**EMPLOYEE RETENTION CREDIT…**

**What, When, How, Why and When**

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When Covid hit America in 2020, people stopped going out and started working more from home, becoming more and more isolated in an effort to reduce exposure. Obviously, this significantly affected commerce and caused a significant downturn in many businesses either due to lockdown or limited operation.

When it became apparent that there was no immediate end in sight, Congress started to become concerned about the well-being of the American economy as well as businesses and the individuals employed by these businesses. As a result, Congress enacted a number of pieces of legislation providing financial assistance to individuals as well as businesses. One such piece of relief was the employee retention credit or ERC for short with its main purpose being an incentive for businesses to maintain and continue to pay employees thus keeping them on the payroll during the crisis.

The ERC is a credit against federal payroll taxes for qualifying wages paid from March 13, 2020 through December 31, 2021. Some taxpayers claimed the ERC right away, but others did not claim the credit but still have the opportunity to do so. So, as a practitioner, what are the questions you have to consider when determining if a client is eligible to claim the employee retention credit? There are basically seven questions you have to ask and consider before making a final recommendation to a client regarding the client’s entitlement to ERC. Those seven questions are as follows:

1. Did the business pay W-2 wages or health insurance in 2020 or 2021 that qualify for ERC?
2. Was the operation an actual business or charity?
3. What is the business’s qualifying criteria?
4. Which wages count for ERC?
5. How much ERC does the business qualify for?
6. How and when should the business apply for ERC?
7. What are the costs and risks of applying for the credit?

**Question 1 – Did the business pay qualifying Wages?**

Only employee W-2 wages and qualifying healthcare costs qualified for ERC. Accrued wages do not qualify. Wages paid in 2019 or prior do not qualify. Wages paid from January 1, 2020 through March 12, 2020 do not qualify. Wages paid after December 31, 2021 do not qualify.

Net earnings from self-employment of a sole proprietor do not qualify. W-2 wages of a family member of a sole proprietor do not qualify. Net earnings from self-employment of a partner in a partnership do not qualify. W-2 wages of a family member of a 50% owner of a partnership do not qualify. W-2 wages of a more than 50% owner of an S Corp or C Corp. and W-2 wages of a spouse of a more than 50% owner of an S Corp or C Corp. do not qualify if such majority owner has a living relative. W-2 wages of any other family member of a majority owner of an S Corp. or C Corp. do not qualify. (Note that the IRS position regarding S Corp and C Corp majority ownership changed in 2021. The IRS’s original position was that wages of a C Corp. or S Corp owner and spouse qualified regardless of percentage of ownership.) Non-spouse relatives of the majority owner do not qualify however non spouse relatives of a non-majority owner do qualify. Refer to Notice 20 21–49.

**Question 2 – Was the of the entity an actual business or charity?**

To claim the ERC, the operation of the entity must be an actual business or charity that employs qualifying employees. This means that investment activity does not rise to the level of a trade or business and is not eligible for employer ERC. Additionally household employees are not eligible for ERC.

There are two factors that are taken into consideration to determine if an activity rises to the level of a trade or business. First the profit motive of the business. And second was the business carried on with regularity and continuity. It is the facts and circumstances that will control the applicability of each of these factors in each case.

Additionally for real estate, there are four factors as to whether or not the activity will constitute a trade or business. The type of property, the number of rental properties, the involvement of the owner or agent and the type of rental.

**Question 3 - What is the business’s qualifying criteria?**

A business or charity will qualify for ERC in one of three ways.

1. A full or partial suspension of operations by a government order.
2. A significant drop in gross receipts.
3. The business is a recovery start up business.

