Congressional Research Service
Informing the legislative debate since 1914

INSIGHT

COVID-19: The Employee Retention Tax Credit

March 31, 2020

The Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136) includes an employee retention payroll tax credit intended to help businesses retain employees during the Coronavirus disease 2019, or COVID-19, public health emergency. Employee retention remains a policy concern, as a number of economic sectors have announced layoffs resulting from the COVID-19 induced economic fallout. Unemployment insurance claims have surged following these widespread layoffs. This Insight summarizes the employee retention tax credit in the CARES Act, makes comparisons to previous employee retention tax credits enacted as disaster tax relief, and highlights some economic and policy considerations.

The Employee Retention Tax Credit

The employee retention tax credit (ERTC) allows eligible employers to claim a payroll tax credit of up to $5,000 per employee for qualified wages paid while closed or having reduced operations due to COVID-19. The credit is computed as 50% of up to $10,000 in qualified wages paid to an eligible employee. (Eligible employees are generally those who have been employed by the employer for at least 30 days.) Health plan expenses can be treated as qualified wages when computing the credit. The credit can be taken for wages paid after March 12, 2020, and before January 1, 2021.

Eligible employers are those who (1) are required to fully or partially suspend operations due to a COVID-19-related order (including nonprofit employers); or (2) have gross receipts 50% less than gross receipts in the same quarter in the prior calendar year (with the credit no longer being available once gross receipts are 80% of prior year calendar quarter gross receipts).

Congressional Research Service
https://crsreports.congress.gov
IN11299

Qualified wages depend on the number of employees the employer had during 2019. If the employer had more than 100 full-time employees, qualified wages are wages paid when employee services are not provided. (Qualified wages are limited to the amount the employee would have been paid for working an equivalent duration during the 30 days preceding the non-service period). If the employer had 100 or fewer full-time employees, all employee wages paid by eligible employers are credit-eligible. Wages taken into account for this credit cannot be taken into account for the tax credit for employer-provided paid family and medical leave.

The refundable structure of the payroll tax credit allows businesses to receive the benefit more quickly than typically would be the case for an income tax credit. Additionally, the Secretary of the Treasury is instructed to administer the credit in a way that allows for advance payment of the credit.

Employers cannot claim this credit if they had indebtedness of a small business interruption loan forgiven. This credit does not apply to government employers. A provision provides for transfers to the Old-Age and Survivors Insurance Trust Fund and the Disability Insurance Trust Fund, so that the Social Security trust funds would not be affected.

The Joint Committee on Taxation (JCT) estimates that the ERTC will reduce federal revenue by $54.6 billion (the combined total for FY2020 and FY2021).

Employer Retention Tax Credit: Stylized Example

Employer: Retail establishment ordered shut down as a nonessential retail business on March 20, 2020; establishment had 10 full-time employees in 2019 and still had 10 full-time employees in 2020. On March 20, 2020, employer laid off five employees; five employees continue to be paid.

Wages: Between March 20, 2020, and March 31, 2020, each retained employee receives $1,500 in wages.

Payroll Tax Credit: Payroll credit for this business is calculated as $1,500 × 50% × 5 = $3,750.

The business paid $7,500 in wages between March 20 and March 31, and it can claim a payroll tax credit of $3,750. As a small employer, all wages paid are eligible for the tax credit, regardless of whether services were provided.

The tax credit computed here reduces the employer's employment taxes. Assume that this employer had paid $9,750 in employer payroll taxes during the first quarter (January to March) of 2020. This employer would be able receive a $3,750 credit against their first quarter 2020 payroll taxes. If the business continues to be shut down in the second quarter, the employer may be able to claim additional tax credits.

Past Use of Employee Retention Tax Credits

ERTCs have often been enacted as a tax policy response to major disasters. Most recently, the Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Division Q of the Further Consolidated Appropriations Act, 2020; P.L. 116-94) included an income tax credit for employers who continued to pay wages to their employees after a disaster—in this case, generally those declared in 2018 and 2019—made the business inoperable. The credit is computed as 40% of the employee's first $6,000 in wages paid between the date the business became inoperable and the date it resumed significant operations or 150 days after the last day of the incident period. As an income tax credit, nonprofit employers do not receive any benefit. As part of the general business credit, businesses with limited tax liability may be able to carry back unused tax liability to offset positive tax liability in the prior tax year, or carry the credit forward to offset future positive tax liability for up to 20 years.

The JCT estimated that this provision will reduce federal revenue by $0.3 billion in FY2020.

Policy and Economic Considerations

The ERTC reduces the after-tax cost of compensating an employee. Because employees cost less, firms are presumably willing to pay for more hours and retain more employees than they would absent the credit. When businesses keep individuals employed these individuals continue to earn income, reducing unemployment compensation expenditures and helping to maintain individuals' incomes.

Payroll tax credits can be delivered relatively quickly, addressing potential concern about timing associated with past ERTCs. In the past, as income tax credits, employee retention credits have offered limited benefits to taxpayers with a limited income tax liability. A payroll tax credit does not depend on income tax liability. Further, payroll tax credits can be claimed by nonprofit employers.

One metric for evaluating the effectiveness of ERTCs relates to the *economic efficiency*, or "bang for the buck," of these incentives. In the current context, this would be credits claimed for wages paid to employees that would have otherwise been laid off, or had their hours reduced, relative to credits claimed for employees that would have remained on the payrolls, absent the tax credit. The larger this ratio, the more economically efficient the incentive.

Smaller employers (those who had 100 full-time employees or fewer in 2019) will be able to claim the tax credit for wages paid to employees that would have been retained absent the incentive, as well as any employees that are now retained because of the incentive. Although the credit can be claimed only for wages paid to employees who are not working, larger firms may be able to claim the credit for wages that would have been paid had the credit not been available. (Certain large businesses have announced their intent to pay employees during COVID-19 closures, although continuing to pay employees will become more challenging the longer businesses are closed.) To the extent that this credit is claimed for employees that would have been retained absent this credit, it is less economically efficient than payments directly targeted at those who are laid off.

Author Information

Molly F. Sherlock
Specialist in Public Finance

Disclaimer