

*This document provides guidance about the Employee Retention Tax Credit. This guidance is subject to interpretation and change. You should consult with a practicing professional and review information issued by the IRS before taking advantage of the Employee Retention Tax Credit.*

## Introduction

Employers with Paycheck Protection Program (PPP) Loans are now eligible for the Employee Retention Tax Credit (ERTC) for the period March 13, 2020<sup>1</sup> through December 31, 2021. This document will walk through key steps in calculating and applying the ERTC. Please note that the ERTC does not apply to those identified in Step 4 on Page 5.

## Overview of the ERTC

The ERTC is a dollar-for-dollar reduction against payroll taxes on a quarter-by-quarter basis with the filing of Form 941 – Employer Federal Tax Return. The total deposit for payroll taxes consists of Medicare Tax, Social Security Tax and Federal Income Tax Withholding for Employees. The ERTC reduces these taxes for those employers who qualify.

The ERTC is calculated on the first \$ 10,000 of qualified wages for each employee at a rate of 50% in 2020 and at a rate of 70% in 2021. Qualified wages consist of gross pay<sup>2</sup> for the employee + allocated health insurance expenses. See example below:

*Figure 1 - Quarterly Schedule for ERTC*

		Quarter 2 - April 1, 2020 to June 30, 2020		
	Allocated	Total	Impose	Calculate
Wages	Health	Qualified	Ceiling @	Tax Credit
Paid	Expenses	Wages	\$10,000	50%
\$ 14,500	Owner is excluded	100% control S Corp		
\$ 11,025	\$ 1,590	\$ 12,615	\$ 10,000	\$ 5,000
\$ 7,216	\$ 1,428	\$ 8,644	\$ 8,644	\$ 4,322
\$ 5,152	\$ 1,493	\$ 6,645	\$ 6,645	\$ 3,322
<b>\$ 37,893</b>	<b>\$ 4,511</b>	<b>\$ 27,904</b>	<b>\$ 25,289</b>	<b>\$ 12,644</b>

The quarterly schedule (Figure 1) will support the submission of forms to the IRS related to the ERTC.

<sup>1</sup> The legislation indicates the effective date as “after March 12, 2020” and “before July 1, 2021”

<sup>2</sup> Pay subject to FICA Taxes

## Eligibility for the ERTC

Employers<sup>3</sup> who were operational in 2020 are eligible for the ERTC on a quarter-by-quarter basis one of two ways:

1. **Shut Down Test:** The business was partially or fully shut down by an “appropriate governmental authority” which negatively impacted operations. See IRS guidance on what represents a “shut down” > <https://www.irs.gov/newsroom/covid-19-related-employee-retention-credits-determining-when-an-employers-trade-or-business-operations-are-considered-to-be-fully-or-partially-suspended-due-to-a-governmental-order-faqs> or
2. **Gross Receipts Test:** The business experienced a drop in gross receipts<sup>4</sup> in the 2020 quarter of more than 50% compared to the same quarter in 2019. The gross receipts test is only 20% in 2021 compared to 2019 effective January 1, 2021 for Q1 and Q2.

A business that is not required to shut down, but does so on a voluntary basis can still qualify for the ERTC per the Gross Receipts Test.

## Limitation – Larger Employers

For employers with more than 100 Full Time Employees<sup>5</sup>, the ERTC is limited to payroll for those employees not rendering a service. Smaller employers (100 or fewer FTE’s) can use the ERTC regardless if the employee works or not. Effective January 1, 2021, the FTE threshold gets raised to 500 FTE’s (full time employees).

For larger employers that have furloughed employees, but are continuing to pay wages, these wages should qualify for the ERTC. If you maintain a formal time and attendance system, you may want to go back in 2020 and identify non-productive time or non-billable time. These hours may qualify for the ERTC since you were paying the employee without any real work delivered.

