

Snapshot

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Accounting for the Employee Retention Tax Credit

The Coronavirus Aid, Relief and Economic Security (CARES) Act of 2020 and subsequent amendments provide various forms of financial assistance to businesses and individuals in response to the COVID-19 pandemic. One form of assistance that many entities have applied for is the Employee Retention Tax Credit (or the Employee Retention Credit or ERC), which provides assistance similar to a government grant to qualifying employers in the form of refundable payroll tax credits.

Because U.S. GAAP does not currently contain direct guidance for business entities receiving government grants, business entities analogize to other standards to account for grants received, such as the ERC. Entities should carefully consider whether they have met the recognition threshold in the guidance to which they are analogizing before recognizing income related to the ERC. Recipients of the ERC should also ensure that they provide all required disclosures, all of which we discuss in further detail below.

Employee Retention Credit

The ERC is a fully refundable payroll tax credit that was enacted under the [CARES Act](#) to provide financial incentives to eligible businesses to retain their

workforce through the period of financial hardship resulting from COVID-19.

An employer is eligible for the ERC if it operated a trade or business in 2020 or 2021 and experienced either of the following conditions:

- A full or partial suspension of their trade or business during any calendar quarter in the covered period between March 12, 2020 and September 30, 2021 (for most entities¹) due to government orders limiting commerce, travel, or group meetings due to COVID-19 (the “governmental order test”); or
- A significant decline in gross receipts calculated for the years 2020 and 2021 using certain thresholds and comparisons to the same quarter in 2019 (the “gross receipts test”).

The IRS has issued [incremental guidance](#) about the ERC in various forms (Notices and FAQs, for example) that may be helpful for entities to review.

There are many specific criteria set forth by the IRS to consider when performing a full ERC analysis to determine whether the employer meets one of the above tests to qualify for the ERC—for example, applying aggregation rules to determine whether

¹ The Infrastructure Investment and Jobs Act retroactively terminated the covered period on September 30, 2021 rather than through December 31, 2021, except for certain start-up organizations.

certain entities are treated as a single eligible employer; determining which factors to consider for a full or partial suspension of operating the trade or business; evaluating what constitutes gross receipts for purposes of the “gross receipts test”; and, deciding which quarters to use in calculating the reduction in gross receipts.

Qualifying entities determine the ERC to which a qualifying employer may be entitled based on a percentage of qualified wages paid out during the period(s) in which an employer is eligible in 2020 and 2021. This calculation is based on the aggregated group’s average number of full-time employees in 2019.

Without entity-specific information to the contrary, a refund issued by the IRS after an entity claims the credit (generally by filing quarterly Form 941) does not necessarily indicate that the employer was entitled to the ERC. The IRS may subsequently initiate an ERC audit to recover ERC refunds that were issued, including potential penalties and interest, if the IRS determines the employer is not ERC-eligible or is ineligible for the full ERC claimed. The general statute of limitations for employment tax audits is three years, but the IRS’s ERC guidance has an extended five-year statute for the third quarter of 2021.² In a recent communication, the IRS indicated that it would bring civil suit against employers for fraudulent claims, extending the statute of limitations to five years.³ Additionally, on September 14, 2023, the IRS [announced a moratorium on processing new ERC claims](#) through at least December 31, 2023.

Accounting frameworks

The accounting and disclosure requirements for government assistance provided to a business entity depends on whether the assistance is considered a loan, a payment for goods or services, an income tax credit, or a grant.

The ERC is a refundable payroll tax credit as opposed to an income tax credit and, therefore, is not within the scope of ASC 740, *Income Taxes*. Additionally, the ERC functions like a government grant and should be accounted for in a manner consistent with other government grants.

The FASB has provided direct accounting guidance in ASC 958-605 for not-for-profit entities (NFPs) to use when accounting for government grants such as the

ERC. Business entities, however, are excluded from the scope of ASC 958-605 and, lacking other direct guidance in U.S. GAAP, are allowed to analogize to other accounting guidance to account for the ERC.

