Chapter 6: Small Business Issues

Please note. Corrections were made to this workbook through January of 2022. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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COORDINATION OF COVID-19 SMALL BUSINESS BENEFITS

Since the COVID-19 pandemic outbreak in 2020, Congress has enacted various legislation to combat the related economic fallout. Relevant legislation includes the Families First Coronavirus Response Act[1] (FFCRA), the Coronavirus Aid, Relief, and Economic Security (CARES) Act[2], the Consolidated Appropriations Act of 2021[3] (CAA), the American Rescue Plan Act[4] (ARPA), as well as numerous interpretative procedural bulletins issued by the IRS and the Small Business Administration (SBA). Understanding how each relief measure works and its relationship with other relief programs can be daunting.

Note. The information provided is from the most recent rulings and procedural announcements issued. It includes no comparison to the original provisions and no explanation of how actions and interpretations issued after their introduction may have altered any of the programs illustrated.

EMERGENCY ECONOMIC INJURY DISASTER LOANS (EIDL)[5]

The SBA EIDL program was a direct lending provision from SBA that allowed for borrowing at reduced interest rates. The loans are not forgivable, but payment deferral for 18 months is available, although interest continues to accrue. Maximum borrowing was $2 million per business. Loan proceeds were to be used to meet financial obligations and operating expenses that the business could not meet because of the COVID-19 pandemic.

Eligible Recipient[6]

The EIDL program enables businesses, cooperatives, and agricultural entities with 500 or fewer employees to be eligible for loans. Sole proprietors, independent contractors, most nonprofit organizations, and faith-based organizations are also eligible for EIDL loans.

Coordination with Other Relief Benefits

A business that obtained an EIDL loan can also receive funds from a Paycheck Protection Program (PPP) loan (discussed later). However, the PPP and EIDL cannot be used for the same expenses.[7] EIDL borrowers could also qualify for the employee retention credits (ERC) (discussed later).[8]

FIRST DRAW PPP LOANS[9]

Created by the CARES Act, private lenders made first draw PPP loans, which the SBA guaranteed. The first draw PPP loans covered payroll and specific operating expenses (such as mortgage interest, rent, utilities, worker protection costs, uninsured property damage, supplier costs, expenses for operations) for 24 weeks from February 15, 2020, through June 30, 2020 (the "covered period"). First draw loans were available through May 31, 2021. The loans were eligible for forgiveness, subject to specific rules.

1. *Families First Coronavirus Response Act,* PL 116-127.
2. *CARES Act,* PL 116-136.
3. *Consolidated Appropriations Act of 2021,* PL 116-260.
4. *American Rescue Plan Act,* PL 117-2.
5. *Economic Injury Disaster Loans*. Benefits.gov. [www.benefits.gov/benefit/1504] Accessed on Jun. 22, 2021.
6. *Frequently Asked Questions COVID-19 Economic Injury Disaster Loan (EIDL).* Apr. 27, 2021. SBA. [www.sba.gov/sites/default/files/2021-05/COVID-19%20EIDL%20FAQs_FINAL-508.pdf] Accessed on Jul. 21, 2021.
7. *CARES Act,* PL 116-136, §1102(b); see also *Cross-program eligibility on SBA COVID-19 relief options*. SBA [www.sba.gov/funding-programs/loans/covid-19-relief-options/cross-program-eligibility-sba-covid-19-relief-options] Accessed on Jul. 30, 2021.
8. *CARES Act,* PL 116-136, §1102, amending *Small Business Act,* 15 USC 636(a), §7(a)(2)(Q).
9. *CARES Act,* PL 116-136, §1102; *First Draw PPP Loan.* SBA. [www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/first-draw-ppp-loan] Accessed on Jul. 21, 2021.

Eligible Recipient

Eligible recipients for the first draw PPP loans included the following.

- Sole proprietors
- Independent contractors
- Self-employed persons
- Small businesses that meet SBA size standards

> **Note.** More information on the SBA size standards can be found at **uofi.tax/21b6x2** [www.sba.gov/federal-contracting/contracting-guide/size-standards].

- Various nonprofit businesses with the greater of 500 employees or that meet the SBA industry size standard if they have more than 500 employees
- Accommodations and food service businesses with more than one physical location and less than 500 employees per location

Coordination with Other Relief Benefits[10]

The original IRS interpretation of the CARES Act precluded PPP recipients from also receiving ERC credits. Under the CAA, PPP recipients are permitted the ERC if the two programs are not applied to the same benefits. PPP loan forgiveness is not available for payroll costs that the borrower used to receive the ERC, emergency paid sick leave credit or emergency family and medical leave expansion Act (FMLA) credit. First draw PPP loan borrowers could also apply for other SBA programs if the funds were not used for the same purpose or EIDL loans.

> **Note.** For self-employed borrowers with no employees, the original determining factor in calculating the eligible PPP loan amount was the net profit of the sole proprietor. The SBA Interim Final Rule (IFR)[11] clarified that sole proprietors could use their gross revenue to calculate the maximum amount of PPP borrowing for which they might qualify. While borrowers could not adjust first draw PPP borrowing already in place, the SBA IFR provided opportunities for sole proprietors to borrow more money in the PPP second draw program.
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> This limitation did not apply to self-employed farmers filing Schedule F, *Profit or Loss From Farming*. For more information, see the 2021 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 5, Agricultural and Rural Investment Issues.

SECOND DRAW PPP LOANS[12]

Under the CAA, the PPP second draw loan program provided eligible recipients that previously received a PPP loan with an additional loan that had the same general terms as the first draw loan. As with first draw loans, the borrowing covered up to 24 weeks of payroll and select operating expenses. The program's funding ran out on May 31, 2021.

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10. *Consolidated Appropriations Act of 2021,* PL 116-260, §206(c), Div. EE, amending *CARES Act,* PL 116-136, §2301.
11. 13 CFR Part 120.
12. *Consolidated Appropriations Act of 2021,* PL 116-260, §311, Div. N; *Paycheck Protection Program Second Draw Loans.* U.S. Treasury. [home.treasury.gov/system/files/136/Top-line-Overview-of-Second-Draw-PPP.pdf] Accessed on Jul. 22, 2021.

Eligible Recipient

Businesses are eligible for a second draw loan if they previously received a first draw loan and have no more than 300 employees. This includes sole proprietors, independent contractors, and gig economy workers. It leaves out businesses with more than 300 employees but fewer than 500 employees, such as those who qualified for first draw loans. Any first draw loan proceeds must have been exhausted on authorized uses for the borrower to qualify for second draw loans. The borrower must have demonstrated a 25% reduction in gross receipts in any quarter of 2020 compared with the same quarter in 2019. Different rules applied if the business was not in operation for the entirety of 2019.

Coordination with Other Relief Benefits[13]

PPP second draw loan recipients may also receive ERC benefits. Second draw loan recipients may qualify for loan forgiveness but may not use the same qualifying expenses as those used for the ERC, emergency paid sick leave credit or emergency FMLA credit they use to qualify for second draw loan forgiveness.

Practitioner Planning Tip

The CAA clarified that expenses paid with forgiven PPP loan proceeds may still qualify for a tax deduction.[14] The IRS provided further guidance and a safe harbor provision for 2020 returns already filed.[15] If the expenses paid with forgiven PPP proceeds were not deducted on the 2020 return, the taxpayer may elect to include the omitted deductions when filing their 2021 return. When to use the safe harbor provision may provide a planning opportunity for practitioners with their clients.

ERC FOR 2020[16]

The ERC was designed to cover costs of eligible businesses that retained employees on the payroll during the COVID-19 pandemic. In 2020, the credit is a refundable credit taken against the employer's share of social security taxes.

Eligible Recipient

Employers that meet one of the following requirements are eligible for the ERC.

- Their operations were wholly or partially shut down due to government order.
- They experienced a significant decline in gross receipts that was greater than 50% for any quarter in 2020 compared with the same quarter in 2019.

The credit is equal to 50% of the qualified wages paid from March 13 through December 31, 2020. The amount of wages considered per employee for the credit is $10,000 **for the calendar year.**

13. *Consolidated Appropriations Act of 2021,* PL 116-260, §206(c), Div. EE, amending *CARES Act,* PL 116-136, §2301.
14. *Consolidated Appropriations Act of 2021,* PL 116-260, §276, Div. N, amending *CARES Act,* PL 116-136, §1106(i).
15. Rev. Proc. 2021-20, 2020-50 IRB 1552.
16. *Consolidated Appropriations Act of 2021,* PL 116-260, §§206 and 207, *Employee Retention Credit.* Apr. 15, 2021. IRS. [www.irs.gov/coronavirus/employee-retention-credit] Accessed on Jul. 22, 2021.

The definition of qualified wages depends on the number of employees in 2019.

- **100 employees or fewer**. All payroll issued to employees is included in qualified wages, regardless of their ability to work due to a partial or complete shutdown or a significant decline in gross revenue due to COVID-19.
- **More than 100 employees**. The law only considers qualified wage amounts paid to employees who are not working due to the business being partially or entirely shut down or that experienced a significant reduction in gross receipts as qualified wages.

Safe Harbor. On August 10, 2021, the IRS released Rev. Proc. 2021-33.[17] It contains **a safe harbor provision for determining gross receipts** in the calculations required for the ERC. Taxpayers utilizing the safe harbor may **exclude** the following from gross receipts.

- The amount of PPP forgiven loans
- Shuttered Venue Operators Grants under the Economic Aid to Hard-Hit Small Businesses, Non-Profits, and Venues Act
- Restaurant Revitalization Grants under the ARPA

The Rev. Proc. explains that an employer elects to apply the safe harbor simply by excluding amounts from the listed programs to determine if they are an eligible employer for a calendar quarter for the ERC.

Employers must apply the safe harbor consistently for determining ERC eligibility by excluding amounts from the listed programs mentioned from their gross receipts for each calendar quarter in which gross receipts are used to determine ERC eligibility. The employer claiming the credit must apply the safe harbor to all employers treated as a single employer under the aggregation rules.

An employer is not required to use the safe harbor, and the Rev. Proc. explains the safe harbor does not permit the exclusion from gross receipts amounts from the listed programs for any other federal tax purpose.

The Rev. Proc. is intended to update and provide clarification for IRS Notice 2021-20[18] regarding ERC calculations for qualified wages paid after March 12, 2020 and before January 1, 2021; IRS Notice 2021-23[19] addressing ERC calculations for qualified wages paid after December 31, 2020 and before July 1, 2021; and IRS Notice 2021-49,[20] which addresses ERC calculations for qualified wages paid after June 30, 2021 and before January 1, 2022.

Qualified Wages for Related Parties. Wages paid to parties related to a greater than 50% owner do not qualify for the ERC.[21] The CARES Act refers to IRC §§51(i)(1) and 280C(a) for the definition of qualified wages. IRC §51(i)(1)(A) attempts to define related parties by referencing IRC §§152(d)(2)(A) through (G) to define applicable relationships to the taxpayer.[22]

- A child or a descendant of a child
- A brother, sister, stepbrother, or stepsister
- The father or mother or an ancestor of either
- A stepfather or stepmother
- A son or daughter of a brother or sister of the taxpayer
- A brother or sister of the father or mother of the taxpayer
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

17. Rev. Proc. 2021-33, 2021-34 IRB 327.
18. IRS Notice 2021-20, 2011-11 IRB 922.
19. IRS Notice 2021-23, 2021-16 IRB 1113.
20. IRS Notice 2021-49, 2021-34 IRB 316.
21. IRS Notice 2021-20, 2021-11 IRB 922.
22. IRC §§152(d)(2)(A)-(G).

The wages of employees who have a previously listed relationship to the business owner (greater than 50% owner) are not qualified wages for ERC purposes.

The IRS states that the definition of a greater than 50% owner includes individuals who **directly or indirectly own greater than a 50% interest** in a business.[23] The term "directly or indirectly" in §51(i)(1)((A) is "determined with the application of section 267(c)…" Under the family attribution rules of IRC §267(c)(4), **members of the family** include brothers and sisters (whole or half-blood), spouse, ancestors, and lineal descendants. In addition to this family attribution rule, §267(c) also includes entity-to-member attribution, partner-to-partner attribution, and limits on reattribution.[24] The attribution of ownership occurs regardless of whether the family member has any ownership interest in the business.[25] The rules under §267 apply to determine a greater than 50% owner for ERC purposes and can create many indirect owners because of their relationship to direct owners. The rules of attribution, in essence, create a "back door" disqualification of the wages of a greater than 50% owner.

Example 1. George is a 100% sole shareholder of Apex Travel, Inc., an S corporation. Apex Travel also employs George's son, Alex. Alex's wages do not qualify for ERC because he is related to George. However, nothing stated explicitly in the Code prevents George's wages from being considered qualified wages for ERC purposes. When attribution rules under §267(c)(1) are considered, two owners can own more than 50% of the business either directly or indirectly. Alex is considered to own Apex indirectly by being George's son, and George by directly owning greater than 50% of the business. Neither George's nor Alex's wages may be considered eligible for the ERC.[26]

Example 2. John and Mary (siblings) are shareholders/employees in an S corporation with William, who is not related. All three owners are roughly equal in their ownership (John owns 34%). The attribution rules apply to John and Mary, which gives them a total of 67% ownership (34% + 33%), and therefore none of their wages are eligible for ERC. William's wages will qualify for ERC since he owns 33% of the stock, less than 50%.[27]

Example 3. Meg and Marty are cousins. They each own 50% of the stock of their S corporation. They are the only employees of their corporation. Cousins are not a relationship under the family attribution rules. Therefore, because neither Meg nor Marty own greater than 50% of the stock of their S corporation, their wages are qualified wages for ERC purposes.[28]

Example 4. Use the same facts as in **Example 3,** except Meg and Marty employ their grandmother, Marge. Family attribution rules apply to ancestors. Because of this relationship, Marge is considered a 100% owner of the S corporation because of her ancestral relationship to the two 50% owners, Meg and Marty. The relationship causes the wages of all three to be ineligible for ERC.[29]

When asking the question "Does a related party have qualified wages for ERC?" finding substantial authority can be somewhat difficult, as the authorities iteratively refer back to other sources. The following diagram will help visualize the relationship between the sources on this issue.

$$\text{CARES Act §2301(e)} \Rightarrow \text{IRS FAQ \#59} \Rightarrow \text{IRC §51(i)(1)} \Rightarrow \begin{array}{l}\text{IRC §267(c)}\\ \text{IRC §152(d)(2)}\end{array}$$

23. *COVID-19-Related Employee Retention Credits: Determining Qualified Wages FAQs.* Apr. 26, 2021. IRS. [www.irs.gov/newsroom/covid-19-related-employee-retention-credits-determining-qualified-wages-faqs] Accessed on Jul. 28, 2021.

24. IRC §§267(c)(1), (3), and (5).

25. Treas. Reg. §1.267(c)-1.

26. Excerpted from IRC §267(c)(1).

27. Ibid.

28. Ibid.

29. Ibid.

On August 4, 2021, the IRS issued Notice 2021-49.[30] The notice was designed to provide clarification to issues which arose from Notice 2021-20[31] and Notice 2021-23.[32]

Regarding related parties, the notice provides guidance about spouses employed by the same employer. In particular, the notice concludes that spouses who have **no other living familial relationships** (other than to each other) are **not** related parties for the purposes of ERC qualified wages.

The following examples are adapted from the notice.

Example 5. The Mills Corporation is owned 100% by Tom Jones, an individual. The corporation is an eligible employer for ERC purposes for the first calendar quarter of 2021. Tom is married to Jerilyn, and together they have no other living family members as defined in §267(c)(4). Tom and Jerilyn are both employees of The Mills Corporation. Pursuant to the attribution rules of §267(c), Jerilyn is attributed 100% ownership of The Mills Corporation, and both Tom and Jerilyn are treated as 100% owners. However, Tom and Jerilyn do not have any of the relationships to each other described in §§152(d)(2)(A)–(H) (illustrated previously). Accordingly, wages paid by The Mills Corporation to Tom and Jerilyn in the first calendar quarter of 2021 may be treated as qualified wages if the amounts satisfy the other requirements to be treated as qualified wages.

Example 6. Use the same facts as **Example 5,** except Tom and Jerilyn have a son, Greg, who does not work for the same employer as Tom and Jerilyn. His existence creates as familial relationship which causes the wages The Mills Corporation paid to Tom and/or Jerilyn to **not** be considered qualified wages for ERC purposes.

Example 7. Little Buddies Industries, an S corporation, is solely owned by Jonas Grumby. Jonas has a son, Gilligan. Little Buddies Industries is an eligible employer for ERC for the first calendar quarter of 2021. Jonas is an employee of Little Buddies Industries, but Gilligan is not. Pursuant to the attribution rules of §267(c), Gilligan is attributed 100% ownership of Little Buddies Industries, and both Jonas and Gilligan are treated as 100% owners. Jonas has the relationship to Gilligan described in §152(d)(2)(C). Accordingly, Little Buddies Industries may not treat as qualified any wages paid to Jonas because he is a related individual for purposes of the ERC.

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Coordination with Other Relief Benefits[33]

An eligible employer can claim both the ERC and the PPP, but ERC recipients cannot request PPP forgiveness for the same payroll used to generate the ERC.[34] Qualified wages for PPP and ERC can be applied to either program, but not to both.

Employers may also not apply the same wages used for ERC for the following assistance.[35]

- Emergency paid sick leave or emergency family medical leave under FFCRA
- Employer credit for paid family and medical leave
- Employees cannot be counted for both the ERC and the work opportunity tax credit (WOTC) (discussed later)

ERC recipients may not qualify for the increasing research activities credit (R&D) with the same wages (discussed later).[36]

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30. IRS Notice 2021-49, 2021-34 IRB 316.
31. IRS Notice 2021-20, 2011-11 IRB 922.
32. IRS Notice 2021-23, 2021-16 IRB 1113.
33. *Consolidated Appropriations Act of 2021,* PL 116-260, §206(c), Div. EE, amending *CARES Act,* PL 116-136, §2301.
34. *Employers May Be Able to Claim the Employee Retention Credit and Have a PPP Loan.* Feb. 2, 2021. IRS. [www.irs.gov/forms-pubs/employers-may-be-able-to-claim-the-employee-retention-credit-and-have-a-ppp-loan] Accessed on Jun. 23, 2021.
35. *Employee Retention Credit.* Apr. 15, 2021. IRS. [www.irs.gov/coronavirus/employee-retention-credit] Accessed on Jul. 22, 2021.
36. *Consolidated Appropriations Act of 2021,* PL 116-260, §207(f)(1), Div. EE, amending *CARES Act,* PL 116-136, §2301(h)(1).

Practitioner Planning Tip

Because CAA provided the retroactive provisions for ERC credit for PPP borrowers, taxpayers have been amending 2020 payroll reports to generate the ERC. It is important to note that even though the ERC benefit is received in 2021, the 2020 payroll expenses must be reduced by this credit. If the payroll expense was not reduced by this credit, the return should be amended.[37]

ERC FOR 2021[38]

For 2021, eligible employers can claim the ERC for an amount equal to **70%** of qualified wages paid between January 1 and June 30, 2021, under the CAA. The ARPA extended the benefit to all four quarters of 2021.

IRS Notice 2021-49,[39] issued on August 4, 2021, was designed to provide clarification to issues that arose from Notice 2021-20[40] and Notice 2021-23.[41] Regarding ERC eligible wages, the notice addressed the following.

