WHITE PAPER

The Forensic Toolkit: Analysis of the interplay between COVID-19 payroll tax credits and the Paycheck Protection Program

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Contents

Introduction

The paycheck protection program (PPP) has ended, funds have been disbursed, businesses are spending the funds, and many financial institutions have opened their PPP loan forgiveness portals and are reaching out to borrowers encouraging them to apply for forgiveness. At the same time, businesses that received PPP loans are taking advantage of other COVID-19 benefits like payroll tax credits and other Small Business Administration (SBA) programs. Now is the time to take a deep dive into the forensics of PPP loan forgiveness and the interplay with payroll tax credits and the increased likelihood of an SBA or IRS audit.

This Special Report on COVID-19 payroll tax credits and their interplay with payroll aspects of various SBA programs can be used as a forensic toolkit to help you better understand how to help your clients navigate the aftermath of COVID-19 legislation. This report discusses the different SBA or IRS payroll relief programs granted, best practices and pitfalls to avoid, the likelihood of an SBA and IRS audit, and points users to in-depth, detailed analysis on where to find solutions in Checkpoint®.

Can IRS know whether a business received a PPP Loan?

How should PPP money be spent to obtain full forgiveness?

Can the SBA know if a business claimed the employee retention credit or other payroll credits?

What are the recordkeeping requirements for payroll tax credits and SBA loan/grant funds?

What is the likelihood of an audit by IRS or SBA?

From early 2020 through 2021, legislation has been enacted to alleviate the economic hardships suffered by many businesses during the Coronavirus pandemic. Government assistance was available to keep employees earning wages despite forced quarantine shutdowns, even if employees needed to step away from work commitments due to a Coronavirus-related absence. The paid sick and family leave credits, employee retention tax credit (ERC) and payroll tax deferrals helped struggling businesses keep valued workers on the payroll throughout 2020 and 2021. SBA stimulus in the form of forgivable loans, like the PPP loan, and grants, such as the Restaurant Revitalization Grant and the Shuttered Venue Operator's Grant, provided much-needed relief to struggling businesses that experienced Coronavirus-related revenue decreases compared to pre-pandemic times.

Congress made the relief readily available to businesses for the asking. And the eligibility qualifications and substantiation fine print for these programs have one major theme: the payroll function.

The Biden administration made it clear they're interested in increasing IRS's budget for added enforcement efforts. Meanwhile, legislation passed in 2021 for payroll tax credits increased the statute of limitations period from 3 to 5 years under which IRS may audit recipients to ensure compliance.

CONGRESSIONAL TAX RELIEF DUE TO COVID-19 PANDEMIC		
Signed into Law	**Acronym**	**Legislative Act**
Mar. 18, 2020 PL 116-127	FFCRA	**Families First Coronavirus Response Act** Mandated the following: • Emergency paid sick leave for employees • Emergency family and medical leave
Mar. 27, 2020 PL 116-136	CARES	**Coronavirus Aid Relief and Economic Security Act** Established the following: • Employee retention tax credit (ERC), max of $5,000 per EE for 2020 • Deferred ER payroll taxes (elective) • Accelerated payment of paid sick and family leave credits • First draw: Paycheck Protection Program • PPP forgiveness 75% wages and 25% other costs, covered period 8 weeks • SBA PPP loan forgiveness isn't taxable as discharge of indebtedness income
Aug. 8, 2020		**Presidential memo** (Trump) defers the EE's portion of Social Security taxes through Dec. 31, 2020, penalties and interest won't accrue until May 1, 2021.
Dec. 27, 2020 PL 116-260	CAA	**Consolidated Appropriations Act** Extended existing payroll tax related provisions: • ERC extended and expanded, max $7,000 per EE/ per quarter for the first half of 2021 • Payroll tax credit for expanded paid sick, family and medical leave • Second draw: Paycheck Protection Program • PPP loans are not includible in income, expenses are fully deductible and loans are forgivable. • SBA funding of Shuttered Venue Operator Grants
Mar. 11, 2021 PL 117-2	ARPA	**American Rescue Plan Act** Made voluntary the Paid sick and family leave (reset time bank, extended family leave 12 weeks). Extended the ERC ($7,000/EE/quarter for the second half of 2021) COBRA Premium Subsidies SBA funding of: • Targeted Economic Injury Disaster Loan Advances • Restaurant Revitalization Grants

Eligible employers can claim one or several payroll tax credits during the same calendar quarter while also receiving SBA forgivable loans and grants. However, an employer cannot claim PPP loan forgiveness on the same funds used to pay qualifying wages when the employer also claimed the ERC on those same wages. An employer cannot claim a double benefit on payroll tax credits on the same wages in the same calendar period.

Paycheck Protection Program

The CARES Act of 2020 established the PPP which authorized the SBA to make loans to certain small businesses (including sole proprietors, independent contractors, and eligible self-employed individuals) that meet applicable size standards (generally either no more than 500 employees or 300 employees, per physical location in some cases) and that were negatively impacted by the COVID-19 pandemic. The PPP provides up to 24 weeks of cash-flow assistance through 100% federally guaranteed loans of up to 2½ times average monthly payroll costs (up to a maximum of $10 million for first draw loans and $2 million for second draw loans) so that eligible recipients can maintain payroll and cover other essential expenses during the Coronavirus pandemic.

Since its inception, the PPP has undergone numerous revisions.

A trap for the unwary is that no double-dipping can occur on the same wages relating to COVID-19 benefits

LEGISLATIVE CHANGES TO PPP LOAN RULES

Legislative changes to PPP	CARES Act 3/27/2020	PPP Flexibility Act 6/5/2020	CAA 12/27/2020	ARPA 3/11/2020
Covered Payroll Costs	75%	60%	60%	60%
Covered Non-Payroll Cost (rent, utilities, mortgage interest before 2/15/20; operations expenses, property damage costs, supplier costs, worker protection expenses)	25%	40%	40%	40%
Covered Period	8 weeks	8 weeks or 24 weeks	Between 8 – 24 weeks	Between 8-24 weeks
First Draw	Yes	Yes	Yes	Yes
Second Draw	No	No	Yes	Yes
Deferral Period	6 months	10 months	10 months	10 months

PPP loans are forgivable, eligible expenses paid with forgiven PPP loans are deductible and the forgiven loan is not includible in income.

