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Permanent, improved tax credit for paid family and medical leave

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With the passage of the One Big Beautiful Bill Act ([Pub. L. No. 119-21](#)), the federal tax credit for employers providing paid family and medical leave has been made permanent and improved. In addition to removing the credit expiration date, the law removes policy requirements that previously put the credit out of reach for many employers, particularly multistate employers. Beginning in 2026, more employers providing paid family and medical leave that meets certain requirements can take advantage of a general business tax credit ranging from 12.5% to 25% of wages paid to qualifying employees for up to 12 weeks of family and medical leave per taxable year. First enacted as a two-year pilot program under the Tax Cuts and Jobs Act of 2017 ([Pub. L. No. 115-97](#)), the general business tax credit had been extended through 2020 and again through 2025 by earlier appropriations legislation ([Pub. L. No. 116-94](#) and [Pub. L. No. 116-260](#)).

Policy requirements

For employers to claim the general business tax credit under [Section 45S](#) of the Internal Revenue Code (IRC), there must be a written policy describing the paid leave program that offers at least two weeks of paid family and medical leave (PFML) to qualifying employees and satisfies specific federal Family and Medical Leave Act (FMLA) requirements. If all conditions are met, the credit is available to any employer providing paid leave for a specific FMLA purpose — even if the employer is exempt from the FMLA or the employee taking the leave is ineligible for FMLA protection.

The written PFML policy — whether contained in a single document, multiple documents or a larger leave policy — must meet several criteria (described in more detail below) related to:

- Employee eligibility
- Qualifying leave

- Duration of paid leave
- Wage replacement
- Federal FMLA protections

Employee eligibility

The written policy must provide paid leave to all qualifying employees, 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.

A qualifying employee has at least one year of service and a prior year compensation of no more than 60% of the IRC § 414(q)(1)(B) highly compensated employee (HCE) threshold (in 2025 and 2026, the [threshold](#) is \$160,000). Earlier guidance ([IRS Notice 2018-71](#), Q&A-13) provided that to determine whether an employee has been employed for at least one year, employers may use any reasonable method. Requiring 12 consecutive months of work was characterized as an unreasonable method. There is no minimum-hours-worked requirement.

Example. In 2025, Alpha Co. offers paid parental leave to full-time employees (those working at least 30 hours per week) who have worked for the company for at least one year. The policy does not qualify Alpha for a PFML tax credit for 2025 because it is not offered to part-time employees.

Beginning with the 2026 tax year, qualifying employees are limited to those customarily working at least 20 hours per week (as opposed to all full- and part-time employees), and employers can choose to reduce the required term of service to six months.

Example. In 2026, Alpha Co. amends the policy to add paid parental leave for part-time employees working less than 30 but at least 20 hours per week. Assuming other requirements are met, the paid parental leave policy qualifies Alpha for a PFML tax credit for parental leave paid to employees in 2026 who earned no more than \$96,000 in 2025 (60% of \$160,000).

The employer policy can provide for more generous eligibility requirements, but PFML wages paid to employees other than qualifying employees will not be considered when determining the tax credit amount.

Qualifying leave reasons

The written policy must provide paid leave specifically designated 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

An employer doesn't have to offer each type of FMLA leave on a paid basis to qualify for the credit. However, according to prior guidance ([IRS Notice 2018-71](#), Q&A-9), in order to qualify for the credit the paid leave must be exclusively for an FMLA reason and may not be used for any other reason. The only exception is for a policy that allows the paid FMLA leave to be used to care for additional individuals not specified in the FMLA. But note that leave taken for non-FMLA qualifying reasons will not be considered when determining the credit amount.

Example. Bravo Co. offers paid leave for an employee to care for a seriously ill family member, which includes parents, grandparents, children, grandchildren, siblings and a spouse or domestic partner. Assuming other requirements are met, the policy qualifies Bravo for the PMFL tax credit. When calculating the credit, leave paid to qualifying employees to care for family members other than a spouse, parent, son or daughter will not be considered when determining the amount of the tax credit because FMLA leave for this purpose is limited to caring for those family members.