1. It defined **applicable employment taxes** to **include** the Medicare portion of employer's payroll tax that may be used for the ERC. The CARES Act originally only allowed ERC on the qualified wages paid to employees plus the employer's share of Old Age, Survivors and Disability Insurance (OASDI). The definition of qualified wages now includes the employer's entire share of Federal Insurance Contributions Act (FICA) (7.65%). **However, the notice indicates this treatment is applicable only to the third and fourth quarters of 2021.**
2. Tips are considered qualified wages for purposes of the ERC.
3. IRC §45B allows employers to claim a credit for social security & Medicare tax paid on tips. ERC is also allowed on those tips that are qualified wages. Therefore, ERC qualified wages do not need to be reduced for the FICA tip credit (discussed later).

Eligible Recipient

Eligible employers must demonstrate a greater than 20% decline in gross receipts for 2021 compared to the same quarter in **2019.** To determine eligibility for the credit, there is an election to use gross receipts of the immediately preceding quarter. For example, to determine if a business qualifies for the first quarter of 2021, a business may compare the fourth quarter of 2020 to the fourth quarter of 2019.[42] For employers averaging **500 employees or fewer,** all wages paid are qualified wages, regardless of whether the employee can work. The business must have been partially or entirely shut down or have experienced a significant decline in gross receipts.

For employers averaging **more than 500 employees,** qualified wages are the wage amounts paid to employees who are not working because of the partial or complete business shutdown or a significant decrease in gross receipts.

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37. IRS Notice 2021-49, 2021- 34 IRB 316.
38. *American Rescue Plan Act,* PL 117-2, §9651; *New law extends COVID tax credit for employers who keep workers on payroll.* Jan. 27, 2021. IRS. [www.irs.gov/newsroom/new-law-extends-covid-tax-credit-for-employers-who-keep-workers-on-payroll] Accessed on Jul. 22, 2021.
39. IRS Notice 2021-49, 2021-34 IRB 316.
40. IRS Notice 2021-20, 2021-11 IRB 922.
41. IRS Notice 2021-23, 2021-16 IRB 1113.
42. *Consolidated Appropriations Act of 2021,* PL 116-260, §§207(d)(2)(B)(i)(I),(II) and (ii), Div. EE, amending *CARES Act*, PL 116-136, §2301(c)((c)(2).

The maximum ERC available is $7,000 per employee, per calendar quarter, for a total of $28,000 in 2021.

Coordination with Other Relief Benefits[43]

ERC recipients cannot request PPP forgiveness for the same payroll used to generate the ERC. Employers may also not apply the same wages used for ERC for the following assistance.[44]

- Emergency paid sick leave or emergency family medical leave under FFCRA
- Employer credit for paid family and medical leave
- Employees cannot be counted for both the ERC and the WOTC (discussed later)

ERC recipients may not qualify for the R&D credit (discussed later).[45]

> **Note.** For a discussion on ERC availability for employers affected by qualified disasters, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

EMERGENCY PAID SICK LEAVE CREDIT[46]

The FFCRA provided a refundable payroll tax credit for up to 80 hours (10 days maximum) of COVID-19-related sick leave pay for employees. The original expiration date of the program was December 31, 2020.[47] The CAA extended the expiration date to March 31, 2021.[48] The ARPA reset the program to cover the period April 1, 2021, through September 30, 2021.[49]

> **Note.** The CAA's extension of sick leave benefits did not create an additional sick leave period for the extended period (January 1–March 31, 2021). For example, an employee who received paid sick leave benefits in May of 2020 could not receive a new period of paid sick leave under the CAA extension for February 2021. However, the ARPA extension did create a new "sick leave period." The same employee who received paid sick leave benefits in May of 2020 could receive another round of paid sick leave benefits for contracting COVID-19 in June of 2021, for example.

The credit is limited to $511 per day per sick or quarantined employee ($5,110 maximum). The limit is $200 per day for employees who are caring for a minor child or person diagnosed with COVID-19 (capped at $2,000).

43. *American Rescue Plan Act,* PL 117-2, §3134(h).

44. *Employee Retention Credit.* Apr. 15, 2021. IRS. [www.irs.gov/coronavirus/employee-retention-credit] Accessed on Jul. 22, 2021.

45. *Consolidated Appropriations Act of 2021,* PL 116-260, §207(f)(1), Div. EE.

46. *Families First Coronavirus Response Act,* PL 116-127, §7001, Div. E; *COVID-19-Related Tax Credits for Paid Leave Provided by Small and Midsize Businesses FAQs.* Apr. 21, 2021. IRS. [www.irs.gov/newsroom/covid-19-related-tax-credits-for-paid-leave-provided-by-small-and-midsize-businesses-faqs] Accessed on Jul. 22, 2021.

47. *Families First Coronavirus Response Act,* PL 116-127, §7001(g), Div. E.

48. *Consolidated Appropriations Act of 2021,* PL 116-260, §286(a), Div. N, amending *Families First Coronavirus Response Act,* PL 116-127, §§7001(g), 7002(e), 7003(g), and 7004(e).

49. *American Rescue Plan Act,* PL 117-2, §§9641, 9642, and 9643.

Eligible Recipients[50]

All employers with fewer than 500 employees qualify. In addition, self-employed persons also qualify, subject to limitations.

1. The self-employed individual is under a federal, state, or local quarantine or isolation order related to COVID-19.
2. A healthcare provider has advised the self-employed individual to self-quarantine due to concerns related to COVID-19.
3. The self-employed individual experiences symptoms of COVID-19 and seeks a medical diagnosis, or seeks or awaits the results of a diagnostic test or a medical diagnosis of COVID-19, or the employee obtains immunization for COVID-19 or is recovering from an illness, injury, disability, or other condition related to immunization.
4. The self-employed individual cares for an individual subject to a federal, state, or local quarantine or isolation order related to COVID-19 or has advice from a healthcare provider to self-quarantine due to concerns related to COVID-19.
5. The self-employed individual cares for their child if the child's school or place of care has been closed or the childcare provider is unavailable due to COVID-19 precautions.
6. The self-employed individual experiences any other substantially similar condition specified by the Secretary of Health and Human Services.

If an eligible self-employed individual is unable to work or telework because of a circumstance described in items 1–3 above, the **qualified sick leave equivalent amount** equals the number of days (up to a maximum of 10 days) during the tax year that the individual cannot perform services in the applicable trade or business for one of those three reasons, multiplied by the lesser of the following.

- $511
- 100% of the individual's average daily self-employment (SE) income for the tax year.

If an eligible self-employed individual is unable to work or telework because of a circumstance described in items 4–6 above, the qualified sick leave equivalent amount equals the number of days (up to a maximum of 10 days) during the tax year that the individual cannot perform services in the trade or business for one of those three reasons, multiplied by the lesser of the following.

- $200
- 67% of the individual's average daily SE income for the tax year.

The qualified **family leave equivalent amount** for an eligible self-employed individual is an amount equal to the number of days (up to 50) during the tax year that the self-employed individual cannot perform services for which they would be entitled to paid family leave if the individual were employed by an eligible employer (described earlier), multiplied by the lesser of the following.

- $200
- 67% of the average daily SE income of the individual for the tax year, or the prior tax year

Average daily SE income equals the individual's net SE earnings for the tax year divided by 260. The ARPA allows self-employed individuals to calculate average daily SE income using the **prior** tax year instead of the current tax year.

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50. *COVID-19-Related Tax Credits for Paid Leave Provided by Small and Midsize Businesses FAQs.* Apr. 21, 2021. IRS. [www.irs.gov/newsroom/covid-19-related-tax-credits-for-paid-leave-provided-by-small-and-midsize-businesses-faqs] Accessed on Jul. 22, 2021.

Coordination with Other Relief Benefits

An employer who claims the FFCRA emergency paid sick leave credit can also use the Emergency FMLA Expansion Act credit (discussed next).[51] Wages used to qualify for the ERC programs or employer credit for paid family and medical leave cannot qualify for this credit.[52] Wages used to qualify for PPP loan forgiveness may not also be used for FFCRA.[53]

EMERGENCY FMLA CREDIT

The FMLA provides a refundable payroll tax credit to compensate employers for providing COVID-19 related paid leave to employees under the Emergency Family and Medical Leave Expansion Act.[54] The credit is limited to $200 per day with a total of $10,000 per employee.[55]

Eligible Recipient

All employers (other than governmental employers)[56] with fewer than 500 employees qualify. The credit was originally in effect for wages paid from April 1, 2020 through December 31, 2020,[57] but was extended by the CAA to March 31, 2021.[58] The ARPA further extended the benefit for the period April 1 through September 30, 2021.[59]

Self-employed persons may qualify as well, subject to limitations as discussed previously.[60]

Coordination with Other Relief Benefits[61]

Employers may also use the emergency paid sick leave under FFCRA.[62] Wages used to qualify for the ERC programs, WOTC, or employer credit for paid family and medical leave cannot qualify for this credit. Wages used to qualify for PPP loan forgiveness may not also be used for FFCRA.[63]

WOTC[64]

The WOTC is a nonrefundable general business credit that is extended by CAA through 2025.[65] Employers receive credit for hiring persons from targeted groups that are traditionally underrepresented. The credit is a percentage of wages paid to employees who meet specific employment requirements.

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51. Ibid.
52. *Families First Coronavirus Response Act,* PL 116-127, §7003.
53. *CARES Act,* PL 116-136, §1102(a)(2), amending §7(a) of the Small Business Act.
54. *Families First Coronavirus Response Act,* PL 116-127.
55. *Families First Coronavirus Response Act,* PL 116-127, §3102(b).
56. *Families First Coronavirus Response Act,* PL 116-127, §7001(e)(4).
57. *Families First Coronavirus Response Act,* PL 116-127, Div. C, §3102.
58. *Consolidated Appropriations Act of 2021,* PL 116-260, §286(b)(1), Div. N.
59. *American Rescue Plan Act,* PL 117-2, §3131(h).
60. *Families First Coronavirus Response Act,* PL 116-127, §7002.
61. *American Rescue Plan Act,* PL 117-2, §3131(f)(3).
62. Ibid.
63. *American Rescue Plan Act,* PL 117-2, §§3131(f)(3) and 3132(f)(3).
64. IRC §51; *Work Opportunity Tax Credit.* Mar. 2, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/work-opportunity-tax-credit] Accessed on Jul 1, 2021.
65. *Consolidated Appropriations Act of 2021,* PL 116-260, §113(a), Div. EE.

Eligible Recipient

All employers with employees are eligible for the WOTC. However, the WOTC is nonrefundable, so the credit may not be taken if the employer has no tax liability. In this case, the credit can be carried back or carried forward. The credit is based on wages paid to individuals in the following targeted populations.

- Qualified veterans
- Qualified ex-felons
- Needy families needing temporary assistance
- Other individuals described in §51(d)

The credit is equal to 40% of qualified wages if the individual works more than 400 hours. It is equal to 25% of qualified wages if the individual works a minimum of 120 hours. Qualified wages are limited to $6,000 in the employee's first year of employment unless the individual is a qualified veteran. For a qualified veteran, up to $12,000 of wages are considered for the credit.

Coordination with Other Relief Benefits[66]

If the employer utilizes the WOTC, they are not eligible for ERC on the same wages.

TARGETED EIDL ADVANCE AND SUPPLEMENTAL TARGETED ADVANCE[67]

Targeted EIDL advances and supplemental targeted advances were emergency grants to provide working capital to qualified businesses and nonprofits. The maximum targeted EIDL advance is $10,000. The supplemental targeted advance provides up to $5,000 in working capital. These advances differ from the EIDL loan because the advances do not need to be repaid. However, eligible businesses must first apply for an EIDL loan. After the business applies for the loan, the SBA sends an email inviting the business to apply for the advance programs.

Eligible Recipient

For the targeted EIDL advance, businesses and nonprofits must be located in low-income communities, experience a greater than 30% loss in gross revenue, and have 300 or fewer employees. For the supplemental targeted advance, businesses and nonprofits must also be located in low-income communities. However, the business or nonprofit must have experienced a greater than 50% loss in gross revenue and must have 10 or fewer employees.

The same business entities that are eligible for the EIDL loans are eligible for the advances. This does not include agricultural enterprises.

Coordination with Other Relief Benefits[68]

The CAA repealed an earlier requirement under the CARES Act that EIDL advances must reduce the amount of PPP borrowing eligible for forgiveness.

> **Observation.** Even though the PPP lending programs have expired, some borrowers may not have filed for PPP loan forgiveness. In addition, a taxpayer may still benefit from other provisions mentioned. For example, payroll tax filings from 2020 might be amended to claim FFCRA sick leave credits or the ERC. The key to the benefit is that the same payroll from the same period cannot qualify for multiple benefits. It is likely best to allocate payroll to forgive PPP borrowing before examining payroll for additional benefits.

66. *CARES Act,* PL 116-136, §2301(h)(1).

67. *Targeted EIDL Advance and Supplemental Targeted Advance*. SBA. [www.sba.gov/funding-programs/loans/covid-19-relief-options/eidl/targeted-eidl-advance-supplemental-targeted-advance] Accessed on Jul. 1, 2021.

68. *Consolidated Appropriations Act of 2021,* PL 116-260, §§333(b) and (c), Div. N, repealing *CARES Act,* PL 116-136, §1110(e)(6).

Example 8. Barney's Better Barnacles Bivouac, LLC is an exotic pet store established as a sole proprietorship. During 2020, the business was nearly shuttered due to COVID-19 related business shutdowns due to government order. Barney Bittle, the owner, did not want to lose his six longtime employees, so he sought various methods to keep the employees on the payroll and continue business operations. He read about SBA assistance in March of 2020 and received an EIDL advance of $10,000. The advance helped him keep his doors open. However, his personal resources began to drain significantly.

In mid-April 2020, Barney met with his banker to seek advice and alternatives. His banker suggested a PPP loan. Barney's business was approved for a PPP loan of $72,527 based on his 2019 payroll. The banker explained that the loan was to be used for qualified business expenses within eight weeks[69] after receipt. If it met the requirements, it potentially would be eligible for forgiveness. Barney indicated that using the funds for business expenses would be no issue. His banker contacted Barney in June of 2020 and informed him that the rules were revised, and he could use either the eight week or a new 24-week qualifying period.[70] Barney explained that the PPP money was already spent on qualified expenses well within that time frame.

His banker contacted Barney again in late 2020 to submit paperwork to have the PPP loan forgiven. It was submitted and approved. When asked how his business was doing, Barney explained he did not know how much longer he could survive financially, and his banker encouraged him to be patient as other relief measures were forthcoming from the federal government. The banker expressed sympathy for Barney's situation and told him at this point that other COVID-19 relief provisions, such as the ERC, were not available to him because he had received a PPP loan.

Example 9. Use the same facts as **Example 8.** The CAA passed in December 2020 and contained provisions for another round of PPP lending. Barney received a call from his banker in early February 2021 with the news regarding the second round PPP and Barney immediately applied. He received another $72,527 based on his 2019 payroll because it was greater than his 2020 payroll.

When completing the paperwork for the second round PPP loan, Barney's banker suggested he meet with an experienced tax professional because many other changes contained in the CAA could help Barney.

Barney met with Betty Bingham, a local enrolled agent. Barney explained to Betty that he was just barely able to keep his doors open. Betty explained that they should review the ERC because it is available for businesses that received PPP loans. She believed based on the information provided by Barney, that his business qualified for the 2020 ERC. The only caveat, she explained, was that the same wages used for 2020 PPP forgiveness could not also be used to qualify for the 2020 ERC. A second limitation for the ERC is that no more than $10,000 in wages paid for 2020 could be considered for each employee. Barney stated that he had already received forgiveness of his 2020 PPP loan. Betty indicated that was not a problem and asked Barney to gather his 2020 payroll records and she would run some calculations.

Betty created an analysis of Barney's 2020 wages. Her calculations were based on the following.

1. Barney allocated 100% of payroll in the covered period to the PPP first round loan to make certain loan forgiveness was covered.
2. Betty used the remaining wages after those allocated to PPP loan forgiveness to calculate 2020 ERC for Barney, which totaled $30,000. Betty suggested to Barney that he amend his 2nd, 3rd and 4th quarter Form 941, *Employer's Quarterly Federal Tax Return* filings for 2020 to obtain these refunds.

ERC calculations for the quarters in question follow, along with a summary calculation showing the total amount of COVID-19 relief Barney received in 2020.

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69. *Paycheck Protection Program Loan Forgiveness Application*. SBA. [www.sba.gov/sites/default/files/2020-05/3245-0407%20SBA%20Form%203508%20PPP%20Forgiveness%20Application.pdf] Accessed on Aug. 1, 2021.

70. *Paycheck Protection Program Flexibility Act,* PL 116-142.

Employee	Wages Jan. 1, 2020 to Mar. 12, 2020	Wages Mar. 13, 2020 to Apr. 17, 2020	PPP Money Received Apr. 17, 2020	Wages Apr. 17, 2020 to Jun. 30, 2020	2nd Quarter ERC-Qualified Wages
			$72,527		
Amy	$ 9,615	$ 3,346		$ 3,846	$ 3,346
Bob	15,923	5,869		6,369	5,869
Clint	6,396	2,568		2,567	2,568
Dave	11,362	4,150		4,405	4,150
Evelyn	8,971	3,588		3,788	3,588
George	19,059	6,153		6,154	6,153
Total wages	$71,326	$25,674		$27,129	$25,674
ERC %					× 50%
2nd quarter ERC					$12,837

Employee	Wages Jul. 1, 2020 to Aug. 15, 2020	Total Wages Apr. 17, 2020 to Aug. 15, 2020 Used for PPP	Wages Aug. 16, 2020 to Sep. 30, 2020	3rd Quarter ERC-Qualified Wages [a]
Amy	$ 6,692	$10,538	$5,769	$ 5,769
Bob	10,951	17,320	9,554	4,131
Clint	4,115	6,682	3,855	3,855
Dave	6,156	10,561	6,775	5,850
Evelyn	6,177	9,965	5,382	5,382
George	11,307	17,461	9,231	3,847
Total wages	$45,398	$72,527	$40,566	$28,834
ERC %				× 50%
3rd quarter ERC				$14,417

[a] Limited to $10,000 annually per employee.

Employee	Wages Oct. 1, 2020 to Dec. 31, 2020	4th Quarter ERC-Qualified Wages
Amy	$11,538	$ 885
Bob	19,108	0
Clint	3,577	3,577
Dave	12,640	0
Evelyn	10,765	1,030
George	18,472	0
Total wages	$76,100	$5,492
ERC %		× 50%
4th quarter ERC		$2,746

EIDL advance		$ 10,000
Fully-forgiven PPP loan		72,527
2nd quarter ERC	$12,837	
3rd quarter ERC	14,417	
4th quarter ERC	2,746	
Total 2020 ERC	$30,000	30,000
Total 2020 COVID-19 relief		$112,527

Example 10. Use the same facts as in **Example 9.** Betty explained to Barney that he could use the same process in 2021. As with 2020, Barney wanted to ensure that his second round PPP loan would be forgiven like the first round PPP loan. Betty agreed. She also explained to Barney that although the 2020 ERC used a factor of 50% of maximum qualified wages of $10,000 for calendar year 2020, the 2021 factor was **70%** of $10,000 of qualified wages for **each quarter** in 2021 that Barney's business qualified due to a reduction in gross income when compared to the previous year.

Barney did not receive his second round PPP loan of $72,527 until February 11, 2021. Therefore, Betty indicated the wages paid for the period January 1 through February 11, 2021 could be used for ERC. This resulted in a first quarter 2021 Form 941 ERC credit of $27,926. Betty suggested Barney adjust his Form 941 payroll tax deposits for the first quarter rather than wait for a refund. Barney appreciated the suggestion as he stated that business was improving but cash flow was still tight.