The Paycheck Protection Program Flexibility (PPPF) Act of 2020, made substantial changes to the PPP, including decreasing the percentage that loan proceeds must be used on payroll costs from 75% to 60%, thereby increasing the percentage that may be used for covered nonpayroll costs such as rent, mortgage interest and utilities from 25% to 40%. Additionally, the PPPF Act permits borrowers to defer payments of principal, interest, and fees to 10 months after the last day of the covered period (the earlier of 24 weeks or Dec. 31, 2020). Prior to the PPPF Act, the deferral period would end after 6 months. The covered period to spend funds on covered expenses for full PPP loan forgiveness was revised to allow borrowers to choose either an 8- or 24-week covered period as opposed to the only 8-week covered period that was available under the CARES Act at inception of the program.

The Consolidated Appropriations Act, 2021 (CAA, 2021) includes provisions that make significant changes to the PPP regarding the covered period and the covered expenses for PPP loan forgiveness and added additional funding to the program. The covered period to spend funds for

full PPP loan forgiveness was revised to allow borrowers to choose a covered period ending at the point of the borrower's choosing between 8 and 24 weeks after the loan disbursement date. Additionally, the CAA expanded the allowable and forgivable covered expenses for use of PPP funds (**See Covered Expenditures**).

How should PPP money be spent to obtain full loan forgiveness? An important feature of the PPP is that borrowers can have the loan partially or fully forgiven to the extent the loan proceeds were used for covered expenditures.

First Draw Loans: (Application period closed Aug. 8, 2020, but later reopened in 2021 through May 31, 2021). To obtain full PPP loan forgiveness, at least 60% of loan proceeds must have been used for payroll expenses. No more than 40% could be used for covered nonpayroll costs such as rent, mortgage interest and utilities. Borrowers could defer loan repayments up to 10 months after the last day of the covered period (for 2020 first draw loans prior to Jun. 5, 2020, 8 weeks; for 2020 first draw loans on or after Jun. 5, 2020, 8 or 24 weeks but not extending beyond Dec. 31, 2020; for 2021 first draw loans, a period of between 8 to 24 weeks, at the borrower's election).

Second Draw Loans: (Approved under the CAA 2021; application period closed May 31, 2021.) Borrowers could take a second draw PPP loan if the business has no more than 300 employees (per physical location in some cases), fully exhausted the first draw loan funds, and suffered a 25% or greater reduction in revenue in comparable quarters of 2019 and 2020. Businesses in the food and accommodation industries could receive second draw loans of up to 3 ½ times average payroll costs instead of the maximum that otherwise applies of 2 ½ times average payroll costs.

Covered Expenditures: Under the CARES Act, covered expenditures includes: (1) payroll costs; (2) interest (but not principal) payments on mortgages in place before February 15, 2020; (3) rent under leases that began before February 15, 2020; and (4) payments for utilities that were turned on before February 15, 2020. The list of covered expenditures was expanded under the CAA 2021 for all loans other than first draw loans for which the borrower received forgiveness before December 27, 2020, to include not only payroll, mortgage interest, rent and utilities, but also:

i. Covered operations expenditures. Payment for any software, cloud computing, and other human resources and accounting needs.

ii. Covered property damage costs. Costs related to property damage due to public disturbances that occurred **during 2020** that are not covered by insurance.

iii. Covered supplier costs. Expenditures to a supplier pursuant to a contract, purchase order, or order for goods in effect before the covered period (or during the covered period for perishable goods) that are essential to the recipient's operations at the time at which the expenditure was made.

iv. Covered worker protection expenditure. Personal protective equipment and adaptive investments to help a loan recipient comply with federal, state, or local COVID-19 health and safety guidelines during the period between Mar. 1, 2020, and the end of the national emergency declaration.

Self-employed individuals that file a Schedule C can use gross profit instead of net income to calculate their maximum PPP loan amount for loans approved after Mar. 4, 2021 (ARPA 2021).

Borrowers that need assistance with PPP loan forgiveness can call the SBA directly at (877) 552-2692, Monday – Friday, 8 a.m. - 8 p.m. EST.

Applying for PPP Loan Forgiveness

Borrowers seeking full or partial forgiveness of their PPP loan must file an application with their PPP lender through the lender's PPP forgiveness portal by completing either SBA Form 3508, 3508 EZ, or 3508S. On Aug. 4, 2021, the SBA launched the PPP Direct Forgiveness Portal, a streamlined application portal to allow borrowers that received PPP loans of $150,000 or less to apply for forgiveness directly through the SBA if their lender opts into the program.

Tax Treatment of PPP Loan Forgiveness

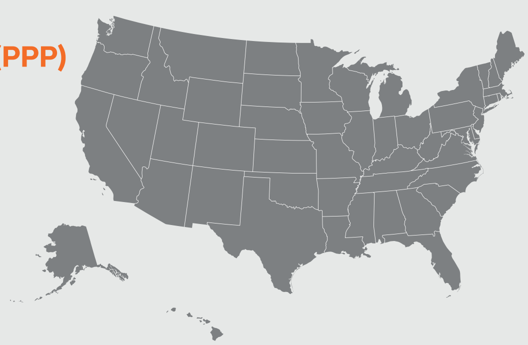
From a federal perspective, forgiven PPP loans are not includible in gross income. Normally IRS would not allow a deduction for expenses arising from tax exempt income. However, the CAA 2021 allowed deductions for eligible expenses and ensured the tax basis and other attributes of the borrower's assets would not be reduced because of loan forgiveness.

From a state taxation perspective, things are not as clear. Not all states are on board with the federal tax treatment of PPP loans. As of this report, 32 states conform to the federal rule specifying that forgiven PPP loans won't be taxed as income, while 24 states and U.S. tax jurisdictions conform to the normal federal expense deductibility rule. Meaning for those 24 states and jurisdictions, forgiven PPP loans are considered tax exempt income, but eligible expenses cannot be deducted for state income tax purposes.