## Applying the Gross Receipts Test

Assuming the business was not shut down, apply the Gross Receipts Test. Use Gross Income reported on the tax returns (2019 and 2020) or Gross Revenues per financial statements. Break out Gross Revenues for 2019 and 2020 on a quarterly basis. Once the business qualifies for the ERTC in any one quarter, continue to use the ERTC until the business has recovered to a point where Gross Revenues are more than 80% of the comparable quarter in 2019 and then in the following quarter stop using the ERTC.

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<sup>3</sup> Employers eligible include businesses, tax exempt organizations, universities and hospitals.

<sup>4</sup> Gross Receipts are defined as “total sales (net of returns and allowances) and all amounts received for services. Gross receipts also include income from investments and from incidental or outside sources (e.g., interest, dividends, rents, royalties and annuities) that the business collected.

<sup>5</sup> FTE = Full Time Employees is defined as those employees who work 30 hours or more in a week or 130 hours or more in a month which count as 1.0.

Here is an example of how this might work:

Figure 2 - Gross Receipts Test for 2020

	Quarter 2 Revenues	Quarter 3 Revenues	Quarter 4 Revenues
Gross Receipts in 2019 by Quarter	\$ 166,000	\$ 187,000	\$ 214,000
Gross Receipts in 2020 by Quarter	\$ 98,000	\$ 86,000	\$ 177,000
Are gross receipts less than 50% of 2019 ?	59% - No	46% - Yes	n/a
Did follow-on quarter go over 80% of 2019 ?	n/a	n/a	83% - Yes

In the example above, Gross Revenues were less than 50% (46%) in Q3 2020 compared to Q3 2019. This business can use the ERTC for Q3 2020. Now shift to the 80% rule – at what point does the business go above 80% of gross revenues compared to the 2019 quarter? In Q4 the business is at 83% and thus, can continue to apply the ERTC in this quarter. One you get over 80%, you stop for that respective quarter when it comes to taking the ERTC. The 80% rule runs out in Q1 of 2021 and thereafter, you will need to apply the 20% gross receipts test on a quarter-by-quarter basis.

### Step 1 – Identify Quarters Where You Qualify

The first step related to the ERTC is to identify all quarters where the business qualifies. Apply the two eligibility tests to each quarter in 2020:

Figure 3 – Identify All Eligible Quarters for the ERTC

Qualification Test	Q2-2020	Q3-2020	Q4-2020	Q1-2021	Q2-2021
Was the business shut down partially or fully by an order issued by the government?	Yes	No	Yes	?	?
Did the business experience a drop of over 50% in gross revenues during the quarter compared to 2019?	No	No	No	? 20% drop	? 20% drop

Start with Q2 2020 and move forward through Q4 2020. Next, move to Step 2.

## Step 2 – Collect the Wages for the Quarters

Now that the quarterly periods are identified, collect the gross pay for each employee for the applicable quarters. Make sure to pull the respective Quarterly Payroll Reports (Form 941). This is needed to identify the Non-Refundable portion of the ERTC which is based on the Employer's portion of Social Security Taxes.

Figure 4 – Collect Payroll Information for ERTC

The image shows a portion of Form 941 for 2020, specifically the 'Part 1' section where payroll information is reported. The form includes fields for Employer Identification Number (EIN), Name, Trade name, and Address. A 'Report for this Quarter of 2020' section allows the user to select a quarter (1: January, February, March; 2: April, May, June; 3: July, August, September; 4: October, November, December). Below this, three lines of data are provided: Line 1 (Number of employees) is 4; Line 2 (Wages, tips, and other compensation) is 37,893.00; and Line 3 (Federal income tax withheld) is 8,067.00. To the right of the form is a summary table showing the total wages paid for six employees.

Empl No.	Wages Paid
1	\$ 14,500
3	\$ 11,025
5	\$ 7,216
6	\$ 5,152
	<b>\$ 37,893</b>

The total wages paid and reported on Form 941 should match the breakdown by employee. Many CPA's will use "Medicare Wages" from Line 5 when picking up gross wages per Form 941.