*Gross Receipts*

Determining if there has been a sufficient drop in gross receipts to qualify for ERC is a mathematical computation. For 2020, a business will qualify for ERC if it’s drop in gross revenue in any one quarter of 2020 is 50% or more compared to the same calendar quarter of 2019. For 2021 a business will qualify for ERC if it’s drop in gross revenue in any one quarter of 2021 is 20% or more of the same calendar quarter of 2019. If a business meets the drop in the gross receipts test, all qualifying wages, subject to dollar limits, paid in the entire qualifying quarter count for ERC. Related businesses must be aggregated as a group to determine if said aggregated group of businesses meets the gross receipts test.

*Full or Partial Suspension*

Determining whether there has been a full or partial suspension by government order qualifying the business for ERC is dependent on the facts and circumstances but a little bit more specific. The full or partial suspension of business operations **must be due to an order from a government authority related to Covid which limited commerce travel or group meetings**. Additionally, if an employer meets full or partial government suspension, qualifying wages subject to the dollar limits, are only eligible for those days paid during the government suspension and not the full qualifying quarter. It’s not surprising that the biggest area of uncertainty in this factor is the interpretation of *partial* suspension of operations.

*Recovery Startup Business*

A recovery startup business is one that begins operations after February 15 of 2020 and has less than 1 million average annual gross receipts.

**Question 4 - What costs qualifying for ERC?**

In addition to actual W-2 wages, ERC includes group health costs, paid sick or disability leave, pension or retirement plan contributions, tips, severance pay, stock options, any pay excluded from employee compensation, and agricultural labor.

It is also important to note that large employers have different rules regarding eligibility of wages for the credit as opposed to small employers. In 2020 qualifying wages of a large employer is a business that employs more than 100 actual full-time employees who are being paid and *not* performing services. In 2020, a small employer has less than 100 actual employees who are being paid and includes employees that are being paid for not performing services but also includes employees being paid for providing services. In 2021 this number changes to more than 500 for large and less than 500 for small thus expanding the number of business eligible for the credit as well as the amount of the credit. Lastly, for 2020, pay raises for employees don’t qualify if the pay raises exceed the rate of pay in place within 30 days before the drop in revenue or government suspension occurred. This rule does not apply in 2021.

**Question 5 – How much of ERC does the business qualify for?**

Both full-time and part-time employee wages count for ERC. But let’s now look at the amount of the ERC to which a business is entitled.

For 2020, there is a maximum of $10,000 of wages paid per year per employee at a 50% rate. ($5,000). For 2021 there is a max of $10,000 of wages paid per quarter per employee at a rate of 70%. ($7,000).

For 2020 and the first two quarters of 2021 the credit provides a tax offset for the employer’s portion of the social security tax (FICA). For the last two quarters of 2021 the credit provides a tax offset for the employer’s portion of the Medicare tax.

For the fourth quarter of 2021, only recovery startup businesses are eligible to claim ERC for up to $7000 per employee but the entire business is limited to $50,000 per eligible quarter.

**Question 6 – How and when should a business apply for ERC?**

There are two ways to apply for the ERC. The first is to apply on an employer’s original federal employment tax return (for most employers, a form 941) and the second is to apply on an amended federal employment tax return (for most employers, a form 941X).

A business that has not yet claimed ERC on an original return, has until April 15 of 2024 for 2020 and April 15 of 2025 for 2021 to claim the credit. It is important to note here that the American Rescue Plan Act (hereinafter ARPA) gave the IRS an extra two years to examine ERC claims for the third and fourth quarter of 2021. ARPA did not change the three-year period of time for the taxpayer to claim a refund. This means that The IRS has until April 15 of 2027 to examine the third and fourth quarters of 2021 for ERC claims.

**Question 7 – What are the costs and risks of claiming ERC?**

Obviously, the cost of applying for ERC depends on the professionals providing the services to assist the taxpayer in claiming the credit. The risks of applying for ERC depend on the aggressiveness of the position(s) taken in support of the claim, likelihood of audit selection and preparation in support of the credit gathered before and maintained should audit occur. Given the significant increase in IRS funding by Congress, it is likely that the IRS will challenge ERC claims that take positions outside of existing IRS guidance. It is also more likely than not that the dollar amount of the credit will be a factor. Lastly, with increased enforcement, this will likely result in the assertion of penalties, including fraud and potential criminal charges in egregious cases. While businesses should not shy away from money to which they are justified in claiming and receiving, businesses should also be wary of unnecessarily aggressive and or illogical positions not within the spirit of the legislation to avoid both civil and possible criminal sanctions.