State and local charts: Paycheck Protection Program (PPP)

Checkpoint Edge State create-a-chart features COVID-19 Related:

- **PPP Loan forgiveness as taxable under state rules (CARES Act and CAA).**
- **PPP state conformity for deductible expenses paid with forgiven PPI loans**



SBA PPP Audit

What is the likelihood of an SBA audit? The SBA announced in July 2021 that it has dropped the Loan Necessity Questionnaire requirement for businesses that received $2 million or more in PPP loans. However, this announcement by the SBA doesn't negate the "loan necessity" certification made in the original PPP loan application and in no way indicates that there will be no audit. Absent this requirement, the SBA can diversify their audit population, which could result in an increased likelihood of an audit of any business that received a PPP loan regardless of the amount of the loan.

Can the SBA know whether a borrower received the Employee Retention Credit? Yes. In the loan forgiveness application process, the SBA specifically requests payroll tax information including Form 941 (see Supporting Documentation for PPP Loan Forgiveness). In addition, IRC Sec. 6103 authorizes IRS to share tax information by entering into agreements with governmental agencies for tax administration purposes. IRS and other federal, state, and local agencies share data with each other through a variety of ongoing initiatives.

Can the IRS know whether a taxpayer received PPP loan forgiveness? Yes. Through the federal information sharing program, collaboration with SBA, and by making adjustment for PPP loan forgiveness on Schedule M-1 of the borrower's tax return, IRS can know whether a taxpayer received PPP loan forgiveness.

Freedom of Information Act (FOIA). Since Jul. 2020, the SBA has released detailed loan-level data regarding the loans made under the PPP to keep the public informed of the assistance and actions that the agency and thousands of lenders across the country are taking during the COVID-19 pandemic. The publicly released PPP data is based on information submitted by lenders to the SBA and is made available under the Freedom of Information Act (FOIA).

The SBA disbursed around $800 billion in forgivable loans to nearly 12 million businesses. The SBA received 5.6 million applications for loan forgiveness and has forgiven 5.2 million applicants totaling nearly $470 billion dollars[1]

PPP Original Application Certifications

When applying for a PPP loan, borrowers had to make several certifications, including two significant certifications concerning "economic necessity" and the "use of funds."

PPP Loan Application Certifications:

"Current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant."

"The funds will be used to retain workers and maintain payroll; or make payments for mortgage interest, rent, utilities, covered operations expenditures, covered property damage costs, covered supplier costs, and covered worker protection expenditures as specified under the Paycheck Protection Program Rules; I understand that if the funds are knowingly used for unauthorized purposes, the federal government may hold me legally liable, such as for charges of fraud."

Borrowers who agreed to the above certifications, by initialing or checking next to these options, are deemed to have made the "economic necessity" and "use of funds" certification in "good faith" and the SBA may focus their attention in these areas during an audit.

[1] Statistics as of Aug. 2021.

PPP Forgiveness Certifications

A borrower applying for PPP loan forgiveness makes certain certifications that may become a focal point for loan forgiveness and potential audit. The loan forgiveness application requires the borrower to certify, for a second time, the "use of funds," as stated below.

The dollar amount for which forgiveness is requested (which does not exceed the principal amount of the PPP loan):

- *was used to pay business costs that are eligible for forgiveness (payroll costs to retain employees; business mortgage interest payments; business rent or lease payments; business utility payments; covered operations expenditures; covered property damage costs; covered supplier costs; or covered worker protection expenditures),*
- *includes all applicable reductions due to decreases in the number of full-time equivalent employees and salary/hourly wage reductions,*
- *includes payroll costs equal to at least 60% of the forgiveness amount,*
- *for any owner-employee (with an ownership stake of 5% or more) or self-employed individual/ general partner, does not exceed 2.5 months' worth of compensation received during the year used to calculate the PPP loan amount, capped at $20,833 per individual in total across all businesses.*

If the SBA rejects the lender's decision to forgive the loan, modifies the loan forgiveness amount, or determines that the borrower was not eligible for the loan, the borrower then has administrative appeal rights within the SBA to have the audit determination reviewed.

Applying for forgiveness can trigger a full SBA audit of the PPP loan

When a borrower applies for forgiveness, the lender makes its determination of forgiveness based on the documentation provided by the borrower, applying the SBA rules in place at the time of the application, and submits its decision to the SBA within 60 days of receiving a complete loan forgiveness application. The SBA has 90 days (about 3 months) to review the forgiveness determination made by the lending institution.

The SBA can either accept or reject the lender's decision altogether or modify the proposed forgiveness amount. Factors considered by the SBA in its evaluation of the PPP loan forgiveness decision (which could lead to a full SBA audit) include:

i. Whether the borrower was eligible to receive the loan,

ii. Whether the funds were spent on covered expenses in the applicable covered period,

iii. Whether the payroll costs (qualified wages) submitted for forgiveness were used to obtain ERC,

iv. Whether employee compensation levels were maintained during the covered period,

v. Whether employee head count was maintained during the covered period.

PPP Loan Necessity

To aid in its audit of "economic necessity" criteria, the SBA created a "Loan Necessity Questionnaire" (SBA Form 3509 and SBA Form 3510), which was originally intended for the automatic audits of those businesses that received $2 million or more in PPP loan funds. While the use of the loan necessity questionnaire has been discontinued, the questionnaire provides great insight into what the SBA is looking for in a PPP audit. The questionnaire consists of a series of Yes/No questions regarding the borrower's business activity and liquidity. The SBA and IRS can use this information to identify audit issues.

Business Activity Assessment. Questions in this section focus on the impact the Coronavirus pandemic had on the operation of the business. The questions center around gross revenue, the occurrence of business shutdowns, restrictions, disruptions, reduction in number of employees, and alterations the business had to make to accommodate business continuity during the pandemic.

The questionnaire can also be used to identify audit issues as follows:

Reduction in revenue percentages – A primary criterion of the ERC and the second draw PPP loan is the revenue reduction percentage for comparable quarters in 2019 and 2020. Asking the borrower this question provides information that can be used to determine whether the borrower was qualified to receive the second draw PPP loan and it can also be shared with IRS to aid in employment tax audits concerning ERC and other payroll tax credits.

Business shutdown due to COVID-19 – One criterion that creates necessity for a PPP loan is if a business was ordered to be shut down by a state or local authority due to COVID-19. The questions in this section can be used to establish loan necessity but can also be used to establish criteria for a business to obtain the ERC. This information is a prime target for sharing with IRS.

