

David Rogers: That makes a lot of sense. So we've talked about the employers who are eligible, talked about the wages, and let's talk about the employee count in terms of, for each year, how many employees an employer is permitted to have and still be eligible for the employee retention.

Ruth Wimer: This is a very important question, because while any size of employer can get the retention credit, it's far easier and more employee wages count when the employer is viewed as a small employer. And, the definition of a small employer is dependent on the number of employees in the affiliated group. Business entities are aggregated and treated as a single employer, where there are members of the same control group of corporations, having employees under common control or a part of an affiliated service group as provided under internal revenue code, Section 15 A or B, which basically looks at 50% ownership, or under Section 414 M and O, which are kind of a complicated analysis. And note that these are the same rules used for aggregating entities for employee benefit purposes and for qualified plans, but with a lower ownership requirement about the 50% or more. Note that private equity firms may not come under these control group definitions because the private equity firm may not be considered a trade or business for these purposes. So the entities in which a private equity firm invests may separately be viewed for purposes of being a small or large employer.

David Rogers: And now let's talk for first for 2020, and then for 2021, the definition of a small employer versus a large employer with more than a hundred. So what wages count dependent upon how many employees the employer has?

Ruth Wimer: Again, note that small employers get more benefits than large employers and for 2020, if an employer averaged more than 100 full-time employees during 2019. The measurement is always looking at 2019 for the year in question. Qualified wages only include amounts paid to employees on furlough or otherwise not providing services. For small employers, qualified wages include those wages, including the healthcare costs up to $10,000 per employee paid to any employee during the period operations were suspended or the period of decline in gross receipts, regardless of whether the employee is providing services or not. In 2020, employers can only count wages up to the amount that the employee would have been paid for working in an equivalent duration during the 30 days immediately proceeding the period of economic hardship. So that's another restriction, and for 2020 retention credit that you can't count increases in salary given to employees during the quarter in question. So in summary for 2020, a small employer looks at a hundred employees or less. And when that occurs, the entire payroll, all the employees on the payroll, can be used for purposes of the retention credit, not just those who are being paid while they're not working.

David Rogers: That makes sense. And we'll talk in a little bit about how the PPP loan, also needs to be considered with respect to the retention credit for either large or small employers. So I know in 2021, they made it a little bit easier. Again, I think Congress recognizing that the pandemic is ongoing in affecting many employers. So let's talk about the employee count for 2021.

Ruth Wimer: Okay. So again, for 2021, many of the rules were loosened up and we note that being a small employer is beneficial because all employees wages count, not just those who are paid for not working. So the qualified wages for 2021 work the same way as for 2020, but the employee threshold count is increased to 500 full-time employees rather than just a hundred. So that includes many, many more employers into the groups that can qualify for using the entire payroll and all employees, even if they're working as eligible for the retention credit, rather than just those employees who are being paid while they're not working. And again, you always look at the number of employees that were there in 2019 for purposes of the year in question. So in 2021, you're going to look at your payroll in 2019, but you get to be considered a small employer if you have 500 or less full-time employees, and then you can count all wages paid to all employees.

David Rogers: Quite a benefit with respect to the tax credit. And yet there's more – for certain employers who have really not rebounded from the pandemic and are under severe distress, there is an even broader credit. So let's go through that.

Ruth Wimer: The American Rescue Plan Act of 2021 extended the retention credit through the second half of 2021. And so for the second half, there's a special, very generous rule. If a company was considered distressed, which means that its receipts were less than 10% of the gross receipts in the quarter as compared all the way back to 2019 (that means the employer is in pretty bad shape,) then the employer can get that wonderful retention credit for all employees on the payroll, even if it is not below the 500 employee threshold, which generally applies for 2021. If an employee has thousands and thousands of employees, it's able to get the $7,000 per employee per quarter credit for all those employees, even though it's a large employer. Now to qualify for this, again, it had to have gross receipts of less than 10% in the quarter as compared to the same quarter in 2019. And the statute seems to also allow that prior reference quarter to qualify for this purpose. You'll recall in general, for 2021, the law has changed and you look at either the quarter that you're in or the prior quarter for determining whether you meet the gross receipts test. So in the third quarter of 2021, you can claim wages paid for that quarter based on being distressed in the second quarter of 2021. That's how the statute reads, we're waiting IRS guidance on that point.

David Rogers: We've seen a few clients in the travel and leisure industry is still not rebounding. And so not withstanding the fact that they have more than 500 employees at this point, they're still eligible to get this retention credit of up to $28,000 in 2021. I referred earlier to the connection with the PPP loan. And so let's talk about an employer who also received the PPP loan that hopefully was forgiven, but nonetheless received that. How can they get the retention credits for 2020 or 2021?

Ruth Wimer: Originally, if an employer received a Cares Act small business interruption loan under the Paycheck Protection Program, then the employer was not eligible for the employee retention credit. So the employer was getting one or the other. Now retroactively, employers can get the retention credit if they meet the government orders test or the gross receipts test, which we discussed earlier, but just not on the same wages used for PPP loan forgiveness. So that means employers can go back to 2020, or in 2021, they can get both the retention credit and the PPP loan.

