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## GRIST

## CONGRESS WEIGHS EXTENDING TAX CREDIT FOR PAID FAMILY AND MEDICAL LEAVE

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The federal tax credit for employers providing paid family and medical leave would extend beyond 2019 under legislation pending in Congress. A Senate bill ([S 1628](#)) would continue the credit for three years and improve employers' ability to claim the credit. A House measure ([HR 3301](#)) would merely extend the credit for one more year without any other changes. The tax credit, enacted by Republicans as a two-year pilot program under the Tax Cuts and Jobs Act ([PL 115-97](#)), is currently set to expire Dec. 31, 2019.

**ACTION NEEDED TO EXTEND CREDIT**

Employers providing paid family and medical leave can take advantage of a general business tax credit for 2018 and 2019. 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.

The Senate's proposed Paid Family Leave Pilot Extension Act would not only extend the credit through 2022 but also remove some barriers present in the current program. The most notable change would eliminate the exclusion of wages paid during leave mandated by a state or local law when calculating the employer-provided benefit. Whether the House will agree to the Senate's revisions is unclear. House and Senate talks on whether or how to continue the credit are intensifying as part of negotiations over broader legislation to extend a number of expired or expiring tax provisions that lawmakers hope to pass by year-end.

The remainder of this article gives a refresher on the requirements and restrictions on qualifying for the tax credit

## CURRENT 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.

### 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 following:

- **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](#) that arises because a spouse, son, daughter 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. Under current guidance, this measure is exclusive of any

paid family and medical leave provided under a state or local government program or required by a state or local law. The Senate bill would amend Section 45S so an employer could include mandated benefits when determining if its paid leave policy meets the required rate of pay.

- ***FMLA protections apply.*** To qualify for the credit, employers must provide certain employee protections required under 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 “non-interference” language:

[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 other relatives — a sibling, grandparent, grandchild or domestic partner — who have 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 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. Eight states and the District of Columbia have enacted paid family and medical leave mandates. In addition, Hawaii and Puerto Rico require paid STD leave. Thirteen states, the District of Columbia, and 22 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).

The Senate bill aims to make this provision less restrictive — and the tax credit more widely available — by allowing an employer policy to include the percentage of wages paid as state or local mandated leave benefits toward the 50%-of-wages threshold for credit-eligible paid leave. If the bill is adopted as currently drafted, however, the tax credit calculation would still exclude benefits paid under a state government program or required by a state or local law, so an employer would not receive credit for those amounts.

## 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 \$72,000 — 60% of the prior year's threshold for a highly compensated employee (\$120,000 for 2017 or 2018)

*Example.* In 2019, 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 \$72,000 in 2018. Assuming other requirements are met, Big Co. can take the tax credit for paid family and medical leave.

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.

## 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. Proposed amendments to Section 45S may or may not get enacted. However, if the Senate bill is enacted as drafted, the changes to the state and local mandated paid leave limitations would apply retroactively to the 2018 and 2019 tax years.

- **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.** If the credit is extended beyond 2019, 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 non-taxable 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 pre-existing 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.
- **Future changes to credit.** The credit will expire at the end of 2019 unless the House or Senate bill wins approval. 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 the proposed legislation to extend the pilot program.



## RELATED RESOURCES

### Non-Mercer Resources

- [HR 3301](#), Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Congress, June 18, 2019)
- [S 1628](#), Paid Family Leave Pilot Extension Act (Congress, May 23, 2019)
- [26 USC § 45S](#), Employer Credit for Paid Family and Medical Leave
- [Section 45S Employer Credit for Paid Family and Medical Leave FAQs](#) (IRS, June 28, 2019)
- [In Focus: Employer Tax Credit for Paid Family and Medical Leave](#) (Congressional Research Service, March 20, 2019)
- [Notice 2018-71](#), Employer Credit for Paid Family and Medical Leave (IRS, Sept. 24, 2018)

### Mercer Law & Policy Resources

- [Connecticut Enacts Paid Family and Medical Leave](#) (Aug. 29, 2019)
- [ME, NV Paid Accrued Leave Mandates Expand State Paid Sick Leave Law Totals](#) (July 1, 2019)
- [Massachusetts Delays, Increases Paid Family and Medical Leave Contribution](#) (June 14, 2019)
- [Employers Need To Prepare Now for Washington, DC's Universal Paid Leave](#) (June 11, 2019)
- [Massachusetts Updates Draft PFML Rules, Posts Model Notice](#) (April 23, 2019)
- [New Jersey Updates, Expands Family and Disability Benefits](#) (March 26, 2019)
- [Colorado Proposes Paid Family and Medical Leave Insurance Program](#) (March 15, 2019)
- [2019 State-Mandated Short-Term Disability Contributions and Benefits](#) (Jan. 31, 2019)

### Other Mercer Resources

- [The Pressure Is on To Modernize Time-Off Benefits: 6 Survey Findings](#) (Jan. 16, 2019)
- [Think Globally, Comply Locally: How Employers Navigate Leave Laws](#) (Nov. 15, 2018)
- [Will You Be the Last Kid on the Block To Add Paid Parental Leave?](#) (Oct. 22, 2018)

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