

Fox Rothschild Podcast

The Presumption of Innocence Podcast Series: Episode 4 Understanding the Employee Retention Credit

*Featuring Matthew Adams of Fox Rothschild LLP and
Stephanie O'Rourke and Dana Fried of CohnReznick*

Adams: Hi everyone, and welcome to “The Presumption of Innocence,” a podcast brought to you by the White-Collar Criminal Defense and Regulatory Compliance Practice at Fox Rothschild. I'm Matt Adams, your host for today. I'm one of the co-chairs of the practice group, and I have the great fortune of being joined by two phenomenal guests and friends of our firm, Stephanie O'Rourke and Dana Fried, both of the CohnReznick accounting firm.

Stephanie is a CPA and tax partner leading their National Hospitality Emerging Concepts Group and was the co-leader of the SBA Task Force that was intimately involved in dissecting many, many of the various programs that emerged as a result of the COVID-19 pandemic.

Dana has a JD and an LLM. He serves as a Managing Director in the National Tax Services Practice Group at CohnReznick. He leads up their Executive Compensation and Employee Benefits Practice and is instrumental in leading the firm's practice in assisting employers with ERC tax credit issues.

That's what we're talking about today. We're going to unpack the Employee Retention Credit, which on its face could seem a dry subject and perhaps not worthy of a podcast, but it's one of the largest and I think most impactful pieces of the CARES Act, which was passed in March of 2020 in direct response to the COVID-19 pandemic. It arises out of Section 2301 of the CARES Act to provide eligible employers with a refundable tax credit. That concept of a refundable tax credit is critical to an understanding of what we're here to talk about today.

So, Dana, I want to kick it to you. Tell me in very basic terms what a refundable tax credit is.

Fried: Thanks, Matt. Hi, everybody. The concept originally could have been an income tax credit, except for the fact that Congress wanted this to be available both for taxpaying entities as well as not-for-profit, non-taxpayers. So, they went with the payroll tax, and that's the only reason they went with the payroll tax.

A fully refundable tax basically means, (whether you do or don't owe payroll taxes, this is sort of separate and apart) in theory, if you've paid all your payroll taxes and then become entitled to an ERC, then as a fully refundable payroll tax, you can simply request your credit in the form of a check. That's generally what people have been doing, getting very – in some cases, very, very – significant amounts.

Adams: So, like we saw with PPP, like we saw with portions of the EIDL program, this is basically free government money.

Fried: Not quite free. That's because, unlike some of the others – the FFCRA credits, for example, were actually gross income for income tax purposes – there is a tax hit here to the employer. Again, if it's a taxpayer in the sense that when you receive an ERC, it reduces the employer compensation deduction for that year, dollar for dollar. In theory, it increases your taxable income, so it's not quite free. But you're right that it's not a loan that you have to repay or have forgiven. It's a check.

O'Rourke: Matt, to Dana's point about the taxability of the credit, being that there is a reduction in your wage deduction, I would like to point that out, because there is a misconception employers believe that when they are applying for the credit or receive the refund is when the reduction comes through, but that is not the case. If you applied for a credit based upon 2020 wages, that reduction in wage deduction has to happen in 2020 and the same for 2021. I do want to point that out, because people do not understand that. They're actually getting refunds much later and actually amending their returns much later. There are some people still amending for 2020.

Adams: Right. I appreciate you amplifying that, Stephanie. It's like we've seen with many of the government stimulus programs that have been brought about by the COVID-19 pandemic. We've seen it with PPP, and I know the three of us have talked extensively about both iterations of the PPP program. In one of the earlier versions of our "Presumption of Innocence" podcast, we actually dissected the anatomy of an investigation into PPP fraud. But suffice it to say, for purposes here, when the government is literally providing taxpayers the opportunity to get a check in the mail from the government, the opportunities for fraud and abuse are significant. We see every day new headlines about criminal prosecutions being brought against individuals throughout the country who have taken advantage of some of these programs.

But obviously, starting from the perspective that in order to avail yourself properly of these programs, you need to have your ducks in a row before getting involved, buying from the credit... Stephanie, I'd like you to walk us through a little bit about some of the documentation that needs to be in place in order to both assess eligibility for the program and to assess the amount of the available credit to the taxpayer. Now, we're going to talk separately about the standard. What does the taxpayer need to have at the ready to start making those determinations?