Betty remained in contact with Barney. Wages were sufficient by May 15 (within the 24-week covered period for PPP qualification) to allocate $72,527 of wages paid for PPP loan forgiveness. After allocating enough second quarter 2021 wages to PPP loan forgiveness, $40,673 of qualified wages (limited to $10,000 per employee per quarter) remained that were potentially eligible for the 2021 ERC. In addition, Barney explained to Betty that he had two employees who, during this quarter, tested positive for COVID-19 and had to quarantine. The wages paid to the two employees during the quarantine (two weeks) were $5,500 total. Betty explained these wages qualify for credit under the FFCRA and create their own credit. The wages used for the FFCRA credit must be subtracted from those wages eligible for ERC. This resulted in an ERC for the 2nd quarter of $24,621. However, in the 3rd quarter of 2021, Barney's business gross receipts had significantly improved to the point where 2021 gross receipts were 90% of the 2020 amounts. Therefore, no ERC is available for the 3rd quarter of 2021.

In December 2021, Betty met with Barney for some yearend planning. Barney explained that business again took a downturn likely due to the COVID-19 Delta variant. Betty calculated that Barney's 4th quarter gross receipts were only 72% of the similar period in 2020 and therefore Barney qualified for an ERC. The ERC qualified wages created a 4th quarter credit of $40,414.

ERC calculations for the quarters in question follow, along with a summary calculation showing the total amount of COVID-19 relief Barney received in 2021.

Employee	Wages Jan. 1, 2021 to Feb. 11, 2021	PPP Money Received Feb. 11, 2021	Wages Feb. 12, 2021 to Mar. 31, 2021	1st Quarter ERC-Qualified Wages
		$72,527		
Amy	$ 5,769		$ 7,692	$ 5,769
Barney	9,554		12,738	9,554
Clint	3,852		0	3,852
Dave	6,106		0	6,106
Evelyn	5,382		7,177	5,382
George	9,231		12,308	9,231
Total wages	$39,894		$39,915	$39,894
ERC %				×70%
1st quarter ERC				$27,926

Employee	Wages Apr. 1, 2021 to May 15, 2021	PPP Used for Wages	Wages May 16, 2021 to Jun. 30, 2021	FFCRA Wages	2nd Quarter ERC-Qualified Wages
Amy	$ 5,319	$ 5,319	$ 4,769	$4,000	$ 769
Bob	9,104	9,104	9,854		9,854
Clint	1,284	1,284	4,856	1,500	3,356
Dave	2,292	2,292	6,581		6,581
Evelyn	5,383	5,383	5,882		5,882
George	9,230	9,230	8,731		8,731
Total wages	$32,612	$32,612	$40,673		$35,173
ERC %					× 70%
2nd quarter ERC					$24,621

In the 2nd quarter, Barney fails the 80% test and is not eligible for an ERC on the 3rd quarter wages.

Employee	Wages Jul. 1, 2021 to Sep. 30, 2021	3rd Quarter ERC-Qualified Wages
Amy	$12,000	$0
Bob	18,000	0
Clint	7,500	0
Dave	7,500	0
Evelyn	11,500	0
George	20,000	0
Total	$76,500	$0
ERC %		× 70%
3rd quarter ERC		$0

Employee	Wages Oct. 1, 2021 to Dec. 31, 2021	4th Quarter ERC-Qualified Wages
Amy	$11,538	$10,000
Bob	19,108	10,000
Clint	7,734	7,734
Dave	12,640	10,000
Evelyn	10,765	10,000
George	18,472	10,000
Total wages	$80,257	$57,734
ERC %		× 70%
4th quarter ERC		$40,414

Fully-forgiven round two PPP loan		$ 72,527
FFCRA credit		5,500
1st quarter ERC	$27,926	
2nd quarter ERC	24,621	
3rd quarter ERC	0	
4th quarter ERC	40,414	
Total 2021 ERC	$92,961	92,961
Total 2021 COVID-19 relief		$170,988

Example 11. Use the same facts as **Example 10.** When Barney met with Betty in May of 2021, he mentioned that he had read not all the PPP loan proceeds were required to be been used for payroll. Betty agreed but stated that at least 60% of the PPP loan proceeds must have been used for payroll.[71] The remainder of the PPP loan could then be used for other qualified business expenses. Therefore, Betty explained, fewer wages needed to be allocated toward PPP loan forgiveness which allowed more wages not used for PPP loan forgiveness to be utilized for the ERC. Using this approach gained Barney an additional $16,558 of ERC ($109,519 – $92,961).

Employee	Wages Jan. 1, 2021 to Feb. 11, 2021	PPP Received Feb. 11, 2021	Wages Feb. 12, 2021 to Mar. 31, 2021	60% PPP Used for Wages	1st Quarter ERC-Qualified Wages
		$72,527			
Amy	$ 5,769		$ 7,692	$ 7,692	$ 5,769
Barney	9,554		12,738	12,738	9,554
Clint	3,852		0	0	3,852
Dave	6,106		0	0	6,106
Evelyn	5,382		7,177	7,177	5,382
George	9,231		12,308	12,308	9,231
Total	$39,894		$39,915	$39,915	$39,894
ERC %					× 70%
1st quarter ERC					$27,926

Employee	Wages Apr. 1, 2021 to May 15, 2021	60% of PPP Used for Wages	Wages May 16, 2021 to Jun. 30, 2021	FFCRA Wages	2nd Quarter ERC-Qualified Wages
Amy	$ 5,319	$ 0	$ 4,769	$4,000	$ 6,088
Bob	9,104	3,601	9,854		10,000
Clint	1,284	0	4,856	1,500	4,640
Dave	2,292	0	6,581		8,873
Evelyn	5,383	0	5,882		11,265
George	9,230	0	8,731		17,961
Total wages	$32,612	$3,601	$40,673		$58,827
ERC %					× 70%
2nd quarter ERC					$41,179

In the 2nd quarter, Barney fails the 80% test and is not eligible for an ERC on the 3rd quarter wages.

71. *PPP loan forgiveness.* SBA. [www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/ppp-loan-forgiveness#section-header-2] Accessed on Aug. 1, 2021.

Employee	Wages Jul. 1, 2021 to Sep. 30, 2021	3rd Quarter ERC-Qualified Wages
Amy	$12,000	$0
Bob	18,000	0
Clint	7,500	0
Dave	7,500	0
Evelyn	11,500	0
George	20,000	0
Total	$76,500	$0
ERC %		× 70%
3rd quarter ERC		$0

Employee	Wages Oct. 1, 2021 to Dec. 31, 2021	4th Quarter ERC-Qualified Wages
Amy	$11,538	$10,000
Bob	19,108	10,000
Clint	7,734	7,734
Dave	12,640	10,000
Evelyn	10,765	10,000
George	18,472	10,000
Total wages	$80,257	$57,734
ERC %		× 70%
4th quarter ERC		$40,414

Fully-forgiven round two PPP loan		$ 72,527
FFCRA credit		5,500
1st quarter ERC	$ 27,926	
2nd quarter ERC	41,179	
3rd quarter ERC	0	
4th quarter ERC	40,414	
Total 2021 ERC	$109,519	109,519
Total 2021 COVID-19 relief		$187,546

Barney's COVID-19 relief benefits between 2020 and 2021 totaled $300,073 ($112,527 during 2020 + $187,546 in 2021).

TAXABLE COMPENSATION ISSUES

Compensation is any form of remuneration paid to an individual for services rendered as an employee to one or more employers.[72] Compensation occurs in various forms such as wages, paid time off, jury duty, gifts, awards, and prizes, and fringe benefits; some of which are subject to payroll taxes.

> **Note.** Whenever there is a transfer of value to an employee in return for the employee providing services, the transfer is likely considered wages.

COMPENSATION CONSIDERED WAGES

Paid Time Off[73]

Vacation and other payments for time away from employment generally are considered wages. When employees benefit from paid vacation time, these payments are considered taxable wages. The rule still applies if employees receive extra compensation for the vacation time they do not take. Being paid for vacation time earned but not used is considered taxable compensation.

Other types of payments made during periods when employees are not at work are taxable compensation as well (e.g., paid holidays, sick pay, parental leave, military leave pay, and disability pay).

> **Note.** Whether disability pay is includable as taxable compensation is based on who paid the premiums. For more detail on includable and excludable disability payments, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Unexpected Issues for Individual Taxpayers.

Jury Duty Pay

When an employer pays its employees while the employee serves on jury duty, the wages paid are taxable wages for payroll tax purposes.[74] The amount includable as taxable compensation depends on how the employee's jury duty pay is treated by the employee's regular employer.[75]

- If an employer reduces an employee's compensation by jury fees received, employment taxes under IRC §3101, including social security and Medicare, are excluded from wages subject to those taxes.[76]
- An employer may require employees to turn over their jury duty pay to the employer. Under these circumstances, the amount included in social security wages and Medicare wages is reduced by the jury duty pay turned over to the employer.[77]
- If an employee's wages are **not** reduced by jury duty pay, which the employee retains instead of turning over to their employer, then their regular wages are subject to social security tax and Medicare tax.

> **Note.** The previous statement does not imply that jury duty is not taxable compensation. The employee has a responsibility to report the jury duty pay received individually. Compensation in any form is generally taxable.

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72. IRC §3231(e).

73. IRS Pub. 15, *Employer's Tax Guide;* Treas. Reg. 31.3231(e)-1(a)(3).

74. IRS Pub. 525, *Taxable and Nontaxable Income.*

75. IRC §62(a)(13); Treas. Reg. §1.61-2(a)(1).

76. IRC §3121 only considers the "cash value of all remuneration (including benefits) paid…," which excludes the reduction of compensation by jury fees retained by the employee.

77. IRC §62(a)(13); Treas. Reg. §1.61-2(a)(1); and IRS Pub. 525, *Taxable and Nontaxable Income*.

Gifts, Awards, and Prizes

Gifts, awards, and prizes may be considered taxable wages.[78] Based on the employee-employer relationship, most gifts provided to employees are presumed to be compensation. Unless it can be demonstrated that a gift is unrelated to business,[79] gifts to employees are includable as taxable wages for payroll tax purposes. For example, a gift given when attending an employee's wedding might be considered unrelated to business and therefore not included in their taxable wages.

Gifts of property are generally treated no differently from monetary gifts, with a small exception for tangible items with a nominal value[80] (de minimis gifts such as a turkey, ham, or gift basket.) This does not apply to gifts of cash, regardless of the amount.[81]

> **Note.** Gift certificates are considered cash equivalents and represent taxable compensation.[82]

Employee performance awards are generally considered includable wages because they are provided as an incentive for an employee's performance or services.[83]

To be considered **excludable,** the award must be a qualified plan award. A **qualified plan award** must be made under an established written plan, cannot discriminate in favor of highly compensated employees (more than $130,000 compensation in 2020), and the average cost of all employee achievement awards cannot exceed $1,600 in a year. For nonqualified plan awards, the limit is $400. There are three circumstances when noncash awards are **not** treated as includable wages.[84]

1. Employee achievement awards of tangible personal property are excluded when they are awarded to an employee for achieving length of service goals. These include retirement, safety awards, and productivity awards.
2. Certain prizes or awards contributed to charities in recognition of charitable, scientific, artistic, or educational achievement.
3. De minimis awards and prizes provided infrequently for a nominal value.

> **Note.** For additional information on qualified and nonqualified award plans, see the 2018 *University of Illinois Federal Tax Workbook,* Vol B, Chapter 1: New Developments — Business Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

78. IRC §§61(a), 74(a), and 3121.
79. The U.S. Supreme Court established that a transfer of property or value only constitutes a tax-free gift if it is made through "detached and disinterested generosity" or "out of affection, respect, admiration, charity or like impulses." See *Comm'r v. Duberstein*, 363 U.S. 278 (1960).
80. IRC §132(e)(1); IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*
81. Treas. Reg. §1.132-6(c); IRC §132(a); IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*
82. Ibid.
83. IRC §274(j); IRS Pub. 5137, *Fringe Benefit Guide.*
84. Ibid.

Fringe Benefits[85]

A fringe benefit is a type of payment for the performance of services. Fringe benefits for employees represent taxable wages unless expressly excluded (excluded fringe benefits are covered later). If the recipient of the fringe benefit is an employee, their wages are increased by the value of the fringe benefit less the sum of:

- The amount excluded by law and
- The amount the employee paid for it.

Additionally, the benefit is generally subject to employment taxes (discussed later). For a nonemployee recipient, the benefit is not subject to employment taxes but may need to be reported on a Form 1099-NEC, *Nonemployee Compensation,* or a Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* The following table summarizes employment tax treatment for various types of fringe benefits.[86]

Treatment Under Employment Taxes			
Type of Fringe Benefit	**Income Tax Withholding**	**Social Security and Medicare (including Additional Medicare Tax when wages are paid in excess of $200,000)[1]**	**Federal Unemployment (FUTA)**
Accident and health benefits	Exempt,[2] except for long-term care benefits provided through a flexible spending or similar arrangement.	Exempt, except for certain payments to S corporation employees who are 2% shareholders.	Exempt
Achievement awards	Exempt[2] up to $1,600 for qualified plan awards ($400 for nonqualified awards).		
Adoption assistance	Exempt[2,3]	Taxable	Taxable
Athletic facilities	Exempt if substantially all use during the calendar year is by employees, their spouses, and their dependent children, and the facility is operated by the employer on premises owned or leased by the employer.		
De minimis (minimal) benefits	Exempt	Exempt	Exempt
Dependent care assistance	Exempt[3] up to certain limits, $5,000 ($2,500 for married employee filing separate return).		
Educational assistance	Exempt up to $5,250 of benefits each year. (See *Educational Assistance*, later in this section.)		
Employee discounts	Exempt[3] up to certain limits. (See *Employee Discounts*, later in this section.)		
Employee stock options	See *Employee Stock Options*, later in this section.		
Employer-provided cell phones	Exempt if provided primarily for noncompensatory business purposes.		
Group-term life insurance coverage	Exempt	Exempt[2,4,6] up to cost of $50,000 of coverage. (Special rules apply to former employees.)	Exempt
Health savings accounts (HSAs)	Exempt for qualified individuals up to the HSA contribution limits. (See *Health Savings Accounts*, later in this section.)		
Lodging on your business premises	Exempt[2] if furnished on your business premises, for your convenience, and as a condition of employment.		
Meals	Exempt[2] if furnished on your business premises for your convenience.		
	Exempt if de minimis.		
No-additional-cost services	Exempt[3]	Exempt[3]	Exempt[3]
Retirement planning services	Exempt[5]	Exempt[5]	Exempt[5]
Transportation (commuting) benefits	Exempt[2] up to certain limits if for rides in a commuter highway vehicle and/or transit passes ($270) or qualified parking ($270). (See *Transportation (Commuting) Benefits*, later in this section.)		
	Exempt if de minimis.		
Tuition reduction	Exempt[3] if for undergraduate education (or graduate education if the employee performs teaching or research activities).		
Working condition benefits	Exempt	Exempt	Exempt

[1] Or other railroad retirement taxes, if applicable.
[2] Exemption doesn't apply to S corporation employees who are 2% shareholders.
[3] Exemption doesn't apply to certain highly compensated employees under a program that favors those employees.
[4] Exemption doesn't apply to certain key employees under a plan that favors those employees.
[5] Exemption doesn't apply to services for tax preparation, accounting, legal, or brokerage services.
[6] You must include in your employee's wages the cost of group-term life insurance beyond $50,000 worth of coverage, reduced by the amount the employee paid toward the insurance. Report it as wages in boxes 1, 3, and 5 of the employee's Form W-2. Also, show it in box 12 with code "C." The amount is subject to social security and Medicare taxes, and you may, at your option, withhold federal income tax.

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85. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*

86. Ibid.

Advance Commissions[87]

Some taxpayers who are paid commissions may receive commission payments in advance of earning them. Commissions paid in advance are taxable income to a cash-basis taxpayer in the year received. Some compensation plans require them to be repaid if they are never earned. If they are repaid in a subsequent year, the cash-basis taxpayer may deduct them as a business expense or take them as a credit in some circumstances.

Example 12. Katy is a salesperson who is paid monthly on a commission basis. Each week, Katy receives a $300 advance that is charged against her earned commissions. If the advances exceed Katy's commissions for the month, the excess comes out of future commissions. However, Katy has no responsibility to repay any advances if she quits. In that case, any commission advances are taxable wages.

If the employer requires Katy to sign a note or agreement that obligated her to repay the advanced amounts upon demand or specified events (such as voluntary termination or resignation), the **advances are loans instead of taxable wages.**

Payroll Taxes[88]

Wages for employee services performed are subject to payroll taxes. In addition to wages, signing bonuses, payments to cancel a contract or to relinquish contract rights, and compensation paid to a former employee for services performed while they were still employed are subject to payroll taxes.

Currently, the tax rate for social security is 6.2% for the employer and 6.2% for the employee. In 2021, wages up to $142,800 are subject to the social security tax. Additionally, the Medicare tax rate is 1.45% for the employer and 1.45% for the employee. Wages more than $200,000 are subject to an additional 0.9% Medicare tax paid solely by the employee through withholding.

Deferred Social Security Withholdings.[89] Employees had the option of deferring the social security portion of their withholding for September 1 through December 31, 2020. Employees were required to repay the withholding deferral between January 1 and April 30, 2021. If the deferrals were not repaid by April 30, late payment penalties would apply beginning May 1, 2021. CAA extended the repayment period to December 31, 2021. For employees who chose to defer their social security withholding, this gave them all of 2021 to pay the 2020 deferral.[90] Late repayment penalties begin to accrue January 1, 2022.

Practitioner Planning Tip

In preparing 2020 individual returns, it was important to note the actual social security withholding on the taxpayer's Form W-2, *Wage and Tax Statement*, Box 4, instead of relying on the software to automatically enter a default of 6.20%. Employees who repay the 2020 social security deferral during 2021 should receive a corrected 2020 Form W-2.[91] In most cases, the receipt of the corrected W-2 has no impact on the 2020 return that was filed. However, employees who worked for multiple employers in 2020 and had taxable social security wages above the social security wage base ($137,700 in 2020)[92] should consider amending their 2020 returns to generate refunds for excess social security tax withheld.

87. IRS Pub. 525, *Taxable and Nontaxable Income.*

88. IRC §3121(a); Treas. Reg. §31.3121(a)-1(a).

89. IRS Notice 2020-65, 2020-38 IRB 567.

90. *Consolidated Appropriations Act of 2021,* PL 116-260, §274, Div. N.

91. *Form W-2 Reporting of Employee Social Security Tax-Deferred under Notice 2020-65.* May 13, 2021. IRS. [www.irs.gov/forms-pubs/form-w-2-reporting-of-employee-social-security-tax-deferred-under-notice-2020-65] Accessed on Jun. 27, 2021.

92. *Contribution and Benefit Base*. Social Security Administration. [ssa.gov/oact/cola/cbb.html#:~:text=We%20call%20this%20annual%20limit,for%20employees%20and%20employers%2C%20each] Accessed on Jun. 27, 2021.

COMPENSATION NOT CONSIDERED WAGES

Certain forms of remuneration are not considered wages and may be exempt from payroll tax. Some examples of excluded compensation are certain fringe benefits, advances for expenses subject to an accountable plan, and reimbursed business expenses.

Employee Reimbursed Business Expenses[93]

Employers can establish a reimbursement or allowance arrangement to pay advances, reimbursements, and charges for ordinary and necessary employee business expenses.