## Step 3 – Identify the Work Around Time Periods

There is a possibility that all weeks or days in the quarter cannot be included for the ERTC. These time periods need to be excluded from the ERTC calculations. Here are three examples:

1. **PPP Loan for Payroll** – For employers that used their PPP money for payroll, you **cannot** include these time periods for purposes of the ERTC. This will be the most significant issue for most employers; i.e. wages used for PPP are not to be used for the ERTC.

**EXAMPLE:** You used your PPP Loan to cover payroll from June 12, 2020 to August 8, 2020. You should apply the ERTC for the period's March 13 to June 11, 2020 and from August 9, 2020 to December 31, 2020 for the calendar year 2020.

2. **Sick or Family Leave Tax Credit** – Avoid applying multiple payroll tax credits for an employee on the same dates. The Families First Coronavirus Relief Act (FFCRA) provides a Sick Leave and Family Leave credit when employees or family members contract the Coronavirus.

**EXAMPLE:** You have an employee who got sick with the Coronavirus. Under the Families First Coronavirus Relief Act, you used the Sick Leave Credit for this employee from July 9, 2020 to July 21st. Do not apply the ERTC for this employee from July 9th to 21<sup>st</sup>.

3. **Shut Down Fully Lifted** – For non-essential businesses that were allowed to open and there was no shut down at all, the business cannot use the ERTC for the period when there was no shut down. Once again, try and use the Gross Receipts Test when you cannot meet the Shut Down Test.

**EXAMPLE:** Your business has been shut down since April 1, 2020. The City issued an order allowing your business to be fully open from June 15 to June 30<sup>th</sup> before a new partial shut-down was imposed on July 1, 2020. The last two weeks in June should be excluded from the ERTC calculations based on the Shut Down Test for the ERTC.

## Step 4 – Remove Unqualified Employees

In Step 3, specific time frames have been removed from consideration in calculating the ERTC. Another required adjustment relates to personnel on payroll. A business cannot take the ERTC for the following employees:

- An individual who owns 51 percent or more of the value of the stock of employer (if the employer is a C Corp or S Corp)
- An individual who owns 51 percent or more of the capital and profits interest of the employer (if the employer is another entity such as Partnerships, LLC, etc.)
- A grantor, beneficiary, or fiduciary of the employer (if the employer is an estate or trust)
- A family relative of the employer (if the employer is an individual). Family relatives include children, siblings, step-siblings, parents, step-parents, nieces, nephews, aunts, uncles, and in-laws
- Household employees such as maids, butlers and gardeners.

NOTE: The AICPA has submitted a request to the IRS requesting clarification on if the owner and the owner's spouse wages can be included as part of the ERTC. Most CPA's tend to error on the "conservative" side, but there is no clear conclusion if you can include or exclude the owner and the spouse. Here is a recent CPA video that further touches on this topic >

<https://youtu.be/C0ZbLnsESMk>

## Step 5 – Add Allocated Health Expenses (Optional)

One final adjustment is optional. Qualified wages for the ERTC includes the gross wages of the employee and any "allocable health insurance expenses." If employees are paid high wages, then

reaching the \$ 10,000 ceiling per employee is fairly easy without the inclusion of health insurance expenses. However, if the ERTC is not using the entire \$ 10,000 ceiling, then consider adding health expenses in arriving at qualified wages. This can be particularly important where employers furlough employees without pay, but continue to pay their health insurance.

