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Congress extends tax credit for paid family and medical leave

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Feb. 12, 2021

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The federal tax credit for employers providing paid family and medical leave has been extended through 2025, under the Consolidated Appropriations Act of 2021 (Pub. L. No. 116-260). First enacted as a two-year pilot program under the Tax Cuts and Jobs Act of 2017 (Pub. L. No. 115-97), the tax credit had been extended through 2020 by earlier appropriations legislation (Pub. L. No. 116-94). Now employers providing paid family and medical leave that meets certain requirements can take advantage of a general business tax credit for 2021 through 2025. The temporary credit ranges from 12.5% to 25% of wages paid to qualifying employees for up to 12 weeks of family and medical leave per taxable year. However, certain requirements and limitations put the credit out of reach for many employers with paid leave programs.

Requirements for tax credit

For employers to claim the credit under Section 45S of the Internal Revenue Code (IRC), paid leave programs must meet several requirements. For example, employers must have a written policy describing the program, which must satisfy specific Family and Medical Leave Act (FMLA) requirements and offer at least two weeks of paid leave to certain full- and part-time employees. An employer doesn't have to offer each type of FMLA leave on a paid basis to qualify for the credit. If all conditions are met, the credit is available to any employer providing paid family and/or paid medical leave — even if the employer is exempt from the FMLA or the employee taking the leave is ineligible for FMLA protection.

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Written policy providing paid family and medical leave

To qualify for the credit, an employer must have a written paid family and medical leave policy — whether contained in a single document, multiple documents or a larger leave policy — that meets several criteria. The policy must be in place before the paid leave is taken. However, IRS Notice 2018-71 allowed retroactive payments for qualifying leave in 2018 to receive the credit, as long as employers adopted or amended a written policy before the end of 2018. Specific policy requirements include the provisions described below.

Full-time and part-time employees eligible. Employers must provide the paid leave to all qualifying employees (defined later), whether full-time or part-time, even if they do not qualify for FMLA coverage. If the policy excludes a group of otherwise qualified employees (such as collectively bargained employees), the employer cannot take the tax credit.

At least two weeks of paid leave. The policy must provide at least two weeks of paid leave to full-time employees and a prorated amount to part-time employees. For example, if an employer's parental leave policy provides only five days of paid leave, the credit wouldn't be available.

Paid leave limited to FMLA-protected purposes. A paid leave policy for general purposes — such as sick leave or paid time off (PTO) — does not qualify an employer for the credit. Instead, the policy must specifically provide paid leave for one or more of the reasons allowed under the FMLA:

- To bond with a new child after birth or placement for adoption or foster care
- To care for a spouse, son, daughter or parent who has a serious health condition
- To care for the employee's own serious health condition
- To handle a qualifying exigency related to a spouse's, son's, daughter's or parent's active military duty or call to active duty
- To care for a related service member with a serious injury or illness

Leave pay equals at least 50% of regular pay. The policy must provide that the employer will pay at least 50% of regular wages during the leave. This benefit does not include any paid family and medical leave provided under a state or local government program or required by a state or local law.

FMLA protections apply. To qualify for the credit, employers must provide certain employee protections required by the FMLA — even if the employer or employee normally is FMLA-exempt or the leave otherwise wouldn't qualify for FMLA protection. As a result, a paid leave policy covering FMLA-ineligible employees or offered by an FMLA-exempt employer must contain the following language:

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> [Employer] will not interfere with, restrain, or deny the exercise of, or the attempt to exercise, any right provided under this policy. [Employer] will not discharge, or in any other manner discriminate against, any individual for opposing any practice prohibited by this policy.

Because the paid leave must be available to qualifying employees without regard to hours worked and at worksites that may not be subject to FMLA, most employers have to include this noninterference language in their policies if they want to access the credit.

Benefit variations for different types of FMLA leave permitted

Employers can obtain the credit even if they don't provide paid leave for all FMLA purposes or offer the same benefit or duration for all types of FMLA leave. A policy that provides paid leave for one or more FMLA-type purposes — including a short-term disability (STD) policy, as detailed below — suffices if all other conditions are met.