Additionally, there are risks concerning how courts will rule on challenged claims. In this regard, it is particularly important for businesses and professionals to consider not only the specific rules regarding ERC but also the purpose of ERC. This was not legislation producing a credit that was intended simply to stimulate the economy and give away money. This was legislation intended to encourage businesses operating during Covid suffering economic crisis to keep employees on the payroll and provide economic assistance to help insure the businesses survival.

As the first round of exams by the IRS has already started in relation to ERC, let’s take a look at the information being sought by the IRS for those already selected for exam. Based on the IRS information document requests, businesses should anticipate requests for information regarding the following:

1. The grounds for eligibility for ERC. Specifically, the details of meeting the qualification tests.
2. List of the government orders that either fully or partially suspended the business.
3. Gross receipts computations, spreadsheets and backup financial records for all relevant quarters.
4. The actual ERC calculation of the credit claim.
5. Payroll journals.
6. Records reflecting health plan expenses.
7. 2020 and 2021 payroll tax returns and income tax returns.
8. List of all owners.
9. List of all employees.
10. Detail regarding related party information.
11. PPP loan forgiveness information.
12. Proof of allocation of wages paid between PPP and ERC.

As stated above the three grounds for eligibility for ERC are either a full or partial suspension by government order related to COVID of the operation of a business, a drop in gross receipts or establishing that the business is a recovery start a business.

**SIGNIFICANT DECLINE IN GROSS RECEIPTS**

Gross receipts” for purposes of ERC for an employer other than a tax-exempt organization, has the same meaning as when used under section 448(c) of the Code. Under the section 448(c) regulations, “gross receipts” means gross receipts of the taxable year and generally includes total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103 of the Code), dividends, rents, royalties, and annuities, regardless of whether those amounts are derived in the ordinary course of the taxpayer's trade or business. Gross receipts are generally not reduced by cost of goods sold but are generally reduced by the taxpayer’s adjusted basis in certain property used in a trade or business or capital assets sold. Gross receipts do not include the repayment of a loan, or amounts received with respect to sales tax if the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the sales tax to the taxing authority.

A significant decline in gross receipts for purposes of ERC is determined by identifying the first calendar quarter in 2020 (if any) in which an employer’s gross receipts are less than 50 percent of its gross receipts for the same calendar quarter in 2019. The period during which there is a significant decline in gross receipts ends with the earlier of January 1, 2021, or the calendar quarter that ***follows*** the first calendar quarter in which the employer’s 2020 quarterly gross receipts are greater than 80 percent of its gross receipts for the same calendar quarter in 2019. For example, Employer A’s gross receipts were $100,000, $190,000, and $230,000 in the first, second, and third calendar quarters of 2020, respectively. Its gross receipts were $210,000, $230,000, and $250,000 in the first, second and third calendar quarters of 2019, respectively. Thus, Employer A’s 2020 first, second, and third quarter gross receipts were approximately 48 percent, 83 percent and 92 percent of its 2019 first, second, and third quarter gross receipts, respectively. Accordingly, Employer A experienced a significant decline in gross receipts commencing on the first day of the first calendar quarter of 2020 (the calendar quarter in which gross receipts were less than 50 percent of those in the same quarter of 2019) and ending on the first day of the third calendar quarter of 2020 (the quarter following the first quarter in which the gross receipts were more than 80 percent of those in the same quarter of 2019). Thus, Employer A is an eligible employer during the first and second calendar quarters of 2020.