Business Restrictions – Restriction questions focus on significant changes a business had to make to stay in operation during the Coronavirus pandemic, including the amount of the cash outlay required for the changes. Answers to these questions provide information that can be used to establish necessity and provide information on the type of covered expenses a business claims it spent with PPP funds. This helps the reviewer determine if the pandemic necessitated the type of expenses incurred by the business. From an IRS perspective, this information aids in determining whether business expenses are ordinary and necessary, and therefore allowable.

Start and End Dates. Asking questions regarding specific start and end dates establishes that the expenditures paid and incurred were not outside of the time frame of the pandemic and fall within the specified date criteria for loan forgiveness.

Q6A_ "Between March 13, 2020, and the end of the loan forgiveness covered period of the PPP loan, did Borrower begin any new capital improvement projects not due to COVID-19?"

Q6B_ "If the answer to Q6A is YES, what were Borrower's approximate cash outlays for those projects?"

Answering "Yes" to question Q6A could cause a two-fold consequence. A "YES" answer would disqualify forgiveness for PPP funds used on capital improvements not related to the pandemic which is why it is so vital that businesses keep records that separate pandemic and non-pandemic activities. Answering "Yes" could also indicate fraudulent use of PPP funds that do not align with the "use of funds" certification (see above) in the original PPP loan application.

Liquidity Assessment. Don't be misled by the terminology, "Liquidity Assessment" and assume these questions focus on assessing the liquidity (i.e., the ability to convert assets to cash) of the borrower. Not the case. Instead, these questions focus more on how the business used the funds received from the PPP loan that created liquidity. For example, several questions ask about whether the business owners received dividends or distributions, and the amounts of compensation to employees. Clues of how this information could be used by SBA to identify audit issues are as follows:

PPP Funds used to pay dividends and distributions to owners. For purposes of PPP loan forgiveness, payroll costs include amounts paid to compensate owners of the business described as "Owner Compensation." Realizing that businesses compensate owners and employees in several ways, questions about dividends and distributions help the SBA determine whether the payroll costs submitted for forgiveness include distributions and dividends, which are not allowed, as opposed to owner compensation, which is allowed. Using PPP funds for distributions and dividends could indicate a fraudulent use of funds in a manner inconsistent with the certification made in the application.

PPP funds used to prepay debt. The PPP rules for how funds should be spent are very specific and indicate that amounts must be utilized to pay "covered expenses." The rules do not allow PPP funds to be used to pay "liabilities," which are different from expenses. Understanding how "expenses" and "liabilities" could be commingled or even recorded in the books and records erroneously, the SBA will take a closer look at expenses submitted for PPP loan forgiveness to verify that the expenses do not contain amounts for the prepayment of any debt. PPP loan forgiveness will be denied for amounts used to prepay liabilities of the business. Again, this could also indicate fraudulent use of funds since the funds were not spent according to the certification made in the application.

Excess payroll costs. For purposes of PPP loan forgiveness, only payroll costs of $100,000 or less per employee qualify. Answering "Yes" to questions relating to employees compensated over $250,000 could be a red flag.

Supporting Documentation for PPP Loan Forgiveness

When a borrower applies for PPP loan forgiveness, the supporting documentation requested may help the SBA determine whether a borrower also claimed the ERC. Documents and information that the SBA requests for payroll costs include:

- bank account statements or third-party payroll service provider reports documenting the amount of cash compensation paid to employees,
- tax forms (or equivalent third-party payroll service provider reports) for the periods that overlap with the Covered Period,
- payroll tax filings reported, or that will be reported, to IRS (typically, Form 941),
- state quarterly business and individual employee wage reporting and unemployment insurance tax filings reported, or that will be reported, to the relevant state, and
- payment receipts, cancelled checks, or account statements documenting the amount of any employer's contributions to employee health insurance and retirement plans that the borrower included in the forgiveness amount.

Five COVID-19 payroll tax relief programs

Five payroll tax relief measures that provide employers with an employment tax deferral or tax credit against certain employer payroll costs (i.e., the employer portion of certain payroll taxes) attributable to eligible wages paid to employees, include:

i. Employee paid sick leave credit,

ii. Employee paid family leave credit,

iii. Employer's (and employee's) payroll tax deferral,

iv. The employee retention tax credit, and

v. The COBRA (Consolidated Omnibus Budget Reconciliation Act) premium assistance tax credit.

Congress's intent for payroll credits and deferrals is to make it possible for businesses to retain cash by allowing employers to reduce payroll tax deposits or even request advance refunds of the credit by filing Form 7200, *Advance Payment of Employer Credits Due to COVID-19*. These credits are intended to help employers retain existing employees and, in the case of ERC, hire more employees.

Paid Sick and Family Leave Credits

Apr. 1, 2020 – Mar. 31, 2021. Employers with fewer than 500 employees (considered to be small/midsize employers) were mandated, through Dec. 31, 2020, to provide employees with paid sick leave and family leave if they were impacted by COVID-19. Relief in the form of paid sick and family leave credits lessened the economic burden facing employers. The CAA further extended the paid sick and family leave credits to Mar. 31, 2021, for employers who voluntarily provided paid sick and family leave to employees.

Qualified paid sick and family leave means the employee:

The daily wage limit for employees described in Items (i) – (iii) below, was capped at $511/day

i. is subject to a federal, state, or local quarantine or isolation order related to COVID-19,

ii. has been advised by a health care provider to self-quarantine,

iii. is unable to work or telework due to experiencing symptoms, and seeking a medical diagnosis, of COVID-19,

The daily wage limit for employees described in items (iv) – (vi) below, was capped at $200/day

iv. is caring for someone quarantined or in medical isolation advised by a health care provider,

v. is caring for a child because the child's school or daycare facility is closed, or daycare provider is unavailable due to COVID-19 precautions,

vi. is experiencing any other substantially similar conditions (related to COVID-19).

An eligible employer who pays qualified sick leave wages (up to 80 hours, $5,111 max) and qualified family leave wages (up to 10 weeks, $10,000 max), including any qualified health plan expenses and certain collectively bargained contributions allocable to those wages, during a calendar quarter, may receive 100% refundable tax credits on wages paid against the employer's share of Medicare tax through Mar. 31, 2021. The employer's share of social security tax (6.2% rate) was not imposed on paid sick and family leave wages prior to Apr. 1, 2021.

