



KPMG report: Notice 2021-23 and employee retention credit for first two calendar quarters of 2021

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The IRS on April 2, 2021, released an advance version of Notice 2021-23 to provide guidance with respect to the employee retention credit (“ERC”) for the first two calendar quarters of 2021. In particular, Notice 2021-23 addresses amendments to Section 2301 of the *Coronavirus Aid, Relief, and Economic Security Act* (Pub. L. No. 116-136) (“CARES Act”) made by Section 207 of the *Taxpayer Certainty and Disaster Tax Relief Act of 2020*, which was enacted as Division EE of the *Consolidated Appropriations Act, 2021* (Pub. L. No. 116-260) (“Relief Act”). Amendments to the ERC made by Section 207 of the Relief Act are generally effective beginning January 1, 2021.

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Background

As originally enacted under Section 2301 of the CARES Act, the ERC provides a refundable payroll credit for eligible employers, including tax-exempt organizations, whose business has been affected by COVID-19 for qualified wages paid after March 12, 2020, and before January 1, 2021.¹ An employer is generally considered to be an eligible employer with respect to any calendar quarter (1) for which the operation of the trade or business carried on during such quarter is fully or partially suspended due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings due to COVID-19 (the “partial suspension test”), or (2) there is a significant decline in gross receipts for such quarter (the “gross receipts test”).

Retroactive changes to Section 2301 were made to the ERC by Section 206 of the Relief Act.² The IRS recently issued Notice 2021-20 to formalize and clarify previously issued information contained in the “frequently asked questions” (“FAQs”) available on the IRS website with respect to the ERC for the 2020 calendar year.³

¹ See [TaxNewsFlash](#): JCT description of employee retention credit, payroll deferral provisions in CARES Act

² See [TaxNewsFlash](#): Review of compensation and benefits-related tax provisions in Consolidated Appropriations Act, 2021

³ See [TaxNewsFlash](#): Notice 2021-20 provides much anticipated guidance regarding the employee retention credit for 2020

Prospective changes to the ERC were also made by the Relief Act. In particular, Section 207 of the Relief Act extends the application of the ERC to qualified wages paid after December 31, 2020, and before July 1, 2021, it increases the potential credit available for qualified wages, and it modifies the computation of qualified wages paid during that time period.

Additional changes to the ERC were made under Section 9651 of the *American Rescue Plan Act of 2021* (“ARP Act”) (Pub. L. No. 117-2) (March 11, 2021). In particular, the ARP Act enacted section 3134 of the Internal Revenue Code of 1986, as amended, for wages paid after June 30, 2021, and before January 1, 2022. Notice 2021-23, however, does not address the changes made to the ERC by the ARP Act, and further guidance regarding section 3134 is expected from the Treasury Department and the IRS.

Notice 2021-23

The amendments to the ERC for the first two quarters of 2021 only affect specific portions of Section 2301 of the CARES Act. As a result, the applicable provisions of Notice 2021-20 that were not changed by the Relief Act continue to apply to the ERC for the first two quarters of 2021. Additional guidance regarding amendments to the ERC for the first two calendar quarters by the Relief Act is described in more detail below.

Eligible employers—Public colleges and universities and certain entities providing medical care

Although the ERC is not available to certain governmental entities (e.g., the government of the United States, the government of any state or political subdivision thereof, or any agency or instrumentality of any of the foregoing), the ERC may be available to certain governmental entities and tax-exempt organizations for the first two quarters of 2021 if the other relevant ERC requirements are satisfied.

As amended, the ERC is available to an organization described under section 501(c)(1) and exempt from tax under section 501(a), as well as for any governmental entity if such entity is:

- A college or university (as defined in section 170(b)(1)(A)(ii) and Treas. Reg. §1.170A-9(c)(1)); or
- An entity whose principal purpose or function is providing medical or hospital care (within the meaning of section 170(b)(1)(A)(iii) and Treas. Reg. §1.170A-9(d)(1)).

These entities are treated as satisfying the trade or business requirement of section 2301(c)(2)(A)(i).

Decline in gross receipts

General gross receipts test: As amended, an employer is an eligible employer due to a decline in gross receipts with respect to any calendar quarter for which its gross receipts (within the meaning of section 448(c), or, for an organization described in section 501(c) and exempt from tax under section 501(a), within the meaning of section 6033) for the calendar quarter are less than 80% of its gross receipts for the same calendar quarter in 2019. For purposes of the ERC for the first two quarters of 2021, the gross receipts test is determined separately for each calendar quarter and is based on this 80% threshold.