A policy can even extend more generous benefits or longer leaves for some FMLA-like purposes than others. For example, an employer's policy can provide:

- 10 weeks of leave at 100% pay to bond with a new child, but only six weeks of leave at 60% pay to care for a family member with a serious illness
- Two weeks of FMLA-type leave at 50% pay for all qualifying employees and an additional two weeks of FMLA-type leave at 50% pay for qualifying employees at the company for five or more years

Broad definition of family permitted

Many employers have policies that offer paid or unpaid leave for FMLA purposes, but broadly define "family" to include more relatives than the FMLA recognizes. For example, a covered employee is entitled to job-protected FMLA leave to care only for a spouse, son, daughter or parent with a serious health condition. Notice 2018-71 clarifies that an employer policy may go beyond the FMLA and allow paid leave to care for another relative — a sibling, grandparent, grandchild or domestic partner — who has a serious health condition. However, the employer can only claim the tax credit for a qualifying employee's paid leave to care for a spouse, son, daughter or parent with a serious health condition, as specified in the FMLA.

STD benefits can qualify for tax credit

Disability plans — self-funded or insured — providing pay during leave for serious health conditions meeting FMLA's definition qualify for the tax credit. This presumably is true only if the payments — whether made by an insurer or the employer — are taxable to employees, but IRS hasn't addressed whether nontaxable STD benefits may count toward the tax credit. We believe this is the case for insured

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plans because the tax credit relies on the Federal Unemployment Tax Act (FUTA) definition of wages (IRC § 3306(b)), which include the first six months of sick pay received from an insurance company.

The method of paying for disability coverage determines whether the benefits are taxable to employees:

- **Taxable disability benefits.** In general, short- or long-term disability benefits are taxable to employees if the employer makes all contributions to pay for the coverage. Employer contributions include any pretax salary reductions made for an employee's disability coverage under a cafeteria plan, as long as the cost of that coverage isn't imputed as taxable income to the employee.
- **Nontaxable disability benefits.** If an employee pays for the coverage on an after-tax basis, any disability payment received by the employee is not taxable.
- **Partly taxable disability benefits.** When both the employee and the employer pay for the coverage, complex rules determine the portion of disability pay taxable to the employee.

Leave ineligible for tax credit

Employer-paid leaves for reasons not recognized by the FMLA don't qualify for the tax credit. In addition, the tax credit does not apply to any wage payments during leave required by or paid under a mandatory state or local program. Finally, the law prohibits double-dipping, so otherwise qualifying paid leave is not eligible for the credit unless the employer reduces its annual deduction for employee compensation by a corresponding amount.

Non-FMLA purpose does not qualify

An employer's policy must specifically designate paid leave for FMLA-type purposes, even if it provides paid leave for other non-FMLA purposes. The tax credit is not available for employer-paid vacation, personal, PTO, medical or sick leave used for a non-FMLA purpose.

For example, a paid leave policy that offers two weeks of paid leave for child bonding as a benefit separate from and in addition to a general PTO policy providing three weeks of paid leave could satisfy the Section 45S criteria for child-bonding leave. But an employer policy that provides two weeks of paid sick leave for ailments ranging from a minor cold or virus to a serious health condition does not satisfy the criteria, since the paid leave is not limited to FMLA-type purposes. For the same reason, a four-week PTO program that employees can use for any reason — including FMLA-type purposes — fails to satisfy the credit's conditions.

State or local paid leave requirements

An employer can't take the credit for leave paid by a state or local government program or required by a state or local law. Nine states and the District of Columbia have enacted paid family and medical leave

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mandates. In addition, Hawaii and Puerto Rico require paid STD leave. Fifteen states, the District of Columbia, and over 20 localities mandate some type of accrued paid sick leave or PTO. Paid leaves under these or similar mandates are ineligible for the tax credit.

