KPMG report: Notice 2021-20 provides much anticipated guidance regarding the employee retention credit for 2020

March 5, 2021
Introduction

The IRS on March 1, 2021, released an advance version of Notice 2021-20 to provide guidance on the employee retention credit (“ERC”) with respect to the 2020 calendar year.

Although Notice 2021-20 [PDF 476 KB] (102 pages) formalizes much of the information included in the previously issued frequently asked questions (“FAQs”) available on the IRS website, Notice 2021-20 contains further clarifications of the FAQs by constructing a safe harbor approach while also addressing recent retroactive changes regarding interaction with employers that received a Paycheck Protection Program (“PPP”) loan.

This report highlights some of the more significant clarifications in Notice 2021-20 (the “Notice”).

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Background

Enacted under section 2301 of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136 (“CARES Act”), the ERC provides a refundable payroll credit of 50% of qualified wages paid in 2020 by eligible employers whose business has been affected by COVID-19. An employer is generally considered to be an eligible employer with respect to any calendar quarter (1) for which the operation of the trade or business carried on during calendar year 2020 is fully or partially suspended due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings due to COVID-19; or (2) during the period in which the employer had a significant decline in gross receipts.

For 2020, qualified wages are limited to $10,000 of compensation, including qualified health plan expenses, paid to each employee. Thus, the maximum amount of the credit per employee for wages
paid after March 12, 2020, and before January 1, 2021, is $5,000 (50% x $10,000). For employers who averaged more than 100 full-time employees in 2019, qualified wages are limited to amounts paid for which an employee did not provide services due to circumstances related to the employer’s eligibility for the credit.

In December 2020, the CARES Act was amended by section 206 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, which was enacted as Division EE of the Consolidated Appropriations Act, 2021, Pub. L. 116-260 (“Relief Act”). The Relief Act extends and expands the ERC in a number of different ways, including for example, providing that employers who receive a PPP loan may still qualify for the ERC and codifying that the gross receipts test for a tax-exempt organization is determined under section 6033.1

In an effort to provide assistance regarding the ERC, the IRS on its website following enactment of the CARES Act released FAQs that were updated several times in 2020.2 Other available information related to the ERC as originally enacted includes the Senate Finance Committee FAQs and the Joint Committee on Taxation description of the CARES Act provisions.3

Notice 2021-20

The Notice provides guidance regarding the ERC as it applies to qualified wages paid after March 12, 2020, and before January 1, 2021; however, the Notice generally does not address changes made by the Relief Act for qualified wages paid after December 31, 2020. The Treasury Department and IRS are expected to issue additional guidance related to the modifications made by the Relief Act applicable to calendar quarters in 2021.

The Notice is organized in a question and answer format (“Q/A”) with many of the Q/As substantially mirroring the FAQs previously issued by the IRS. There are, however, important clarifications, as well as safe harbors, contained in the Notice. These are detailed below.4

Full or partial suspension of a trade or business

Similar to the FAQs, Notice 2021-20 continues to rely on the distinction between an essential and nonessential business with updated rules to refine when an essential business may be considered to experience a partial suspension.

Partial suspension of more than a nominal portion of business operations. Under Q/A-11, an essential business may be considered to have a partial suspension of operations if, under the facts and circumstances, more than a nominal portion of its business operations are suspended by a governmental order.5 For purposes of the ERC, a portion of the employer’s business operations will be deemed to constitute more than a nominal portion of the business operations if either:

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1 Read TaxNewsFlash
2 Read TaxNewsFlash (April 2020), TaxNewsFlash (June 2020); and TaxNewsFlash (November 2020).
3 Read the Senate Finance Committee FAQ release and TaxNewsFlash (April 2020)
4 The FAQs on the IRS website have not been updated to reflect the changes contained in Relief Act, but a new legend indicates that guidance for qualified wages paid after March 12, 2020, and before January 1, 2021, is included in the Notice.
5 The term “nominal” is not itself within the ERC provisions of the CARES Act; however, it was utilized in the FAQs and is frequently used in the Notice.
• The gross receipts from that portion of the business operations is not less than 10% of the total gross receipts (both determined using the gross receipts of the same calendar quarter in 2019), or
• The hours of service performed by employees in that portion of the business are not less than 10% of the total number of hours of service performed by all employees in the employer’s business (both determined using the number of hours of service performed by employees for the same calendar quarter in 2019).

