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Employee retention credit: Navigating the suspension test

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Establishing eligibility for the employee retention credit (ERC) by satisfying the business operations suspension test (suspension test) is similar to venturing into remote parts of the world: The payoff from a successful journey can be tremendous, but the road is arduous. Complexity adds uncertainty, guidance is lacking, and what appears to be an easy path may lead you off a cliff.

While the ERC program has fully sunset, employers may still file claims for any credits they were entitled to in 2020 through the third quarter of 2021, and interest remains strong. Like a sign on a path warning of danger ahead, this item is intended to help mitigate risk for those still pursuing the ERC by (1) breaking down the suspension test into its core components and (2) shedding light on areas to proceed with caution. As an aside, this is a complex analysis with many moving parts, most of which are beyond the scope of this discussion, and consulting someone with experience is advisable.

The suspension test overview

Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, and Notice 2021-20, an employer can be eligible for the ERC if it experiences a full or partial suspension or modification of operations due to COVID-19-related orders from an appropriate governmental authority. This is the suspension test, and it is one of three means for eligibility, the others being relatively objective determinations of whether a business experienced a “significant decline” in gross receipts or qualifies as a “recovery startup business.” Unlike those other methods of qualifying for the ERC, the suspension test is highly subjective, based on facts and circumstances, lacks a significant amount of guidance, and is subject to additional limitations. To help understand the test, it is best broken down into its core components.

The suspension test is a two-part test, applied on a quarterly basis, in which an employer must establish:

1. It is subject to a governmental order in effect, and

2. The order has more than a nominal impact on its business operations, either due to suspending them or requiring modifications to them.

For establishing that suspensions and modifications of business operations have occurred, Notice 2021-20 provides employers with safe-harbor tests, as will be discussed in more detail later. For a suspension, employers must show that *more than a nominal portion* of business operations were affected. For a modification (for example, a change made to satisfy social-distancing requirements), employers must show that the modification caused *more than a nominal effect* on business operations. It is critical to distinguish between whether a suspension or modification has occurred in order to apply the relevant safe-harbor test. Employers with one or more components of their operations suspended or modified should strive to meet the applicable safe harbor, as failure to do so increases the risk that the IRS may challenge their eligibility. In the event an employer cannot meet a safe harbor, it still may be eligible for the ERC if it can otherwise show that the governmental order impacted business operations more than nominally.

Test 1: Governmental order

The first part of the suspension test is whether the employer is subject to a relevant governmental order. Eligibility for the ERC under the suspension test requires an order, proclamation, or decree from a federal, state, or local government that limits commerce, travel, or group meetings due to COVID-19. The level of enforcement of the government order is irrelevant for these purposes. Notice 2021-20 indicates that an issuing state or local government must have jurisdiction over the employer's operations.

Satisfactory examples of a government order include a state governor's mandating that all nonessential businesses must close until further notice, a city mayor's requiring all businesses to limit occupancy to 50% of legal capacity, and a local health department's ordering all establishments to close four hours early to clean and disinfect the premises to mitigate the spread of COVID-19. Critically, note that in each instance, compliance is *mandatory;* conversely, government action that does not qualify would include a government official merely encouraging diligence in maintaining social distancing or avoiding unnecessary travel or guidance issued by the Centers for Disease Control and Prevention (CDC), as compliance is voluntary.

It is highly recommended that employers save copies of the applicable governmental orders, identify the effective date ranges of the orders and the applicable language impacting the employer, and provide a robust narrative detailing the specific impacts of the order on their operations. As noted above, while an employer can still be eligible for the ERC under the suspension test if it does not meet either of the safe harbors, discussed below, that scenario demands a detailed and compelling narrative that establishes that the government order imposed more than a nominal impact on business operations.

Test 2.a: Suspension: More-than-nominal portion

The second part of the suspension test is whether the government order has more than a nominal impact on business operations. There are two available safe harbors for demonstrating this. To the extent an employer's operations are *suspended,* the employer should utilize the more-than-nominal *portion* safe-harbor test. Under this test, the impacted portion of an employer's operations will be deemed "more than nominal" for the quarter in which the employer is testing eligibility if either:

- The gross receipts from that portion of the business make up at least 10% of the employer's total gross receipts (both determined using the gross receipts from the same calendar quarter in 2019); or
- The hours of service performed by employees in that portion of the business make up at least 10% of the employer's total employee service hours (both determined using the service hours performed by employees in the same calendar quarter in 2019).

Example 1: A restaurant must close (i.e., a suspension of business) its on-site dining due to a governmental order (test 1 met). The restaurant is allowed to continue sales to the public via carryout and delivery. Because it can no longer offer on-site dining, which represented 30% of the restaurant's total gross receipts in the same quarter of 2019, a more-than-nominal portion of operations has been impacted (test 2.a met). As both parts of the suspension test are met after applying the appropriate safe harbor, the restaurant is eligible for the ERC.

Caution: This "lookback" test considers historical information from 2019. While at face value it seems simple, the guidance is not clear on how the factors (i.e., numerator and denominator) should be considered for complex organizational structures (e.g., franchises in multiple jurisdictions with varying levels of suspension, aggregated employers with multiple separate and distinct trades or businesses, etc.). Without clearer guidance on how to utilize the safe harbor for these complex scenarios, questions remain as to how to apply the test properly.

