
The Section 2301 Employee Retention Credit gets a little bit complicated once you dig into the details.

But if you're a small business owner, you want to learn how this credit works. The credit may be one of the key tools you use to work your way through the COVID-19 crisis.

Furthermore, the money available through the employee retention credit? Yeah, that money may be the fastest cash you receive. Maybe even available in a few days or so. (I'm thinking about the first quarter's payroll returns due soon.)

But let's dig in to the details.

The Section 2301 Formula in a Nutshell

At a high level, the Section 2301 formula works pretty simply. For eligible employers paying qualified wages, the formula works like this:

Employee Retention Credit = (Qualified wages + Qualified Health Plan Expenses) x 50%

Let me provide three quick examples to show you how this works...

Example 1: Suppose you pay an employee $1,000 of qualified wages. You get a credit equal to 50% or $500.

Another example because, in many situations, employers also provide health insurance which plugs into the formula...

Example 2: Suppose you pay an employee $1,000 of qualified wages and also provide $500 of qualified employee health insurance. In this case you get a credit equal to 50% of $1,500 or $750.

Another wrinkle: Section 2301 essentially limits the employee retention credit to $5,000 because the formula looks only at the first $10,000 of qualified wages and health plan expenses.

Example 3: Your firm employs two workers. One worker you pay $10,000 in wages. And for him, you receive a $5,000 employee retention credit. A second worker you pay $20,000 in wages. And for her, you also receive a $5,000 employee retention credit.

Collecting the Cash

Okay, a key question: How do you get this cash? And how quickly can you get it?

The employee retention credit goes on your employment tax returns. Presumably on those quarterly 941 forms you file (or your payroll service files) at the end of the quarter.

Further, the credit works as a refundable credit. That means—and we need to wait for some of the details on this—that you don't just get to reduce your employment taxes to zero. You can even use the credits to get a refund of taxes you haven't even actually paid.

The bottom-line: Once the IRS figures out the mechanics, this should be easy and fast.

Eligibility Requirement #1: You Were in Business

Tax law sets out three eligibility requirements for employers who want to use the Section 2301 employee retention credit.

The first eligibility requirement that all employers must meet? Carrying on a trade or business during calendar year 2020. You don't get an employee retention credit if you don't "retain" employees and don't continue operating during the 2020 COVID-19 crisis.

This makes sense. Congress provides this generous credit to subsidize employers who continue to operate.

Eligibility Requirement #2: You Were Disrupted

The second eligibility requirement looks at whether or not a business has been disrupted. And one of two "disruption" tests need to be met:

The first "disruption" test? An appropriate governmental authority must issue orders "limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to the coronavirus 2019 (COVID-19)."

Example 4: In Washington state where I work, for example, our governor issued orders that all non-essential businesses should close on March 23, 2020 through at least April 6, 2020. (See here if you're interested.) A bunch of businesses including restaurants, bars, athletic clubs, and any other business where large groups congregated got shut down. That decree from the governor counts as an "order." Affected employers are disrupted and therefore eligible for the credit for at least that time interval.

The second "disruption" test? If gross receipts for the quarter equal less than 50% of the gross receipts for the same quarter in 2019.

Example 5: Suppose you run a trucking service that delivers food to grocery stores and restaurants in Washington state. Food distribution firms (like a trucking company delivering food to grocery stores) don't need to suspend operations. But government orders closing restaurants and bars due to COVID-19 would surely damage your business. If your firm generated less than $50,000 of gross receipts in the first quarter of 2020, but generated $100,000 or more of gross receipts in the first quarter of 2019, you qualify for the employee retention credit.

An important point about the second test: A firm eligible due to a 50 percent drop in quarterly revenue loses its eligibility the quarter *after* its quarterly revenues exceed 80% of the revenues for the same calendar quarter in the prior year.

One other note: You would probably (possibly?) use both tests described above. The goal would be to have enough eligibility that your firm accumulated $10,000 of qualified wages for each employee.

Eligibility Requirement #3: No "Small Business Interruption" Loan

A third eligibility requirement exists, too. That rule? If an eligible employer receives a small business interruption loan, also known as a "paycheck protection program" loan, that employer loses eligibility for the employee retention credit.