Note also that a paid leave policy for general purposes — such as sick leave, vacation or paid time off (PTO) — does not qualify an employer for the tax credit.

Example. Charlie Co. provides all employees working at least 20 hours a week a bank of 32 hours of paid sick leave at the start of each year. The policy requires employees to use paid sick leave concurrently with unpaid FMLA leave. The paid sick leave policy does not qualify Charlie for the PFML tax credit.

Earlier guidance ([IRS Notice 2018-71](#), Q&A-11) confirmed that paid leave provided under a short-term disability (STD) program, whether self-insured by an employer or provided through an STD insurance policy, can qualify for the tax credit if all policy requirements are met.

Duration of paid leave

The written policy must provide at least two weeks of paid leave annually to full-time qualifying employees and a prorated amount to part-time qualifying employees. A part-time employee is defined as someone who is customarily employed for fewer than 30 hours per week. At the employer's choosing, the policy can provide for a longer duration of paid leave. The tax credit, however, is limited to 12 weeks of paid leave for each qualifying employee.

Example. In 2025, Delta Co. offers 12 weeks of paid parental leave only to employees regularly working at least 30 hours per week. Delta's policy does not qualify the company for a PFML tax credit for parental leave paid to employees in 2025 because a prorated amount isn't offered to part-time employees.

Example. Delta Co. amends the policy to add a prorated amount of paid parental leave to employees regularly working less than 30 but at least 20 hours per week, beginning in 2026. Employees working

less than 20 hours per week are excluded. Assuming other requirements are met, the parental leave policy qualifies Delta for a PFML tax credit for parental leave paid to employees in 2026 who earned no more than \$96,000 in 2025.

Wage replacement

The written policy must provide for at least 50% of wages normally paid during the leave period. Wages are defined by [IRC § 3306\(b\)](#) and generally include all remuneration except payments made to or on behalf of an employee for retirement, medical, disability or death benefits. Overtime and discretionary bonuses are excluded. Prior [guidance](#) requires employers to determine wages normally paid to employees who are paid on a basis other than a salaried or hourly rate using the [Fair Labor Standard Act rules](#). Policies providing for more generous wage replacement are eligible for a larger tax credit.

Prior to 2026, leave benefits paid by the employer policy were required to be at least 50% of wages independent of any benefits paid by a state or local program or required by a state or local law. For example, an employer PFML policy providing 100% wage replacement did not qualify for the tax credit if the employer benefit was offset by — or used to top off — state-mandated PFML benefits greater than 50% of wages. This made it impossible for employer policies covering employees in jurisdictions with active PFML or STD programs or mandates to qualify for the tax credit.

Pursuant to amendments made by OBBBA, beginning in 2026, payments from state or local PFML or STD programs or mandated by state or local law will not disqualify an otherwise qualified employer policy. In other words, an employer PFML policy providing at least 50% wage replacement may qualify for the tax credit, regardless of whether the benefits paid under the policy are offset by — or used to top off — benefits from a state or local PFML or STD program or mandated by state or local law.

Example. Echo Co. has employees in every state. In 2025, Echo offers paid parental leave to all employees working at least 20 hours per week, after nine months of service. Full-time employees (those who regularly work at least 30 hours per week) are eligible for 12 weeks of paid leave. Part-time employees are eligible for a prorated amount of paid leave. The policy provides 100% of regular wages during parental leave. Leave under the policy must be taken concurrently with any child-bonding leave available to the employee through a state-mandated PFML program. For example, when the leave qualifies for benefits under both the Echo policy and a state PFML program providing 70% wage replacement, wages paid under the Echo policy are offset by benefits received from the state program. Echo's policy does not qualify the company for a PFML tax credit for parental leave paid to employees in 2025 because the policy pays only 30% wage replacement when offset by state PFML program benefits.