David Rogers: Well, let's go through an example of how this is coordinated. I know the IRS has issued Notice 2021-20. So let's perhaps give an example of how the retention credit in PPP are now coordinated on a retroactive basis.

Ruth Wimer: Well, the IRS was fairly generous. The IRS said, if you can have the PPP loan in accordance to the statute, the law was changed to say, you can have the PPP loan and go back and obtain the retention credit, but you just can't use the exact same wages. And so it begs the question, which are the same wages? Well, by way of an example, if an employer obtained a loan for $200,000, and this employer was required and did report a minimum of $120,000 of payroll costs (that is wages,) but also reported another $80,000 of other eligible expenses, (such as rent and utilities,) on the loan forgiveness application that was already filed, the SBA approves forgiveness on the $200,000 loan in this instance. the employer may now claim a retroactive retention credit of qualified wages paid above the 120,000 covered by the PPP loan during 2020. So in instances where the forgiveness application was already filed, the IRS looks at that application and just simply looks at the wages claimed on that application and says, any other wages paid during 2020 may be used for the retention credit. Now, mind you, the employer also had to meet either the government's ordered tests or the gross receipts test for 2020.

David Rogers: So that makes sense. Let's use a similar example because many of our clients have already filed their PPP loan forgiveness paperwork. Now they realize that they can have a retention credit perhaps retroactively for 2020. So in that example that you just used, let's modify it a little bit. And if the employer still had the $70,000 of other eligible expenses, but didn't report it as such and just listed the $200,000 of wages, what now? What are they eligible for?

Ruth Wimer: Well, this is the one area where he guidance is a little harsh, and the guidance says if you already submitted for loan forgiveness, and just because you didn't want to be bothered with submitting the other non-payroll expenses in the application, it just submitted payroll expenses of $200,000, the IRS says too bad, you lost your opportunity. And now for the retention credit, you can only use wages that are above and beyond the $200,000 you actually put on that application. So the employer can't go back and say, well, I could have put on another $70,000 – it's too late for that. Now the good news I, it well could be that in addition to what was put on that application, there are other quarters not covered by the PPP loan for which one of the two criteria were mad and there's wages that are eligible for the retention credit. In other words, the PPP loan period does not cover the entire year.

David Rogers: So we've, we've seen that in a number of real cases with clients that there's still room for the retention credit for 2020. Ruth is a payroll tax expert, and we're going to now go through the three ways that you can claim the credit, the employee retention credit. So Ruth, let's summarize those three ways and then make a recommendation as to what most of our clients are thinking about using at this point.

Ruth Wimer: There are generally three ways to claim the employee retention credit. The first is to withhold back any and all employment taxes. And that includes social security, Medicare, and federal income tax withholding in anticipation of the credit. And that's what many employers who have cashflow problems are in fact doing. The second way to get that employee retention credit is to request a refund on the employment tax return, the form 941, by most employers four times a year. So the IRS has amended that form to allow the employer to claim back various credits, one of which is the retention credit. So the employer will just put it as a line item, the amount that he's owed, and the employer will send a check or use it as an overpayment for the following quarter's employment tax deposits. Then finally there is the ability to request an advance credit through the form designated by the IRS with some limitations. And this is the form 7200 where the employer can claim the credit in advance of having sufficient employment tax to deposit or filing the form 941 for the quarter.

David Rogers: Whatever which of the three routes are you thinking most employers will take advantage of in order to get the credit?

Ruth Wimer: It seems to me, because there's always some risk in withholding back employment tax deposits, there can be penalties (although the IRS and the statute indicates that there's a waiver If the employer was acting in good faith.) Probably the best way to go, and the way that we see most of our clients getting the retention credit is, as I mentioned, a line item on the form 941 quarterly tax return for employment taxes. And there, the IRS has instructions, and like I said, has a line for the amount of the employee retention credit, and that's probably the easiest and safest way for the employer to be made whole for the retention credit that he's owed.

David Rogers: Okay, but say I'm an employer that's really having a cashflow problem. What's the quickest way to get the retention credit?

Ruth Wimer: Well, the quickest way is to withhold the employment taxes that would otherwise be deposited. And many employers are depositing the withheld taxes from employee's paychecks every two weeks, maybe even every one week. And they, when they withhold from the paychecks, the social security taxes, Medicare taxes, and federal income tax, the employer can simply say, well, I have a deposit that's owed that's less than the retention credit the IRS owes me, so I will just hold back that deposit and be made whole immediately in that fashion.

David Rogers: So perhaps additional risks, but probably the quickest way for an employer to obtain the credit. Thank you again, Ruth, for that information regarding the employee retention credit. And thank you to our listeners for listening to another edition of our Benefits Blast podcast. You can subscribe to the Benefits Blast podcast via Apple iTunes or Google, or by visiting the Winston & Strawn website for more insights on the latest legislative, regulatory, and practice developments, concerning employee benefits, labor employment, and executive compensation.

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