In practice, business entities generally apply one of three frameworks by analogy to recognize and measure government assistance, all of which have been noted by the [AICPA](#): (1) the guidance on contributions received by NFPs in ASC 958-605, (2) the guidance regarding gain contingencies in ASC 450-30, and (3) the guidance on government grants and assistance in International Accounting Standards (IAS) 20. Regardless of the accounting framework used by analogy, an entity should consider the disclosure requirements of ASC 832, *Disclosure of Government Assistance*, in addition to the disclosure guidance in the framework to which they have analogized.

An entity that has already adopted an accounting policy for accounting for government grants should continue to apply that policy to the ERC.

Summary of recognition thresholds

Standard	Threshold for recognition
IAS 20 on government grants	When there is reasonable assurance, the entity will comply with the conditions and receive the grant
ASC 958-605 on contribution revenue	When the barrier to entitlement is substantially met
ASC 450-30 on gain contingency	When all related contingencies have been met and the gain is realized or realizable

IAS 20 on government grants

Under IAS 20, government grants are recognized when there is reasonable assurance that the grant will be received and that all conditions related to the grant will be met. If the grantor provides resources without affirming that the grant’s conditions have been or will be met and retains the right to subsequently audit the grantee’s assertions about these conditions being met, the assessment of whether there is reasonable

² The American Rescue Plan Act of 2021 (ARPA) extended the statute of limitations for IRS assessments to five years for employee retention credit claims for the second half of 2021.

³ Pursuant to IRC Section 7405(b).

assurance that these conditions will be met should be made without considering the likelihood that an audit will be performed.

Grants that meet the recognition threshold under IAS 20 should be recognized in income on a systematic and rational basis over the period when the entity incurs related costs after considering any clawback conditions. The manner in which the grant is received, such as a reduction of a liability or a cash payment, does not impact the accounting. IAS 20 also states that a forgivable loan from a government should be treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

Under the IAS 20 model, there are two types of government grants: *asset-related* and *income-related*.

The primary condition of an *asset-related grant* is that the entity qualifying for the grant should purchase, construct, or otherwise acquire long-term assets. An asset-related government grant might also feature subsidiary conditions that could restrict the type or location of the assets as well as the periods during which they are acquired or held.

All other government grants are considered *income-related*.

For asset-related government grants, IAS 20 includes two acceptable methods of presenting the amount received in the financial statements. Under the first method, an entity initially recognizes the grant as a deferred income liability that is subsequently recognized in income on a systematic basis over the useful life of the related asset. Under the second method, the carrying amount of the asset is calculated, net of the proceeds received under the grant, and the grant is recognized in income over the life of a depreciable asset as a reduction to depreciation expense. Under both methods, the receipt of the grant and purchase of the related asset are separately presented in the statement of cash flows.

For income-related government grants, IAS 20 similarly includes two acceptable methods for presenting the amount received under the grant. Under the first method, the amount of the grant is presented separately in income. Under the second method, the amount of the grant is deducted from the related expense. Under both presentation methods, the grant is recognized in income on a systematic basis over the periods in which the reporting entity recognizes as expenses the related costs for which the grant is intended to compensate.

Under IAS 20, if a government grant that was previously recognized becomes repayable, it should be accounted for as a change in estimate. Repayment

of an asset-related grant should be recognized by increasing the carrying amount of the asset or by reducing the deferred income balance by the amount repayable. Additionally, an entity should immediately recognize in income the cumulative additional depreciation that would have been recorded if the amount repaid had been part of the asset's cost basis. Repayment of an income-related grant should be applied against any deferred credit recognized from the grant and the remainder to income.

ASC 958-605 on contribution revenue

ASC 958-605 provides accounting guidance for recipients of contributions. While the scope of that guidance specifically excludes business entities receiving contributions from the government, the AICPA in [TQA 3200.18](#) suggested that entities other than NFPs may analogize to this guidance.

When applying ASC 958-605, an entity must determine whether a grant contains a donor-imposed condition that precludes recognition until the condition is met and the grant becomes unconditional. A donor-imposed condition is a stipulation by the donor that either

- Represents one or more barriers that must be overcome for the entity to be entitled to the grant
- Requires the recipient to return the funds if the barrier(s) are not overcome

In order to meet these two conditions, the guidance stipulates that the barrier(s) must be "substantially met." An entity applying ASC 958-605 must evaluate whether the barrier is "substantially met" without regard to the probability that it will be met in the future.