Expenses paid under an **accountable plan** are not considered wages and are not subject to employment taxes. An accountable plan must meet the following three rules.

1. The employee must have paid or incurred the allowable expenses in the capacity as an employee. The expense must not otherwise be paid as a wage.
2. The employee must substantiate the expenses to the employer within a reasonable time.
3. The employee must return any amount in excess of the substantiated expenses within a reasonable time.

Note. For more information on accountable plans, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Practitioner Planning Tip

The Tax Cuts and Jobs Act (TCJA) suspended deductibility of miscellaneous itemized deductions for tax years 2018 through 2025.[94] Unreimbursed employee business expenses for most employees were deducted as miscellaneous itemized deductions and are suspended for the TCJA period. Practitioners are encouraged to recommend their business clients establish written accountable plans for advances or reimbursements of employee expenses incurred on behalf of the employer. The employer may still deduct the expense, and the employee does not include the reimbursement in compensation as described previously. The creation of an accountable plan may aid the employer in addressing unhappy employees who are unable to deduct employee business expenses they incur while on company business.[95]

Caution. The decision to reimburse employee incurred business expenditures could be construed as a wage recharacterization. Rev. Rul. 2012-25[96] warns that if wage recharacterization is determined, the accountable plan rules have not been met and all amounts paid are taxable as wages. An example of a wage recharacterization includes an employer offering to reimburse mileage the employee incurs while on company business. In return for the reimbursement, the employer reduces the employee's hourly wage or salary.

93. IRS Pub. 15, *Employer's Tax Guide.*
94. *Tax Cuts and Jobs Act,* PL 115-97, §11045.
95. IRC§62(c).
96. Rev. Rul. 2012-25, 2012-37 IRB 337.

A **nonaccountable plan** is an arrangement that does not meet the requirements for an accountable plan.[97] Amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes.[98]

Nontaxable Fringe Benefits

Some fringe benefits are excluded from taxable compensation if they meet certain conditions. Fringe benefits included in compensation were covered previously. This section explores some nontaxable fringe benefits in greater detail.

Examples of fringe benefits that are not taxable compensation include the following.[99]

- Benefits received through employer health or accident insurance[100]
- Health insurance premiums paid by an employer[101]

> **Note.** The ARPA[102] provides premium assistance for continuing health insurance benefits under the Consolidated Omnibus Budget Reconciliation Act of 1985[103] (COBRA). COBRA premium assistance for the period beginning after April 1, 2021 through September 30, 2021, is a tax-free benefit under the ARPA.[104]

- Qualified tuition reductions for employees of educational institutions[105]
- Meals or lodging provided for the employer's convenience[106]

> **Note.** The meals must be provided on the employer's business premises. This nontaxable fringe benefit provided by employers to employees should not be confused with the meals and entertainment expense deduction. The TCJA repealed the "entertainment" portion of the ordinary "meals and entertainment" tax deduction for businesses,[107] but retained the 50% deduction for meals.[108] The CAA amends IRC §274(n)(2) to allow a 100% business deduction for business purpose food and beverages paid in tax years 2021 and 2022 if a restaurant provides the food and beverage.[109]

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97. IRS Pub. 15, *Employer's Tax Guide.*
98. Treas. Reg. §1.62-2(c)(5).
99. IRS Pub. 5137, *Fringe Benefit Guide.*
100. IRC §105.
101. IRC §106.
102. *American Rescue Plan Act,* PL 117-2.
103. *Consolidated Omnibus Budget Reconciliation Act of 1985,* PL 99-272.
104. *American Rescue Plan Act,* PL 117-2, §9501.
105. IRC §117(d).
106. IRC §119.
107. *TCJA,* PL 115-97, §13304.
108. IRC §274(n)(2).
109. *Consolidated Appropriations Act of 2021,* PL 116-260, §210, Div. EE, amending IRC §274(n)(2).

- Cafeteria plans[110]

Note. The CAA temporarily made changes to flexible spending arrangements (FSAs) for 2021 in several ways.[111] First, any unspent FSA dollars from 2020 or 2021 may be rolled over to the next plan year. The unspent dollars rolled over are in addition to the maximum amount employees can contribute for the year. This amount changes to $2,750 for 2021.[112] Second, the usual grace period ending March 15[113] to spend dollars contributed from the previous year for expenses incurred during the previous year (or forfeit the contributions) can be expanded by employers for a full 12 months from the end of the plan year (i.e., now December 31 instead of March 15).[114] Third, employers may permit employees to make midyear changes to the FSA elections.[115] Additional changes impacting dependent care arrangements are discussed later in this section.

- Qualified educational assistance program[116]

Note. Employees are limited to an annual aggregate benefit of no more than $5,250 per calendar year from all employers. CAA extended $5,250 in employer-paid student loan payments to the definition of qualified educational assistance for payments made after December 31, 2020 and before January 1, 2026.[117] The CARES Act added the original provision for $5,250 of annual employer payment of student loans to the definition of qualified educational assistance[118] under IRC §127(c)(1)(B), but it only covered the period March 27, 2020 through December 31, 2020.

Practitioner Planning Tip

Tax practitioners are encouraged to make inquiries about the source of student loan interest payments when taxpayers provide student loan interest deduction information for their tax preparation. The interest paid on student loan borrowing paid by a taxpayer's employer is not deductible by the employee.[119]

110. IRC §125.
111. *Consolidated Appropriations Act of 2021,* PL 116-260, §214, Div. EE. These changes impact health as well as dependent care FSA arrangements.
112. Rev. Proc. 2020-45, 2020-46 IRB 1016.
113. Prop. Treas. Reg. §1.125-1(e)(1) permits an employer to elect to extend the grace period by 2.5 months under normal conditions.
114. *Consolidated Appropriations Act of 2021,* PL 116-260, §214(c)(1), Div. EE.
115. *Consolidated Appropriations Act of 2021,* PL 116-260, §214(e), Div. EE.
116. IRC §127.
117. *Consolidated Appropriations Act of 2021,* PL 116-260, §120, Div. EE, amending IRC §127(c)(1)(B).
118. *CARES Act,* PL 116-136, §2206, amending IRC §127(c)(1)(B).
119. IRC §127(c)(7).

The following table from IRS Pub. 5137 compares various types of educational assistance.

Feature	Section 127 Qualified Educational Assistance	Section 132(d) Working Condition Fringe	Section 117(d) Qualified Tuition Reduction
Written plan required	Yes	No	No
Undergraduate courses covered	Yes	Yes	Yes
Graduate courses covered	Yes	Yes	No*
Must be job-related	No	Yes	No
Courses qualifying employee for new trade or business covered	Yes	No	Yes
Courses needed to meet minimum job requirements covered	Yes	No	Yes
Can discriminate in favor of highly compensated employees	No	Yes	No
Dollar limitation	$5,250	No	No
Definition of employee includes:			
Current employees	Yes	Yes	Yes
Family members	No	No	Yes
Laid-off employees	Yes	No	No
Employees retired or on disability	Yes	No	Yes
Independent contractors	No	Yes	No
Educational expenses covered:			
Tuition	Yes	Yes	Yes
Books, supplies, equipment	Yes	Yes	No
Tools or supplies employee may keep	No	No	No
Education involving sports, games, hobbies	No**	No**	Yes
Meals, lodging or transportation	No	Yes	No

* See text for exceptions

** Yes, if specifically job related

Note: These are general rules.

- Working condition fringe[120]

Note. IRC §132(d) states that the employer's property or services is considered a working condition fringe benefit to the extent that if the employee had paid for the product or service themselves, the payment would be tax deductible. No guidance is provided to this language, given the elimination of the deductibility of unreimbursed employee business expenses during the TCJA years.

120. IRC §132(d).

- Dependent care assistance program (DCAP)[121]

Note. For tax year 2021 only, the DCAP contribution limit maximum increased to $10,500 (from $5,000) for individuals filing as single, head of household, or married filing a joint return (MFJ). For married couples filing separately (MFS), the 2021 limit is increased to $5,250 (from $2,500).[122] For additional changes to rules impacting DCAP as well as other FSA arrangements, see Cafeteria Plans, discussed previously, and the CAA, PL 116-260, §214, Div. EE.

- No-additional-cost service (any service provided by an employer to an employee for the employee to use if such service is offered for sale to customers in the ordinary course of business in which the employee is performing services and the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service))[123]
- Qualified employee discounts[124]
- De minimis fringe benefit[125]

Note. The IRS provides examples of de minimis fringe benefits.[126]

- Controlled, occasional employee use of a photocopier
- Occasional snacks, coffee, doughnuts, etc.
- Occasional tickets for entertainment events
- Holiday gifts
- Occasional meal money or transportation expense for working overtime
- Group-term life insurance for employee spouse or dependent with face value not more than $2,000
- Flowers, fruit, books, etc., provided under special circumstances
- Personal use of a cell phone provided by an employer primarily for business purposes

- Qualified transportation fringe benefit[127]
- Qualified moving expense reimbursements[128]

Note. For tax years 2018 through 2025, except for moves involving members of the Armed Forces, this provision is suspended.[129]

121. IRC §129.
122. *American Rescue Plan Act,* PL 117-2, §9632.
123. IRC §132(b).
124. IRC §132(c).
125. IRC §132(a)(4).
126. *De Minimis Fringe Benefits.* Jul. 15, 2021. IRS. [www.irs.gov/government-entities/federal-state-local-governments/de-minimis-fringe-benefits] Accessed on Aug. 1, 2021.
127. IRC §132(f).
128. IRC §132(a)(6).
129. *Tax Cuts and Jobs Act,* PL 115-97, §11048.

- On-premises athletic facilities[130]

> **Note.** An employer that operates an on-premises gym or other athletic facility can exclude the value of an employee's use of the facility from their wages. Substantially all the use of the facility must be by employees (includes former employees who retired or left on disability), their spouses (includes a widow(er) of a former employee who retired or left on disability), and their dependent children. Employees also include a leased employee who provides services on a substantially full-time basis for at least a year if the services are performed under the employer's primary direction or control, and a partner who performs services for a partnership. The exclusion is not available if the facility is available to the general public, through memberships, rental, or similar arrangement. The facility does not need to be on the business premises but must be located on premises the employer owns or leases and operates.[131]

- Qualified retirement planning services[132]
- Qualified military base realignment and closure fringe benefit[133]
- Adoption assistance programs[134] (limited to $14,440 in 2021, subject to income phaseouts)[135]

NONCASH PAYMENTS

Generally, noncash payments are included in compensation at the fair market value (FMV) of the benefit or noncash payment provided.[136]

> **Caution.** The IRS (or Department of Labor) could challenge the value placed on the noncash payment.

Certain fringe benefits have more specific valuation requirements, for example, employer-provided use of company vehicles. The value to include as compensation involves using either the automobile lease valuation rule, the vehicle cents-per-mile valuation rule, or the commuting valuation rule.[137]

PAYMENTS FOR CASUAL LABOR

Occasionally, workers are paid for work that does not promote or advance their regular employment. However, the term **casual labor** is not defined by the IRS. Instead, it is defined by some state departments of employment security. When the term casual labor is searched on the IRS website, search outcomes are redirected to the discussion of independent contractor versus an employee.[138]

> **Note.** Taxpayers who pay workers $600 or more during the year as nonemployees are required to report these business-related payments to the IRS by filing Form 1099-NEC. In general, Form 1099-NEC must be filed by January 31 for payments during the previous calendar year. Nonemployee compensation may be subject to backup withholding at a rate of 24% if a payee has not provided a taxpayer identification number (TIN) to the payer or the IRS notifies the payer that the payee provided a TIN that does not match their name in IRS records.[139]

130. IRC §132(j)(4).
131. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*
132. IRC §132(m).
133. IRC §132(n).
134. IRC §137.
135. IRS News Rel. 2020-245 (Oct. 26, 2020).
136. Treas. Reg. §1.61-2(d)(1).
137. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*
138. *Independent Contractor (Self-Employed) or Employee?* Jul. 2, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee] Accessed on Aug. 1, 2021.
139. *Businesses must report nonemployee compensation and backup withholding:* Jul. 8, 2021. IRS. [www.irs.gov/newsroom/businesses-must-report-nonemployee-compensation-and-backup-withholding] Accessed on Aug. 1, 2021.

Regardless of the project or job duration, the question as to the treatment of payments revolves around common law rules. An analysis of the degree of control and independence is based on the following three categories.[140]

1. **Behavioral.** Does the employer control what work is assigned to the worker and how the work is done?
2. **Financial.** Does the employer control how the worker is paid or reimbursed for expenses?
3. **Type of Relationship.** Is there a written contract for the work to be performed? Does the employer offer the worker employee-type benefits? Could the working relationship continue after the given project is completed?

There is no set number of factors to prove a worker is an employee versus an independent contractor. No one factor is more important than another in making the determination. The entire relationship should be analyzed, to consider the degree of control over the worker, and any factors that are analyzed should be documented to support the determination.

Practitioner Planning Tip

To support the position that a hired worker is not an employee, employers have used **independent contractor agreements** which can be found easily on the Internet. While not providing legal advice, if a review by the IRS or a department of labor finds the employment meets the factors listed previously, the determination that a worker is an employee may be reached regardless of the existence of an independent contractor agreement. Tax practitioners should carefully consider the facts and circumstances involved and ask probing questions to determine the true nature of the relationship between the worker and the employer such as:

- Does the worker provide services to others besides the employer in question?
- Does the worker hold themselves out as a business?
- Does the worker have common business practices such as business cards, a business phone number, website, advertising, etc.?
- Does the worker provide their own insurance?

Note. The treatment of employees as independent contractors or providing payments for casual labor can present various income, employment classification, and tax issues. For more information and discussion relating to worker classification issues, see the 2017 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Employment Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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[140] *Independent Contractor (Self-Employed) or Employee?* Jul. 2, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee] Accessed on Aug. 1, 2021.

EXCESS BUSINESS LOSSES

TCJA created excess business losses (EBLs), which are defined as the excess (if any) of:[141]

1. A taxpayer's aggregate deductions from **trades or businesses,[142] minus**
2. The sum of:
   a. The taxpayer's aggregate **trade or business gross income and gains**, **plus**
   b. $250,000 ($500,000 for MFJ taxpayers).

If an EBL is created, the EBL above the limitations is converted to a net operating loss (NOL). That loss may only be carried forward, and the deductibility of the NOL carryforward is limited to 80% of the income in the carryforward year.[143]

Practitioner Planning Tip

The introduction (and now reemergence) of the EBL rules can significantly impact taxpayers with hedge fund investments. Tax professionals are encouraged to ask probing, in-depth questions of their clients who participate in hedge fund activities. They need to determine if the taxpayer's involvement in these activities rises to the level of a trade or business (with continuity and regularity), which would subject their activity to the EBL limitations, or if their involvement constitutes an investment activity which is not subject to EBL rules.

Observation. TCJA made wholesale changes to NOLs.[144] For tax years beginning after December 31, 2017, NOLS may only be carried forward,[145] and the NOL may only offset 80% of the income in the carryforward year.[146] However, there is no time limit as to how many years an NOL may be carried forward.[147]

The CARES Act suspended the TCJA NOL rules for tax years 2018, 2019, and 2020.[148] The CARES Act changes permitted the carryback of NOLs from these years.[149] The TCJA rules for NOLs (carryforward only, limitation to 80% of income in the carryforward year) return in 2021. It can be concluded from these actions that the changes implemented under TCJA were not repealed but rather postponed by actions taken under the CARES Act.

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141. *Tax Cuts and Jobs Act,* PL 115-97, §11012, added IRC §461(l).
142. While not defined by Internal Revenue statutes, trades or businesses were defined in prior years in the instructions to Form 461, *Limitations on Business Losses* to include involvement in activities with continuity and regularity. Furthermore, the CARES Act §2304(b)(2) clarified that wages are not treated as business income to determine the EBL limitation.
143. *Tax Cuts and Jobs Act,* PL 115-97, §13302, amending IRC §172.
144. *Tax Cuts and Jobs Act,* PL 115-97, §13302, amending IRC §172.
145. *Tax Cuts and Jobs Act,* PL 115-97, §13302(b).
146. *Tax Cuts and Jobs Act,* PL 115-97, §13302(a)(2)
147. *Tax Cuts and Jobs Act,* PL 115-97, §13302(b)(1)(B).
148. *CARES Act,* PL 116-136, §2303, temporarily amending IRC§172.
149. *CARES Act,* PL 116-136, §2303(b).

When first created, EBLs were to exist during the TCJA years, 2018 through 2025. However, the CARES Act[150] retroactively eliminated the IRC§461(l) EBL provision for tax years 2018 and 2019 and suspended the limitation for the tax year 2020.[151] EBLs are, therefore, in effect for tax years **beginning in 2021.** The ARPA[152] extends the EBL provisions under TCJA for an additional year through 2026.[153]

Practitioner Planning Tip

For any returns filed for tax years 2018 or 2019, which included EBL loss limitations, tax practitioners should advise their clients to amend those returns to remove the EBL calculated limitation on losses, if any. The NOL carryovers originally computed under TCJA using EBL limitations affect carryback and carry forward NOLs.

Assuming there are no further changes to EBLs, tax practitioners need to be aware of the provisions and plan accordingly with their clients for tax years 2021 through 2026.

Note. EBLs are calculated on IRS Form 461, *Limitations on Business Losses*. As of the date of publication of the 2021 *University of Illinois Federal Tax Workbook*, neither the 2021 Form 461 nor its instructions were released. For more information and in-depth examples of the EBL and NOL rules, see the 2020 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Net Operating and Excess Business Losses. See also the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments, for more discussion on this topic.

The original EBL provision under TCJA included an inflation adjustment provision to the original $250,000 ($500,000 for MFJ taxpayers) limitation.[154] For tax year 2021, the inflation adjusted limitation is $262,000 ($524,000 for MFJ taxpayers).[155]

Practitioner Planning Tip

The introduction of EBLs created an "alter ego" to deduction provisions in TCJA such as 100% bonus depreciation and expanded expensing under IRC §179. While the TCJA provisions for accelerated depreciation are enticements to write off assets immediately instead of over time, EBLs limit the immediate benefit of the accelerated write-off and convert excess losses to NOLs, which are limited to 80% of income in the carryforward year. Practitioners are encouraged to consider any potential EBL impact when advising clients to write off asset purchases versus choosing more extended period depreciation decisions.

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150. *CARES Act,* PL 116-136.

151. *CARES Act,* PL 116-136, §2304(a).

152. *American Rescue Plan Act,* PL 117-2.

153. *American Rescue Plan Act,* PL 117-2, §9041(a). Extending the provisions of IRC§461(l) through Dec. 31, 2026. §9041(b) of the ARPA places the effective date as "after Dec. 31, 2025," the date at which the EBL provision under TCJA is set to expire.

154. *Tax Cuts and Job Act,* PL 115-97, §11012(a)(3)(B).

155. Rev. Proc. 2020-45, 2020-46 IRB 1016.

CHANGES TO SMALL BUSINESS TAX DEDUCTIONS

The CAA added or changed several tax deductions related to small businesses.

BUSINESS MEALS

The business meal deduction (discussed previously) is increased in some cases for tax years 2021 and 2022 from 50%[156] to 100%.[157] The law contains a new provision enacted to help restaurants impacted by COVID-19. This provision states that for the 100% deduction to apply, the food must be provided by a restaurant.[158] Deductions for entertainment, which TCJA eliminated[159] were not impacted by the CAA. Business entertainment remains nondeductible.