O'Rourke: Sure. So, unlike the PPP, when you are applying for the credit, you are not handing in any payroll records or employee records or financial statements or things of that nature. You should definitely have the documentation on hand, acting as if you will be audited by the IRS. Dana likes to say, "Just put it in your top drawer to have it."

Part of the requirement, and we'll talk about this further a little bit down the line...but whether you're a small employer, a large employer, you need to determine the number of your full-time employees – not full-time equivalent, but full-time employees – in 2019. There are other exceptions to that rule based upon when you started, but let's just say you need to have documentation associated with that.

Your reduction in revenue when you compare quarters from either 2020 and 2021 to 2019, you have to have financial statements or tax support for those quarters, no different than you would have for your tax return. If you are looking at a partial suspension of operations due to government orders, you're going to have to have that documentation available with respect to

how those government orders affected your business and caused that partial suspension of operations.

Obviously, your payroll records, your payroll journals...if you receive PPP, as everybody I'm sure knows, you can't double dip. You need to make sure that you're providing that documentation, or have on hand that documentation, to show the wages that you used for PPP as compared to the wages that you're using for ERC to ensure that you're not double dipping.

If you've taken other per se credits, whether it be an FFCRA credit, whether it be a WOTC (Work Opportunity Tax Credit), the government made sure you weren't losing the same wages for many of the different credits out there. So, having that documentation in your top drawer and making sure that you have everything ready before you get audited, or if you get audited, it's important.

Please note that what you are filing with the government is an amended payroll tax return. Or, if you're doing the credit as you go along – some people could have done with their payroll companies – then your payroll company has that information.

Adams: I'd like to tell people when we're talking about documentation requirements, I refer to it as the "break glass if needed file." I know I've shared with the two of you when we're talking about PPP requirements, the idea that the government can come back and look at the basis for what you're claiming can't be overstated. I think getting those documents, getting your ducks in a row before you go and take the credit through the amended return process, is critically important in surviving the defensibility question.

Now, Dana, anything to add as it relates to documentation?

Fried: Yes, I'd just like to point out that Congress was very cognizant of the fact that this is not an application like PPP. This is claiming a credit on a payroll tax return. The historical audit percentage on payroll tax returns is extremely low, maybe 1-2%, and Congress was very concerned about that and didn't want people taking a flier and hoping not to get audited. So as a technical matter, in order to be eligible, this isn't getting your ducks in a row. This is required under the statute. The employer must have in its possession documentation of its eligibility for the credit, the fact that it paid qualified wages and qualified health plan expenses, and the actual calculations in backup. So, this really isn't the usual situation of, "Put it in your desk and hope for the best." This is, "it must be in your desk" or as a technical matter, you're not eligible to claim the credit in the first place.

Adams: Yes, that's a very good point. To build on what you just said, Dana, about the historically low frequency of these being audited. In light of the fact that technically it's not free money, but it sure seems like free money, do you expect that the frequency of audit, sort of scrutiny of these amended returns, increases?

Fried: I don't know how to answer that question for the simple reason that we've all been listening to the IRS for years say how terribly understaffed it is. Right now, of course, lots of people have COVID and possibly at the government as well, so it's really hard to say. We know for a fact that they've been very slow in responding, so we have no way of knowing whether or not they're going to be able to put themselves into a position of greater audits than they have done historically. You also have to remember that the folks in that group of payroll experts,

they're not necessarily controlled group experts or revenue recognition experts. The fact is that this law is very broad and very complex. So, you ask a fair question. I really don't know the answer. It's really a matter of, you would think, cost-benefit analysis: does the government want to train people and make a huge investment in a credit that's only available for basically six quarters? Or would they prefer to put the money and effort into training people to do other types, perhaps more beneficial to the government, such as auditing very wealthy people and very large corporations?