Under ASC 958-605, a government grant is measured at the fair value of the contribution received at the time when the barrier is overcome. This guidance requires unconditional grants to be recognized as revenue or other income in the income statement, and does not permit such grants to be recorded as an offset to related expenses.

ASC 450-30 on gain contingencies

Under ASC 450-30, a contingency that might result in a gain is not recognized until it has been resolved, at which time, the gain becomes realized or realizable.

Application of accounting frameworks to the ERC

Under each accounting framework, the ERC cannot be recognized as grant income until the threshold for recognition in the given framework has been met. Additionally, prior to the receipt of cash, an entity should not recognize the ERC on the balance sheet

until the threshold for recognition in the given accounting framework has been met.

IAS 20

Under IAS 20, the ERC is regarded as an income-related grant. Recognition is not appropriate until the recognition threshold has been met—that is, when it is reasonably assured that (1) the reporting entity will receive the credits, and (2) the IRS would conclude, under audit, that the eligibility criteria for the credits received have been met. We believe condition (2) is considered met no later than when the statute of limitations on the IRS's ability to audit the reporting entity's eligibility for the ERC has expired. As most entities claim the ERC in periods following the covered period, the ERC typically relates to employee expense already incurred in prior periods, and so the ERC is generally recognized in full at the time when the recognition criteria are met.

IAS 20 provides entities with options in presenting government grants in the financial statements. Because the ERC is considered an income-related grant under IAS 20, an entity may elect to present the income in one of two ways: (1) gross as a grant or other income item, or (2) net as a deduction from the expense category in which the reporting entity reports employment taxes (typically employee compensation).

ASC 958-605

Under ASC 958-605, the ERC is considered a grant with a donor-imposed condition. The barrier that must be overcome is the reporting entity's eligibility for the ERC, and the donor's right of return is carried out in the form of an audit by the IRS. As a result, the ERC cannot be recognized until either (1) the barrier of eligibility is substantially met, or (2) the statute of limitations expires and the donor can no longer require the grantee to return the funds.

Once the condition is met and the ERC becomes unconditional, it is recorded as income in the amount received. Generally, we believe that recognizing the ERC as revenue would not be appropriate, as the government is not a customer.

ASC 450-30

Under the gain contingency guidance in ASC 450-30, the ERC is recognized only after the related contingency is resolved and deemed realizable, at which time, the grant would be recognized in the income statement as a gain. The contingency for the ERC is resolved only after either (1) the IRS affirms the reporting entity's eligibility, or (2) the statute of limitations that applies to the IRS's ability to audit the reporting entity's eligibility has expired.

Other potential accounting consequences

Entities that claim the ERC may also need to amend prior income tax return filings to reduce previously taken payroll deductions for which the ERC has now been claimed. Entities should carefully evaluate the impact of such amendments to prior income tax returns, considering the guidance in ASC 740. The analysis may be complex when juxtaposing the extended five-year statute of limitations on ERC claims with the general three-year statute of limitations on amended income tax returns. In this scenario, entities may be required to assess the ERC-related amendments as an uncertain tax position under ASC 740, particularly when an entity's ERC claim has not met the recognition threshold under the applicable accounting framework.

Analysis of the recognition thresholds

Because the ERC is paid out by the IRS when an entity files for the ERC and is only potentially recaptured through an audit, receipt of the credits or related cash refunds does not provide evidence or confirmation that the eligibility criteria for the credits have been met. As noted above, on September 14, 2023, the IRS [announced](#) a moratorium on processing new ERC claims through at least December 31, 2023. The moratorium was ordered in response to "rising concerns about a flood of improper claims" and to "protect honest small business owners from scams." As part of that announcement, the IRS also indicated that it would be "shifting its focus to review [previously filed] claims for compliance concerns, including intensifying audit work and criminal investigations on promoters and businesses filing dubious claims." IRS Commissioner Danny Werfel urged entities to carefully examine the credentials of service providers offering to assist with filing ERC claims, noting that "businesses should seek out a trusted tax professional who actually understands the complex ERC rules, not a promoter or marketer hustling to get a hefty contingency fee." The IRS also [issued](#) a separate list of red flags to assist entities in identifying service providers that may more likely be associated with an inappropriate ERC claim.