Employer-paid amounts that exceed the state-required benefit may qualify for the credit if the excess benefit independently satisfies the wage threshold required under Section 45S. Specifically, the written policy must provide for the minimum rate of pay (50% of wages) after excluding any leave paid or required by state or local law.

Employers subject to state paid leave laws may find the federal family medical leave tax credit unworkable as a practical matter. When the state-mandated leave payments exceed 50% of wages — and employers must provide at least an additional 50% to claim the federal tax credit — some employees would receive more than 100% of pay while on leave. Few employers would view that as a reasonable result. In fact, some state programs reduce the standard benefit amount when a covered individual is concurrently receiving an employer benefit to avoid anyone receiving more than 100% of regular pay. This result is equally undesirable when employees and employers have to pay into the state-mandated program.

Multistate employers also may find the tax credit unworkable if they have some employees in a state mandating paid leave. Under the current law, an otherwise compliant multistate leave policy that offsets employer-provided paid leave by any benefits paid under a state or local leave program fails to satisfy the credit's criteria. According to Notice 2018-71, the offsetting language means a class of qualifying employees may not be eligible for 50% of wages from the employer during the leave — and excluding any qualifying employees is impermissible. As a result, the entire policy fails — even for employees in states without a paid leave mandate, and even if employees in states with mandates still receive at least 50% of wages from the employer despite the offsetting provision.

Consider the following:

> *Example.* An employer's policy provides six weeks' leave at full wages for a qualifying employee to bond with a new child. The benefit runs concurrently with and is offset by any state-mandated family leave benefits that employees receive. The state-paid benefits may or may not equal 50% of wages, depending on the employee's average weekly wage and the state's benefit cap. Under current rules, the policy would fail because some employees are not eligible for 50% of wages from the employer during leave (due to the offset).

A 2019 Senate bill (S 1628) sought to make this provision less restrictive — and the tax credit more widely available — by allowing an employer to count the percentage of wages paid as mandatory state or local leave benefits toward the 50%-of-wages threshold for credit-eligible paid leave. It's unclear if these or similar efforts to make the credit more accessible will be revisited in the future.

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Credit calculations

The tax credit equals the “applicable percentage” of wages paid to qualifying employees on family or medical leave for up to 12 weeks. The applicable percentage ranges from 12.5% to 25%, with the 12.5% minimum increasing by 0.25% for each percentage point by which the leave’s pay rate exceeds 50% of wages.

Qualifying employees

The credit is only available for paid family and medical leave provided to qualifying employees — generally, nonhighly compensated employees, whether full- or part-time. According to the statute, qualifying employees must meet two conditions:

- Have been employed by the employer for at least one year
- Had prior-year compensation at or below 60% of the prior year's threshold for a highly compensated employee (0.6 x $125,000 for 2019 and 0.6 x $130,000 for 2020 or 2021)

  Example. In 2021, Big Co. offers two weeks of paid family and medical leave to all full- and part-time employees who have worked for the company at least one year and made less than $78,000 in 2020. Assuming other requirements are met, Big Co. can take the tax credit for paid family and medical leave provided in 2021.

To determine whether an employee has been employed for at least one year, employers may use any reasonable method, as long as it does not require a minimum number of hours worked.

Of course, an employer can provide paid family or medical leave to employees earning higher pay or employed for less than one year. But the employer can’t take the credit for leave payments to those employees.

No double tax benefit

Employers must reduce their annual tax deduction for compensation paid to employees by the amount of any credit taken for paid family and medical leave. In addition, any wages taken into account in determining the employee retention credit for employers subject to closure due to COVID-19 under the Coronavirus Aid, Relief and Economic Security (CARES) Act (Sec. 2301 of Pub. L. No. 116-136) cannot count as wages for the FMLA tax credit. The same restriction applies to any wages counted toward the payroll credit for COVID-19-related paid sick or family leave under the Families First Coronavirus Response Act (FFCRA) (Secs. 7001 and 7003 of Pub. L. 116-127). The 2021 appropriations act extended the retention credit through July 1, 2021, and the payroll credit for FFCRA paid leave through March 31, 2021.