Adams: From where I sit, I've seen the government bring to bear quite a significant number of new technologies, like artificial intelligence, to pick out outliers when it comes to these COVID-19 recovery programs. I think in my view, there is going to be a band at which they are going to scrutinize. And it's got to be on the higher end, right? What I think the government is going to bring to bear on this is similar to what they've been doing in the health care space, which is where there are large astronomical amounts of the credit being given to a particular taxpayer. Those are going to take scrutiny. But I really appreciate your point about not just "break glass if needed." This is a legal requirement that you have your documentation lined up, that you have your ducks in a row, before taking the credit.

Let's shift directly into some of the mechanical aspects of the credit. I know there's both legal and accounting issues galore unpacking what really is a two-part test: whether there is an eligible employer, and then secondly, whether there are qualified wages.

Let's talk, Dana, you and me, about the eligible employer standard. Then I want to take it over to our CPA friend Stephanie for a moment to talk about some of the qualified wage issues. Dana, walk us through a little bit of this eligible employer standard and what you see as some of the potential pitfalls.

Fried: Well, I think the most important aspect, just to quickly summarize, is that a lot of employers confuse eligibility with whether they're paying qualified wages. You can be perfectly eligible, but still not have any qualified wages and not be entitled to claim an ERC.

Looking at eligibility specifically: Eligibility is a function of either satisfying an empirical test called the significant decline in gross receipts test, or a facts and circumstances test that your business has suffered a partial suspension of its operations based on a governmental order. So, very quickly, the empirical test is based on comparing gross receipts to 2019. So on the theory that 2019 pre-pandemic base period for comparison purposes, you compare the gross receipts in each calendar quarter of 2019 to the same calendar quarter in 2020 or 2021, with different standards applicable to whether you've had a significant decline for 2020 versus 2021.

One of the key aspects of this was, at the end of 2020, Congress stepped back (and I'm sure it was under attack) and basically said, "We made these thresholds too difficult," and relaxed the threshold very dramatically for 2021. One case being this decline in gross receipts for which a 2020 credit required a greater than 50% decline, and then they eased that requirement to a greater than 20% decline for 2021.

The empirical test is always the way to go if you're able to pass it, because if you do pass it, you are eligible for the entire calendar quarter for which you are testing. However, as you mentioned, Matt, one of the key aspects is gross receipts as determined on a controlled group basis. For some companies, that's not a very complex determination. You have a parent sitting

on top of a subsidiary. But in many, many scenarios, you have multiple individuals with trusts and their own LLCs. It can become a very convoluted and complicated procedure to first figure out which controlled group existed in 2019 versus 2020 versus 2021 for purposes of this empirical test.

If you're unable to pass the test, then you look at facts and circumstances. You will have suffered a partial suspension of your business operations if a government order imposed restrictions on the operations of your business and had more than a nominal effect, taking into account if you were able to conduct comparable operations via telework. So, if your business is sitting in front of a computer with a telephone, and you could do that just as easily as at home, the fact that, for example, your office building was shut or the fact that you were not able to leave your house, would not make the employer eligible under the simple theory that it was able to conduct comparable operations.

Adams: Thanks Dana. Now, I can tell you just from personal experience in trying to help clients unpack that standard that there's a lot more than meets the eye. In terms of discerning truly whether you meet that eligible employer standard in order to avail yourself of the ERC, it really does take careful consideration of the specific facts and circumstances both of your business and the impact that the pandemic has had on your operations. That just can't generally be done with a cookie cutter approach. The clients who I've guided through this process, we have literally spent many pages of legal memoranda trying to show our analysis.

I encourage anyone who is trying to make that eligible employer determination to do so with the careful guidance of legal and accounting professionals like us. Because to go into that without real careful consideration of some of the nuance, like you said about the control group standard and what have you, is really a mistake.

Now, coming to the second prong of the ERC standard, Stephanie, please talk to us a little bit about what it means to have qualified wages.

O'Rourke: To determine qualified wages, it's dependent on if you are a small employer or large employer. If you are deemed to be a large employer where you have, based on 2020 over 100, or 2021 more than 500, as determined your number in 2019, then, if you are deemed to be a large employer, it's basically wages where your employee did not provide a service. So in those instances, we're finding that the credit is not that accretive. It's not that large because most people do not pay people not to work. You have certain instances where they might have kept high-level management on and they paid them. But you also might have other instances where maybe they were out for COVID and they didn't get the FFCRA credit for that, but they were paid anyway, because there were some state requirements in the various states to have these people not work. If you were a small employer, most wages qualify. Again, keeping in mind, if you received PPP, make sure that you're not double dipping.