For self-employed individuals, a refundable paid sick and family leave equivalent credit was available against the "tax imposed by subtitle A" which includes income tax, self-employment tax and net investment income tax through Mar. 31, 2021.

Apr. 1, 2021 – Sept. 30, 2021. Beginning Apr. 1, 2021, employers could voluntarily continue to pay sick and family leave to employees under the above list of qualified reasons, as well as for the additional reason that the employee:

vii. is obtaining the COVID-19 vaccination or recovering from illness related to immunization, or

viii. is caring for someone (personal relationship tie) obtaining the COVID-19 vaccination or recovering from the vaccination.

The paid sick leave bank was reset to a maximum of 80 hours (10-day, $5,111 max), and the paid family leave credit was *reset and increased* to 12 weeks ($12,000 max) per employee. Thus, an initial 10-day employee paid sick day limit applied from Apr. 1, 2020 – Mar. 31, 2021, and a second 10-day limit applied from Apr. 1, 2021 – Sep. 30, 2021. Similarly, paid family leave from Apr. 1, 2020 – Mar. 31, 2021, of 10 weeks was reset as of Apr. 1, 2021, and increased to 12 weeks maximum leave through Sep. 30, 2021.

The credit for paid sick or family leave wages from Apr. 1, 2021 - Sep. 30, 2021, is increased by the employer's share of both Social Security (6.2% rate) and Medicare taxes (1.45% rate) paid on sick and family leave wages for Q2 & Q3 2021. However, the advance refund credit for sick and family leave wages can only be applied against the employer's share of Medicare tax, i.e., reduce the employer's total share of Medicare tax due on Form 941 for Q2 & Q3 2021.

The refundable self-employed paid and family leave equivalent credit was reset from Apr. 1, 2021 - Sep. 30, 2021. However, the credit is limited to offset against self-employed income taxes only.

The employer must include the wage equivalent of the paid sick and family leave credits in income and may deduct, as a business expense, the amounts paid to its employees for qualified leave wages.

Substantiation

Substantiation for paid sick leave requires the employee to provide the employer with a written request for leave formalizing (i) the dates and reason leave is being requested, and (ii) the name of the governmental entity or health care professional advising self-quarantine. In addition, for the family leave credit, an employee must provide the (i) name, (ii) relationship, and (iii) age of family members for whom the employee is requesting family leave as well as (iv) the name of the school or daycare facility that is closed and (v) a representation that no other person was available to provide care during the period.

An employer should maintain the following paid sick and family leave records:

- calculation of the amount of qualified sick and family leave wages paid to eligible employees, including records of work, telework and circumstances of qualified leave,
- calculation of how the employer determined qualified health plan expense allocations; and
- copies of payroll tax returns (Forms 941, or equivalent, and 7200) or records submitted to third-party payors, including proof of entitlement to claim the credit.

No credit is allowed to any employer for any calendar quarter if the employer discriminates, as to the availability of qualified sick and family leave wages to which the credit otherwise applies for that quarter, in favor of highly compensated employees, full-time employees, or employees based on tenure.

Deferral of payroll taxes

Any employer may voluntarily defer their share of Social Security/Railroad Retirement tax on employee wages paid from Mar. 27, 2020 - Dec. 31, 2020, for up to two years. The deferred employer share of payroll taxes requires 50% payment due no later than Dec. 31, 2021 and the remaining 50% due no later than Dec. 31, 2022.

Employees also have the option to defer their share of Social Security tax through Dec. 31, 2020 and penalties and interest won't accrue on deferred payments until Jan. 1, 2022.

Employers paying wages with forgiven PPP loans can also make payroll tax deferrals. Also, an employer is eligible to defer its deposit and payment of the employer's share of payroll tax in anticipation of claiming a paid sick or family leave credit or the ERC.

Employee retention credits

While the ERC existed prior to the Coronavirus pandemic, in Mar. 2020 the CARES Act version of the ERC was created to encourage employers to retain and hire employees during the pandemic. Initially, the ERC applied to wages paid after Mar. 12, 2020, and before Jan. 1, 2021. However, the CAA later modified and extended the ERC to apply to wages paid before Jul. 1, 2021. Then, the ARPA further extended and modified the ERC to apply to wages paid after Jun. 30, 2021, and before Jan. 1, 2022.

EMPLOYEE RETENTION CREDIT RULES 2020 COMPARED TO 2021

Employee Retention Credit	2020 rules	2021 Rules
Applicable Dates	March 13, 2020 - December 31, 2020	January 1, 2021 - December 31, 2021
Eligible Employers	Private -sector employer or tax exempt organization of any size Experienced full or partial government shutdown limiting commerce, travel or group meetings due to COVID-19	Similar to 2020 but expanded to include public colleges/universities, medical or hospital care facilities, tax-exempt U.S. instrumentalities Experienced full or partial government shutdown limiting commerce, travel or group meetings due to COVID-19
Full Time Employees in 2019	Large employers with over 100 full time employees - employee must not have provided services.	Large employers with over 500 full time employees - employee must not have provided services.
Recovery start-up Business, operations beginning Feb. 15, 2020	N/A	Eligible starting July 1, 2021; Avg. Annual gross receipts of less than $1 million. Maximum credit is $50,000 for Q3 & Q4 2021
Qualified Wages including Health Plan Expenses	Up to $10,000 wages x 50% for 2020	Up to $10,000 wages x 70% per quarter, 2021 (including qualified health plan costs)
Maximum credit	$5,000 for the calendar year Mar. 13, 2020 - Dec. 31, 2020	$7,000 per quarter up to $28,000 for calendar year Jan. 1, 2021 - Dec. 31, 2021
Qualified Wages DO NOT include:	Interaction with other tax credits and SBA relief provisions. “No Double-Dipping” Severance payments, Wages to related individuals, Flex Spending Accounts, amounts not subject to FICA	Interaction with other tax credits and SBA relief provisions. “No Double-Dipping” Same as 2020, adding wages considered under: R&D credits, Differential wage credit, work opportunity credit among others.