**KPMG observation**

Notice 2021-20 provides a safe harbor that may be useful for some employers to determine whether there is a partial suspension. However, there may be a partial suspension based on other facts and circumstances relevant to the particular employer, governmental order, and business operations; and careful review is necessary to determine the effect of the governmental order on business operations.

**Comparable operations.** Although an employer may close its workplace due to a governmental order, if the employer is able to continue comparable operations following the closure (e.g., through telework), then the Notice provides that an employer is generally not considered to have a full or partial suspension of business operations due to a governmental order. The following factors, as provided in Q/A-16, may be relevant:

• The employer’s telework capabilities
• Portability of the employees’ work
• The need for presence in the employees’ physical workspace
• The time necessary to transition to telework operations

With respect to the transition time, the Notice provides that if there is a significant delay (e.g., beyond two weeks) in moving operations to comparable telework (e.g., implementing policies or providing equipment), then the employer’s operations may be deemed partially suspended during the transition period.

**KPMG observation**

The factors contained in Q/A-16 are a non-exhaustive list of factors that may be relevant, and each employer’s business operations may vary such that other facts and circumstances need to be considered and evaluated to determine whether the employer can continue comparable operations through telework. The two-week period appears to present a safe harbor, but it is not clear whether the two weeks is intended to suggest that the delay is measured in the aggregate or based on a continuous period of time.

**Modification to business operations resulting in partial suspension.** If all, or all but a nominal portion, of an employer’s business operations may continue, but the operations are subject to modification, then the modification is a partial suspension of business operations if the modification required by the governmental order has more than a nominal effect on the business operations under the facts and circumstances. See Q/A-17.

The types of modifications contemplated to have more than a nominal effect on business operations are described in Q/A-18 and include, for example, limiting occupancy to allow social distancing, requiring
appointments for service (if the business previously offered walk-in service), changing format (e.g., restrictions on buffet or self-serve) or requiring employees and customers to wear face coverings. Merely making a modification does not result in a partial suspension unless the modification, based on the facts and circumstances, has more than a nominal effect on business operations.

In particular, a reduction in the ability to provide goods or services in the normal course of the employer’s business of not less than 10% is deemed to have more than a nominal effect on business operations. For example, occupancy restrictions at a restaurant with indoor dining may result in more than a nominal reduction of the restaurant’s ability to serve customers, whereas occupancy restrictions at a retailer with sufficient physical space to accommodate customers regardless of the restriction may not result in more than a nominal reduction of the retailer’s ability to provide goods to its customers.

Under the Notice, modifications that alter customer behavior (e.g., requiring masks) or require employees to wear masks and gloves while performing their duties will not result in more than a nominal effect on business operations.

**KPMG observation**

While these examples demonstrate whether a modification may result in more than a nominal effect on business operations, the facts and circumstances related to the application of the governmental order on the particular business operations is relevant. The addition of a 10% safe harbor is a helpful clarification to determine whether there is partial suspension.

**Operation in a consistent manner across jurisdictions.** An employer with business operations in multiple jurisdictions may be subject to governmental orders requiring a full or partial suspension in some, but not all jurisdictions. To operate in a consistent manner in all jurisdictions, the employer may establish a policy that complies with the local governmental orders, as well as the Center for Disease Control and Prevention (“CDC”) recommendations and the Department of Homeland Security (“DHS”) guidance. In this situation, Q/A-20 clarifies that the employer would be an eligible employer with respect to all of its operations in all locations for calendar quarters during which the employer’s operations are partially suspended whether or not the employer voluntarily adopts consistent measures for its business operations in other jurisdictions.

**Significant decline in gross receipts**

**Tax-exempt employers.** For purposes of the ERC, Q/A-25 clarifies that gross receipts for a tax-exempt organization means, as provided under the section 6033 regulations, the gross amount received by the organization from all sources without reduction for any costs or expenses (e.g., cost of goods or assets sold, operation costs, or expenses of raising, earning, or collecting such amounts).