But there are instances where there are certain wages that don't qualify. So, having somebody put together all wages and say, "OK, well in the quarter my wages were X, I'm going to claim that." For 2020, it's up to \$10,000 per employee for qualified wages and health care expenses. For 2021, it's \$10,000 per quarter that you look at qualified wages to calculate the credit. There are certain wages that might have been paid during those quarters, or the year of 2020, that are not eligible. So, if you have preexisting vacation, sick and other personal leave wages that are paid out, if you're a large employer, those don't count. If you are a small employer, those wages

will count. If you are paying a former employee for a severance package, that is not considered qualified wages for ERC purposes. If your employees are exempt from Social Security and Medicare taxes, that is another situation where those would not be deemed to be qualified wages. If you are related to ownership of the company – and it's pretty unbelievable how many people are deemed to be related – it's not just your child. It's brother, sister, stepbrother, stepsister, father, mother, niece, nephew, uncle, daughter-in-law, son-in-law. So, if those wages are paid to family members, those are not deemed to be eligible wages for ERC purposes. And obviously, if you are participating in some other credits, whether it's an FFCRA or a Work Opportunity Tax Credit, those are not eligible wages as well.

Something on the positive that people don't realize is that not only is the employer portion of qualified health that they pay, but if the company has a cafeteria plan and there are pretax deductions associated with that for the employees, those count as qualified health care expenses. Dana, do you want to add?

Fried: Just to mention that the \$10,000 that Stephanie is talking about, again, is a function of two things. If your employees are making more than \$40,000 a year and they're there for the whole year, they're going to have \$10,000 of qualified wages. But if you have part time employees or new hires or people who have left who don't have enough wages, you can also count qualified health plan expenses, which are employer premiums for medical, dental and vision. As Stephanie said, employee premiums as well, as long as those employees are paid on a pretax basis, which generally is the case.

O'Rourke: I also want to add: I know at the beginning when people were calculating wages in the hospitality industry that people asked about tips. There was a lot of confusion around tips. It's all wages subject to Social Security and Medicare, so tips would be included. A lot of companies did not believe that that was the case and did not include it, and they are included. So that's something really important because, for certain hospitality companies or just in a tipped environment, that amount could be very large.

Adams: Yes. I think the takeaway from discussion of both prongs is that there's a lot of nuance. There's a lot of intricacy to determining both the eligible employer standard, and there's two tests that you could subscribe to. With application of this sort of convoluted two prong test, I see three basic risks. The small versus large eligibility criteria is something that needs to be carefully considered, especially in organizations that may have many layers and stratified entities that make up their organization chart.

I also see this revenue recognition issue as something really significant when it comes to the qualification standard under the decreased revenue, from the eligible employer standard. As a CPA, Stephanie, oftentimes you have some options about when you recognize revenue, which, as part of some sound tax strategy, may be to recognize revenue in ways that may be tax advantaged. What potential revenue recognition issues do you see as it pertains to ERC?

O'Rourke: I will say, like I tell all my clients and pretty much everybody that I speak to associated with all these programs, don't do anything differently than you would have done in your normal course of your business if you had not received these funds or applied for credit.

If you're an accrual-basis taxpayer, accruals-base financials, it's pretty cut and dry following those standards, when you should recognize revenue, when it's earned. That's when you

should typically recognize revenue from an accrual base. There are nuances in every single industry, whether it's hospitality around gift cards and construction around percentage of completion. What you're representing, how you are preparing your tax returns and what you're representing on your financials, whether they're internal or they're audited, you shouldn't do anything differently.