For the first and second calendar quarters of 2021, the determination of whether an employer is an eligible employer based on a decline in gross receipts is made separately for each calendar quarter and is based on an 80 percent threshold as compared to the same calendar quarter of 2019. In addition, with respect to any employer for any calendar quarter, if the employer was not in existence as of the beginning of the same calendar quarter in calendar year 2019, “2020” replaces “2019.” Accordingly, if an employer was not in existence as of the beginning of the first calendar quarter of 2019, that employer generally determines whether the decline in gross receipts test is met in the first calendar quarter of 2021 by comparing its gross receipts in the first calendar quarter of 2021 to its gross receipts in the first calendar quarter of 2020. Similarly, if an employer was not in existence as of the beginning of the second calendar quarter of 2019, that employer generally determines whether the decline in gross receipts test is met in the second calendar quarter of 2021 by comparing its gross receipts in the second calendar quarter of 2021 to its gross receipts in the second calendar quarter of 2020.

It is important to understand the difference in application of methodology for entitlement to the credit in 2020 as opposed to 2021. Remember, originally the credit was set to end January 1, 2021 so the quarters of eligibility were drafted with a begin date and an end date, i.e. the first quarter gross receipts fall below 50% compared to same quarter in 2019 and ending with the quarter ***following*** the first quarter gross receipts are greater than 80% compared to 2019. That is why in the above IRS example even though the third quarter is 83% compared to 2019 eligibility for the credit remains for that quarter, because it is signal for the end but it is the quarter that ***follows*** that is the ending. When entitlement to the credit was extended into 2021, the concept of beginning and ending was changed and for 2021 each quarter stands on its own.

Additionally, the CARES Act, as amended by the Relief Act, permits an employer to elect to use an alternative quarter to calculate gross receipts. Under this election, an employer may generally determine if the decline in gross receipts test is met for a calendar quarter in 2021 by comparing its gross receipts for the immediately preceding calendar quarter with those for the corresponding calendar quarter in 2019 (substituting 2020 for 2019 if the employer did not exist as of the beginning of that quarter in 2019). Accordingly, for the first calendar quarter of 2021, an employer may elect to use its gross receipts for the fourth calendar quarter of 2020 compared to those for the fourth calendar quarter of 2019 to determine if the decline in gross receipts test is met. If an employer was not in existence as of the beginning of the fourth calendar quarter of 2019, then the alternative quarter election will not be available for the first calendar quarter of 2021. For the second calendar quarter of 2021, an employer may elect to use its gross receipts for the first calendar quarter of 2021 compared to those for the first calendar quarter of 2019 to determine if the decline in gross receipts test is met. If an employer was not in existence as of the beginning of the first calendar quarter of 2019, then that employer may elect to measure the decline in gross receipts for the second calendar quarter of 2021 using its gross receipts for the first calendar quarter of 2021 compared to those for the first calendar quarter of 2020.

For 2020, the employee retention credit equals 50 percent of qualified wages (including allocable qualified health plan expenses) that an eligible employer pays in a calendar quarter. The maximum amount of qualified wages (including allocable qualified health plan expenses) taken into account with respect to each employee for all calendar quarters in 2020 is $10,000; thus, the maximum credit for qualified wages (including allocable qualified health plan expenses) paid to any employee in 2020 is $5,000 per employee. For 2021, the employee retention credit equals 70 percent of qualified wages (including allocable qualified health plan expenses) that an eligible employer pays in a calendar quarter to the maximum of $10,000. Thus, the maximum credit for qualified wages (including allocable qualified health plan expenses) paid to an employee is $7,000 per employee per qualifying quarter.

**FULL OR PARTIAL SUSPENSION**

What qualifies as a disruption or qualifying event justifying a claim of ERC is based on the facts and circumstances of the particular business as well as application of the appropriate qualifying tests. As to businesses that are fully or partially closed due to a government order to qualify for the credit, the government suspension must relate to COVID and must result in more than a nominal effect causing more than a nominal portion of the business to be suspended or modified.