Accordingly, entities should use caution in assessing whether the recognition threshold of the applicable accounting framework has been met and should carefully consider all of the eligibility criteria and the calculation criteria of the ERC. This assessment often requires significant judgment, considering an entity's particular facts and circumstances, and may require the use of subject matter experts familiar with ERC factors, such as identifying a specific government order that required a full or partial suspension of the entity's (and its aggregated group's) operations. Other factors that may also require a detailed analysis to confirm that

the ERC's eligibility criteria have been met and the ERC amount has been calculated appropriately include

- Considering whether the aggregated group rules promulgated by the IRS apply
- Determining the amount of gross receipts to use when applying the gross receipts test
- Determining the number of full-time employees
- Calculating the qualified wages used to claim the ERC, including all required exclusions from the qualified wages, such as certain wage-based credits and Payroll Protection Program loan payroll costs

Applying the IRS guidance to an entity's specific facts is a matter of judgment that must be well supported. In our experience, adequate documentation to support those critical judgments, as well as substantiating document eligibility and the ERC calculation, are imperative components that are lacking in many ERC claims filed. Additionally, entities should carefully consider the extent to which they rely on an ERC service provider to support the entity's ERC claim, as some ERC promoters have specific language in their contracts that put the burden of responsibility for ERC eligibility determinations solely on the entity.

As a result, when considered in combination with the stringent recognition criteria in the applicable accounting frameworks applied by analogy, it may be difficult in practice to establish that an entity has a sufficient basis to recognize the ERC. While an entity may engage a third-party service provider to assist in assessing its eligibility under the ERC and in calculating the amount of tax credits to claim, use of a specialist on its own may not be sufficient to evidence that the recognition threshold has been met. It is important to keep in mind that the entity is responsible for supporting its assertion that the recognition is appropriate with sufficient, competent corroborating evidence.

Accounting for contingent service provider fees

Some entities have entered into contingent fee arrangements with service providers in connection with filing an ERC claim. Commonly, these arrangements require the entity filing the ERC claim to pay the service provider a fee upon filing the claim. The service provider may be required to repay some of this fee in the event the claim is denied or recaptured through IRS audit.

The terms and conditions of such arrangements can vary, so entities with such arrangements will need to evaluate the specific facts and circumstances of their contractual arrangements to determine the appropriate accounting. However, entities generally should

recognize amounts paid or payable to service providers as expenses as the services are rendered. Accordingly, any amounts that may be recoverable from the service provider would be analyzed as contingent gains under ASC 450-30 and, therefore, would generally not be recognized until all related contingencies have been met and the gain is realized or realizable.

Additionally, entities should account for the amounts paid, payable, or recoverable under arrangements with service providers separately from the ERC itself. The ERC and the arrangement with a service provider are separate arrangements with separate counterparties.

Disclosure

The guidance in ASC 832, *Disclosure of Government Assistance*, applies to ERC transactions. That guidance requires the following disclosures about government assistance transactions in the notes to the annual financial statements:

- Information about the nature of the transactions, including a general description and the form (cash or other assets, for example) in which the assistance has been received
- The policies used to account for the transactions
- Line items on the balance sheet and income statement affected by the transactions and the amounts that apply to each financial statement line item in the current reporting period

Furthermore, an entity is required to disclose information about the significant terms and conditions of transactions with a government, which may include

- The duration or period of the agreement
- Any commitments made by the parties
- Provisions for recapturing grant proceeds received, including the conditions that allow recapture
- Other contingencies

The disclosures in ASC 832 are required for annual periods only; however, a public entity that applies for or receives ERC funds in an interim period should disclose its accounting policy for government grants as well as the ERC transaction itself if material, in accordance with the interim disclosure requirements in ASC 270.

An entity that has applied for the ERC must elect an accounting policy as to which accounting framework it will analogize for recognition and measurement prior to its first subsequent financial reporting date. This is necessary in order for the entity to evaluate whether it has met the recognition threshold or not. Accordingly,

an entity that has applied for a grant but has not yet met the given recognition threshold should nonetheless apply the provisions of ASC 832 on describing the nature of the grant, its significant terms and conditions, and the accounting policies elected to account for the grant.

In addition to the disclosure requirements in ASC 832, an entity should also consider whether the disclosure requirements of the accounting guidance to which they analogized for purposes of recognition and measurement apply.

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