With tax basis or cash basis, there's where, from a revenue perspective, if they're holding back checks, let's just say, for a quarter because they had some foresight when they knew that they could apply for this credit. So, if you're holding back checks, obviously if somebody is paying you for your services and you receive the check within the quarter, it should be deposited and it should be recorded on your books. Again, in the normal course of your business, you would probably deposit that. If you're in the fourth quarter – and again, fourth quarter 2021, except in very few circumstances, is no longer part the credit – but, at least for 2021, that would be something that I could see people trying to do. Not depositing in their bank accounts checks that they receive from their customers, so they wouldn't have to record the revenue. Or, certain instances where they are deferring revenue, they're putting it on their balance sheet as saying that they didn't earn it from an accrual basis when they actually did. So, it really comes down to changing your accounting methods and practices, and that's not something that that should be done. Remember that when you're filing a tax return, when you're a company, ownership or the CFO or somebody in your organization is signing off, that they are true and accurate and so you shouldn't be thinking any differently.

Adams: Yes, and I think that's a that's a great point. You can always go by, “Well, this is how we've always recognized revenue, this is our standard accounting principles, and we have an established track record on it,” rather than trying to shave down that square peg and fit it into a round hole just to avail yourself of the credit.

I mentioned the risks, again, of small versus large employer eligibility and the need to dissect the organizational chart. As we've been talking, I'm compiling a list of where I see the regulatory and enforcement risk. One that comes to mind as you talked through the alternative standard for eligible employers before, was what I see as a bit of a gray area associated with suspension of operation and what that really means. I know I've worked, in particular with your firm, on a couple of engagements where in the hospitality industry, for example, maybe there wasn't a shutdown order that closed the restaurant, but perhaps there was an administrative directive from whatever governmental body that said tables had to be further apart which limited the number of patrons who could be in a particular restaurant. Where the capacity used to be 100, now it's 50, because the physical place has to be modified in some way to account for social distancing measures associated with the pandemic. Talk just a little bit about some of the gray areas that come up as it relates to the suspension of operations like that.

Fried: Sure, Matt. Well, what it really boils down to, again, is that it's facts and circumstances and that reasonable people could view facts and circumstances differently. What I always tell clients 100% of the time is that no one knows their business. No payroll agent with the IRS knows their business as well as they do. Ultimately, as I mentioned earlier, it's the obligation of the employer to have documentation in its possession, taking a reasonable position that it has a reasonable basis that it had a partial suspension of operations. What that really does mean is analysis and documentation of that analysis. You mentioned capacity restrictions, and obviously that's been a huge issue for the restaurant industry that the government has said, “Look, if we shut down your restaurant for indoor dining, but we allow you to have takeout and delivery and

you hit a home run and you have more business than you've ever had before because you're really good at takeout and social advertising, et cetera," it doesn't matter as long as there's been a significant restriction on your business.

Capacity restrictions are not only restaurants. Capacity restrictions on manufacturing facilities and factories ... If a factory has a capacity restriction or even a six-foot social distancing restriction, such that they used to have 100 people on the floor, now they can only have 50, that also has a dramatic impact on that particular business' operations. So, it's always a gray area in the sense that every business is different. That's why my position is always it's really the employer's job. We assist by being another objective eye and giving our thoughts as to whether or not they've done a really helpful analysis. But it's like in college when you're told to write a paragraph. The first sentence is supposed to be your thesis and then you explain your thesis. If you're in court and you're writing a brief it's the same idea. You don't just say, "We had a partial suspension because a government order did this or that." You need to go through a full and complete analysis as to how it impacted your business, showing as many different metrics as possible where there was a more than nominal effect on your business operations.

Adams: Like my sixth-grade math teacher said, "You don't get any credit unless you show your work." I think the takeaway from our conversation here today is that there is a lot to unpack when it comes to the ERC. The name of the game when trying to take the credit in a way that minimizes risk to an employer is that you need to do so in a reasonable and a defensible way.

The top three risks that I've distilled from our conversation are really that revenue recognition issue that Stephanie talked about; the gray areas that surround this suspension of operations in circumstances where we have 50 different states doing 50 different things and hundreds of municipalities now getting into the fold as it relates to government restrictions; and then the idea of including some of those ineligible wages in the ultimate calculation.

I can't thank the two of you enough. We've only scratched the surface when it comes to the ERC. For anybody listening to this, I think one of the takeaways is that you need sound accounting advice and legal advice when it comes to making the ultimate determination if the ERC is right for your business. The consequences of failing to do that could be extraordinarily catastrophic.

Thanks again. And thanks for joining us on "The Presumption of Innocence." We'll speak with you next time.