Thus, gross receipts include, but is not limited to:

- The gross amount received as contributions, gifts, grants, and similar amounts without reduction for the expenses of raising and collecting such amounts
- The gross amount of member dues or assessments without reduction for expenses attributable to the receipt of such amounts
- Gross sales or receipts from business activities (including unrelated business activities)
The gross amount received from asset sales without reduction for cost, basis, and sale expenses; and the gross amount received as investment income such as interest, dividends, rents, and royalties.

**Qualified wages**

**Full-time employees.** For purposes of the ERC, a full-time employee is defined as an employee who, in any calendar month in 2019, had an average of at least 30 hours of service per week or 130 hours of service in the month (which is treated as the monthly equivalent of at least 30 hours per week), and the definition is determined in accordance with the Affordable Care Act. See Q/A-31.

**KPMG observation**

The FAQs and Notice continue to describe the meaning of full-time employee as an individual with a specified minimum hours of service and refer to full-time employees as defined under the Affordable Care Act generally. This does not appear to extend one step further to the limited use definition of full-time employees under the Affordable Care Act (which extends to “full-time equivalents” for a limited purpose).

In addition, the average employee calculation used for PPP loan purposes under the CARES Act explicitly refers to full-time equivalent employees and is not calculated the same way as the average full-time employee determination for purposes of the ERC.

**Qualified health plan expenses**

For purposes of the ERC, an employer may treat qualified health plan expenses allocable to the period in which business operations were partially or fully suspended or during which there was a significant decline in gross receipts as qualified wages (up to $10,000 per employee for all calendar quarters in 2020). Example 2, Q/A-41, and Example 3, Q/A-42, clarify that in situations in which the employer lays off or furloughs all employees (but does not treat such employees as terminated for employment tax purposes) and continues to provide health care coverage but does not pay any wages, then a portion of the health plan expenses allocable to the period its operations were partially suspended may be treated as qualified wages for purposes of the ERC.

**KPMG observation**

The additional parenthetical language in Example 2, Q/A-41, and Example 3, Q/A-42, may be intended to clarify that the payment of qualified health expenses in these examples does not represent severance or other post-termination payments. See Q/A-39. However, the implication of the language “for employment tax purposes” in these examples is not entirely clear.

**ERC interaction with PPP loans**

The Notice discusses the interaction of ERC with the PPP, including the changes made in the Relief Act. The Relief Act retroactively amended the CARES Act to provide that an employer that received a PPP
loan could still be eligible for the ERC. Qualified wages for which the employer claims the ERC are excluded from payroll costs paid during the covered period that qualify for forgiveness under the PPP.

An eligible employer can make an election to not take the credit by not claiming the ERC for those qualified wages on its federal employment tax return. Generally, an eligible employer that received a PPP loan is deemed to have made the election for those qualified wages included in the amount reported as payroll costs on a PPP Loan Forgiveness Application. An employer is deemed to have made the election for the amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application sufficient to support the amount of the PPP loan that is forgiven. Of course, if qualified wages are reported as payroll costs and the loan amount is not forgiven, those qualified wages may be taken into account for purposes of the ERC.

**KPMG observation**

At the time taxpayers were submitting these forgiveness applications, there was no consideration of whether payroll costs could also be qualified wages for the ERC. Many taxpayers solely listed payroll expenses as a short-cut on the PPP Loan Forgiveness Application, as payroll costs were well in excess of the amount needed to report, so no other eligible expenses were disclosed. If no other eligible expenses were provided on the PPP Loan Forgiveness Application, then payroll costs that might otherwise have been eligible for the ERC are no longer considered qualified wages. As of March 5, 2021, there does not appear to be any means of amending a PPP Loan Forgiveness Application to list additional eligible expenses. Based on the Notice, taxpayers are bound by the amounts disclosed on the PPP Loan Forgiveness Application, which may reduce the amount of qualified wages available for ERC purposes.

If an employer has not yet applied for forgiveness of the PPP loan, the collateral impact to the ERC needs to be considered in determining how to complete the relevant PPP Loan Forgiveness Application (e.g., including all other eligible expenses in addition to payroll costs).

