

## Employee Retention Credit – Guidance on Majority Owners and Spouses

The Employee Retention Credit (ERC) has been around for a few years in connection with Federal Disaster Areas. Covid related Acts modified this credit (Cares Act §2301) for the year 2020, then it was extended for January-June 2021, then again for July-December 2021. And it may be stopped early (September 30, 2021) under one of the proposals Congress is currently talking about.

The Cares Act denies the ERC for wages paid to certain related parties. This includes individuals (i.e., employees) who are related to:

- The taxpayer (the one who is paying the wages),
- If the taxpayer is a corporation, any individual who owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation (i.e., majority owner of the corporation), or
- If the taxpayer is an entity other than a corporation, any individual who owns, directly or indirectly, more than 50% of the capital and profits interests in the entity.

The act specifically refers to IRC Sections §§280C and 51(i)(1) when referring to related parties.

The first step is to determine WHO the majority owners are. Section 51(i)(1) refers to direct and indirect ownership by referring to ownership as defined in §267(c).

- Section 267(c) deals with ownership and attribution of ownership. This list of relatives for ownership is different from the list of relatives whose wages don't qualify for the ERC. This section basically says ownership of a company includes direct ownership as well as indirect ownership. Indirect ownership says direct ownership is attributed indirectly to the following taxpayers:

- An individual indirectly owns ownership owned directly by his/her family which includes only "brothers and sisters (whether by whole or half blood), spouse, ancestors, and lineal descendants."
- Stock owned by a partnership, corporation, estate, or trust is considered owned indirectly proportionately by the entity's owners.

IRS POSITION as found in Notice 2021-49:

\*\*\* BEGIN QUOTE

Applying the rules of sections 152(d)(2)(A)-(H) and 267(c) of the Code, a majority owner of a corporation is a related individual for purposes of the employee retention credit, whose wages are not qualified wages, if the majority owner has a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant. That is, applying the constructive ownership rules of section 267(c), the direct majority owner's ownership of the corporation is attributed to each of the owner's family members with a relationship described in section 267(c)(4); further, because each of those family members is considered to own more than 50 percent of the stock of the corporation after applying section 267(c), the direct majority owner of the corporation would have a relationship as defined in section 152(d)(2)(A)-(H) to the family member who is a constructive majority owner. Therefore, the direct majority owner is a related individual for purposes of the employee retention credit.

The spouse of a majority owner is a related individual for purposes of the employee retention credit, whose wages are not qualified wages, if the majority owner has a family member who is a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant (and thus is deemed to own the majority owner's shares under section 267(c) of the Code) and the spouse bears a relationship described in section 152(d)(2)(A)-(H) of the Code to the family member. For example, a direct majority owner's brother would be a constructive majority owner under section 267(c)(2) and (4) and the spouse of the direct majority owner would be considered a related individual to the constructive majority owner by virtue of the in-law relationship described in section 152(d)(2)(G).

In the event that the majority owner of a corporation has no brother or sister (whether by whole or half-blood), ancestor, or lineal descendant as defined in section 267(c)(4) of the Code, then neither the majority owner nor the spouse is a related individual within the meaning of section 51(i)(1) of the Code and the wages paid to the majority owner and/or the spouse are qualified wages for purposes of the employee retention credit, assuming the other requirements for qualified wages are satisfied.

\*\*\* END QUOTE

The second step is to determine if any of the employees are related to ANY of the majority owners as defined in §51(i)(1).

- Section 51(i)(1) (Work Opportunity Credit rules) denies the credit for wages paid to related parties as defined in Section 152(d)(2). This portion of section 152 includes the following people related to the owner of the company:

- A) A child or a descendant of a child.
- B) A brother, sister, stepbrother, or stepsister.
- C) The father or mother, or an ancestor of either.
- D) A stepfather or stepmother.
- E) A niece or nephew.
- F) An aunts or uncle.
- G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- H) An individual (other than a spouse) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.

The following examples illustrate the application of these rules. These are from Notice 2021-49 (with some minor wording adjustments made by us). Assume all corporations meet the tests to qualify and the sole issue is whether certain wages qualify.

*Example 1:* Corporation A is owned 80 percent by Individual E and 20 percent by Individual F. Individual F is the child of Individual E. Both Individual E and Individual F are employees of Corporation A. Pursuant to the attribution rules of section 267(c) of the Code, both Individual E and Individual F are treated as 100 percent owners of Corporation A. Individual E has the relationship to Individual F described in section 152(d)(2)(C) of the Code, and Individual F has the relationship to Individual E described in section 152(d)(2)(A). Accordingly, Corporation A may not treat as qualified wages any wages paid to either Individual E or Individual F because

both Individual E and Individual F are each related individuals for purposes of the employee retention credit.

*Example 2:* Corporation B is owned 100 percent by Individual G. Individual H is the child of Individual G. Individual G is an employee of Corporation B, but Individual H is not. Pursuant to the attribution rules of section 267(c) of the Code, Individual H is attributed 100 percent ownership of Corporation B, and both Individual G and Individual H are treated as 100 percent owners. Individual G has the relationship to Individual H described in section 152(d)(2)(C) of the Code. Accordingly, Corporation B may not treat as qualified wages any wages paid to Individual G because Individual G is a related individual for purposes of the employee retention credit.

*Example 3:* Corporation C is owned 100 percent by Individual J. Individual J is married to Individual K, and they have no other family members as defined in section 267(c)(4) of the Code. Individual J and Individual K are both employees of Corporation C. Pursuant to the attribution rules of section 267(c), Individual K is attributed 100 percent ownership of Corporation A, and both Individual J and Individual K are treated as 100 percent owners. However, Individuals J and K do not have any of the relationships to each other described in section 152(d)(2)(A)-(H) of the Code. Accordingly, wages paid by Corporation C to Individual J and Individual K 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 4:* Corporation D is owned 34 percent by Individual L, 33 percent by Individual M, and 33 percent by Individual N. Individual L, Individual M, and Individual N are siblings. Individual L, Individual M, and Individual N are employees of Corporation D. Pursuant to the attribution rules of section 267(c) of the Code, Individual L, Individual M, and Individual N are treated as 100 percent owners. Individual L, Individual M, and Individual N have the relationship to each other described in section 152(d)(2)(B) of the Code. Accordingly, Corporation D may not treat as qualified wages any wages paid to Individual L, Individual M, or Individual N.

Interesting that §51(i)(1) doesn't mention "stepchildren." Nor does it mention "spouse."

Previously IRS had issued Notice 2021-20 (102 pages), focusing on the rules as they apply to 2020, and Notice 2021-23 (17 pages), focusing on the different rules as they apply to Jan-Jun 2021. All three of these Notices deal with the ERC and are in Question/Answer format. We find them useful and recommend reading each of them, in order.

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