Practitioner Planning Tip

With the changes made to the meals and entertainment deduction under TCJA, it has become increasingly complex, yet essential, for tax professionals to separate meals from entertainment during the same event. With the changes made by CAA, even more discussion with the client is warranted.

Tax practitioners might want to create a spreadsheet for their clients to separate expenses by (a) meals provided by a restaurant for employer convenience, (b) meals provided by a restaurant for client meetings, (c) other meals, such as groceries purchased, and d) entertainment.

Example 13. Joe Williams is a sole proprietor entrepreneur. He invites potential business clients, a married couple, to attend a hockey game. Before the game, Joe meets with the couple at a local restaurant where they discuss business matters. After the game, Joe invites the couple to his home for dessert prepared at home. His expenses for dinner, snacks, dessert, and the game are as follows.

- $300 for dinner (he picked up the whole tab)
- $750 for hockey tickets
- $350 snacks and beverages while at the game
- $50 dessert prepared at his home
- Joe has credit card statements to support his expenses.

In February 2022, Joe meets with his tax professional, Joan Cancount. She explains that the $300 dinner and the $350 for snacks and beverages is fully deductible under current law. She explains that half of the $50 for the dessert prepared at his home is deductible because she concludes it did not come from a restaurant. She further explains that there is no deduction for the hockey game tickets because the ticket cost was for entertainment.

156. IRC §274(m).
157. *Consolidated Appropriations Act of 2021,* PL 116-260, §210, Div. EE, amending IRC §274(n)(2).
158. *Consolidated Appropriations Act of 2021,* PL 116-260, §210(a).
159. *Tax Cuts and Job Act,* PL 115-97, §13304(a), amending IRC §274(a).

The IRS provided guidance as to the definition of a restaurant in Notice 2021-25.[160] The definition in the notice is:

> *. . . For this purpose, the term "restaurant" means a business that prepares and sells food or beverages to retail customers for immediate consumption,* ***regardless of whether the food or beverages are consumed on the business's premises****.(emphasis added) However, a restaurant does not include a business that primarily sells pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.*

FARMING NOLS

The previous discussion relating to NOLs has some distinctions under CAA. Specifically, if a farming enterprise[161] had elected 2-year carryback of an NOL under the rules established by TCJA,[162] the farming enterprise can use this carryback or elect 5-year carryback as provided in the CARES Act.[163] If the farming enterprise had waived 2-year carryback, the waiver could be revoked.[164]

TAX PLANNING WITH ADVANCED PREMIUM TAX CREDIT[165]

Persons who purchase health insurance through the healthcare Marketplace as created by the Affordable Care Act[166] (ACA) may be eligible for premium tax credits[167] (PTC) to assist them with paying premiums. There are several factors used to determine the amount, if any, of advanced premium tax credit (APTC), which are credits taken in advance of paying health insurance premiums. Depending on the taxpayer's situation, they may have to repay it or may be eligible for an increased PTC when they file their income tax return. The following factors are considered when determining the APTC.

1. The income the taxpayer projected to the Marketplace when the insurance was purchased
2. The taxpayer's family and the family size in relationship to the federal poverty level (FPL)
3. The actual income (modified adjusted gross income — MAGI)[168] reported on the insured's tax return
4. The cost of Marketplace insurance as a percentage of the taxpayer's MAGI

Item number 3 allows small business taxpayers to modify their income with careful planning.

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160. IRS Notice 2021-25, 2021-10 IRB 898.

161. IRS Pub. 225*, Farmer's Tax Guide,* states, "You are in the business of farming if you cultivate, operate, or manage a farm for profit, either as owner or tenant. A farm includes livestock, dairy, poultry, fish, fruit, and truck farms. It also includes plantations, ranches, ranges, and orchards and groves." There is no reference to the amount of a taxpayer's adjusted gross income, which must come from farming for the activity to be considered a farming enterprise. However, in IRS Topic 416*, Farming and Fishing Income,* the IRS makes the statement that if two-thirds of the taxpayer's adjusted gross income in the current or preceding year is from farming or fishing, then if the taxpayer files their Form 1040 return by the Mar. 1 filing deadline for farmers and fisherman, the taxpayer can avoid penalties for not making estimated tax payments throughout the year.

162. *Tax Cuts and Jobs Act,* PL 115-97, §13302(c)(1).

163. *CARES Act,* PL 116-136, §2303.

164. *Consolidated Appropriations Act of 2021,* PL 116-260, §281(a), Div. N, amending §2303 of the *CARES Act*, PL 116-136, which amended IRC §172(b)(1)(B)(ii).

165. *Advance Premium Tax Credit (APTC).* Healthcare.gov. [www.healthcare.gov/glossary/advanced-premium-tax-credit/] Accessed on Jun. 28, 2021.

166. *Affordable Care Act,* PL 111-148.

167. *Affordable Care Act,* PL 111-148, Title I, Subtitle E, Part I.

168. *What to Include as Income*. Healthcare.gov. [www.healthcare.gov/income-and-household-information/income/#magi] Accessed on Jul. 7, 2021.

OLD LAW

Before enactment of the ARPA, the timing of income and the treatment of expense deductions (i.e., accelerated depreciation expense elections) was necessary for small businesses to find ways to keep a taxpayer's MAGI below 401% of the FPL (see the following table[169]) so that the repayment of the APTC would be capped.[170]

Note. The phrase "timing of income" is most applicable in a farming activity where items of income may be eligible for deferral (such as crop income reporting or crop insurance proceeds). For most other business activities, short of delaying billing for services rendered (for cash-basis taxpayers), income must be reported in the year received.

Persons in Family/Household	Poverty Guideline
1	$12,880
2	17,420
3	21,960
4	26,500
5	31,040
6	35,580
7	40,120
8	44,660

For families/households with more than 8 persons, add $4,540 for each additional person.

The FPL determines the maximum income level for household size when PTCs are no longer available. This calculation is 400% of the poverty guideline for family size (i.e., for a family of four persons, 400% of the FPL would be $106,000 in 2021 ($26,500 × four persons)). Once 401% is reached, all the APTC must be repaid in full.[171] This section refers to this repayment threshold as a **tripwire.**

Practitioner Planning Tip

For tax year 2020 only, the ARPA removed repayment requirements for any amount of the APTC.[172] This removal may afford taxpayers the ability to amend 2020 returns (beyond the instructions provided by Rev. Proc. 2021-20).[173] Taxpayers may consider reducing the amount of §179 expensing, which may have been elected on the originally filed return or apply a more conservative approach toward expensing repairs and maintenance items versus considering these expenditures to be capital improvements. With no tripwire in 2020 (i.e., 401% of the FPL) to contend with, taxpayers and practitioners should consider deferring deductible expenses to future years.

169. *2021 Poverty Guidelines*. Jan. 26, 2021. U.S. Department of Health & Human Services. [aspe.hhs.gov/2021-poverty-guidelines] Accessed on Jun. 28, 2021.

170. IRC §36B(c)(1)(A).

171. Ibid.

172. *American Rescue Plan Act,* PL 117-2, §9662(a), amending IRC §36B(f)(2)(B).

173. IRS News Rel. 2021-84 (Apr. 9, 2021); This instructs taxpayers explicitly not to amend 2020 returns where APTC repayment may have been calculated on an originally filed return. The IRS is making the necessary corrections and sending refunds of APTC repayment to the taxpayer.

NEW LAW FOR 2021 AND 2022

The ARPA has effectively removed the tripwire for 2021 and 2022 by making Marketplace healthcare available and eligible for a subsidy, even if household income exceeds 400% of the FPL.[174]

> **Note.** This statement is not meant to imply that taxpayers will not potentially owe back the APTC for 2021 or 2022. The actions taken in the ARPA removed 401% as the tripwire, as mentioned previously. Taxpayers whose projected income to the healthcare Marketplace is lower than the actual reported income may still be required to repay some or all the APTC received (except in tax year 2020).

The following table[175] illustrates not just the ability of households with income above 400% of the FPL to receive premium assistance but also the ARPA goal to provide more premium assistance by lowering the previous definitions of affordable coverage at all household income levels. For example, suppose household income exceeds 400% of the FPL, and the cost of the second lowest-cost silver plan is more than 8.5% of annual household income. In that case, the household is entitled to premium assistance for the difference between the cost for the second-lowest-cost silver plan and 8.5% of the household income.[176]

> **Note.** The ARPA did not specify a maximum household income limit that may qualify for potential premium assistance. Although as income increases, 8.5% of household income becomes a higher benchmark for premiums to exceed.[177]

Household Income (Expressed as a Percent of the Poverty Line)	Initial Premium Percentage	Final Premium Percentage
Up to 150%	0.0	0.0
150% up to 200%	0.0	2.0
200% up to 250%	2.0	4.0
250% up to 300%	4.0	6.0
300% up to 400%	6.0	8.5
400% and higher	8.5	8.5

> **Note.** The changes made by the ARPA created a special enrollment period to permit persons wanting to enroll or re-enroll with lower premiums (due to the lowered expected affordability as the table mentioned previously). The special enrollment period ran from April 1, 2021, through August 15, 2021.[178]

174. *American Rescue Plan Act,* PL 117-2, §9661.

175. *American Rescue Plan Act,* PL 117-2, §9661(a).

176. *American Rescue Plan Act,* PL 117-2, §9661(a), amending IRC §36B(b)(3)(A) for taxable years beginning in 2021 and 2022.

177. *FAQ: American Rescue Plan Premium Tax Credit Provisions.* Jun. 2021. Center on Budget and Policy Priorities. [www.healthreformbeyondthebasics.org/wp-content/uploads/2021/06/ARP-FAQ-Updated-6.30.21.pdf/] Accessed on Jul. 7, 2021.

178. *2021 Special Enrollment Period Access Extended to August 15 on HealthCare.gov for Marketplace Coverage.* Mar. 23, 2021. News Division, Department of Health and Human Services. [www.hhs.gov/about/news/2021/03/23/2021-special-enrollment-period-access-extended-to-august-15-on-healthcare-gov-for-marketplace-coverage.html] Accessed on Jul. 7, 2021.

Prior to the ARPA, taxpayers were subject to the following premium percentages.[179]

Household Income (Expressed as a Percent of the Poverty Line)	Initial Premium Percentage	Final Premium Percentage
Up to 133%	2.0	2.0
133% up to 150%	3.0	4.0
150% up to 200%	4.0	6.3
200% up to 250%	6.3	8.05
250% up to 300%	8.05	9.5
300% up to 400%	9.5	9.5

Note. Prior law made no provision for households with income greater than 400% of FPL to define the percentage of household income that was considered affordable for the cost of health insurance coverage. The ARPA changed that for tax years 2021 and 2022, as explained previously. Under the ARPA, no one is expected to pay more than 8.5% of their household income (MAGI) for health coverage.

Planning Opportunities

Small businesses are in a unique position to plan how much, if any, of the APTC would be required to be repaid when filing the taxpayer's personal tax return. With the changes made by the ARPA, taxpayers could potentially also impact the expected percentage of household income considered affordable for health insurance premiums.

The opportunities for small businesses which are not available to other taxpayers include the following.

- Contributions to qualified pension plans
- Accelerated depreciation (such as bonus or §179 expense election) for assets placed into service during the tax year
- Determining if expense outlays during the year represent repairs and maintenance versus capital improvements

Example 14. The Jackson Family Robots Company operates as a sole proprietorship. In 2019, the company profit was $125,000. The Jackson family has four members of its household. This was the only source of income for the family. They purchased their health insurance on the healthcare Marketplace.

The 2019 FPL for a family of four was $25,750.[180] In 2019, 400% of the FPL was $103,000 ($25,750 × four members of the household). The Jackson's 2019 MAGI was $116,169 ($125,000 gross income less $8,831 adjustment to income for half of SE tax ($125,000 × 92.35% × 15.30% ÷ 2 = $8,831)).

Their MAGI was at least 401% of the 2019 FPL. Therefore, the Jackson family must repay any APTC. The Jackson family could have avoided this outcome by reducing their MAGI by funding a simplified employee pension (SEP) plan or a traditional deductible IRA or by placing new equipment into service and making a §179 expense election.

From an APTC standpoint, any combination that results in a MAGI reduced below 400% of the FPL would have resulted in the Jackson family having to repay less APTC or possibly requiring no repayment.

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179. IRC §36B(b)(3)(A)(i) prior to the temporary changes under the *American Rescue Plan Act,* PL 117-2, §9661(a).

180. *2019 Poverty Guidelines*. U.S. Department of Health and Human Services. [aspe.hhs.gov/2019-poverty-guidelines#:~:text=2019%20Poverty%20Guidelines%20%20%20%20Persons%20in,%20%20%2426%2C660%20%206%20more%20rows%20] Accessed on Jun. 30, 2021.

Example 15. Use the same facts as **Example 14,** except the year is 2021 and the FPL for a family of four is $26,500.[181] The business profit is still $125,000 and they have the same MAGI of $116,169. This equates to a 438% of FPL ($116,169 ÷ $26,500). Under the previous example, the Jacksons were required to repay the entire amount of any APTC for 2019. With the changes made by the ARPA for 2021, the taxpayer's repayment of any APTC would be limited depending on the cost of their benchmark premium. The Jacksons would only be required to pay $823 per month (8.5% × $116,169 MAGI ÷ 12 months). If the cost of their benchmark plan exceeded $823 per month, the Jacksons would be allowed to keep a portion of the APTC equal to the amount by which the benchmark plan exceeds the $823 per month. They are required to repay any excess.

Example 16. Use the same facts as **Example 15.** The Jackson family took the following actions.

- They placed a $40,000 piece of equipment into service and elected to expense the purchase in full under §179. The expense election reduced their net business profit to $85,000.
- Bill Jackson funded a SEP plan in the amount of $15,799 (($85,000 – $6,005 one half of SE tax) × 20%) for 2021.

These actions reduced their MAGI to $63,196 ($85,000 net profit – half of SE tax ($85,000 × 92.35% × 15.30% ÷ 2) – $15,799 SEP contribution).

MAGI calculations comparing 2019 with 2021 are summarized in the table below.

	Example 14 (2019)	Example 15 (2021)	Example 16 (2021)
Company profit	$125,000	$125,000	$125,000
FPL for family of 4	25,750	26,500	26,500
§179 expense	0	0	40,000
Adjustment for SE tax	8,831 [a]	8,831 [a]	6,005 [b]
SEP plan	0	0	15,799
MAGI	116,169	116,169	63,196
Percentage of FPL	451%	438%	238%

[a] $8,831 = $125,000 company income × 92.35% × 15.3% ÷ 2.
[b] $6,005 = $85,000 company income × 92.35% × 15.3% ÷ 2.

Expensing equipment placed into service and funding a SEP plan reduced the household income below 400% of the FPL. In addition, the MAGI of $63,196 put the Jacksons at 238% of the 2021 FPL ($63,196 ÷ $26,500). With this reduction, the definition of the initial premium percentage dropped from 8.5% of household income to approximately 4% of household income and results in additional PTC being due to the Jacksons when filing their 2021 tax returns. Because they took action to reduce their MAGI, the Smith family paid too much for their health insurance during 2021 and are due a refund for some of the health insurance premiums via the PTC.

181. *2021 Poverty Guidelines.* U.S. Department of Health and Human Services. [aspe.hhs.gov/topics/poverty-economic-mobility/poverty-guidelines/prior-hhs-poverty-guidelines-federal-register-references/2021-poverty-guidelines] Accessed on Aug. 3, 2021.

SMALL BUSINESS TAX CREDITS

In addition to small business tax benefits enacted during the COVID-19 pandemic, small businesses can benefit from other often overlooked credits such as the FICA tip tax credit, R&D credit, the minimum tax credit, and the small employer automatic enrollment credit.

FICA TIP TAX CREDIT[182]

The credit for a portion of employer social security taxes paid with respect to employee cash tips (FICA tip credit) is determined for tax years for the excess employer social security tax paid or incurred by the taxpayer during the year. **Excess employer social security tax** is any tax paid by an employer under IRC §3111 for tips received by an employee during any month if the tips meet both of the following qualifications.

- Deemed to be paid by the employer to the employee under IRC §3121(g) regardless of if the tips are reported under IRC §6053.
- Exceeded the amount wages (excluding tips) paid by the employer to the employee during such month are less than the total amount which would be payable at the minimum wage rate applicable to such individual under IRC §6(a)(1) of the Fair Labor Standards Act of 1938 ($5.15 per hour).[183]

The credit encourages restaurants to report tips as a part of wages subject to social security and Medicare and, to some extent, provides some relief for the portion of social security and Medicare tax that the employer otherwise would have paid. **Only tips received for food or beverages are considered for the FICA tip credit.** The tips must be earned in association with providing, delivering, or serving food or beverages for consumption if tipping employees is a customary practice for compensation (e.g., a college dining hall could be an **excluded** restaurant). Employers may elect not to take the credit any time within three years from the due date of the return on either an original or amended return.[184]

Reporting[185]

Restaurants doing business as a partnership or an S corporation report the credit on Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*. All other taxpayers are not required to file Form 8846 but rather the amount gets reported on Form 3800, *General Business Credit,* part III, line 4f.

> **Note.** Unused credits may be carried back one year and carried forward over 20 years.[186]

182. IRC §45B.
183. See instructions for Form 8846.
184. Ibid.
185. Ibid.
186. IRC §39(a)(1).

Coordination with Other Benefits

Amounts used toward the FICA tip tax credit cannot be used as deductions.[187]

Example 17. Lucy Lovegood owns multiple lemonade restaurants, organized as a C corporation under the name Lucy's Lemonade Stands, Inc. Lucy pays her employees a wage of $4.00 per hour, but they can earn tips to increase their compensation above this amount. During 2020, Lucy's Lemonade reports total tips of $52,360 and the employees worked a total of 10,000 hours. Lucy's Lemonade paid total wages of $40,000 for the year. The minimum wage amount based on the $5.15 per hour standard is $51,500 for the 10,000 total hours.

As a result, $11,500 ($51,500 minimum wage amount – $40,000 actual wage amount) is **not** eligible for the FICA tip credit because this amount represents the portion of the tips corresponding to the difference between the average hourly wage and the minimum wage. Lucy's Lemonade uses the $3,126 credit as calculated on the following Form 8846 to reduce its other income taxes.

Form **8846** | **Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips** | OMB No. 1545-0123

Department of the Treasury
Internal Revenue Service

► Attach to your tax return.
► Go to *www.irs.gov/Form8846* for the latest information.

2020
Attachment Sequence No. **846**

Name(s) shown on return	Identifying number
Lucy's Lemonade Stands, Inc.	23-4567891

Note: Claim this credit **only** for employer social security and Medicare taxes paid by a food or beverage establishment where tipping is customary for providing food or beverages. See the instructions for line 1.