The Notice provides a variety of detailed examples in Q/A-49 on the ERC and PPP loan interaction as follows:

**Example 1**: Employer A received a $100,000 PPP loan and was required to report a total of $100,000 of payroll costs and other eligible expenses (and a minimum of $60,000 of payroll costs) on the PPP Loan Forgiveness Application to receive forgiveness of the entire loan. Employer A reported $100,000 of payroll costs (which would have been qualified wages under the ERC) and no other eligible expenses on the PPP Loan Forgiveness Application. Employer A is deemed to have made an election not to take into account $100,000 of the qualified wages for purposes of the ERC.

**Example 2**: Employer B received a $200,000 PPP loan. Employer B was required to report a total of $200,000 of payroll costs and other eligible expenses (and a minimum of $120,000 of payroll costs) to receive forgiveness of the entire loan. Employer B reported $250,000 of qualified wages as payroll costs and no other eligible expenses on the PPP Loan Forgiveness Application. Employer B is deemed to have made an election to not take into account $200,000 of the qualified wages for ERC purposes. However, Employer B is not treated as making a deemed election for the $50,000 in excess of what was required to be reported.
Example 3: Employer C received a PPP loan of $200,000. Employer C was required to report a total of $200,000 of payroll costs and other eligible expenses (and a minimum of $120,000 of payroll costs) to receive forgiveness of the entire loan. Employer C reported $200,000 of qualified wages as support for forgiveness but failed to report its $70,000 of other eligible expenses. Employer C is deemed to have made an election not to take into account $200,000 of qualified wages for purpose of the ERC. Employer C cannot reduce the deemed election by the amount of other eligible expenses it could have reported on the PPP Loan Forgiveness Application.

Example 4: Same facts as in Example 3 (above), but Employer C reported $200,000 of qualified wages and also reported $70,000 of other eligible expenses in support of forgiveness of the PPP loan. Employer C is deemed to have made an election not to take into account $130,000 of qualified wages for purposes of the ERC, which is the amount included in the reported payroll costs up to (but not exceeding) the minimum amount of payroll costs, together with other eligible expenses, sufficient to support the amount of the loan forgiven.

Example 5: Same facts as Example 4 (above), but Employer C reported $90,000 of other eligible expenses. Employer C is deemed to have made an election not to take into account $120,000 of qualified wages for purposes of the ERC. $80,000 of the qualified wages reported as payroll costs may be treated as qualified wages for ERC purposes.

Example 6: Employer D received a PPP loan of $200,000. Employer D was required to report a total of $200,000 of payroll costs and other eligible expenses (and a minimum of $120,000 of payroll costs) to receive forgiveness of the entire loan. Employer D submitted a PPP Loan Forgiveness Application reporting $130,000 of payroll costs and $70,000 of other eligible expenses. Employer D can demonstrate that the payroll costs consist of $100,000 of payroll costs that are not qualified wages and $30,000 that are qualified wages. Employer D is deemed to have made an election not to take into account $30,000 of qualified wages for purposes of the ERC. Employer D is not deemed to have made an election with respect to qualified wages that were not included in the payroll costs reported on the PPP Loan Forgiveness Application.

Example 7: Same facts as Example 6 (above), but Employer D’s loan is not forgiven. The $30,000 of qualified wages reported as payroll costs on the PPP Loan Forgiveness Application may be treated as qualified wages for purposes of the ERC.

Claiming the ERC

The Notice largely follows the previously released FAQs with some tweaks related to the interaction between the ERC with PPP loans.

Election not to take into account qualified wages. An eligible employer with a PPP loan, as discussed in Q/A-56, is deemed to have made an election not to take qualified wages into account for ERC purposes if such wages are included in the payroll costs reported on a PPP Loan Forgiveness Application, up to the minimum amount of payroll costs together with eligible expenses, sufficient to support the amount of the PPP loan that is forgiven. See also Q/A-49.