One simple way of allocating health expenses is to calculate a rate for the quarterly period based on number of covered employees and hours worked during the quarter. Once you have the rate, apply the rate to the number of days each employee worked during the quarter. See example below:

Figure 5 - Calculate Health Insurance Expense Rate for Quarter

Total Number of Employees on Payroll			4
Health Insurance Premium - April 2020	22	\$	2,250
Health Insurance Premium - May 2020	21	\$	2,250
Health Insurance Premium - June 2020	22	\$	2,250
Total Q2 Health Insurance Expense		\$	6,750
Expense per Employee		\$	1,688
Work Days in 2nd Q 2020			65
Expense per Employee per Day		\$	26

Figure 6 - Apply Health Insurance Expense Rate to Days Worked in the Quarter

	Work Hours in Day		8	
Empl No.	Hourly Pay Rate	Hours in Quarter	Convert Hrs to Days	Allocated Health Exp
1	Salary	Owner		
3	\$ 22.50	490	61	\$ 1,590
5	\$ 16.40	440	55	\$ 1,428
6	\$ 11.20	460	58	\$ 1,493

In the above example, three insurance premiums for the quarter total \$ 6,750. Divide the total by 4 covered employees equals \$ 1,688 per employee. Next, sum the total work days for the quarter and divide into the \$ 1,688 equals the rate of \$ 26. Apply the day rate to the number of days each employee worked in the quarter. For example, employee No. 3 worked 490 hours divided by 8 hours in a day equals 61 days worked x \$ 26 = \$ 1,590 allocated insurance expense.

### Step 6 – Calculate the ERTC

Setup a schedule for each qualified quarter that captures all employees per Step 2. Add columns to calculate the Qualified Wages (Gross Pay + Allocated Health Expenses) and calculate the ERTC subject to the \$ 10,000 ceiling at the rate of 50% in 2020. Here is how the schedule should look for Q2 2020 (April 1, 2020 to June 30, 2020) with any unqualified employees excluded:



Figure 7 - Calculate the Total Employee Retention Tax Credit 2<sup>nd</sup> Q 2020

Empl No.	Wages Paid	Allocated Health Expenses	Total Qualified Wages	Impose Ceiling @ \$10,000	< Breakdown of Qual Wages > Gross Pay Health Exp		Calculate Tax Credit 50%
1	\$ 14,500	Owner is excluded 100% control S Corp					
3	\$ 11,025	\$ 1,590	\$ 12,615	\$ 10,000	\$ 10,000	\$ -	\$ 5,000
5	\$ 7,216	\$ 1,428	\$ 8,644	\$ 8,644	\$ 7,216	\$ 1,428	\$ 4,322
6	\$ 5,152	\$ 1,493	\$ 6,645	\$ 6,645	\$ 5,152	\$ 1,493	\$ 3,322
	<b>\$ 37,893</b>	<b>\$ 4,511</b>	<b>\$ 27,904</b>	<b>\$ 25,289</b>	<b>\$ 22,368</b>	<b>\$ 2,921</b>	<b>\$ 12,644</b>
<i>Totals in bold should tie to IRS Worksheet 1 and / or Forms</i>						Emplr SS Tax	<b>\$ 2,350</b>
						ERTC Balance	<b>\$ 10,294</b>

The total credit for the quarter is \$ 12,644. Employee No. 1 was ignored because this person owns 100% of the business. Also notice that employee No. 3 maxed out at \$ 10,000 in qualified wages. When the business pays payroll taxes for the quarter, the amount due is reduced first by the Non-Refundable amount (\$ 2,350) on line 11d of Form 941 and then the Refundable amount (\$ 10,294) gets reported on line 13d of Form 941.