An eligible employer for ERC means any employer for which the operation of a trade or business is fully or partially suspended during the calendar quarter due to orders from an appropriate government authority limiting commerce travel or group meetings due to the coronavirus.

A *voluntary* suspension of business or reduction in hours of operations does not qualify (however a significant decline and gross receipts may still qualify). A COVID related declaration of a state of emergency by a government does not qualify if it does not limit commerce travel or group meetings in any manner or it does limit commerce travel or group meetings but does not affect the employer’s operation of the business.

In relation to partial suspensions, to qualify for ERC, the partial suspension must be more than a nominal portion of the business suspended by the government order or the government order must have placed a modification against the business which had more than a nominal effect on the business.

IRS Notice 2021–20 provides guidance regarding what qualifies as a partial suspension. If a portion of the business is closed it will be determined to be more than a nominal portion if either the gross receipts or the employee hours have dropped 10% or more compared to the same quarter of 2019.

An employer that operates an essential business is not considered to have a full or partial suspension of operations if the governmental order allows all of the employer’s operations to remain open. However, an employer that operates an essential business may be considered to have a partial suspension of operations if, under the facts and circumstances, more than a nominal portion of its business operations are suspended by a governmental order. For example, an employer that maintains both essential and non-essential business operations, each of which are more than nominal portions of the business operations, may be considered to have a partial suspension of its operations if a governmental order restricts the operations of the non-essential portion of the business, even if the essential portion of the business is unaffected.

In addition, an essential business that is permitted to continue its operations may, nonetheless, be considered to have a partial suspension of its operations if a governmental order requires the business to close for a period of time during normal working hours. Solely for purposes of ERC, a portion of an employer’s business operations will be deemed to constitute more than a nominal portion of its business operations as partially suspended if either the gross receipts from that portion of the business operations is not less than 10 percent of the total gross receipts (both determined using the gross receipts of the same calendar quarter in 2019), or the hours of service performed by employees in that portion of the business is not less than 10 percent of the total number of hours of service performed by all employees in the employer’s business (both determined using the number of hours of service performed by employees in the same calendar quarter in 2019).

An example in Notice 2021–20 Question 11 provides that in quarter one of 2019 gross receipts for the nonessential portion of the business was $80,000. In that same quarter the total business with 1 million. Thus. in 2019 the nonessential business is only 8% not 10%, thus the nonessential portion is not more than a nominal portion of the business in the first quarter of 2020. This is not a partial shutdown so the entire business is not eligible for ERC.

As to hours of service performed by employees, the issue is the hours of service performed by employees in that portion of the business. Again, this is determined using the hours of the same calendar quarter in 2019.

An example in Notice 2021–20 Question 11 provides that in the first quarter of 2019 employee hours for the nonessential portion of the business was equal to 100 hours. In that same quarter hours for the total business were 1000. Thus, in the first quarter of 2019 the employees of the nonessential portion of the business is at least 10% of the total hours so the nonessential portion is more than a nominal portion of the business in the first quarter of 2020 and that would constitute a partial shut down and the entire business would be entitled to ERC.

If all, or more than a nominal portion of business operations continue but operations are subject to modification due to government order, such modification is a partial suspension if the modification has more than a nominal effect on business operations under the facts and circumstances. An example used by the IRS in Notice 2021-20 is a restaurant that had to close on site dining due to a government order. The restaurant was still allowed to continue food or beverage sales via carryout, drive-through and delivery. Because on-site dining was more than a nominal portion of business operations (presumed by IRS) this constituted a partial suspension of business. However, this should not automatically be assumed because it is a facts and circumstances test.

So, what constitutes a modification that is more than a nominal effect on a business? The factors that should be taken into account when determining whether a modification required by a government order has more than a nominal effect on business operations is defined as a government order that results in reduction in the ability of the business to provide goods or services of at least 10%.