Claiming the ERC for a past quarter. An employer may file a refund claim or make an interest-free adjustment by filing Form 941-X, Adjusted Employer’s Quarterly Federal Tax Return or Claim for Refund, for a past quarter to claim the ERC with respect to qualified wages paid in that past quarter. For an employer that received a PPP loan, but did not claim the ERC, Q/A-57, Example 2, clarifies that the employer may file Form 941-X in a timely manner to claim the ERC, but only for qualified wages for which no deemed election was made.
Special fourth quarter rule and PPP loans. If an employer received a PPP loan and reported qualified wages paid in the second and/or third quarter of 2020 as payroll costs on its PPP Loan Forgiveness Application, but the loan was not forgiven under section 7A(g) of the Small Business Act, then the eligible employer may claim the ERC on those wages, as well as any qualified health plan expenses, on the fourth quarter Form 941. To use this special fourth quarter rule, Q/A-58 describes the particular steps an employer should take to claim the ERC on the original fourth quarter Form 941, while also indicating that the employer may use Form 941-X to make an interest-free adjustment or claim a refund for the appropriate quarter.

KPMG observation
These Q/As provide much-needed guidance for employers who may be eligible to claim the ERC following the changes to the ERC provisions of the CARES Act made by the Relief Act.

Other issues

Deduction disallowance. Consistent with section 2301(e) of the CARES Act and the prior FAQs, Q/A-60 provides that the employer’s deduction for qualified wages, including qualified health plan expenses, is reduced by the amount of the ERC. However, Q/A-60 clarifies that an employer does not reduce its deduction for the employer’s share of social security and Medicare.

KPMG observation
Tax professionals understand some employers may have reduced employment tax-related deductions rather than the deduction for general salaries and wages. For federal income tax returns, the impact may be neutral as to reducing wage or employment tax-related deductions, but this can have unintended state tax consequences if treated as a reduction to employment taxes rather than a reduction to the deduction for salary and wages. Employers should carefully evaluate the approach for tax purposes and the collateral impact.

In addition, the section 280C(a) deduction add back appears to track the tax year related to the relevant ERC such that an employer applying for the credit after filing its tax return may need to amend its related tax return if later claiming the ERC for wages included in the earlier return. For example, a taxpayer that previously received a PPP loan has already filed its 2020 tax return. However, because of the retroactive eligibility related to the PPP loan participants, the taxpayer is only now quantifying and claiming an ERC related to wages previously reported and deducted on its 2020 tax return. In this situation, it appears such taxpayer would need to amend its related 2020 tax return to reduce the wage deduction by the amount of the related ERC.

Substantiation. In describing information that a third-party payor must obtain from client employers, Q/A-66 indicates that the third-party payor must obtain information from the client employer necessary to accurately claim the ERC on the client’s behalf. Either the third-party payor or the client employer should maintain appropriate documentation substantiating eligibility for the ERC. See Q/A-67. Adequate substantiation, as described in Q/A-70, includes the following:

- Documentation showing how the employer determined it was an eligible employer that paid qualified wages, including governmental orders suspending business operations; records used to determine
more than a nominal portion of its operations were suspended or whether a governmental order had more than a nominal effect on its business operations; records showing a significant decline in gross receipts; records showing employees received qualified wages and the amounts; and documentation showing wages were paid for not performing services (if a large employer)

- Documentation showing how the employer determined the amount of allocable qualified health plan expenses
- Documentation showing how the employer applied the aggregated group rules and allocation of the ERC
- Copies of Forms 7200 (if any) filed with the IRS
- Copies of relevant employment tax returns

Employers are urged to retain documentation substantiating the ERC for at least four years after the later of the date the employment taxes become due or are paid. See Q/A-71.

KPMG observation

Due to the complexity of the analysis involved in determining whether an employer is an eligible employer paying qualified wages for purposes of the ERC, employers will want to consider how to document the analysis as well as retain appropriate documentation to support the claim for the ERC.

Conclusion

As a result of the expansion of the ERC due to the Relief Act, many employers may be reconsidering whether to claim the ERC for qualified wages paid in 2020 and/or 2021. The Notice provides employers with guidance that may be relied upon when evaluating eligibility for the ERC, determining qualified wages, and claiming the ERC. However, there are a number of areas in which additional guidance would be welcome including, for example, the impact of a disposal of assets on the gross receipts test; whether there are situations in which leave earned while not working may be treated as qualified wages; and additional guidance on the aggregation rules for related groups.

As many situations may involve nuanced facts requiring a detailed analysis of the particular situation, employers may want to seek assistance from a qualified tax advisor to determine the application of the ERC rules contained in the Notice, substantiate their position, and claim the ERC.
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