Test 2.b: Modification: More-than-nominal effect

To the extent an employer's operations are *modified*, the employer should utilize the more-than-nominal *effect* safe-harbor test. Under this test, a modification will have more than a nominal effect if it results in a 10% or more reduction in an employer's ability to provide goods or services in its normal course of business.

Examples of ordered modifications that *may* result in a more-than-nominal effect (note the authors' caution below) include:

- Requiring occupancy restrictions and six-foot distancing; and
- Requiring performance of services only on an appointment basis.

Examples of modifications that likely do not result in a more-than-nominal effect include:

- Requiring employees and customers to wear face coverings; and
- Installing plexiglass or other barriers.

Example 2: Assume the same facts as Example 1, except three months later under a further governmental order (test 1 met), the restaurant is permitted to offer indoor dining service, subject to a 50% capacity restriction (modification). This capacity restriction results in the restaurant having to turn away customers from eating indoors, and indoor sales are down considerably compared with the normal course (25% decrease in customers served, compared with the same quarter in 2019, showing a more-than-nominal effect (test 2.b met)). As both parts of the suspension test are met after applying the appropriate safe harbor, the restaurant is eligible for the ERC.

Caution: The mere existence of a modification, including occupancy restrictions and requiring appointments for services, is insufficient. An employer must still establish that the mandated modification had more than a nominal effect on business operations, which can be demonstrated by showing a 10% or more reduction in the employer's

ability to provide goods or services in its normal course of business. Unfortunately, Notice 2021-20 fails to provide quantifiable parameters by which this 10% reduction can be measured. As stated above, without clearer guidance, questions remain as to proper administration of the safe-harbor test.

Other considerations

There are also additional matters to consider in determining whether an employer qualifies for the ERC.

Comparable operations via telework: Some employers found themselves subject to governmental orders closing their workplaces entirely. At face value, this may seem like a clear-cut case to establish eligibility, yet this too requires additional analysis. In these situations, the employer still must establish that it was unable to continue comparable operations via telework. Notice 2021-20 provides four factors to consider when determining whether the employer could continue comparable operations via telework:

- Employer's teleworking capabilities;
- Portability of employees' work;
- Need for presence in employee's physical workspace; and
- Difficulty or delays in transitioning to telework operations.

Limitations on qualified wages: Two often-overlooked limitations apply to the suspension test:

- *Limitation to the period the order was in effect:* An employer may only count as qualified wages those wages for the period that the order was in effect. For example, an employer's operations may have been temporarily suspended for two weeks in the second quarter of 2020. Only wages pertaining to that two-week period can be treated as qualified, not all wages for the second quarter of 2020.
- *Limitation on trade or business:* The law and guidance appear to limit qualified wages to the specific trade or business that was suspended, and not all wages paid to all employees of the employer if the employer comprises multiple trades or businesses. Unfortunately, available guidance does not appear to contemplate this scenario, and the analysis is further complicated for employers spanning multiple jurisdictions.

Be cautious about taking aggressive positions

Where clear guidance is unavailable, ERC positions should be based on reasonable interpretations of current law and supplemental authority. The ERC was intended to provide relief to employers from the impact of COVID-19 but was not intended to be universally available. It seems clear the IRS will be examining credits claimed with intense scrutiny, as evidenced by Congress's extending the statute of limitation for assessment of payroll tax returns on which the ERC is claimed to five years (Sec. 3134(l)) and the issuance of Treasury regulations directing erroneous ERC claims to be treated as underpayments of payroll taxes and subject to assessment (T.D. 9904). Interest and penalties can additionally be assessed on erroneously claimed credits.

Employers deciding on their ERC position should also consider the significant cumulative costs of a failure to sustain the ERC upon audit, including costs to calculate the credit, compliance costs related to amended filings for claims and subsequent amendments to repay, costs to defend the position upon audit or in court, and the actual repayment. Further, it is possible that the ERC audit might not conclude until after the statute of limitation has expired for the income tax return on which the employer appropriately did not claim deductions for wages giving

rise to the credit, as required by CARES Act, Section 2301(e), and Sec. 3134(e). In this case, the employer would be unable to amend its income tax return to take the deductions, meaning it effectively paid tax on a credit it had to repay. Employers should consider these risks carefully and determine whether they are comfortable with the levels of exposure before proceeding.

Some ill-advised arguments when pursuing the ERC under the suspension test include:

- The employer was following nonmandatory guidance issued by the CDC and/or the Occupational Safety and Health Administration;
- The employer relied on the narrowly applicable suspended-supplier exception on account of macro-level supply chain bottlenecks (including supply shipments stuck at ports); and
- There were increases in costs in order to successfully maintain pre-pandemic levels of operation.

Seek all available resources

The ERC rules are complex, and guidance, while limited, includes substantial warnings for employers that aggressively interpret the rules or fail to conduct appropriate due diligence before reporting the credit. The AICPA has many resources to help members understand the rules (see **Employee Retention Credit Guidance and Resources (https://www.aicpa.org/resources/toolkit/employee-retention-credit-guidance-and-resources)**). The authors recommend that you use all available resources when it comes to the ERC.

Editor Notes

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