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Employer Tax Credit for Paid Family and Medical Leave

Employers providing paid family and medical leave to their employees may be able to claim a tax credit under Section 45S of the Internal Revenue Code (IRC). This In Focus (1) provides an overview of the employer credit for paid family and medical leave; and (2) highlights potential issues to consider when evaluating the credit.

The Employer Credit for Paid Family and Medical Leave

The employer credit for paid family and medical leave (FML) can be claimed by employers providing paid leave (wages) to employees under the Family and Medical Leave Act of 1993 (FMLA; P.L. 103-3). The credit can be claimed for wages paid during tax years that begin in 2018 through 2025.

The credit rate depends on how much employers provide for paid FML relative to wages normally paid. If paid leave is 50% of wages normally paid to an employee, the tax credit is 12.5% of wages paid. If paid leave is 100% of wages normally paid to an employee, the tax credit is 25% of wages paid. The credit rate increases from 12.5% to 25% ratably as leave wages increase from 50% to 100% of wages normally paid. No credit can be claimed for paid FML that is less than 50% of wages normally paid. Further, no credit can be claimed for wages paid on leave that exceed an employee's normal wage rate.

The credit can only be claimed for paid FML provided to certain lower-compensated employees. For wages paid to an employee to be credit eligible, compensation to the employee in the preceding year cannot exceed 60% of a "highly compensated employee" threshold. For 2023, employee compensation in 2022 cannot have exceeded \$81,000. Further, for an employer to claim a credit for wages paid to an employee, the employee must have been employed by the employer for at least 12 months.

The amount of paid FML wages for which the credit is claimed cannot exceed 12 weeks per employee per year. Further, all qualifying employees must be provided at least two weeks of paid FML for an employer to be able to claim the credit (the two-week period is proportionally adjusted for part-time employees).

Tax credits cannot be claimed for leave paid by state or local governments, or for leave that is required by state or local law. Thus, this tax incentive does not reduce the cost of providing leave in jurisdictions where employers are required to do so by a state or local authority.

A tax credit can only be claimed for wages paid for family and medical leave. If an employer provides paid leave (e.g., vacation, personal, or sick leave) that is not specifically set

aside for a FMLA-qualifying purpose, that leave is not considered FML leave. Family and medical leave is restricted to leave associated with (1) the birth of a child or placement of an adopted or foster child with the employee; (2) a serious health condition of the employee or the employee's spouse, child, or parent; (3) an exigency arising out of the fact that a close relative is a member of the Armed Forces and on covered active duty; or (4) to care for a covered servicemember who is a close relative of the employee.

For employers, there are other requirements associated with the credit. To claim the credit, an employer must have a written family and medical leave policy in effect. The policy cannot exclude certain classifications of employees (e.g., unionized employees). Additionally, a qualified employer is required to claim the credit, unless the employer opts out. For employers, the amount of wages and salaries deducted as a business expense is reduced by the amount of credit claimed. Further, the credit cannot be claimed if wages have been used to calculate another tax credit (to avoid a double tax benefit). The credit is part of the general business credit, meaning that unused credits from the current tax year can be carried back one year (offsetting the prior year's tax liability) or carried forward up to 20 years to offset future tax liability. The credit is allowed against the alternative minimum tax (AMT).

Legislative Background

The employer credit for paid family and medical leave was enacted as part of the 2017 tax revision (P.L. 115-97) (commonly referenced as the "Tax Cuts and Jobs Act," or TCJA). When enacted, this credit was made available for two years, 2018 and 2019. The credit's primary sponsor, Senator Deb Fischer, called this credit a "two-year pilot program," after which there would be an opportunity to evaluate whether the credit was achieving its intended goals. The credit was extended through 2020 in the Further Consolidated Appropriations Act, 2020 (P.L. 116-94) and through 2025 in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Division EE of P.L. 116-260).

Estimated Revenue Loss of the Credit

When the credit was first enacted, the Joint Committee on Taxation (JCT) estimated the two-year tax credit would reduce federal revenue by \$4.3 billion between FY2018 and FY2027. The one-year extension through 2020 was estimated to reduce federal revenue by an additional \$2.2 billion between FY2020 and FY2029, while the subsequent extension through 2025 was estimated to reduce federal revenues by an additional \$3.8 billion between FY2021 and FY2030. While most of the revenue losses are expected to occur before the credit's termination, revenue losses are

expected after the credit's termination date as businesses carry forward unused credits to offset future tax liability.