Figure 8 - Applying the ERTC on Form 941 on a prospective basis

**Part 1: Answer these questions for this quarter. (continued)**

11d	Total nonrefundable credits. Add lines 11a, 11b, and 11c . . . . .	11d	<input type="text" value="2350."/>
12	Total taxes after adjustments and nonrefundable credits. Subtract line 11d from line 10 . . . . .	12	<input type="text" value="11,515."/>
13a	Total deposits for this quarter, including overpayment applied from a prior quarter and overpayments applied from Form 941-X, 941-X (PR), 944-X, or 944-X (SP) filed in the current quarter . . . . .	13a	<input type="text" value="-0."/>
13b	Deferred amount of social security tax . . . . .	13b	<input type="text" value="."/>
13c	Refundable portion of credit for qualified sick and family leave wages from Worksheet 1 . . . . .	13c	<input type="text" value="."/>
13d	Refundable portion of employee retention credit from Worksheet 1 . . . . .	13d	<input type="text" value="10,294."/>
13e	Total deposits, deferrals, and refundable credits. Add lines 13a, 13b, 13c, and 13d . . . . .	13e	<input type="text" value="10,294."/>
13f	Total advances received from filing Form(s) 7200 for the quarter . . . . .	13f	<input type="text" value="."/>
13g	Total deposits, deferrals, and refundable credits less advances. Subtract line 13f from line 13e . . . . .	13g	<input type="text" value="10,294."/>
14	Balance due. If line 12 is more than line 13g, enter the difference and see instructions . . . . .	14	<input type="text" value="1,221."/>
15	Overpayment. If line 13g is more than line 12, enter the difference <input type="text" value="."/> Check one: <input type="checkbox"/> Apply to next return. <input type="checkbox"/> Send a refund.		

If the business never took advantage of the ERTC in 2020 and now in 2021 wants to use the ERTC, you will need to complete **Form 941 X** (Amended 941). If you have multiple quarterly periods that require amending, you can capture and report the entire ERTC on 941 X for the 4<sup>th</sup> Q of 2020. This aligns to the original guidance issued by the IRS – the enactment date of December 27, 2020 falls in the fourth quarter and the 2020 ERTC should be taken on this form. **Make sure to complete Lines 18, 26, 30 and 31 on Form 941 X.**

If you want to get an advance payment for the ERTC, you can also fax-in Form 7200 before submitting Form 941 for the current quarter.

Figure 9 - Applying the ERTC on Form 7200 on a retroactive basis

Part I Tell Us About Your Employment Tax Return	
<b>A</b> Check the box to indicate which employment tax return form you file (or will file for 2020): (1) <input checked="" type="checkbox"/> 941, 941-PR, or 941-SS (2) <input type="checkbox"/> 943 or 943-PR (3) <input type="checkbox"/> 944 or 944(SP) (4) <input type="checkbox"/> CT-1	
<b>B</b> Is this a new business started on or after January 1, 2020? <span style="float: right;"><input type="checkbox"/> Yes <input type="checkbox"/> No</span> If "Yes," skip line C unless you've already filed Form 941, Form 941-PR, or Form 941-SS for at least one quarter of 2020.	
<b>C</b> Amount reported on line 2 of your most recently filed Form 941 (or wages reported on Schedule R (Form 941), column (c), by your third-party payer (see instructions)). If you file a different employment tax return, see instructions. <span style="float: right;">Per 1st Q. 2020</span>	
<b>D</b> Enter the total number of employees you have. See instructions <span style="float: right;">36,720 4</span>	
Part II Enter Your Credits and Advance Requested	
1 Total employee retention credit for the quarter. See instructions	1 12,644
2 Total qualified sick leave wages eligible for the credit and paid this quarter. See instructions	2 -0-
3 Total qualified family leave wages eligible for the credit and paid this quarter. See instructions	3 -0-
4 Add lines 1, 2, and 3	4 12,644
5 Total amount by which you have already reduced your federal employment tax deposits for these credits for this quarter	5 -0-
6 Total advanced credits requested on previous filings of this form for this quarter	6 -0-
7 Add lines 5 and 6	7 -0-
8 <b>Advance requested.</b> Subtract line 7 from line 4. If zero or less, don't file this form. <span style="float: right;">Refund Due</span>	8 12,644

## Worksheet 1

Although not required, the IRS provides Worksheet 1 to help reconcile and calculate the ERTC. Worksheet 1 can be found on Page 20 of the instruction booklet for Form 941. Here is an example of how the worksheet would be used in our previous example:

Figure 10 - Using Worksheet 1 to Calculate ERTC

<b>Step 3. Figure the employee retention credit</b>	
3a Qualified wages (excluding qualified health plan expenses) for the employee retention credit (Form 941, Part 3, line 21)	3a 22,368
3b Qualified health plan expenses allocable to qualified wages for the employee retention credit (Form 941, Part 3, line 22)	3b 2921
3c Add lines 3a and 3b	3c 25,289
3d <b>Retention credit.</b> Multiply line 3c by 50% (0.50)	3d 12,644
3e Enter the amount of the employer share of social security tax from Step 1, line 11	3e 2350
3f Enter the amount of the nonrefundable portion of the credit for qualified sick and family leave wages from Step 2, line 2j	3f -0-
3g Subtract line 3f from line 3e	3g 2350
3h <b>Nonrefundable portion of employee retention credit.</b> Enter the smaller of line 3d or line 3g. Enter this amount on Form 941, Part 1, line 11c	3h 2350
3i <b>Refundable portion of employee retention credit.</b> Subtract line 3h from line 3d and enter this amount on Form 941, Part 1, line 13d	3i 10,294

## Additional Points

Here are some finer points that you should keep in mind:

1. For purposes of determining Gross Receipts, it is preferable to look at Gross Income on the business tax return. Additionally, the method of accounting (cash basis or accrual) chosen on the tax return is the method used for determining gross receipts.



2. The amount of credit taken will reduce the deductible payroll expense reported on the business tax return. In our previous example, we had three (3) employees in 2020 and took \$ 5,000 credit per employee or \$ 15,000 in total. Total payroll expenses for 2020 were \$ 145,800. On the business tax return, you should deduct \$ 130,800 (\$ 145,800 - \$ 15,000).
3. Newly formed businesses in 2020 will have to compare Gross Receipts to Q1 2020 as the base period
4. Per the newly enacted legislation, you may use the preceding quarter (safe harbor) to qualify for Q1 2021. If you qualified in 2020 Q4, you can use this previous quarter as your baseline to qualify right away.
5. Tax exempt organizations qualify and should include donations, contributions and grants as part of gross receipts.
6. If the business is using a payroll service provider including a professional employer organization (PEO)— sometimes referred to as an employee leasing company, then this reporting organization is filing on behalf of the Employer and the employer will include these leased employees for purposes of determining the total full-time employees for the ERTC.
7. Use Form 7200 if there is a need for cash prior to submitting Form 941. Do not turn in a single Form 7200 whereby the requested refund amount is more than 70% of your average quarterly wages during the calendar year 2019.

## Immediate Action Items

You should take certain steps to prepare for the ERTC:

1. Determine if you qualify and start collecting documentation to calculate the ERTC.
2. Notify your payroll service provider and others involved with payroll of your intent to take the ERTC.
3. Seek out advice from a practicing professional, such as a Certified Public Accountant (CPA) or Enrolled Agent (EA) for assistance with the ERTC.

## Helpful Links

IRS ERTC > <https://www.irs.gov/coronavirus/employee-retention-credit>

IRS Form 941 > <https://www.irs.gov/forms-pubs/about-form-941>

IRS Form 941 X > <https://www.irs.gov/forms-pubs/about-form-941-x>

IRS Form 7200 > <https://www.irs.gov/forms-pubs/about-form-7200>

Articles > <https://www.uschamber.com/co/start/strategy/coronavirus-employee-retention-tax-credit-guide> | <https://www.patriotsoftware.com/blog/payroll/coronavirus-payroll-tax-credits/> | <https://www.taxbandits.com/form-7200/form-7200-instructions/> | <https://www.shrm.org/resourcesandtools/hr-topics/benefits/pages/valuing-health-plan-costs-for-payroll-tax-credits-coronavirus.aspx>

YouTube > <https://youtu.be/amYt3YdU82Q> | <https://youtu.be/FKUC9dSfLJs> | <https://youtu.be/mhXnYExyh7Q> | <https://youtu.be/EzI4Rjds03s>

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