1	Tips received by employees for services on which you paid or incurred employer social security and Medicare taxes during the tax year (see instructions)	1	52,360
2	Tips not subject to the credit provisions (see instructions)	2	11,500
3	Creditable tips. Subtract line 2 from line 1	3	40,860
4	Multiply line 3 by 7.65% (0.0765). If you had any tipped employees whose wages (including tips) exceeded $137,700, see instructions and check here . . . . ► ☐	4	3,126
5	Credit for employer social security and Medicare taxes paid on certain employee tips from partnerships and S corporations	5	
6	Add lines 4 and 5. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 4f	6	3,126

For Paperwork Reduction Act Notice, see instructions. Cat. No. 16148Z Form **8846** (2020)

CREDIT FOR INCREASING RESEARCH ACTIVITIES[188]

IRC §41 permits taxpayers a credit to the extent that research expenditures increase during the year over a base amount. The credit is better known as the R&D credit. The purpose of the credit is to incentivize research and experimentation by providing a tax credit for activities that develop a new component of a taxpayer's business or improve an existing component's performance, functionality, reliability, or quality. For a business with under $50 million in average annual gross receipts over the last three years, the credit offsets both regular tax and alternative minimum tax (AMT).[189]

187. IRC §45B(c).

188. IRC §41.

189. Instructions for Form 6765.

For certain defined smaller businesses, the R&D credit can offset the employer portion of FICA and Medicare taxes up to $250,000 (with some limitations). This is known as the **payroll tax credit election.**[190] The election to use the R&D credit to offset payroll taxes cannot be made if the taxpayer made the election for five or more preceding tax years. This election may only be revoked with the consent of the Secretary of the Treasury.[191]

> **Note.** For more information on the payroll tax credit election, see the instructions to Form 6765, *Credit for Increasing Research Activities* and Form 8974, *Qualified Small Business Payroll Tax Credit for Increasing Research Activities.*

Eligible Recipient[192]

Taxpayers qualify for the R&D credit if they invest in developing new products, improving the performance of existing ones, or otherwise improve the quality or reliability of a product or business process. Because the credit is computed based on increased research expenditures, the taxpayer's research expenditures must grow over time to be eligible for the credit.

The research must focus on discovering information that is both technological and intended to aid in developing a new or improved business component for the taxpayer. Research must involve hard sciences (e.g., chemistry, physics, or biology) because research involving social sciences does not count for the credit. Research focusing on the style, taste, cosmetic, or seasonal design of products does not count as qualified research for the credit. Substantially all the activities undertaken under the umbrella of qualified research must be a part of a process of experimentation. The experimentation focuses on new or improved functions, improved performance or reliability, or quality. The qualified research expenditures must also satisfy the requirements of IRC §174 (i.e., paid or incurred in connection with a trade or business and be reasonable[193]).

The following items are not eligible for the R&D credit.[194]

1. Research after the recipient has begun commercial production of a business component
2. Adaptation of an existing business component, especially if it adapts an existing business component to a customer's requirements
3. Duplicating an existing business component after examining the product itself, its plans, its specifications, or related public information
4. Surveys or studies
5. Computer software that is developed for internal use by the taxpayer unless it is used in an activity that itself constitutes qualified research
6. Foreign research that is conducted outside the United States, Puerto Rico, or any possession of the United States
7. Social sciences, as any research in social sciences, art or humanities is specifically prohibited
8. Funded research, to the extent that it is funded by a grant, a contract or by any other person, including grants from a government entity

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190. IRC §41(h).
191. IRC §41(h)(4)(B)(ii).
192. IRC §41(d).
193. IRC §§174(a)(1) and (e).
194. IRC §41(d)(4).

Calculating the Credit

The R&D credit is claimed on Form 6765. The R&D credit is the sum of the following.

- 20% of the amount that **qualified research expenses** exceed the base amount
- 20% of the **basic research payments**, consisting of the amount that basic research payments exceed the qualified organization base period amount
- 20% of the amount paid to an **energy research consortium** for energy research if paid while conducting a trade or business of the taxpayer

The credit for **qualified research expenses** (type 1) are incurred either through in-house research or through contract research. The **credit for basic research payments** (type 2) are payments for outsourced research, which a qualified organization must perform. Credits for research performed by an **energy research consortium** (type 3) are only available to a taxpayer who carries on a trade or a business, presumably in an energy-related business.

In addition to in-house expenses, the taxpayer can count 65% of contract research expenses paid to another person for research if the person is not an employee of the taxpayer. That percentage is increased to 75% if the payment is to a tax-exempt research consortium. The percentage further increases to 100% if the payment is to an eligible small business, a higher education institution, or a federal laboratory.[195]

Type 1: Qualified Research Expenses.[196] If the research occurs within the taxpayer's organization, the expense includes wages paid to an employee for services related to research, or the earned income of a sole proprietor. In addition, the expenditures may include supplies consumed in the process of qualified research, but the supplies cannot be improvements to land or depreciable items. Consequently, taxpayers who invest in improving their products, developing new ones, or improving processes are typically those who benefit from this credit.[197]

Example 18. The management of Reliable Pump Corporation (Reliable) anticipates a need in their agriculture market to offer an irrigation pump with better reliability. Two engineers based in Texas invested 40% of their time in 2020 in this task, and they were paid $60,000 in the year. To test the reliability of the pump with water having a higher-than-normal pH, they purchased $5,000 of sodium bicarbonate during 2020 and bought a vat to hold this water solution for $10,000. Reliable can count 40% of the wages of the two engineers or $48,000 ($120,000 in total wages ($60,000 each) × 40%) toward the credit. The $5,000 of sodium bicarbonate counts as a supply, but the vat does not count toward the credit because it is depreciable property. Reliable thus has qualified research expenditures of $53,000 ($48,000 wages + $5,000 sodium bicarbonate supplies).

Alternative Simplified Credit.[198] Taxpayers may elect an alternative simplified credit to reduce the computational complexity of the credit. In this case, the credit is 14% of the amount by which qualified research expenses for the current tax year exceed 50% of the average qualified research expenses for the prior three tax years. Revocation of this election must be by consent of the Secretary of the Treasury.

Example 19. The 4N Fertilizer Corporation (4N), an Illinois C corporation incorporated in 2001, investigates new fertilizer products for corn production. It conducts this research in its Mattoon, Illinois, facility, rather than its Windsor, Ontario, office so that the R&D credit is available. 4N experiments with using the new fertilizer on half of a 40-acre plot in Coles County while using a commercially available fertilizer on the other half of the plot. 4N elects the simplified method of computing the research expense credit. In 2020, its qualified research expenses consisted of $30,000 of wages and $10,000 of supplies. Its qualified research expenses in 2019 totaled $30,000, $25,000 in 2018, and $21,000 in 2017. Its average qualified research expense for the prior three years is $25,333. The 2020 alternative simplified credit is $3,827 (14% × ($40,000 qualified research expenses – (50% × $25,333 average qualified research expenses))). The Form 6765 for 4N follows.

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195. IRC §41(b)(3).
196. IRC §41(b).
197. IRC §41(d)(4)(F).
198. IRC §41(c)(4).

For Example 19

Form **6765**
(Rev. December 2020)
Department of the Treasury
Internal Revenue Service

Credit for Increasing Research Activities

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form6765* for instructions and the latest information.

OMB No. 1545-0619
Attachment Sequence No. **676**

Name(s) shown on return	Identifying number
4N Fertilizer Corporation	12-3456789

Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.

1	Certain amounts paid or incurred to energy consortia (see instructions)			1	
2	Basic research payments to qualified organizations (see instructions)	2			
3	Qualified organization base period amount	3			
4	Subtract line 3 from line 2. If zero or less, enter -0-			4	
5	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	5			
6	Cost of supplies	6			
7	Rental or lease costs of computers (see instructions)	7			
8	Enter the applicable percentage of contract research expenses. See instructions	8			
9	Total qualified research expenses. Add lines 5 through 8	9			
10	Enter fixed-base percentage, but not more than 16% (0.16) (see instructions)	10	%		
11	Enter average annual gross receipts. See instructions	11			
12	Multiply line 11 by the percentage on line 10	12			
13	Subtract line 12 from line 9. If zero or less, enter -0-	13			
14	Multiply line 9 by 50% (0.50)	14			
15	Enter the **smaller** of line 13 or line 14			15	
16	Add lines 1, 4, and 15			16	
17	Are you electing the reduced credit under section 280C? ▶ Yes ☐ No ☐ If "Yes," multiply line 16 by 15.8% (0.158). If "No," multiply line 16 by 20% (0.20) and see the instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached			17	

Section B—Alternative Simplified Credit. Skip this section if you are completing Section A.

18	Certain amounts paid or incurred to energy consortia (see the line 1 instructions)			18	
19	Basic research payments to qualified organizations (see the line 2 instructions)	19			
20	Qualified organization base period amount (see the line 3 instructions)	20			
21	Subtract line 20 from line 19. If zero or less, enter -0-			21	
22	Add lines 18 and 21			22	
23	Multiply line 22 by 20% (0.20)			23	
24	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	24	30,000		
25	Cost of supplies	25	10,000		
26	Rental or lease costs of computers (see the line 7 instructions)	26			
27	Enter the applicable percentage of contract research expenses. See the line 8 instructions	27			
28	Total qualified research expenses. Add lines 24 through 27	28	40,000		
29	Enter your total qualified research expenses for the prior 3 tax years. If you had no qualified research expenses in any one of those years, skip lines 30 and 31	29	76,000		
30	Divide line 29 by 6.0	30	12,667		
31	Subtract line 30 from line 28. If zero or less, enter -0-	31	27,333		
32	Multiply line 31 by 14% (0.14). If you skipped lines 30 and 31, multiply line 28 by 6% (0.06)			32	3,827
33	Add lines 23 and 32			33	3,827
34	Are you electing the reduced credit under section 280C? ▶ Yes ☐ No ☒ If "Yes," multiply line 33 by 79% (0.79). If "No," enter the amount from line 33 and see the line 17 instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached			34	3,827

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13700H Form **6765** (Rev. 12-2020)

For Example 19

Form 6765 (Rev. 12-2020) Page **2**

Section C—Current Year Credit

35	Enter the portion of the credit from Form 8932, line 2, that is attributable to wages that were also used to figure the credit on line 17 or line 34 (whichever applies)	**35**	
36	Subtract line 35 from line 17 or line 34 (whichever applies). If zero or less, enter -0-	**36**	**3,827**
37	Credit for increasing research activities from partnerships, S corporations, estates, and trusts	**37**	
38	Add lines 36 and 37	**38**	**3,827**
	• Estates and trusts, go to line 39. • Partnerships and S corporations not electing the payroll tax credit, stop here and report this amount on Schedule K. • Partnerships and S corporations electing the payroll tax credit, complete Section D and report on Schedule K the amount on this line reduced by the amount on line 44. • Eligible small businesses, stop here and report the credit on Form 3800, Part III, line 4i. See instructions for the definition of eligible small business. • Filers other than eligible small businesses, stop here and report the credit on Form 3800, Part III, line 1c. **Note:** Qualified small business filers, other than partnerships and S corporations, electing the payroll tax credit must complete Form 3800 before completing Section D.		
39	Amount allocated to beneficiaries of the estate or trust (see instructions)	**39**	
40	Estates and trusts, subtract line 39 from line 38. For eligible small businesses, report the credit on Form 3800, Part III, line 4i. See instructions. For filers other than eligible small businesses, report the credit on Form 3800, Part III, line 1c	**40**	

Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section if the payroll tax election does not apply. See instructions.

41	Check this box if you are a qualified small business electing the payroll tax credit. See instructions ☐		
42	Enter the portion of line 36 elected as a payroll tax credit (do not enter more than $250,000). See instructions	**42**	
43	General business credit carryforward from the current year (see instructions). Partnerships and S corporations, skip this line and go to line 44	**43**	
44	Partnerships and S corporations, enter the smaller of line 36 or line 42. All others, enter the smallest of line 36, line 42, or line 43. Enter here and on the applicable line of Form 8974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	**44**	

Form **6765** (Rev. 12-2020)

Example 20. The Smith family operates a 720-acre farm as a sole proprietorship in McLean County, Illinois. They typically grow soybeans in even years and corn in odd years. The soil at the Smith farm has a relatively high level of calcium but a relatively low level of magnesium. Fred Smith is interested in the relationship between the temperature of irrigation water and the leaching of these nutrients, particularly magnesium, from the soil to levels at which it would not benefit the soybean plants. To test the effect of water temperature, Fred Smith set aside two 5-acre plots of soybeans in the southwest corner of the farm. The Smiths irrigated one plot with water heated to a temperature of 24°C, and they irrigated the other plot with unheated water. The water heater cost $5,500, and the propane to run it during April, May, June, and July 2020 cost an additional $350. The work for the experiment required two hired farmhands, who together worked 250 hours on the project and earned $12 per hour. They paid $200 to have the Illinois Farm Research Consortium[199] analyze the soil at the beginning of the study and another $200 at the end of the growing season. The Illinois Farm Research Consortium is an IRC §501(c)(3) organization primarily organized to conduct research on behalf of family farms.

Because of the degree of experimentation involved, Fred Smith and his tax preparer believe that this qualifies for the R&D credit. The Smith family has never undertaken a research project of this nature and elects to use the alternative simplified credit.

The Form 6765 for Mr. and Mrs. Smith follows.

199. This is a fictitious organization used only for the purposes of illustration.

For Example 20

Form **6765** (Rev. December 2020) Department of the Treasury Internal Revenue Service

Credit for Increasing Research Activities

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form6765* for instructions and the latest information.

OMB No. 1545-0619
Attachment Sequence No. **676**

Name(s) shown on return	Identifying number
Fred and Gloria Smith	234-56-7891

Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.

1	Certain amounts paid or incurred to energy consortia (see instructions)			1	
2	Basic research payments to qualified organizations (see instructions)	2			
3	Qualified organization base period amount	3			
4	Subtract line 3 from line 2. If zero or less, enter -0-			4	
5	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	5			
6	Cost of supplies	6			
7	Rental or lease costs of computers (see instructions)	7			
8	Enter the applicable percentage of contract research expenses. See instructions	8			
9	Total qualified research expenses. Add lines 5 through 8	9			
10	Enter fixed-base percentage, but not more than 16% (0.16) (see instructions)	10	%		
11	Enter average annual gross receipts. See instructions	11			
12	Multiply line 11 by the percentage on line 10	12			
13	Subtract line 12 from line 9. If zero or less, enter -0-	13			
14	Multiply line 9 by 50% (0.50)	14			
15	Enter the **smaller** of line 13 or line 14			15	
16	Add lines 1, 4, and 15			16	
17	Are you electing the reduced credit under section 280C? ▶ Yes ☐ No ☐ If "Yes," multiply line 16 by 15.8% (0.158). If "No," multiply line 16 by 20% (0.20) and see the instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached			17	

Section B—Alternative Simplified Credit. Skip this section if you are completing Section A.

18	Certain amounts paid or incurred to energy consortia (see the line 1 instructions)			18	
19	Basic research payments to qualified organizations (see the line 2 instructions)	19			
20	Qualified organization base period amount (see the line 3 instructions)	20			
21	Subtract line 20 from line 19. If zero or less, enter -0-			21	
22	Add lines 18 and 21			22	
23	Multiply line 22 by 20% (0.20)			23	
24	Wages for qualified services (do not include wages used in figuring the work opportunity credit)	24	3,000		
25	Cost of supplies	25	350		
26	Rental or lease costs of computers (see the line 7 instructions)	26			
27	Enter the applicable percentage of contract research expenses. See the line 8 instructions	27	300		
28	Total qualified research expenses. Add lines 24 through 27	28	3,650		
29	Enter your total qualified research expenses for the prior 3 tax years. If you had no qualified research expenses in any one of those years, skip lines 30 and 31	29			
30	Divide line 29 by 6.0	30			
31	Subtract line 30 from line 28. If zero or less, enter -0-	31			
32	Multiply line 31 by 14% (0.14). If you skipped lines 30 and 31, multiply line 28 by 6% (0.06)			32	219
33	Add lines 23 and 32			33	219
34	Are you electing the reduced credit under section 280C? ▶ Yes ☐ No ☒ If "Yes," multiply line 33 by 79% (0.79). If "No," enter the amount from line 33 and see the line 17 instructions for the statement that must be attached. Members of controlled groups or businesses under common control, see instructions for the statement that must be attached			34	219

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13700H Form **6765** (Rev. 12-2020)

For Example 20

Form 6765 (Rev. 12-2020) Page **2**

Section C—Current Year Credit

35	Enter the portion of the credit from Form 8932, line 2, that is attributable to wages that were also used to figure the credit on line 17 or line 34 (whichever applies)	35	
36	Subtract line 35 from line 17 or line 34 (whichever applies). If zero or less, enter -0-	36	219
37	Credit for increasing research activities from partnerships, S corporations, estates, and trusts	37	
38	Add lines 36 and 37	38	219
	• Estates and trusts, go to line 39. • Partnerships and S corporations not electing the payroll tax credit, stop here and report this amount on Schedule K. • Partnerships and S corporations electing the payroll tax credit, complete Section D and report on Schedule K the amount on this line reduced by the amount on line 44. • Eligible small businesses, stop here and report the credit on Form 3800, Part III, line 4i. See instructions for the definition of eligible small business. • Filers other than eligible small businesses, stop here and report the credit on Form 3800, Part III, line 1c. **Note:** Qualified small business filers, other than partnerships and S corporations, electing the payroll tax credit must complete Form 3800 before completing Section D.		
39	Amount allocated to beneficiaries of the estate or trust (see instructions)	39	
40	Estates and trusts, subtract line 39 from line 38. For eligible small businesses, report the credit on Form 3800, Part III, line 4i. See instructions. For filers other than eligible small businesses, report the credit on Form 3800, Part III, line 1c	40	

Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section if the payroll tax election does not apply. See instructions.

41	Check this box if you are a qualified small business electing the payroll tax credit. See instructions ☐		
42	Enter the portion of line 36 elected as a payroll tax credit (do not enter more than $250,000). See instructions	42	
43	General business credit carryforward from the current year (see instructions). Partnerships and S corporations, skip this line and go to line 44	43	
44	Partnerships and S corporations, enter the smaller of line 36 or line 42. All others, enter the smallest of line 36, line 42, or line 43. Enter here and on the applicable line of Form 8974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	44	

Form **6765** (Rev. 12-2020)

6

Information appears in Section B of Form 6765 because Mr. and Mrs. Smith elected to use the alternative simplified credit. The wages paid to farm laborers are shown on line 24, while 75%[200] of the $400 Mr. Smith paid to the research consortium to analyze soil appears on line 27. Mr. and Mrs. Smith file this form with their Form 1040, *U.S. Individual Income Tax Return.*

Mr. and Mrs. Smith file the following applicable page of Form 3800 with their Form 1040.

200. IRC 41(b)(3)(C)(i).

For Example 20

Form 3800 (2020) Page 3

Name(s) shown on return: **Fred and Gloria Smith** | Identifying number: **234-56-7891**

Part III General Business Credits or Eligible Small Business Credits (see instructions)

Complete a separate Part III for each box checked below. See instructions.