For an employer that was not in existence at the beginning of the same calendar quarter in 2019, the employer generally determines whether the general gross receipts test is met by comparing instead to the same calendar quarter in 2020. For example:

- An employer that was not in existence at the beginning of 2019 generally determines whether the gross receipts test is met in the first quarter of 2021 by comparing its gross receipts in the first quarter of 2021 to its gross receipts in the first quarter of 2020.
- If an employer was not in existence as of the beginning of the second quarter of 2019, the employer generally determines whether the gross receipts test is met for the second quarter of 2021 by comparing its gross receipts in that quarter to its gross receipts in the second quarter of 2020.

Alternative test: An alternative test may be used to determine whether the gross receipts test is satisfied by comparing its gross receipts for the immediately preceding calendar quarter with those for the corresponding calendar quarter in 2019. For example:

- Under the alternative test for the first calendar quarter of 2021, the gross receipts for the fourth calendar quarter of 2020 are compared to the gross receipts for the fourth quarter of 2019. If the employer was not in existence as of the beginning of the fourth quarter of 2019, the alternative test is not available.
- Under the alternative test for the second calendar quarter of 2021, the gross receipts for the first quarter of 2021 are compared to the gross receipts for the first quarter of 2019. If an employer was not in existence as of the beginning of the first quarter of 2019, then the employer may elect to measure the decline in gross receipts by using its gross receipts for the first calendar quarter in 2021 compared to those for the first quarter of 2020.

Maximum amount of the ERC

The amount of the ERC, as amended by the Relief Act, equals 70% of qualified wages, including allocable qualified health plan expenses, that an eligible employer pays in a calendar quarter up to a \$10,000 limit for any calendar quarter. Thus, the maximum credit for qualified wages, including allocable qualified health plan expenses, paid to an employee is \$7,000 for each of the first and second calendar quarters of 2021 (thus, a potential ERC totaling \$14,000 for both the first and second quarters of 2021).

Qualified wages

Number of full-time employees: The amount of wages that are considered qualified wages generally depends, in part, on the average number of full-time employees the eligible employer employed during 2019.

- As amended by the Relief Act, an eligible employer is considered a “large eligible employer” if the average full-time employees during 2019 was greater than 500. An eligible employer with 500 or fewer employees is a “small eligible employer.”
- The aggregation rules described in Notice 2021-20 are applicable to determine whether a particular employer is a large or small eligible employer (although the threshold number of employees is different). Generally, under Notice 2021-20, all persons treated as a single employer under section 52(a) or (b), or section 414(m) or (o), is treated as a single employer for purposes of the ERC.
- In defining “full-time employee,” Notice 2021-23 references section 4980H(c)(4) to define full-time employee as an employee who, with respect to any calendar month, had an average of at least 30 hours of service per week or 130 hours of service in the month (130 hours of service in a month are

treated as the monthly equivalent of at least 30 hours of service per week), and does not refer to the separate subsection that—for its limited purpose—requires the addition of full-time equivalents.

Amount of qualified wages:

- With respect to the ERC for the 2020 calendar year, qualified wages could not exceed what the employee would have been paid for working an equivalent duration during the 30 days immediately preceding the start of the full or partial suspension or the first day of the calendar quarter in which the gross receipts test was met.⁴ As amended by the Relief Act, this limitation is not applicable to the computation of qualified wages by an eligible employer for the first two quarters in 2021.
- As amended by the Relief Act, qualified wages for certain organizations described under section 501(c)(1) and exempt from tax under section 501(a) or a governmental entity that is a college, university, or entity whose principal purpose or function is providing medical care, may include certain amounts that are generally disregarded for purposes of section 3121(a). In particular, the computation of qualified wages for such entities includes amounts described in paragraphs (5), (6), (7), (10), and (13) of section 3121(b) (except with respect to services performed in a penal institution by an inmate) for the first two calendar quarters of 2021.

Exclusions from qualified wages: As amended, an eligible employer may not claim a credit under section 41, 45A, 45P, 45S, 51, and 1396 for the first two quarters of 2021 with respect to the same wages used to claim the ERC for such quarters. However, a credit under these sections may be available with respect to other wages. Further, for the first two quarters of 2021 an employee may be included for purposes of computing the ERC for any period the employer may be allowed a work opportunity tax credit under section 51 with respect to such employee.

Reducing employment tax deposits to claim the ERC

An eligible employer may continue to access the ERC for the first two calendar quarters of 2021 prior to filing their employment tax returns by reducing employment tax deposits in anticipation of the ERC in accordance with Notice 2020-22.⁵ The Treasury Department and the IRS anticipate issuing specific guidance regarding penalty relief with respect to the ERC for the 2021 calendar year.

Requesting advance payment of the ERC to claim the ERC

For the first two calendar quarters in 2021, the Relief Act prohibits the advance payment of the ERC to large eligible employers. A small eligible employer may elect to receive an advance payment of the ERC, although not in excess of 70% of the average quarterly wages paid in calendar year 2019 (the “70% advance rule”), and subject to the requirement that such employer reduce deposits in anticipation of the ERC before requesting an advance of the ERC.