EMPLOYEE RETENTION CREDIT RULES 2020 COMPARED TO 2021		
Employee Retention Credit	**2020 rules**	**2021 Rules**
Severely Financially distressed Employer	N/A	July 1, 2021 - Dec. 31, 2021, decline in quarterly receipts of 90%+ compared to 2019.
Payroll Tax Offset	Employers share of Social Security (6.2% rate) and Railroad Retirement and employer's share of Medicare (1.45%)	Jan 1 - June 30, 2021 employer's share of Social Security (6.2%) and Medicare (1.45%). After June 30, 2021, only employer's share of Medicare (1.45%)
Significant decline in gross receipts	Gross receipts for the quarter were 50% less than the same quarter in 2019	Gross receipts for the quarter were 80% less than the same quarter in 2019. A 20% reduction in gross receipts. Alternative quarter election is available.
Authority	IRS Notice 2021-20	IRS Notice(s): 2021-20; 2021-23 (through June 30, 2021)
SBA Loan/grant interplay including other payroll credits	For SBA grants/loans including forgiven PPP loan funds, ERC cannot be used to pay the same wages in the same calendar quarter. ERC cannot be claimed on the same wages where other wage credits are claimed including paid sick/family leave credits.	
Aggregation Rules	Aggregated employers are treated as a single employer for determining (i) whether operations were suspended by government orders; (ii) whether a significant decline in gross receipts occurred; (iii) whether employer is considered large or small and (iv) maximum credit amount per employee.	

For wages paid after Mar. 12, 2020 and before Jan. 1, 2021 the ERC was 50% of qualified wages (including related group health plan expenses) limited to $5,000 per employee for the entire 2020 calendar year.

For wages paid after Dec. 31, 2020 and before Jan. 1, 2022 the ERC was increased to 70% of eligible wages (including related group health plan expenses) up to $7,000 per employee, per calendar quarter, for a maximum of $28,000 per employee for calendar year 2021.

An eligible employer (defined below) can claim a refundable ERC against certain employment taxes. From Mar. 12, 2020 - Jun. 30, 2021 the credit offsets both the employer portion of Social Security/Railroad Retirement tax (6.2% rate) and Medicare tax (1.45% rate). From Jul. 1, 2021 – Dec. 31, 2021 the credit can only be offset against Medicare tax (1.45%) and the Railroad Retirement Medicare equivalent.

Small business employers, defined for this purpose as those with less than 100 full-time employees in 2020 (less than 500 full-time employees in 2021) may claim the credit regardless of whether their employees, for whom the credit is claimed, actually worked or performed services. Large employers, defined as those with more than 100 full-time employees in 2020 (more than 500 full-time employees in 2021) can only claim the ERC with respect to employees who are unable to work or provide services due to Coronavirus-related paid time-off.

Employers that received a PPP loan and used the loan for eligible payroll expenses, and that also received full forgiveness or other COVID relief program grants, such as the Restaurant Revitalization Grant or Shuttered Venue Operator Grant, may still claim the ERC. However, the same wages cannot be used both for seeking forgiveness of a loan and to satisfy a condition of grant funds that are also used to claim the ERC. No double-dipping of any payroll credit or SBA grants or forgiven loan funds is allowed.

NO DOUBLE DIPPING - Qualified wages for the Employee Retention Tax Credit affect wages taken into account under other employee credits and SBA grants

The following credits and grant forgiveness cannot be taken on the same wages where the Employee Retention Tax Credit is also taken on qualified wages:

* Forgiven Payroll Protection Program wages
* Restaurant Revitalization Grants
* Shuttered Venue Operator Grants
* R&D Research Credits; Code Sec. 41
* Indian Employment Credits; Code Sec. 45A
* Differential Wage Credit Active Duty Members of Uniformed Services; Code Sec. 45P
* Employer credit for family and medical leave; Code Sec. 45S
* The Work Opportunity Tax Credit: Code Sec. 51
* The empowerment zone employment credit; Code Sec. 1396
* Payroll tax credit for paid leave; Code Sec. 3131 (*June 30, 2021 - Jan. 1, 2022*)
* Payroll credit for paid family leave; Code Sec. 3132 (*June 30, 2021 - Jan. 1, 2022*)
* ER portion of SS & Medicare tax on qualified sick leave wages (*Apr. 1, 2020 - Mar. 31, 2021*)
* After 3/31/2021, ER portion of Medicare tax only on qualified sick leave wages (*Apr. 1, 2021- Sept. 30, 2021*)
* ER portion of SS & Medicare tax on qualified family leave wages (*Apr. 1, 2020 - Mar. 31, 2021*)
* After 3/31/21, ER portion of Medicare tax only on qualified family leave wages (*Apr. 1, 2021 - Sept. 30, 2021*)

Employer Eligibility

To qualify as an eligible employer, the employer must show that:

i. It was carrying on a trade or business, with a good faith profit motive. A tax-exempt IRC Sec. 501(c) organization is considered to be engaged in a trade or business.

ii. In the calendar quarter to which the ERC is claimed, the employer's trade or business was:

- suspended by a government order (the government order test), OR
- experiencing a "significant decline" in gross receipts, OR
- a "recovery start-up business," that is carrying on a trade or business after Feb. 15, 2020, and that meets certain gross receipts requirements, for wages paid after Jun. 30, 2021, and before Jan. 1, 2022.

For wages paid after Jun. 30, 2021 and before Jan. 1, 2022 special ERC rules exist for qualified employers considered to have "recovery start-up businesses." (i.e., a business that began operations after Feb. 15, 2020, which meets gross receipts requirements). Special rules also apply to employers that are considered "severely financially distressed," which is defined as those suffering a decline in gross receipts of 90% or more compared to the same calendar quarter in 2019.

An employer who was fully or partially suspended in a calendar quarter due to orders from a federal, state, or local government authority limiting commerce, travel or meetings that result in suspension of the employers' operations may be eligible for the ERC. Even "essential businesses" where more than a nominal portion of their business operations were partially suspended may be eligible for the ERC.

