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Claiming the Credit: IRS Issues Guidance on Tax Credits under Families First Coronavirus Response Act

Legal Update

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In addition to the Department of Labor recently-issued temporary rule (discussed in our article “What Employers Need to Know About New DOL Temporary Rule Implementing the Families First Coronavirus Response Act”), the IRS released FAQs to help explain the tax credits offered in conjunction with the Emergency Paid Sick Leave Act (EPLSA) and Emergency Family and Medical Leave Expansion Act (EFMLEA) leave requirements. These credits are available to employers (whether for-profit, non-profit, or self-employed) with fewer than 500 employees, to the extent they have provided EPLSA and EFMLEA leave wages. The IRS FAQs describe the types of paid sick and family leave wages for which eligible employers can receive tax credits, the general parameters of the credits, how an eligible employer can actually receive money and the steps that employers must take to claim and substantiate their claims for credits.

How are the leave payments taxed to the employee?

While the eligible employer may be able to recoup their costs through tax credits, leave wage payments are taxable wages to the employees. In a sense, they are no different than normal compensation, taxes and applicable benefit plan costs (including, for example, retirement plan deferrals or health plan premiums) should be withheld. For purposes of employer withholding, the EPLSA and EFMLEA leave wages are not subject to the *employer portion* of the Old Age, Survivors and Disability Insurance Tax (i.e. Social Security tax), but they are subject to Medicare tax.

What costs can be recouped through tax credit?

Both the EPLSA and EFMLEA leave obligations have corresponding fully refundable (assuming all obligations are met) tax credits that enable an eligible employer to claim a credit for 100 percent of:

- the cost of the leave wage payments (in excess of the employer’s pre-existing paid leave benefits),

- qualified health plan expenses allocable to those leave wages, and
- the eligible employer's share of Medicare taxes on those leave wages.

The credit only applies to leave wages paid between April 1, 2020, and December 31, 2020. In addition, if a credit is claimed for these leave wages, the employer cannot double dip by claiming the Internal Revenue Code Section 45S tax credit (Employer Credit for Paid Family and Medical Leave) on the same wages. This does not prevent an employer from taking both credits if the 45S credit is for wages in excess of the EPSLA and EFMLEA leave credits.

The qualified health plan expenses definition is broad and should contain employer-sponsored medical plans (both insured and self-funded), most Health Reimbursement Arrangements (HRAs), dental plans, vision plans, pharmacy plans, health Flexible Spending Account (FSAs) and others. It does not include employer contributions to a Qualified Small Employer HRAs, Archer MSA or Health Savings Accounts (HSAs). Note that the allocation of qualified health plan expenses is complex, and employers should work with advisors to ensure that full advantage can be taken of this portion of the credit.

Eligible self-employed individuals can also utilize paid sick and family leave wages and are allowed an income tax credit to offset their federal self-employment tax for any taxable year equal to their "qualified sick leave equivalent amount" or "qualified family leave equivalent amount." These concepts, as well as the process for claiming the income tax credit, are discussed more thoroughly in the IRS FAQs.

How does an eligible employer claim the tax credit?

The credit itself is claimed on an eligible employer's quarterly Form 941 tax returns. The credit is claimed against the federal employment taxes (i.e. Social Security and Medicare taxes) owed by the employer. For employers that use third party payers, such as a Professional Employer Organization (PEO), to pay their employees and do not file a Form 941, there is a specific process to enable the third party to claim the credit on the eligible employer's behalf.

As an advance on receiving the credits (which would otherwise only be recognized in quarterly returns), eligible employers can fund the EPSLA and EFMLEA leave wages (and allocable qualified health plan expenses and the eligible employer's share of Medicare tax on the qualified leave wages) by accessing federal employment taxes related to wages paid between April 1, 2020, and December 31, 2020, including withheld taxes, that would otherwise be required to be deposited with the IRS. This means eligible employers can retain the federal employment taxes that otherwise would have been deposited, including federal income tax withheld from employees, the employees' share of Social Security and Medicare taxes, and the eligible employer's share of Social Security and Medicare taxes with respect to all employees. Note that this does not include state income taxes or withholdings for benefit plans.