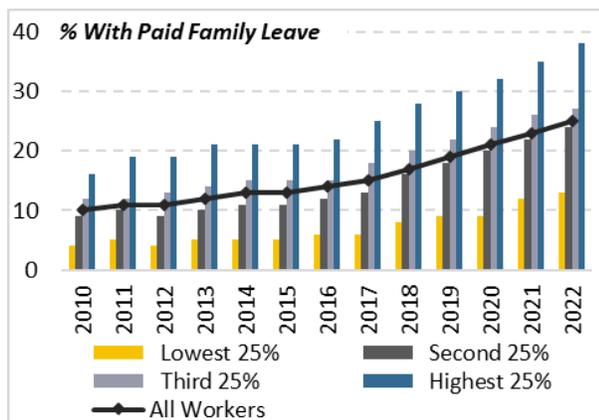
JCT estimates of the cost of the credit's extension have tended to decline over time. One possible explanation is that the credit cannot be claimed for state- or locally mandated leave. As more states have established state-level paid family or medical leave programs, the number of taxpayers potentially able to claim the credit has declined.

Policy Considerations

The employer credit for paid FML is targeted at a group that is less likely to have access to paid family leave: low- and moderate-income workers. In 2022, 25% of all workers had access to employer-provided paid family leave. However, in 2022, 38% of workers in the top 25% of wage earners had access to such paid leave, while 13% of those in the lowest 25% of wage earners had access. For background, see CRS Report R44835, *Paid Family and Medical Leave in the United States*, by Sarah A. Donovan.

The share of workers with access to paid family leave has increased in recent years (see **Figure 1**). Over time, the share of workers in lower-income groups with access to paid family leave has increased at a faster rate than the share in higher-income groups. As a result, the ratio of the share of workers in the highest income group having access to paid family leave, relative to the share of workers in the lowest income group having access to such leave, has fallen. Although access to paid family leave has increased across all income groups, there remains a gap in paid FML benefits between lower- and higher-wage workers.

Figure 1. Paid Family Leave by Wage Category
2010-2022



Source: Bureau of Labor Statistics (BLS).

Notes: Values of \$16.21, \$22.36, and \$35.29 represent the 25th, 50th, and 75th average hourly wage percentiles, respectively, in 2022.

Some workers who do not have paid family and medical leave may be able to use other forms of paid leave (e.g., paid vacation, sick, or personal leave) following the birth or adoption of a child or for their own serious health condition, or that of a close relative.

Will the Credit Increase Paid Leave?

Providing a tax credit for employers that provide paid FML should, on the face of it, tend to increase access to this benefit. How effective the credit will be at achieving this goal remains an open question.

Will the credit, as currently structured, provide a large enough incentive to cause employers to change their behavior (e.g., provide a benefit they do not currently provide)? If the credit itself does not motivate employers to provide paid FML, then employers that provide paid FML for other reasons may receive a “windfall” in reduced tax liability. Currently, large employers and employers of management and professional employees are most likely to provide paid family leave. Employers of management and professional employees, however, are less likely to have large shares of employees below the wage threshold.

Employers that provide paid FML to qualified employees for other reasons, such as to attract high-quality talent, will be able to claim the credit even though their benefit policies have not changed. If most of the credit's beneficiaries are employers that would have provided paid FML without the credit, then the credit is not a particularly efficient mechanism for increasing paid FML.

There is also the possibility that employers choose to substitute credit-eligible paid FML for other forms of leave. An employer could reduce the amount of paid sick, personal, or vacation time off, knowing that employees use this time for paid family and medical leave purposes. By making this choice, when employees take leave for FMLA purposes, the employer would be allowed a tax credit. If other benefits are scaled back in favor of tax-preferred FMLA leave, employees may not be better off.

Options Related to the Current Employer Credit

There are several policy options for the employer credit for paid family and medical leave. First, the credit could be allowed to expire as scheduled. Second, the credit could be extended. Third, the credit could be made permanent. Any extension of the credit could also include a range of potential modifications.

A possible rationale for extending the credit is that there has been limited opportunity for evaluation. Over time, as more data become available, one way to examine whether the credit has been effective could be to look at the gap in paid FML benefits between lower- and higher-wage workers. As shown in **Figure 1**, this gap has persisted, although in recent years the share of lower-wage workers with access to paid FML has increased faster than the share of higher-wage workers with this type of leave benefit. An evaluation of the credit could also consider how many taxpayers claimed the credit for leave that would have been provided absent the tax incentive, as opposed to leave employers provided in response to the credit being available.

The credit could be modified to address a potential range of policy considerations. For example, the credit could be redesigned to provide a larger incentive to employers with few employees. Employees at smaller establishments are less likely to have access to paid family leave than employees at larger establishments. Another option might be to provide a tax credit to reduce the cost of leave insurance premium payments paid by employers purchasing leave insurance for their employees. This could potentially support state-level opt-in leave insurance policies.

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