- A ☒ General Business Credit From a Non-Passive Activity
- B ☐ General Business Credit From a Passive Activity
- C ☐ General Business Credit Carryforwards
- D ☐ General Business Credit Carrybacks
- E ☐ Reserved
- F ☐ Reserved
- G ☐ Eligible Small Business Credit Carryforwards
- H ☐ Reserved

I If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III . . . ▶ ☐

	(a) Description of credit **Note:** On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.		(b) Enter EIN if claiming the credit from a pass-through entity.	(c) Enter the appropriate amount.
1a	Investment (Form 3468, Part II only) (attach Form 3468)	1a		
b	Reserved	1b		
c	Increasing research activities (Form 6765)	1c		
d	Low-income housing (Form 8586, Part I only)	1d		
e	Disabled access (Form 8826)*	1e		
f	Renewable electricity, refined coal, and Indian coal production (Form 8835)	1f		
g	Indian employment (Form 8845)	1g		
h	Orphan drug (Form 8820)	1h		
i	New markets (Form 8874)	1i		
j	Small employer pension plan startup costs and auto-enrollment (Form 8881)	1j		
k	Employer-provided child care facilities and services (Form 8882)*	1k		
l	Biodiesel and renewable diesel fuels (attach Form 8864)	1l		
m	Low sulfur diesel fuel production (Form 8896)	1m		
n	Distilled spirits (Form 8906)	1n		
o	Nonconventional source fuel (carryforward only)	1o		
p	Energy efficient home (Form 8908)	1p		
q	Energy efficient appliance (carryforward only)	1q		
r	Alternative motor vehicle (Form 8910)	1r		
s	Alternative fuel vehicle refueling property (Form 8911)	1s		
t	Enhanced oil recovery credit (carryforward only)	1t		
u	Mine rescue team training (Form 8923)	1u		
v	Agricultural chemicals security (carryforward only)	1v		
w	Employer differential wage payments (Form 8932)	1w		
x	Carbon oxide sequestration (Form 8933)	1x		
y	Qualified plug-in electric drive motor vehicle (Form 8936)	1y		
z	Qualified plug-in electric vehicle (carryforward only)	1z		
aa	Employee retention (Form 5884-A)	1aa		
bb	General credits from an electing large partnership (carryforward only)	1bb		
zz	Other. Oil and gas production from marginal wells (Form 8904) and certain other credits (see instructions)	1zz		
2	Add lines 1a through 1zz and enter here and on the applicable line of Part I	2		0
3	Enter the amount from Form 8844 here and on the applicable line of Part II	3		
4a	Investment (Form 3468, Part III) (attach Form 3468)	4a		
b	Work opportunity (Form 5884)	4b		
c	Biofuel producer (Form 6478)	4c		
d	Low-income housing (Form 8586, Part II)	4d		
e	Renewable electricity, refined coal, and Indian coal production (Form 8835)	4e		
f	Employer social security and Medicare taxes paid on certain employee tips (Form 8846)	4f		
g	Qualified railroad track maintenance (Form 8900)	4g		
h	Small employer health insurance premiums (Form 8941)	4h		
i	Increasing research activities (Form 6765)	4i		219
j	Employer credit for paid family and medical leave (Form 8994)	4j		
z	Other	4z		
5	Add lines 4a through 4z and enter here and on the applicable line of Part II	5		219
6	Add lines 2, 3, and 5 and enter here and on the applicable line of Part II	6		219

* See instructions for limitation on this credit.

Form **3800** (2020)

The R&D credit flows from Form 3800 to Form 1040, Schedule 3, *Additional Credits and Payments.*[201]

Regular Credit.[202] Suppose the taxpayer does not elect to use the alternative simplified credit. The regular credit is calculated off a **base amount,** which is the product of the fixed-base percentage and the average annual gross receipts for the four preceding tax years prior to the year the taxpayer is calculating the credit. The base amount cannot be less than 50% of the qualified research expenses for the year. The **fixed-based percentage** is the ratio of the aggregate qualified research expenses for the taxpayer between 1984 and 1988 to the aggregate gross receipts for those years. There are exceptions to the fixed-base percentage for start-up companies when their first tax year with both gross receipts and qualified research expenses began after December 31, 1983 or had fewer than three tax years with both gross receipts and qualified research expenses between 1984 and 1988 inclusive. The fixed-base percentages for start-up companies are illustrated in the following table.

Taxable Year	Portion of Gross Receipts Eligible for Regular Credit
Each of the taxpayer's first five taxable years after 1993 during which it had qualified research expenses	3%
Sixth taxable year	0.16667 of the percentage that qualified research expenses bear to gross receipts for the fourth and five taxable years combined
Seventh taxable year	0.33333 of the percentage that qualified research expenses bear to gross receipts for the fifth and sixth taxable years combined
Eighth taxable year	0.5 of the percentage that qualified research expenses hear to gross receipts for the fifth, sixth, and seventh years combined
Ninth taxable year	0.66667 of the percentage that qualified research expenses bear to fifth, sixth, seventh, and eighth years combined
Tenth taxable year	0.83333 of the percentage that qualified research expenses bear to the fifth through tenth years combined
Subsequent taxable years	The percentage from any five years chosen by the taxpayer from among the fifth through the tenth years that qualified research expenses bear to gross receipts

The fixed-base percentage cap is 16%, and the number is rounded to the nearest 0.01%.

201. See instructions for Form 1040, Schedule 3.

202. IRC §41(c).

Example 21. Sangamon Crop Irrigation Company, an S corporation, installs agricultural irrigation systems and has annual sales of exactly $1,000,000 since 2009. It began a research program in 2010 to learn new methods of irrigating crops in central Illinois. Its sales and qualified research expenditures appear in the table below.

Year	Sequence Number	Gross Receipts	Qualified Research Expenses
2009		$1,000,000	$ 0
2010	1	1,000,000	5,000
2011	2	1,000,000	10,000
2012	3	1,000,000	11,000
2013	4	1,000,000	12,000
2014	5	1,000,000	12,565
2015	6	1,000,000	14,000
2016		1,000,000	0
2017	7	1,000,000	16,000
2018	8	1,000,000	17,000
2019	9	1,000,000	18,000
2020	10	1,000,000	19,000

Because Sangamon had no qualified research expenses in 2016, the company does not include its revenue for that year in calculating qualified research expenses. In preparing its 2020 Form 6765, Sangamon looks at tax years 2014, 2015, 2017, 2018, and 2019, the most recent five years when it incurred qualified research expenses. Its revenue for those five years was $5,000,000, and its qualified research expenses totaled $77,565 ($12,565 + $14,000 + $16,000 + $17,000 + $18,000). The total research expenses are 1.55% ($77,565 ÷ $5,000,000) of the total revenue for the test period years.

The base amount is $15,500 (1.55% × $1,000,000 the average annual revenue for the past four years). Sangamon's 2020 qualified research expenses are $3,500 greater than the base amount ($19,000 - $15,500), so its 2020 Type 1 credit for qualified research expenses is $700 (20% × $3,500).

Type 2: Basic Research Payments.[203] Basic research is any original investigations for the advancement of scientific knowledge that does not have a specific commercial objective. It does not include research conducted outside of the United States or basic research in the social sciences, arts, or humanities.

There are a few hurdles associated with basic research payments. S corporations are not eligible for a credit arising from basic research payments; personal holding companies and service organizations are not eligible, either. IRC §41 imposes the following requirements on payments for basic research.

- The payments must be made in cash during the taxable year.
- The payments must be according to a written agreement.
- The written agreement must be between a corporation and a qualified organization. The qualified organization must perform the research. An exception to this requirement allows tax-exempt scientific organizations or certain grant organizations to perform research. The following requirements are placed on the grant organizations.
    - Qualified §501(c)(3) organizations
    - Established before July 10, 1981
    - Organized and operated exclusively to make grants to educational institutions
    - Make an election for treatment as a private foundation

203. IRC §41(e).

Qualified organizations for conducting research include educational institutions and other tax-exempt organizations to perform scientific research unless they are private foundations. A qualified organization can also be a corporation.

Example 22. Use the same facts as **Example 19,** except that 4N Fertilizer Corporation contracts with the University of Illinois College of Agricultural, Consumer, and Environmental Sciences to research university land. The contract between 4N and the University stipulates that the University owns the intellectual property arising from the research, even though the results are to be shared with 4N under the terms of the contract. Payments under the contract are qualified as basic research payments for the R&D credit.

Example 23. Use the same facts as **Example 21,** except that Sangamon contracts with the University of Illinois College of Agricultural, Consumer, and Environmental Sciences instead of performing the research with its personnel. Unfortunately, Sangamon cannot claim the contribution to the University as a basic research payment because it is an S corporation and is not eligible for a credit resulting from basic research payments that it makes.

Type 2 payments are calculated as the amount that basic research payments exceed qualified organization base period amount, which itself is equal to the sum of the following two items.

- Minimum basic research amount
- A maintenance-of-effort amount

The **minimum basic research amount** is the greater of the following.

- 1% of the average of any amounts paid or incurred during the base period for in-house research expenses and contract research expense, **or**
- Contract research expenses during the base period

The **maintenance-of-effort amount** reflects an increase in nondesignated university contributions made by a taxpayer in a current year over nondesignated contributions to a university in a base period, adjusted for inflation.

The base period is the three-year period ending with the tax year immediately before the taxpayer filed its first tax return. For example, the base period for a company formed in 2014 runs from January 1, 2014 to December 31, 2016.

As a result, a portion of contributions to higher learning institutions become research credits under this provision of the R&D credit. They must exceed an inflation-adjusted amount of nondesignated contributions that were not used as a basic research payment but would have been allowable as a deduction under IRC §170. There is a floor under the minimum basic research amount of 50% of the basic research payments made.

Example 24. Use the same facts as **Example 19,** except that in 2020 4N also makes payments to the University of Illinois under a signed agreement for research. It pays $35,000 to the University because the University conducts technical research that is of interest to 4N but without immediate commercial application. In this case, the minimum research credit is $850 (1% × ($40,000 wages + $10,000 supplies + $35,000 contract research expenses)). The base period was 2001 through 2003, the first three years of 4N's existence when it incurred no research expenses.

Type 3: Energy Research Consortium. The R&D credit for Type 3 payments to an energy consortium is beyond the scope of this chapter. For more information, see §41(f)(6).

MINIMUM TAX CREDIT

Before the TCJA, C corporations were subject to an AMT, provided they did not qualify for an exclusion based on their gross receipts.[204] The TCJA eliminated this tax, but not the minimum tax credit. This allows some corporations an opportunity to reduce their tax liabilities in 2018 and later with a credit arising from paying AMT before 2018. In addition, the CARES Act accelerated the recovery of AMT by making the credit 100% refundable in 2019 and 50% in subsequent years.[205]

The credit is claimed on Form 8827, *Credit for Prior Year Minimum Tax — Corporations.*

Eligible Recipient

C corporations that incurred an AMT liability prior to January 1, 2018 are eligible for the minimum tax credit. In addition, some sole proprietors, partners, and S corporation shareholders may be eligible for this credit based on previous AMT liability reported on their Forms 1040.[206]

Example 25. Use the same facts as **Example 19.** 4N Fertilizer Corporation's receipts before TCJA were too large to qualify for the AMT exemption for small corporations. In 2017, 4N had AMT of $50,000 and no minimum tax credit carryforward. 4N had no tax liability in either 2018 or 2019. 4N's following Forms 8827 show that half of the 2017 refundable credit ($25,000), was refundable in 2018, leaving $25,000 as minimum tax credit carryforward to 2019. The 2019 Form 8827 shows that 4N receives a refund of the remaining amount of the minimum tax credit carryforward from its 2017, or $25,000.

Note. Because of the CARES Act provision making minimum tax credits refundable, it is unlikely that any carryforwards of credits persist beyond 2021.

Form **8827** — **Credit for Prior Year Minimum Tax—Corporations** — OMB No. 1545-0123 — **2018**

Department of the Treasury
Internal Revenue Service

► Attach to the corporation's tax return.
► Go to *www.irs.gov/Form8827* for the latest information.

Name	Employer identification number
4N Fertilizer Corporation	12-3456789

1	Alternative minimum tax (AMT) for 2017. Enter the amount from line 14 of the 2017 Form 4626	1	50,000
2	Minimum tax credit carryforward from 2017. Enter the amount from line 9 of the 2017 Form 8827	2	
3	Enter any 2017 unallowed qualified electric vehicle credit (see instructions)	3	
4	Add lines 1, 2, and 3	4	50,000
5	Enter the corporation's 2018 regular income tax liability minus allowable tax credits (see instructions)	5	0
6	Enter the refundable minimum tax credit (see instructions)	6	25,000
7	Add lines 5 and 6	7	25,000
8a	Enter the **smaller** of line 4 or line 7. If the corporation had a post-1986 ownership change or has pre-acquisition excess credits, see instructions	8a	25,000
b	**Current year minimum tax credit.** Enter the smaller of line 4 or line 5 here and on Form 1120, Schedule J, Part I, line 5d (or the applicable line of your return). If the corporation had a post-1986 ownership change or has pre-acquisition excess credits, see instructions. If you made an entry on line 6, go to line 8c. Otherwise, skip line 8c	8b	0
c	Subtract line 8b from line 8a. This is the current year refundable minimum tax credit. Include this amount on Form 1120, Schedule J, Part III, line 20c (or the applicable line of your return)	8c	25,000
9	**Minimum tax credit carryforward to 2019.** Subtract line 8a from line 4. Keep a record of this amount to carry forward and use in future years	9	25,000

204. *Tax Cuts and Jobs Act,* PL 115-97, §12001.

205. *CARES Act,* PL 116-136, §2305.

206. See instructions for Form 1040.

For Example 25

Form 8827 (2018) Page 2

Worksheet for Calculating the Refundable Minimum Tax Credit Amount. See instructions. Keep for your records.

1	Alternative minimum tax for 2017. Enter the amount from line 14 of the 2017 Form 4626	1	50,000
2	Minimum tax credit carryforward from 2017. Enter the amount from line 9 of the 2017 Form 8827	2	0
3	Add lines 1 and 2	3	50,000
4	Enter the corporation's 2018 regular tax minus allowable credits (see instructions for Form 8827, line 5)	4	0
5	Subtract line 4 from line 3	5	50,000
6	Refundable minimum tax credit. Multiply line 5 by 50% (0.50). Enter this amount on Form 8827, line 6	6	25,000

Form **8827** (Rev. May 2020) Department of the Treasury Internal Revenue Service

Credit for Prior Year Minimum Tax—Corporations

▶ Attach to the corporation's tax return.
▶ Go to *www.irs.gov/Form8827* for the latest information.

OMB No. 1545-0123 **2019**

Name: **4N Fertilizer Corporation** Employer identification number: **12-3456789**

1	Minimum tax credit carryforward from 2018. Enter the amount from line 9 of the 2018 Form 8827	1	25,000
2	Enter the corporation's 2019 regular income tax liability minus allowable tax credits (see instructions)	2	
3	Enter the refundable minimum tax credit (see instructions)	3	25,000
4	Add lines 2 and 3	4	25,000
5a	Enter the **smaller** of line 1 or line 4. If the corporation had a post-1986 ownership change or has pre-acquisition excess credits, see instructions	5a	25,000
b	**Current year minimum tax credit.** Enter the smaller of line 1 or line 2 here and on Form 1120, Schedule J, Part I, line 5d (or the applicable line of your return). If the corporation had a post-1986 ownership change or has pre-acquisition excess credits, see instructions. If you made an entry on line 3, go to line 5c. Otherwise, skip line 5c	5b	0
c	Subtract line 5b from line 5a. This is the current year refundable minimum tax credit. Include this amount on Form 1120, Schedule J, Part III, line 20c (or the applicable line of your return)	5c	25,000
6	**Minimum tax credit carryforward.** Subtract line 5a from line 1. Keep a record of this amount to carry forward and use in future years	6	

Form 8827 (Rev. 5-2020) Page 2

Worksheet for Calculating the Refundable Minimum Tax Credit Amount. See instructions. Keep for your records.

1	Minimum tax credit carryforward from 2018. Enter the amount from line 9 of the 2018 Form 8827	1	25,000
2	Enter the corporation's 2019 regular tax minus allowable credits (see instructions for Form 8827, line 2)	2	0
3	Refundable minimum tax credit. Subtract line 2 from line 1. Enter this amount on Form 8827, line 3	3	25,000

SMALL EMPLOYER AUTOMATIC ENROLLMENT CREDIT FOR RETIREMENT SAVINGS OPTIONS[207]

With the Setting Every Community Up for Retirement Enhancement (SECURE)[208] Act, Congress took action to provide for the financial needs of Americans in retirement. Several provisions provided small businesses with incentives to participate in the process, and the small employer automatic enrollment credit was a vital part of this.

Eligible Recipient

The small employer automatic enrollment credit offers a $500 credit to companies with no more than 100 employees for up to three years if they implement automatic enrollment for retirement savings options for new employees. The credit is available in the first year the company has an automatic enrollment in a retirement savings plan, as defined by IRC §414(w)(3). The credit is effective for plan years starting after 2019.

207. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §105; IRC §45T.

208. *Further Consolidated Appropriations Act of 2020,* PL 116-94.

The following types of employer plans qualify for the credit.[209]

- Plans that meet the requirements in IRC §401(a) (qualified pension, profit-sharing, and stock bonus plans)
- Annuity plans under IRC §403(a)
- SEP[210]
- Savings incentive match plan for employees (SIMPLE) retirement accounts[211]

This list does not include §403(b) plans, even though it contains annuity plans under §403(a).

Example 26. The Lawnmasters Company is a rapidly growing landscape maintenance firm with trouble attracting enough qualified employees to meet the demand for its services. The company has 20 employees and operates as an S corporation. Lawnmasters implements a SEP plan with an automatic enrollment provision for new employees. This plan goes into effect on April 1, 2021, just before its seasonal hiring goes into full swing. The company qualifies for the $500 credit associated with the small employer automatic enrollment credit for the following tax years ending in 2021, 2022, and 2023.

If a group of businesses are under the same control, the employees among all firms count toward the 100-employee limit.[212] However, only employees who earned more than $5,000 in the past year count toward the limit. If leased employees work for any of the firms, they also count toward the limit,[213] unless either of the two following conditions are met.[214]

- The leased employee is covered by a plan maintained by the leasing organization.
- Less than 20% of the employer's nonhighly compensated employees are leased employees.

Example 27. ABC Plumbing Company and DEF Heating & Air Conditioning Company are two separate C corporations owned by Lucy Hayes. ABC employs 45 plumbers and leases 10 employees through a professional employer organization (PEO), all of whom earned more than $5,000. DEF Heating employs 46 technicians and leases 12 employees through the same PEO that ABC uses. All persons working for DEF also earn more than $5,000. Neither ABC nor DEF is eligible for the small employer automatic enrollment credit because the combined total of 113 employees exceeds the 100-employee limitation.

Safe Harbor Matching Contribution[215]

Under the safe harbor basic matching formula, each eligible nonhighly compensated employee receives qualified matching contributions equal to the sum of:

1. 100% of the employee's elective contributions that do not exceed 3% of the employee's safe harbor compensation; and
2. 50% of the employee's elective contributions greater than 3% but do not exceed 5% of the employee's safe harbor compensation.

209. IRC §4972(d), as provided in *Further Consolidated Appropriations Act of 2020,* PL 116-94, §105.
210. IRC §408(k).
211. IRC §408(p).
212. IRC §414(b).
213. IRC §414(n)(2).
214. IRC §414(n)(5)(A).
215. IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans)*; Treas. Reg. §1.401(k)-3(c).

Employees participate automatically in their employers' retirement plans by requesting that their employer make contributions directly to the plan with amounts deducted from their compensation. The plan may provide a default percentage of the employee's income to be contributed by the employer to the plan. The employee participating in the plan can change the percentage of contribution or even have it canceled. Although new employees can opt out of participation in the plan, they are automatically enrolled if they do not indicate the contrary.

Reporting

The credit is reported first on Form 8881, *Credit for Small Employer Pension Plan Startup Costs and Auto-Enrollment*,[216] and then on Form 3800. The $500 credit is on Form 8881, part II, line 9. This credit then appears on Form 3800, part III, line 1j in column c. It also appears on the first page of Form 3800, part I, line 1.

Example 28. Use the same facts as **Example 19,** except that 4N Fertilizer (a C corporation) has 2020 income tax of $21,000, 25 employees, and has a SIMPLE plan in place since 2018. However, the SIMPLE plan did not have automatic enrollment, and employee participation has lagged behind management's expectations. In February 2021, 4N amended its SIMPLE plan to include the automatic enrollment for new employees. 4N is an eligible employer since it has fewer than 100 employees and implemented the plan in a tax year after December 31, 2020. 4N's Forms 8881 and 3800 follow.