It is on this point that we get into a very vague area. The IRS’s position appears to require that the government order needs to limit the operation of the business itself in some way, not the population at large which affects the business. That being said, does the government order have to directly hurt the business or merely limit it? If the requirement is hurt the business, must the “pain” be financial or could the business be hurt in some other way that can be demonstrated and thus qualify for ERC. Could the limit on the business be the lost opportunity cost of not being able to grow during 2020 or 2021?

Question 13 of Notice 2021–20 gives us an idea of what the IRS believes is NOT a full or partial suspension. In the example, there was an auto repair service business and a government order that limited travel and required communities to stay home, except for certain essential travel like going to the doctor or the grocery store. The auto repair business declined significantly. The IRS determined that there was no full or partial suspension of operations due to a government order. However, ERC eligibility could still be established if there was a significant decline and gross receipts.

Alternatively, pursuant to Notice 2021–20 at Question 10, an order from a local official imposing a curfew on residents that impacts the operating hours of a trade or business for a specific time will qualify as a partial suspension so long as the order is related to Covid. This means that if during 2020 or 2021 a restaurant is ordered by the local health department to close down due to a health code violation, since it’s unrelated to Covid even though it occurred during this period, the business will not qualify for ERC. However, if a Covid related order impacts the operating hours of a business, a partial suspension has occurred.

Naturally, questions arise on the issue of teleworking. If a workplace is closed by a government order related to COVID but able to continue operations comparable to operations prior to the closure by requiring employees to telework, operations are not fully or partially suspended. Again, the business may still qualify regarding gross receipts.

Of course, determining whether a business can continue to engage in *comparable* operations is an issue for consideration. What is the portability of the employees’ work? Is the need for the presence of the employees at the physical workspace critically necessary, as opposed to beneficial but not necessary? What about the adjustment period for a business to transition to telework operations? Some adjustment period is expected. Generally operations are not partially suspended as a result of an adjustment period. However, if it takes more than two weeks to convert to comparable telework then this may be deemed a partial suspension during transition.

To summarize the difference between partial suspension versus modification and the relevance to ERC, if a workplace is closed by government order for some purpose, but open for other purposes or the business is able to continue some operations remotely, then this is still a partially suspended business because it comes from a COVID government order. Alternatively, if all operations of the business may continue, even if subject to modification (for example social distancing) this modification is not a partial suspension due to a government order unless the business can establish that the modification had more than a nominal effect on the business operations. This will be determined by the facts and circumstances of each case.

Notice 2021–20 provides examples to help clarify this point. Question 17 Example 3 provides that a retail business is closed due to a government order. However, the business also maintains a website and can still continue to fill online orders. The online orders are unaffected by the government order. Nevertheless, the business is considered to have a partial suspension due to the government order closing the retail store locations.

Notice 2021–20 Question 17 Example 5 provides that a grocery store who is operating an essential business under a government order is required by government order to discontinue self-serve operations such as a salad bar. The grocery store may offer prepared or prepackaged food. As a result the store modifies operations to close the salad bar and other self-serve offerings and instead offers prepackaged salads and other items. Under the facts and circumstances this change does not have more than a nominal effect on business operations even though it is a modification and as such the business operations are not partially suspended.

Notice 2021–20 Question 17 Example 6 provides that a large retailer is required to close a storefront location due to a government order but permitted to provide customers with curbside service to pick up items ordered online or by phone. This is considered a partial suspension due to a government order because the businesses had to close it storefront location. The example continues that two months later, under a subsequent government order, the business is permitted to reopen at store locations but most enforce social distancing guidelines requiring the business to admit only a specified number of customers in the store per 1000 ft.². This social distancing does result in customers waiting in line for a short period of time to enter the store during certain busy times of the week. The IRS’s position under the facts and circumstances is that the government order to enforce social distancing did not constitute more than a nominal effect on business operations, it provided merely a modification not rising to the level of qualifying the business as partially suspended and thus not eligible for ERC once the storefront is re-opened.