Average quarterly wages: For purposes of the 70% advance rule, the Treasury Department and the IRS determined that “average quarterly wages” means the average wages (as defined in section 3121(a)), or compensation (as defined in section 3231(e)), both determined without regard to the social security wage

⁴ Notice 2021-20, Q/A-35.

⁵ See [TaxNewsFlash](#): Notice 2020-22: Penalty relief, reduced federal employment tax deposits in anticipation of tax credits (COVID-19)

base, paid in each calendar quarter in 2019. The average quarterly wages for the 70% advance rule are computed based on the quarterly wages paid by all members of the aggregated group.

For a small eligible employer who files Form 941, *Employer's Quarterly Federal Tax Return*, the average quarterly wages for the 70% advance rule are calculated by averaging the "Taxable Medicare wages & tips" required to be reported on Line 5c on all Forms 941 required to be filed for wages paid in 2019.

For a small eligible employer that files an annual federal employment tax return, the average quarterly wages for the 70% advance rule are calculated by dividing the amount required to be reported on the following forms, as applicable, by four:

- Line 4, "Total wages subject to Medicare tax," on the 2019 Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*;
- Line 4c, "Total Medicare wages and tips," on 2019 Form 944, *Employer's Annual Federal Tax Return*;
- The sum of amounts in the "Compensation" columns on Line 2, "Tier 1 Employer Medicare Tax – Compensation (other than tips and sick pay)," and Line 9, "Tier 1 Employer Medicare Tax – Sick Pay," on the 2019 Form CT-1, *Employer's Annual Railroad Retirement Tax Form*.

To the extent seasonal employees (as defined in section 45R(d)(5)(B)) are employed by a small eligible employer, the small eligible employer may elect to determine the average quarterly wages based on wages for the 2019 calendar quarter which corresponds to the calendar quarter in which the election relates rather than the average quarterly wages paid in calendar year 2019. This method is used by requesting an advance based on the amount of wages of the 2019 calendar quarter corresponding to the calendar quarter to which the election relates. A small eligible employer that was not in existence in 2019 may use the average quarterly wages paid in 2020 to apply the 70% advance rule, and elects to use this rule by requesting an advance based on such wages.

Small eligible employers that come into existence in 2021: A small eligible employer that came into existence in 2021 may not claim an advance payment of the ERC. Similar to other eligible employers, however, these small eligible employers may reduce their employment tax deposits in anticipation of claiming the ERC on Form 941 (or other applicable federal employment tax return) in accordance with Notice 2020-22.

Small eligible employers that come into existence in 2019 or 2020: For employers that were in existence for some, but not all, calendar quarters in 2019 or 2020, average quarterly wages are determined by dividing the sum of wages paid in 2019 or 2020, as applicable, by the number of calendar quarters in 2019 or 2020, as applicable, in which that eligible employer existed. For example:

- If the eligible employer was only in existence for three calendar quarters in 2019, the employer would add the wages paid in each of those quarters and divide the total by three.

If the employer was only in existence for a portion of a calendar quarter, then the employer should estimate the wages paid in the calendar quarter based on the wages paid in the portion of the calendar quarter in which it existed using any reasonable method. For example:

- If the eligible employer existed for two out of the three months in the quarter, then the employer may multiply the wages paid in those two months by 1.5 before averaging the wages for that quarter with the wages for the other calendar quarters.

If an employer who files Form 943, 944, or CT-1 existed only for part of 2019 or 2020, then the employer may use any reasonable method to annualize the wages paid (or compensation for Form CT-1 filers) prior to dividing by four.

Conclusion

As a result of the expansion and changes to the ERC under the Relief Act, employers may be considering whether to claim the ERC for qualified wages paid for the first two quarters of 2021. When read together Notice 2021-20, as amplified by Notice 2021-23, provide employers with information to assist in evaluating eligibility for the ERC, determining qualified wages, and claiming the ERC. However, many situations may involve nuanced facts requiring a detailed analysis to determine whether the ERC is available. Further, additional questions remain outstanding, such as the computation of gross receipts for certain governmental entities and section 280G. As a result, employers may want to seek assistance from a qualified tax advisor to determine the application of the ERC rules contained in Notice 2021-23, substantiate their position, and claim the ERC.

Contact us

For more information, contact a tax professional with KPMG's Washington National Tax:

Robert Delgado

T: +1 (858) 750-7133

E: rdelgado@kpmg.com

Erinn Madden

T: +1 (202) 533-3757

E: erinnmadden@kpmg.com

Terri Stecher

T: +1 (202) 533-4830

E: tstecher@kpmg.com

www.kpmg.com

kpmg.com/socialmedia



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