Because 4N is a C corporation, the $500 credit for the automatic enrollment appears as a part of the $4,327 credit appearing on Schedule J, part I, line 5c of its 2020 Form 1120, *U.S. Corporation Income Tax Return*, where it offsets a portion of 4N's income tax.

Form **8881** (Rev. December 2020) Department of the Treasury Internal Revenue Service

Credit for Small Employer Pension Plan Startup Costs and Auto-Enrollment

▶ Attach to your tax return.

▶ Go to *www.irs.gov/Form8881* for instructions and the latest information.

OMB No. 1545-1810

Attachment Sequence No. **130**

Name(s) shown on return: **4N Fertilizer Corporation** | Identifying number: **12-3456789**

Part I Credit for Small Employer Pension Plan Startup Costs

1	Qualified startup costs incurred during the tax year . . . . [1]		
2	Enter one-half of line 1	2	
3	Enter the number of employees eligible to participate in the pension plan. See instructions. ______ X 250	3	
4	Enter the greater of $500 or the amount from line 3 (Do not enter more than $5,000)	4	
5	Enter the smaller of line 2 or line 4	5	
6	Credit for small employer pension plan startup costs from partnerships and S corporations	6	
7	Reserved for future use	7	
8	Add lines 5 and 6. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j	8	

Part II Small Employer Auto-Enrollment Credit

9	Enter $500 if an auto-enrollment option is provided for retirement savings	9	500
10	Small employer auto-enrollment credit from partnerships and S corporations	10	
11	Add lines 9 and 10. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j	11	500

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 33435N Form **8881** (Rev. 12-2020)

216. Instructions for Form 8881.

For Example 28

Form **3800**

Department of the Treasury
Internal Revenue Service (99)

General Business Credit

► Go to *www.irs.gov/Form3800* for instructions and the latest information.
► You must attach all pages of Form 3800, pages 1, 2, and 3, to your tax return.

OMB No. 1545-0895
2020
Attachment Sequence No. **22**

Name(s) shown on return	Identifying number
4N Fertilizer Corporation	12-3456789

Part I **Current Year Credit for Credits Not Allowed Against Tentative Minimum Tax (TMT)**
(See instructions and complete Part(s) III before Parts I and II.)

1	General business credit from line 2 of all Parts III with box A checked			1	500
2	Passive activity credits from line 2 of all Parts III with box B checked	2			
3	Enter the applicable passive activity credits allowed for 2020. See instructions			3	
4	Carryforward of general business credit to 2020. Enter the amount from line 2 of Part III with box C checked. See instructions for statement to attach			4	
	Check this box if the carryforward was changed or revised from the original reported amount ► ☐				
5	Carryback of general business credit from 2021. Enter the amount from line 2 of Part III with box D checked. See instructions			5	
6	Add lines 1, 3, 4, and 5			6	500

Part II **Allowable Credit**

7	Regular tax before credits: • Individuals. Enter the sum of the amounts from Form 1040, 1040-SR, or 1040-NR, line 16, and Schedule 2 (Form 1040), line 2 • Corporations. Enter the amount from Form 1120, Schedule J, Part I, line 2; or the applicable line of your return • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a and 1b; or the amount from the applicable line of your return			7	21,000
8	Alternative minimum tax: • Individuals. Enter the amount from Form 6251, line 11 • Corporations. Enter -0- • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 54			8	0
9	Add lines 7 and 8			9	21,000
10a	Foreign tax credit	10a			
b	Certain allowable credits (see instructions)	10b			
c	Add lines 10a and 10b			10c	
11	**Net income tax.** Subtract line 10c from line 9. If zero, skip lines 12 through 15 and enter -0- on line 16			11	21,000
12	**Net regular tax.** Subtract line 10c from line 7. If zero or less, enter -0-	12	21,000		
13	Enter 25% (0.25) of the excess, if any, of line 12 over $25,000. See instructions	13			
14	Tentative minimum tax: • Individuals. Enter the amount from Form 6251, line 9 • Corporations. Enter -0- • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 52	14	0		
15	Enter the greater of line 13 or line 14			15	
16	Subtract line 15 from line 11. If zero or less, enter -0-			16	21,000
17	Enter the **smaller** of line 6 or line 16			17	500
	C corporations: See the line 17 instructions if there has been an ownership change, acquisition, or reorganization.				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 12392F Form **3800** (2020)

For Example 28

Form 3800 (2020) Page **2**

Part II Allowable Credit *(continued)*

Note: If you are not required to report any amounts on line 22 or 24 below, skip lines 18 through 25 and enter -0- on line 26.

18	Multiply line 14 by 75% (0.75). See instructions	**18**	
19	Enter the greater of line 13 or line 18	**19**	
20	Subtract line 19 from line 11. If zero or less, enter -0-	**20**	
21	Subtract line 17 from line 20. If zero or less, enter -0-	**21**	
22	Combine the amounts from line 3 of all Parts III with box A, C, or D checked	**22**	
23	Passive activity credit from line 3 of all Parts III with box B checked . . . **23**		
24	Enter the applicable passive activity credit allowed for 2020. See instructions	**24**	
25	Add lines 22 and 24	**25**	
26	Empowerment zone and renewal community employment credit allowed. Enter the smaller of line 21 or line 25	**26**	**0**
27	Subtract line 13 from line 11. If zero or less, enter -0-	**27**	**21,000**
28	Add lines 17 and 26	**28**	**500**
29	Subtract line 28 from line 27. If zero or less, enter -0-	**29**	**20,500**
30	Enter the general business credit from line 5 of all Parts III with box A checked	**30**	**3,827**
31	Reserved	**31**	
32	Passive activity credits from line 5 of all Parts III with box B checked . . . **32**		
33	Enter the applicable passive activity credits allowed for 2020. See instructions	**33**	
34	Carryforward of business credit to 2020. Enter the amount from line 5 of Part III with box C checked and line 6 of Part III with box G checked. See instructions for statement to attach	**34**	
	Check this box if the carryforward was changed or revised from the original reported amount ▶ ☐		
35	Carryback of business credit from 2021. Enter the amount from line 5 of Part III with box D checked. See instructions	**35**	
36	Add lines 30, 33, 34, and 35	**36**	**3,827**
37	Enter the **smaller** of line 29 or line 36	**37**	**3,827**
38	**Credit allowed for the current year.** Add lines 28 and 37. Report the amount from line 38 (if smaller than the sum of Part I, line 6, and Part II, lines 25 and 36, see instructions) as indicated below or on the applicable line of your return. • Individuals. Schedule 3 (Form 1040), line 6 • Corporations. Form 1120, Schedule J, Part I, line 5c • Estates and trusts. Form 1041, Schedule G, line 2b	**38**	**4,327**

Form **3800** (2020)

6

For Example 28

Form 3800 (2020) Page 3

Name(s) shown on return	Identifying number
4N Fertilizer Corporation	12-3456789

Part III General Business Credits or Eligible Small Business Credits (see instructions)

Complete a separate Part III for each box checked below. See instructions.

A [x] General Business Credit From a Non-Passive Activity
B [ ] General Business Credit From a Passive Activity
C [ ] General Business Credit Carryforwards
D [ ] General Business Credit Carrybacks
E Reserved
F Reserved
G [ ] Eligible Small Business Credit Carryforwards
H Reserved

I If you are filing more than one Part III with box A or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III ▶ [ ]

	(a) Description of credit **Note:** On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.		**(b)** Enter EIN if claiming the credit from a pass-through entity.	**(c)** Enter the appropriate amount.
1a	Investment (Form 3468, Part II only) (attach Form 3468)	1a		
b	Reserved	1b		
c	Increasing research activities (Form 6765)	1c		
d	Low-income housing (Form 8586, Part I only)	1d		
e	Disabled access (Form 8826)*	1e		
f	Renewable electricity, refined coal, and Indian coal production (Form 8835)	1f		
g	Indian employment (Form 8845)	1g		
h	Orphan drug (Form 8820)	1h		
i	New markets (Form 8874)	1i		
j	Small employer pension plan startup costs and auto-enrollment (Form 8881)	1j		500
k	Employer-provided child care facilities and services (Form 8882)*	1k		
l	Biodiesel and renewable diesel fuels (attach Form 8864)	1l		
m	Low sulfur diesel fuel production (Form 8896)	1m		
n	Distilled spirits (Form 8906)	1n		
o	Nonconventional source fuel (carryforward only)	1o		
p	Energy efficient home (Form 8908)	1p		
q	Energy efficient appliance (carryforward only)	1q		
r	Alternative motor vehicle (Form 8910)	1r		
s	Alternative fuel vehicle refueling property (Form 8911)	1s		
t	Enhanced oil recovery credit (carryforward only)	1t		
u	Mine rescue team training (Form 8923)	1u		
v	Agricultural chemicals security (carryforward only)	1v		
w	Employer differential wage payments (Form 8932)	1w		
x	Carbon oxide sequestration (Form 8933)	1x		
y	Qualified plug-in electric drive motor vehicle (Form 8936)	1y		
z	Qualified plug-in electric vehicle (carryforward only)	1z		
aa	Employee retention (Form 5884-A)	1aa		
bb	General credits from an electing large partnership (carryforward only)	1bb		
zz	Other. Oil and gas production from marginal wells (Form 8904) and certain other credits (see instructions)	1zz		
2	Add lines 1a through 1zz and enter here and on the applicable line of Part I	2		500
3	Enter the amount from Form 8844 here and on the applicable line of Part II	3		
4a	Investment (Form 3468, Part III) (attach Form 3468)	4a		
b	Work opportunity (Form 5884)	4b		
c	Biofuel producer (Form 6478)	4c		
d	Low-income housing (Form 8586, Part II)	4d		
e	Renewable electricity, refined coal, and Indian coal production (Form 8835)	4e		
f	Employer social security and Medicare taxes paid on certain employee tips (Form 8846)	4f		
g	Qualified railroad track maintenance (Form 8900)	4g		
h	Small employer health insurance premiums (Form 8941)	4h		
i	Increasing research activities (Form 6765)	4i		3,827
j	Employer credit for paid family and medical leave (Form 8994)	4j		
z	Other	4z		
5	Add lines 4a through 4z and enter here and on the applicable line of Part II	5		3,827
6	Add lines 2, 3, and 5 and enter here and on the applicable line of Part II	6		4,327

* See instructions for limitation on this credit.

Form **3800** (2020)

Coordination with Other Relief Benefits[217]

The small employer automatic enrollment credit does not reduce any other credits. This credit may be used in addition to the small employer pension plan startup credit. However, the same costs that are used toward the small employer automatic enrollment credit should not also be used as deductions.

SMALL EMPLOYER PENSION PLAN STARTUP COST CREDIT[218]

The small employer pension plan startup cost credit offers certain small employers a means to recover up to 50% of the cost of setting up a pension each year for three years. Effective for tax years beginning after December 31, 2019, the credit is the greater of $500 or the lesser of:

- $250 for each nonhighly compensated employee and who is eligible to participate in the plan, or
- $5,000.

Consequently, an employer that maintains eligibility for three years stands to receive total tax credits of up to $15,000 for eligible costs. These costs include ordinary and necessary expenses for the establishment or administration of the plan and employee education related to the plan's retirement provisions.

Eligible Recipient

The rules regarding eligibility are somewhat different from the rules for the small employer automatic enrollment credit, although the definition of eligible employer is the same. Participants must not all be the company's senior management because of the requirement that at least one plan participant is not a highly compensated employee.[219]

The small employer pension plan startup cost credit uses the definition of highly compensated employee found in §414(q). That section identifies highly compensated individuals as those who meet one of the following requirements.

- Owns at least 5% of the equity of the firm during the preceding year, or
- Meets both the following conditions:
  - Earns compensation of at least $130,000 during the year (2021)[220]
  - Earns income placing them in the group of top 20% of earners at the company

Therefore, a firm's pension plan must have at least one individual who does **not** meet either of the requirements above and therefore is not highly compensated. The dollar amount of compensation is adjusted for inflation every year and typically appears in an IRS notice released shortly before the beginning of the tax year. Furthermore, the types of plans that qualify for the small employer pension plan startup credit are the same as qualify for the small employer automatic enrollment credit.[221]

Coordination with Other Relief Benefits

The small employer pension plan startup credit does not reduce any other credits. In fact, this credit may be used in addition to the small employer automatic enrollment credit. However, the same costs that are used toward the small employer pension plan credit should not also be used as deductions.[222]

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217. IRC §265(a)(1); and Treas. Reg. §1.265-1, as referred to in IRS Notice 2020-32, 2020-21 IRB 837.

218. *Further Consolidated Appropriations Act of 2020,* PL 116-94, §104; IRC §45E.

219. IRC §45E(d)(1)(B).

220. IRS Notice 2020-79, 2020-46 IRB 1014.

221. IRC §45E(d)(2), referring to IRC §4972(d).

222. IRC §265(a)(1); and Treas. Reg. §1.265-1, as referred to in IRS Notice 2020-32, 2020-21 IRB 837.

Example 29. Use the same facts as in **Example 18,** except for the following issues.

- Reliable Pump Corporation is an S corporation that meets the eligible small employer qualifications for the small employer pension plan startup credit.
- Reliable has never had an employee pension plan.
- Reliable employs 21 non-highly-compensated individuals.

The management of Reliable Pump Corporation had been contemplating an employee pension plan for some time, and the SECURE Act provided the incentive to start a SEP plan. They contacted an investment firm in December 2019 immediately after passage of the Act. Their SEP plan went into effect effective January 1, 2020. The list of participating employees also includes four management personnel, each of whom owns more than 5% of Reliable's stock or earn more than $130,000. All 21 nonhighly compensated employees participate.

In starting its SEP plan, Reliable incurs the following costs in 2020.

- $300 flat maintenance fee ($25 monthly)
- $2,700 maintenance fee per participant ($9 monthly × 25 employees × 12 months). The plan covers 25 total employees, including 21 nonhighly paid employees plus four management personnel.
- $200 to print informative brochure
- $1,056 to hire a human resource firm to provide employee education because the new SEP includes a provision that new employees are automatically enrolled unless they opt out

During 2020, Reliable incurs total costs for its qualified start up plans under IRC §45E(d)(1)(A) of **$4,256** ($300 + $2,700 + $200 + $1,056). Additionally, Reliable is eligible for the $500 small employer auto-enrollment credit. Reliable's Form 8881 for 2020 and the applicable section of its Form 1120-S, *U.S. Income Tax Return for an S Corporation* follow.

Form **8881** (Rev. December 2020) Department of the Treasury Internal Revenue Service

Credit for Small Employer Pension Plan Startup Costs and Auto-Enrollment

► Attach to your tax return.
► Go to *www.irs.gov/Form8881* for instructions and the latest information.

OMB No. 1545-1810
Attachment Sequence No. **130**

Name(s) shown on return: **Reliable Pump Corporation**
Identifying number: **12-3456782**

Part I Credit for Small Employer Pension Plan Startup Costs

1	Qualified startup costs incurred during the tax year	1	4,256		
2	Enter one-half of line 1			2	2,128
3	Enter the number of employees eligible to participate in the pension plan. See instructions. 21 X 250			3	5,250
4	Enter the greater of $500 or the amount from line 3 (Do not enter more than $5,000)			4	5,000
5	Enter the smaller of line 2 or line 4			5	2,128
6	Credit for small employer pension plan startup costs from partnerships and S corporations			6	
7	Reserved for future use			7	
8	Add lines 5 and 6. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j			8	2,128

Part II Small Employer Auto-Enrollment Credit

9	Enter $500 if an auto-enrollment option is provided for retirement savings	9	500
10	Small employer auto-enrollment credit from partnerships and S corporations	10	
11	Add lines 9 and 10. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j	11	500

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 33435N Form **8881** (Rev. 12-2020)

For Example 29

De	d	Other deductions (see instructions) . . . . Type ▶	12d	
Credits	13a	Low-income housing credit (section 42(j)(5))	13a	
	b	Low-income housing credit (other)	13b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable) . .	13c	
	d	Other rental real estate credits (see instructions) Type ▶	13d	
	e	Other rental credits (see instructions) . . . Type ▶	13e	
	f	Biofuel producer credit (attach Form 6478)	13f	
	g	Other credits (see instructions) . . . . . Type ▶ **SEE STATEMENT 1**	13g	**2,628**
	14	Name of country or U.S. possession ▶		

STATEMENT 1
FORM 1120S, LINE 19
OTHER DEDUCTIONS

REDUCTION FOR SMALL EMPLOYER PENSION PLAN STARTUP COSTS CREDIT	$ -2,128
REDUCTION FOR SMALL EMPLOYER PENSION PLAN AUTO-ENROLLMENT	$ -500
TOTAL	$ -2,628

The small employer automatic enrollment credit and the small employer pension plan startup cost credit appear together on line 13g of Form 1120-S, Schedule K, *Shareholders' Pro Rata Share Items.* In addition, there is little room for the name of the credit and the tax preparer should expect a statement to generate, even if the taxpayer qualifies for only one of the credits. Because the credit flows through to stockholders or to partners, the taxpayer does not file a Form 3800. Instead, the credit is reported in box 13 of Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.,* or box 15 of Schedule K-1 (Form 1065) . Code 'P' is used with either Schedule K-1.

> **Example 30.** Use the same facts as **Example 29,** except that one of the four management personnel participating in the plan is Lucy Hayes, the S corporation's majority shareholder with 82% of the stock. The other three shareholders each own 6% of the stock. Assume further that Reliable has ordinary business income of $100,000 for the year 2020. Lucy's 82% share of the ordinary business income is $82,000, and her share of the credit is $2,155 ($2,628 × 0.82). The top part of Lucy's Schedule K-1 (Form 1120-S) follows.

For Example 30

671120

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120-S) **2020**

Department of the Treasury
Internal Revenue Service

For calendar year 2020, or tax year

beginning 01 / 01 / 2020 ending 12 / 31 / 2020

Shareholder's Share of Income, Deductions, Credits, etc. ► See separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
12-3456782

B Corporation's name, address, city, state, and ZIP code
Reliable Pump Corporation
123 W Fry St
Peoria IL 61603

C IRS Center where corporation filed return

Part II Information About the Shareholder

D Shareholder's identifying number
***-**-5337

E Shareholder's name, address, city, state, and ZIP code
Lucy Hayes
123 E Main St
Dunlop IL 61525

F Current year allocation percentage . . . 82 %

G Shareholder's number of shares
Beginning of tax year 82
End of tax year 82

H Loans from shareholder
Beginning of tax year . . . . . . $
End of tax year . . . . $

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	82,000	13	Credits	P* 2,155
2	Net rental real estate income (loss)				
3	Other net rental income (loss)				
4	Interest income				
5a	Ordinary dividends				
5b	Qualified dividends		14	Foreign transactions	
6	Royalties				
7	Net short-term capital gain (loss)				
8a	Net long-term capital gain (loss)				
8b	Collectibles (28%) gain (loss)				
8c	Unrecaptured section 1250 gain				
9	Net section 1231 gain (loss)				
10	Other income (loss)		15	Alternative minimum tax (AMT) items	
11	Section 179 deduction		16	Items affecting shareholder basis	
12	Other deductions				
			17	Other information	

18 ☐ More than one activity for at-risk purposes*
19 ☐ More than one activity for passive activity purposes*

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see the Instructions for Form 1120-S. www.irs.gov/Form1120S Cat. No. 11520D Schedule K-1 (Form 1120-S) 2020