Businesses that reduce operating hours due to government order are considered to have partially suspended operations. Notice 2021–20, Question 19 Example 1, provides a business operates a food processing facility that normally operates 24 hours a day but the government order issued by the local health department requires all food processing businesses to deep clean their workplaces once every 24 hours to reduce the risk of Covid exposure, and as a result to comply the business reduces daily operating hours by five per day so that a Covid deep cleaning can be conducted once every 24 hours in compliance with the government order, then this will constitute a partial suspension of operations and provide eligibility for ERC.

What happens with businesses in multiple locations? If a business operates on a national or regional basis the business may be subject to government orders requiring closure of their locations in certain jurisdictions but not others. Notice 2021–20 at Question 20 provides that in these scenarios where a portion of businesses are limited in operations by a government order but not all of them that business will still be considered to be partially suspended and that makes the business eligible for ERC for all operations. It is not limited only to those businesses operations partially suspended.

In summary, if a portion of the business is closed then it will be determined that this is more than a nominal portion, if either gross receipts or employee hours are down at least 10% compared to the same quarter in 2019. If no portion of the business is closed but modification of operations have occurred it will be determined to be more than a nominal effect if the required modification for results in a reduction in the ability of the business to provide goods or services of at least 10%. Finally all members of an aggregated group of businesses are treated as a single employer for purposes of ERC.

**SUPPLIER CHAIN ISSUES CONSITUTING SUSPENSION**

So, what happens when there is a government order that affects a supplier of a business? An essential business may have full or partial suspension if the business has suppliers that are unable to make deliveries of critical goods and materials due to a Covid related government order that causes the supplier to suspend operations. For example, if an auto parts manufacturing business cannot get supplies to operate, that business should qualify as partially suspended and eligible for ERC if it’s supplier of raw materials is required to shut down by a Covid government order and it’s unable to procure these raw materials elsewhere so the businesses is not able to perform its operations as a result thereof. The question gets more complicated when a supplier is closed by a COVID related government order that affects a business and severely harms the businesses ability to provide its goods or services but doesn’t necessarily suspend the activity in which the business engages. Or alternatively, those to whom the business supplies are shut down so there is no or a limited market. Under that scenario the business should qualify under the gross receipts test, but not necessarily.

When considering the eligibility for ERC on the basis of a supply chain disruption of business, the business must be able to prove the following:

1. A supplier was unable to make deliveries of critical goods and materials
2. Due to a COVID-19 government order
3. That caused the supplier to suspend its operations, and
4. The business was not able to secure critical goods or materials elsewhere.

Reminder, in this situation the wages eligible are limited only to wages paid during the effect of the government order.

Points of disruption in the supply chain are as follows:

1. Sourcing point
2. Storage point
3. Transfer point
4. Shipping (via land, air or water)
5. Destination

It’s important to note that if a business is subject to a government order that fully or partially suspends operations and the order is later lifted, the business does still qualify but only for the periods the business operations were fully or partially suspended. The employer is ERC eligible for the entire calendar quarter but can only claim ERC for wages paid during the period the order was in force.

Thus, the main difference in relation to eligible wages and the qualifying criteria on which the business relies to claim the credit is if the business is relying on the gross receipts test, all wages actually paid during the entire quarter will qualify for the credit. However, if there is a full or partial suspension due to a government order, the business is only eligible for ERC on wages paid during the time of the suspension and not the entire calendar quarter.

**RECOVERY STARTUP BUSINESS**

Written into law by the ARPA, a new category of eligible employers was added for potential relief and provides that “recovery startup businesses” may be eligible employers for ERC for wages paid **after June 30, 2021, and before January 1, 2022**.

Section 3134(c)(5) of the Code defines a “recovery startup business” as an employer that began carrying on any trade or business after February 15, 2020, for which the average annual gross receipts of the employer does not exceed $1,000,000, and that is not otherwise an eligible employer due to a full or partial suspension of operations or a decline in gross receipts. In the case of an eligible employer that is a recovery startup business, the amount of the credit allowed for each of the calendar quarters cannot exceed $50,000.