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Employer considerations

Before adopting or changing a leave policy to take advantage of the tax credit or factoring the credit into the budget, employers should keep a few things in mind:

- **State and local paid leave mandates.** Employers with employees in states with paid leave mandates should discuss the credit with tax advisers and determine whether the credit is currently available.
- **Written policy, recordkeeping and notice.** Employers claiming the credit need to document their paid leave program and substantiate that employees used paid leave for an FMLA purpose. Employers must ensure their written policies contain all provisions detailed above, including FMLA-like protections for employees not covered by the FMLA. Employers also have to confirm that payroll and leave administration vendors can provide the records needed to calculate the credit. Section 45S does not require any particular employee notice about the employer's paid leave policy, but employers that do provide notice must supply it in a manner reasonably designed to reach all qualifying employees.
- **Duration of paid leave available.** Employers should confirm the duration of prorated paid leave for part-time employees is at least equal to the ratio of a part-timer's expected weekly work hours to a full-timer's expected weekly work hours. Employers may use any reasonable method to determine how many hours an employee is expected to work in a week, but any employee who customarily works less than 30 hours per week should be considered part-time. Current paid leave programs may not satisfy this requirement.
- **Expanding paid leave programs.** Employers that currently limit paid family and medical leave for part-timers or offer paid leave for one but not all FMLA-allowed uses (such as only paid maternity and paternity leave) might consider expanding the program to increase the tax credit available.
- **Short-term disability benefits.** If the cost of short-term disability coverage is tax-free for employees, then any benefits paid are taxable to employees. When these taxable benefits are provided for a qualifying employee's serious health condition, they should count toward the employer's tax credit (assuming the benefits are not driven by state law). IRS has not addressed whether nontaxable STD benefits may count toward the tax credit. In addition, for STD benefits to qualify for the tax credit, the disability policy can't have eligibility provisions inconsistent with Section 45S requirements. So an STD policy must be available to all qualifying employees and must not contain, for example, any preexisting condition exclusions.
- **Tax impact.** The tax credit for paid family and medical leave applies only to wages as defined by Section 3306(b) (without regard to the $7,000 FUTA limit). Employers cannot take a tax credit under Section 45S and the general business credit under Section 38 for the same wages. Employers must also reduce any deduction for wages or salaries paid in the taxable year by the credit received for paid FMLA leave.

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- **Future changes to credit.** The credit will expire at the end of 2025 unless extended again or permanently adopted. Employers that are taking advantage of the credit — or that would if the current limitations related to state and local benefit mandates are eased — might consider supporting legislation to modify and make permanent the program.

Related resources

Non-Mercer resources

- Pub. L. No. 116-260, the Consolidated Appropriations Act, 2021 (Congress, Dec. 27, 2020)
- Pub. L. No. 116-94, the Further Consolidated Appropriations Act, 2020 (Congress, Dec. 20, 2019)
- Section 45S, Employer credit for paid family and medical leave
- Section 45S employer credit for paid family and medical leave FAQs (IRS, Nov. 24, 2020)
- In focus: Employer tax credit for paid family and medical leave (Congressional Research Service, Jan. 16, 2020)
- Notice 2018-71, Employer credit for paid family and medical leave (IRS, Sept. 24, 2018)

Mercer Law & Policy resources

- Paid sick leave mandates continue to expand at state level (Feb. 8, 2021)
- Tracking federal COVID-19 laws affecting employee benefits, jobs (Feb. 1, 2021)
- 2021 state paid family and medical leave contributions and benefits (Jan. 20, 2021)
- DOL and IRS issue COVID-19 guidance on emergency paid leave (Jan. 15, 2021)
- Colorado voters approve paid family and medical leave law (Nov. 10, 2020)
- Mercer supports national paid leave standard (Sept. 15, 2020)
- CARES Act expands unemployment benefits, aims to stem job losses (April 15, 2020)
- Connecticut enacts paid family and medical leave (Aug. 29, 2019)

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