A "significant decline" in the employer's gross receipts occurs if the employer experiences a 20% reduction in gross receipts for a calendar quarter in 2021 compared to the same calendar quarter in 2019. For 2020, the period of significant decline began the first quarter the employer experienced a 50% reduction in gross receipts compared to the same calendar quarter in 2019. In 2021, eligible employers can elect to determine the gross receipts test based on either (i) a corresponding quarter in 2019 or (ii) the previous 2020 quarter (i.e., Q1 2021 qualification can be determined by comparing Q4 2020 to Q4 2019).

If a trade or business is operated by multiple members of an aggregated group and the operations of one member are suspended by a government order, or if the aggregate group experiences a significant decline in gross receipts, then all members of the group are treated as a single employer for purposes of the ERC. The aggregation rules that treat related employers as a single employer can be complicated and may require a review of multiple government orders. Eligibility also involves determining economic hardship by compiling financial data as evidence of a substantial decline in gross receipts for the aggregate group.

While employers of any size may be eligible for the ERC, the paid sick and family leave credits only apply to employers with fewer than 500 employees.

Many employers experienced steady revenue or even increases in revenue during the pandemic and may erroneously believe that they aren't eligible for the ERC. This is false.

Expense Eligibility

After employer eligibility is determined, an employer must identify the wages, payroll taxes and qualified health plan expenses per employee, per quarter, used to calculate credits under each program. It's critical that the eligible expenses per employee are identified before any deferral or credit for a quarter is taken on Forms 941 or 7200.

Qualified health plan expenses include employer and employee pretax contributions for group medical, dental and vision coverage, plus contributions to health reimbursement arrangements and health flexible spending accounts (FSAs).

Employers should consider using unique payroll codes to identify eligible wages under each program so that, upon request or examination, the employer has payroll reports readily available substantiating each program credit.

PAYROLL WAGE EARNINGS CODES: EXAMPLE CODES

Specific payroll wage earning codes should be assigned to each employee's paycheck stub to assist in the tracking of paid sick or family leave, payment of ERTC on wages and allocable healthcare benefits as well as SBA PPP Loans and Grants for eligible payroll expenses.

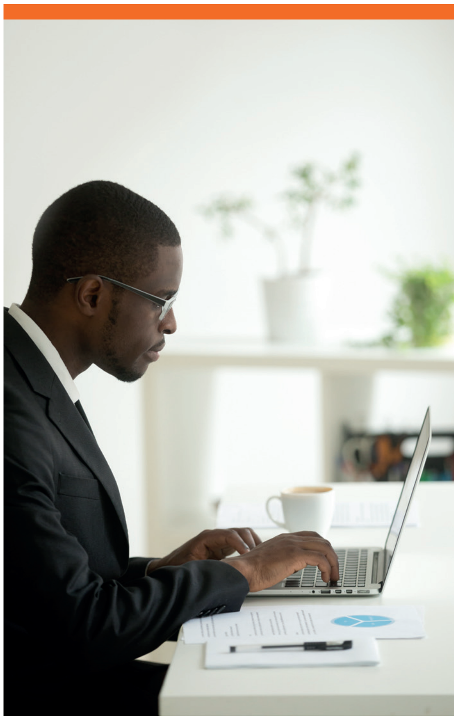
EXAMPLE CODES: Recommended Payroll earnings and Memo Codes*	Act/Definition	Qualified Wage Paid Dates
ERTC 70%	Qualified employee wages for the employee retention credit	Jan. 1, 2021 - Dec. 31, 2021
ERTC 50%	Qualified employee wages for the employee retention credit	Mar. 13, 2020 - Dec. 31, 2020
ERTC NB	New business after Feb. 15, 2020	Effective Jul. 1, 2021
ERTC ADV	Small employer = > 500 full time employees in 2019	Jan. 1, 2021 - Dec. 31, 2021
FF ER Health Credit	Families First Corona Virus Relief Act Paid sick and Family Leave credit	Apr. 1, 2020 - Dec. 31, 2020
FF EFMLEA Expansion	Families First Emergency Family Medical Leave Act Expansion	Apr. 1, 2020 - Dec. 31, 2020
FF EPSLA	Families First Employee Sick Leave Pay	Apr. 1, 2020 - Dec. 31, 2020
FF CARE Pay	Families First CARES Pay	Apr. 1, 2020 - Dec. 31, 2020
ARP FMLA Expansion	American Rescue Plan Act - family medical leave act expansion	(i) 1/1/2021 - 3/31/2021; (ii) 4/1/2021 - 9/30/2021
ARP ESP	American Rescue Plan Act - employee sick pay	(i) 1/1/2021 - 3/31/2021; (ii) 4/1/2021 - 9/30/2021
ARP FLP	American Rescue Plan Act - family leave pay	(i) 1/1/2021 - 3/31/2021; (ii) 4/1/2021 - 9/30/2021
Draw 1 PPP 6/5/20	First draw paycheck protection program funds, prior to 6/5/20	(within 8 weeks of disbursement)

PAYROLL WAGE EARNINGS CODES: EXAMPLE CODES (CONTINUED)

Recommended Payroll earnings and Memo Codes*	Act/Definition	Qualified Wage Paid Dates
Draw 1 PPP	First draw paycheck protection program funds,	(within 24 weeks of disbursement)
Draw 2 PPP	Second draw paycheck protection program funds	(within 24 weeks of disbursement)
RRG	Restaurant Revitalization Grant eligible expenses - wages	through March 11, 2023
EIDL ADV	Economic Injury Disaster Loan Advance	
TEIDL ADV	Targeted Economic Injury Disaster Loan Advance	
STEIDL ADV	Supplemental Targeted (EIDL) Advance	
SVOG	Shuttered Venue Operator's Grant eligible expenses - wages	one year from date of receipt of funds

FTC S-3175.9 Required Form W-2 reporting for wages qualifying for the refundable payroll tax credit for paid COVID-19 leave

*IRS Notice 2020-54, 2020-31 IRB - required reporting on employees W-2 of qualified sick and family leave Self-employed individuals report the families first qualified sick or family leave wages on Form 7202



While third-party payroll providers may have systems available to accommodate the data and calculations of deferrals and credits, employers are ultimately responsible for notifying their third-party providers as well as identifying and substantiating each credit or deferral, per employee, per calendar quarter.