A recovery startup business is an employer that began carrying on a trade or business after February 15, 2020. Therefore, the determination of when an employer “began carrying on a trade or business” is made in the same manner as for purposes of section 162. In general, for purposes of section 162, a taxpayer has not begun carrying on a trade or business “until such time as the business has begun to function as a going concern and performed those activities for which it was organized.”

Section 3134(c)(5) of the Code indicates that the average annual gross receipts of an employer is determined by applying rules similar to the rules in section 448(c)(3) of the Code and that the 3-taxable-year period ends with the taxable year preceding the calendar quarter for which the employer is claiming the employee retention credit. The large eligible employer rule defines qualified wages as wages paid with respect to which an employee is not providing services due to a full or partial suspension or a decline in gross receipts. The small eligible employer rule defines qualified wages as wages paid during any period qualifying for ERC due to a full or partial suspension or paid with respect to any employee during a quarter in which there is a significant decline in gross receipts. Small employers receive enhanced benefits under the ERC regime. Specifically, for the time they are an eligible employer, **they can include wages paid to all employees**. Large employers can only include wages paid to employees for not providing services.

Neither the large eligible employer rule nor the small eligible employer rule was updated to include a recovery startup business. Thus, the language of the statute does not include a definition of qualified wages applicable to a recovery startup business. However, the inclusion of recovery startup businesses as a new category of eligible employer and the provision of a specific limitation on the amount of the employee retention credit to which recovery startup businesses are entitled, indicates that Congress intended that this new category of eligible employer be able to claim the employee retention credit.

In order to carry out this intent, the Treasury Department and the IRS have concluded that it is appropriate to read the small eligible employer rule to include a recovery startup business as requiring average annual gross receipts for the prior 3 taxable years of not more than $1,000,000. Accordingly, in the third and fourth calendar quarters of 2021, a recovery startup business that is a small eligible employer may treat all wages paid with respect to an employee during the quarter as qualified wages.

The determination of whether an employer is a recovery startup business is made separately for each calendar quarter. For example, if an eligible employer is a recovery startup business in the third quarter of 2021 but is not a recovery startup business in the fourth quarter of 2021 because it is an eligible employer due to a full or partial suspension or a decline in gross receipts during the fourth quarter of 2021, the $50,000 limitation applies to the third quarter of 2021 but does not apply to the fourth quarter of 2021. The aggregation rules also apply when determining whether an employer’s trade or business is fully or partially suspended or the employer experiences a decline in gross receipts. Similarly, the aggregation rules apply when determining if an employer is a recovery startup business. The aggregation rules also apply with respect to the $50,000 limitation of the credit.

**CONCLUSION**

Like much of the COVID related legislation and relief, the statute for ERC is fairly sparse and much of the guidance that we have to apply in our practice is from the IRS so we don’t have any real case law to refer to as to how the courts will interpret the statute or whether or not the courts will agree with currently stated IRS positions. Some aspects are quite clear but others are uncertain. As a result, in practice, representatives should anticipate that each case is unique and different and will turn on the facts and circumstances and how well the business can document and prove its eligibility within stated criteria and the spirit of the legislation.

As with the filing of any tax returns, or submission of information and documentation at exam, all information and documentation must be true and accurate and businesses need to take particular care in maintaining the information and documentation used to support it’s basis and entitlement to the credit should the return be selected for audit. As such practitioners who are giving advice and guidance to these businesses, practitioners must be fully versed in the law and the business’s entitlement to claim government COVID relief funds. Nevertheless, since there are a significant number of businesses who are eligible and have not yet claimed the ERC it is important for practitioners to also advise those businesses of their entitlement and guide them through the process and advise about the documentation and verification to be maintained should the request for credit be questioned by the IRS.