If an eligible employer does not have enough federal employment taxes set aside for deposit to cover its obligation to provide EPSLA and EFMLEA leave wages (and allocable qualified health plan expenses and the employer's share of Medicare tax on the qualified leave wages), the employer may request an advance of the credits by completing Form 7200, Advance Payment of Employer Credits Due to COVID-19. The eligible employer will account for the amounts received as an advance when it files its quarterly Form 941. If federal employment taxes owed by the employer are not enough to cover the credit, the employer may be entitled to a refund for that excess.

How should an employer document and substantiate the credit?

Written Leave Requests

Unlike the Department of Labor guidance that permits oral notice for paid leave, to claim the tax credits, an employer must receive a written request from the employee leave that provides:

- the employee's name;
- the date or dates for which leave is requested;
- a statement of the COVID-19-related reason the employee is requesting leave and written support for such reason; and
- a statement that the employee is unable to work, including by means of telework, for such reason.

In the case of a leave request based on a quarantine order or self-quarantine advice, the statement from the employee should include:

- the name of the governmental entity ordering quarantine or the name of the health care professional advising self-quarantine, and
- if the person subject to quarantine or advised to self-quarantine is not the employee, that person's name and relation to the employee.

In the case of a leave request based on a school closing or childcare provider unavailability, the statement from the employee should include:

- the name and age of the child (or children) to be cared for,
- the name of the school that has closed or place of care that is unavailable, and
- a representation that no other person will be providing care for the child during the period for which the employee is receiving family medical leave.
- With respect to the employee's inability to work or telework because of a need to provide care for a child older than fourteen during daylight hours, a statement that special circumstances exist requiring the employee to provide care must also be included.

Employer Record Keeping

To fully substantiate the tax credit, employers must maintain internal records that include the following information in addition to written leave requests:

- documentation to show how the employer determined the amount of qualified sick and family leave wages paid to employees that are eligible for the credit, including records of work, telework and qualified sick leave and qualified family leave
- documentation to show how the employer determined the amount of qualified health plan expenses that the employer allocated to wages
- copies of any completed Forms 7200, Advance of Employer Credits Due To COVID-19, that the employer submitted to the IRS
- copies of the completed Forms 941, Employer's Quarterly Federal Tax Return, that the employer submitted to the IRS (or, for employers that use third party payers to meet their employment tax obligations, records of information provided to the third-party payer regarding the employer's entitlement to the credit claimed on Form 941)

Employers should keep all of these records for at least four years after the date the employment tax becomes due or is paid, whichever comes later.

How do these credits interact with the CARES Act?

The Coronavirus Aid, Relief and Economic Security Act (CARES Act) also offers several incentive programs for employers to maintain employees on payroll. The IRS FAQs mention two in particular:

- There is a new employee retention credit equal to 50 percent of qualified wages (including allocable qualified health plan expenses) paid to employees after March 12, 2020, and before January 1, 2021, up to \$10,000 in qualified wages for each employee for all calendar quarters. However, the qualified wages for the employee retention credit do not include the amount of EPLSA and EFMLEA leave wages for which the employer received tax credits under the FFCRA. Both credits can be taken, but not on the same dollars.
- The Payroll Protection Program permits employers to obtain forgivable loans to fund payroll through as late as June 30, 2020. However, if an eligible employer receives tax credits for EPLSA and EFMLEA leave wages, those leave wages will not be considered "payroll costs" for purposes of loan forgiveness. In other words, while an eligible employer may take advantage of both loan forgiveness and tax credits on leave payments, there is no ability to use both on the same dollars.

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The IRS also plans to issue more guidance on the CARES Act programs in the short term. The legal landscape regarding employer paid leave is shifting rapidly in the current environment. Feel free to contact your Fredrikson & Byron attorney for help navigating the changes.