The ERC is not included in the employer's income for federal income tax purposes. However, the employer is not allowed an income tax deduction for wages equal to the ERC amount. Therefore, if an employer paid an employee $10,000 in wages and took a $5,000 ERC, the employer's deduction for wages must be decreased by $5,000.

COBRA Assistance premium tax credits

The ARPA provides additional relief for employers and individuals by creating a 100% COBRA premium subsidy for assistance eligible individuals for COBRA continuation coverage due to an involuntary termination of employment, or a reduction in hours, because of the COVID-19 pandemic. The premium assistance tax credit is available for 6 months, from Apr. 1, 2021 - Sep. 30, 2021, where the premium is advanced by the employer, plan or insurer and fully reimbursed through a refundable credit against Social Security/Railroad Retirement (6.2% rate) and Medicare (1.45% rate) taxes. Individuals are not required to include the amount of premium assistance in their taxable income for the year. The COBRA premium assistance ends when the individual becomes *eligible* for other coverage or Medicare, regardless of whether the individual enrolls in the coverage.

Forms 941 and 7200

Employers will report payroll tax deferrals and credits on Form 941 (quarterly filers) and reconcile amounts with any reduced federal employment tax deposits or advance refunds. If the payroll tax credits exceed applicable employment taxes due, the excess can be refunded to the employer or applied to the next calendar quarter.

Advance refunds can be requested by filing Form 7200.

> Form 7200 advance refund credits *cannot* be requested by:
>
> - New businesses formed after Dec. 31, 2020
> - Businesses claiming an advance for ERC are limited to:
>   - Employers with 500 or fewer employees in 2019
>   - Newly formed 2020 businesses, employers with 500 or fewer employees in 2020

Payroll tax penalty relief

IRS Notice 2020-22 provides relief from the failure to deposit penalty under IRC Sec. 6656 for not making deposits of employment taxes in anticipation of paid sick and family leave credits, ERC and for the employer deferral of payroll taxes, but not for amounts in excess of the allowable credit(s) or deferrals.

To avoid penalties, employers must:

- pay qualified wages to the employee in the calendar quarter before the due date of the required deposit,
- reduce the deposit by no more than the anticipated credit, and
- not file Form 7200 seeking a payment of an advance credit.

IRS COVID TAX TIP 2021-64, 5/10/21

1 Don't use Form 7200 to simply claim the ERC
Only use Form 7200 to request advance payment of ERC
Claim the actual ERC on an employment tax return (Form 941).

2 Don't forget to inform any third-party payroll agent of any requested or received advance payment credits using Form 7200.

3 When amending Form 941 to retroactively request ERC, where PPP loan funds were also received, complete ALL the lines on Form 941-X that relate to both qualified wages and qualified health plan expenses.

IRS Payroll Tax Audit

What is the likelihood of an IRS audit? As previously stated, employers claim COVID-19 relief relating to payroll tax credits on Forms 941 and 7200. Thus, compliance verification by IRS will come in the form of a payroll tax audit. Payroll tax audits are a standalone process within IRS, independent of a typical federal income tax examination. IRS employment tax specialists are part of one of two groups, either 1) the Small Business/Self-Employed Division or 2) the Tax-Exempt and Government Entities Division.

IRS selects who will be examined for a payroll tax audit in several ways. For example, some industries have a history of more tax evasion than others and may be selected for audit based on the high likelihood of finding errors, such as where the lines between independent contractors and employees are blurred. Sometimes an employee within the organization knows of an area of risk and divulges this information to IRS through the anonymous whistle-blower program.

IRS employment tax specialists can frequently determine if the taxpayer is ripe for examination simply by reviewing a company's Form 941. An "unofficial audit" can occur where an amended Form 941X requests a significantly large refund and a specialist sends a notice requesting additional support for the amended return. This scenario could occur for the many employers who had to file an amended Form 941X to claim the ERC after Congress retroactively repealed the rule prohibiting employers who received PPP loans from claiming ERCs. Also, in the past, employment audit specialists have chosen topical areas, called campaigns, where abuse or misunderstanding of the Code occurred frequently.

Also, IRS criminal investigation unit has stepped up its enforcement and investigation activities for COVID-19-related fraud, including fraudulently obtained PPP loans and abuse of payroll tax credits such as the ERC.

Currently, IRS resources are stretched incredibly thin. The number of IRS employees is down 22% over the last decade, from nearly 95,000 employees in 2010 to under 75,000 employees in 2019. Much of this attrition is due to retirements, but a significant amount is due to a lack of funding and resources. For example, IRS's budget was cut by 20% over that same 10-year period. IRS continues to request budget increases to beef up its enforcement effort. Recently, U.S. Treasury Secretary Janet Yellen stated that under President Joe Biden's fiscal 2022 budget request, an IRS budget increase of $1.8 billion would include $900 million for added enforcement efforts. The Biden administration appears to agree, supporting IRS's request for additional funding.

What are the recordkeeping requirements for payroll tax credits and SBA loan/grant funds? The statute of limitations period under which IRS examining agents may request and review transactions relating to the ERC and paid sick and family leave credits was extended from 3 years to 5 years for 2021 tax returns. The SBA can request documentation supporting loan forgiveness for up to 6 years after the loan is forgiven or repaid in full. Still, due to the interplay of wage-based subsidies and grant/loan forgiveness programs, it's recommended that all documentation be maintained for 6 years even though the statute of limitations for maintaining documentation for the ERC and paid sick and family leave credit may be less for some filing deadlines in 2020.

An employment tax audit campaign could be designed to review the interplay of wage benefits assigned to PPP, paid sick and family leave and the ERC to ensure there is no double dipping.

Conclusion

Due to the billions of dollars of COVID-19 related tax benefits being dispensed and claimed, practitioners and payroll departments need to prepare and keep documentation substantiating an employer's eligibility for the proceeds they receive and the credits they claim in advance of an IRS employment tax audit or an SBA audit.

Keeping track of all the diverse sources of COVID-19 funding and the use of this funding to keep employees on payroll can be incredibly challenging and create a trap for the unwary. Within this toolkit, an infographic is provided that can assist with coding the payroll costs within an accounting system. See the infographic "Hypothetical payroll earnings codes for tracking purposes" above for specific codes that could be assigned in the tracking of COVID-19 funding programs and payroll tax credits.

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