Specifically, the statute says this, "If an eligible employer receives a covered loan under paragraph 36 of section 7(a) of the Small Business Act (15 U.S.C. 636 (a)), as added by section 1102 of this act, such employer shall not be eligible for the credit under this section."

Note: Just so you know, this loan program basically provides you with free money if you meet the requirements. And no, I am not kidding. (I've got a blog here that explains how to get one of these loans: Paycheck Protection Program Loan: A Small Business Life Saver.)

Qualified Wages

The 50% employee retention credit applies to qualified wages and qualified health plan expenses. What counts, however, as "qualified wages" depends on the size of the employer organization. Furthermore, not everything you might guess counts actually "counts."

Employers with more than 100 Employees

If the average number of full-time employees employed by your firm during 2019 exceeds 100, qualified wages refer to amounts paid to employees not providing services due to COVID-19.

Note: Section 2301 uses the "Obamacare" definition of "full-time employee"... so someone "employed on average at least 30 hours of service per week."

Example 6: Again, suppose you operate a trucking company that historically delivers food both to grocery stores and restaurants. Assume that half of your drivers deliver food to grocery stores (essential businesses that continue to receive food deliveries) and half the drivers deliver to restaurants (deemed nonessential businesses which suspend food deliveries due to the COVID-19 crisis.) If you continue to a pay wages to truck drivers who used deliver food to restaurants, those wages count as "qualified wages for" purposes of the employee retention credit formula.

Example 7: Assume the same facts as in example 6 but with one twist: You furlough or layoff all of the truck drivers who previously delivered food to restaurants. In this case, your firm pays no qualified wages. The wages paid to the truck drivers delivering food to grocery stores don't count. You don't get an employee retention credit.

Employers with 100 or Fewer Employees

The "qualified wages" accounting works differently for employers with 100 or fewer employees.

For these employers, all wages paid while the firm maintains eligibility count as qualified wages.

Example 8: Assume one last time you operate an "eligible" trucking company that delivers food both to grocery stores, (an essential business) and to restaurants (a nonessential business). Say that economic conditions require you to lay off all of your truck drivers who deliver food to restaurants. But say you continue to employ the shop employees and the truck drivers delivering food to grocery stores. In this case you get to take the employee retention credit on all of the wages your firm pays. You don't lose the credit because you couldn't continue to employ everyone.

The Limitation and "Look Back" Rules for Qualified Wages

Two rules to note: First, the employee retention credit doesn't include as "qualified wages" sick leave or family leave provided by Section 7001 or Section 7003 of the Families First Coronavirus Response Act.

Second, Section 2301 limits qualified wages based on the pay rate the employee earned in the preceding 30 days. Essentially, qualified wages may not exceed the amount an employee was paid for work during the 30 days immediately preceding eligibility.

Example 9: An employee earns $20 an hour of qualified wages during a month your firm is eligible for the employee retention credit. However, in the preceding month the employee earned $10 an hour for the same work. In this situation, only $10 an hour of the employee's wages paid during the period of eligibility count as qualified wages. Not the entire $20 an hour.

Qualified Health Plan Expenses

One final thing to mention. Qualified wages, per section 2301, include "an eligible employer's qualified health plan expenses."

More specifically, qualified health plan expenses include amounts paid or incurred by an employer to provide and maintain a group health plan (as defined in section 5000(b)(1) of the Internal Revenue Code), but only to the extent such amounts are excluded from the gross income of employees by reason of section 106(a) of the tax code.

Note: Qualified health plan expenses therefore do not include self-employed health insurance such as an S corporation shareholder employee might receive.

The Section 2301 statute doesn't specify how you're supposed to allocate or calculate what "qualified health plan expenses" count as wages. And the law directs the Secretary of Treasury to provide rules for doing this. But presumably, you can (and will need to) use some sort of common-sense pro rata allocation works.

Other Resources You Might Find Useful

Interested in more practical information about COVID-19 and your small business?

We did a quick overview of the small business tax breaks included with the CARES act earlier this week here: COVID-19 Small Business Tax Breaks

And then last week, we did a post about redoing your business plan for this Corona Virus thing: Small Business Survival Guide to the Corona Virus Crisis.