Example. Echo Co.'s parental leave policy remains unchanged for 2026. Assuming other requirements are met, the policy qualifies Echo for a PFML tax credit for parental leave paid to employees in 2026 who earned no more than \$96,000 in 2025. This is because the policy provides for 100% wage replacement (surpassing the 50% minimum requirement) and any offsets for state PFML benefits are not taken into consideration.

Example. Foxtrot Co. has employees in multiple states. In 2025, Foxtrot offers an STD policy to all employees, full-time and part-time. The policy provides full-time employees (those regularly working at least 30 hours per week) 100% wage replacement for 26 weeks of leave and part-time employees 60% wage replacement for 26 weeks of leave. Leave under the policy must be taken concurrently with any medical leave available to the employee through a state-mandated PFML or STD program. When the leave qualifies for benefits under both the Foxtrot policy and a state PFML or STD program, wages paid under the Foxtrot policy are offset by benefits received from the state program. Foxtrot's policy does not qualify the company for a PFML tax credit for STD benefits paid to employees in 2025 because the policy pays part-time employees less than 50% of wages when offset by applicable state PFML or STD program benefits. The policy also fails if any full-time employees would receive less than 50% wage replacement from the employer due to state PFML or STD program benefit offsets.

Example. Foxtrot Co.'s STD policy remains unchanged for 2026. Assuming other requirements are met, the policy qualifies Foxtrot for a PFML tax credit for up to 12 weeks of STD benefits paid to employees in 2026 who earned no more than \$96,000 in 2025. This is because the policy surpasses the 50% wage replacement requirement for all qualifying employees and any offsets for state PFML benefits received are not taken into consideration.

Federal FMLA protections

The written policy must provide the employee the 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 (aka "added employees") or offered by an FMLA-exempt employer (aka "added employer") must ensure the employer:

- Will not interfere with, restrain or deny the exercise of or the attempt to exercise any right provided under the policy
- Will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy

Sample language is provided in [Notice 2018-71](#), Q&A #3. This requirement applies to an employer subject to FMLA that has at least one qualifying employee who is not covered by FMLA, and an employer not subject to FMLA (i.e., has no employees covered by FMLA).

Credit calculation

The original law provides a general business credit based on the applicable percentage of wages paid to qualifying employees on PFML during the tax year. OBBBA added an alternative pathway for employers with insured PFML policies. Beginning with the 2026 tax year, qualifying insured employer policies are eligible for a credit based on the applicable percentage of total premiums paid or incurred by the employer during the tax year.

In either case, 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 rate of pay under the PFML policy exceeds 50% of wages. When calculating the potential value of the PFML tax credit, there are a number of important limitations to keep in mind:

- Only PFML wages paid to qualifying employees are taken into account. PFML wages paid to non-qualifying employees are not taken into account (i.e., those whose earnings are more than 60% of the HCE threshold and those who worked for the employer for less than 12 months — or six, if the employer elects — before taking leave).
- Only PFML wages paid for FMLA-type leaves are taken into account. PFML wages paid for non-FMLA leaves are not taken into account (e.g., paid leave to care for a seriously ill grandparent).
- Only 12 weeks of PFML wages paid to a qualifying employee are taken into account. PFML wages paid in excess of 12 weeks for a qualifying employee are not taken into account (e.g., STD benefits paid for weeks 13 through 26).
- PFML wages paid by a state or local government or required by state or local law are not taken into account (e.g., benefits paid by a state-mandated PFML program or under an equivalent self-insured PFML plan).
- PFML wages taken into account for a qualifying employee can't exceed the PFML leave hours taken into account multiplied by the employee's normal rate of pay.

For an insured plan, the applicable percentage of total premiums paid or incurred by the employer during the tax year is presumably determined without regard to whether any qualifying employees took PFML.

To claim the credit, an eligible employer must file [IRS Form 8994](#) (Employer Credit for Paid Family and Medical Leave) and [IRS Form 3800](#) (General Business Credit) with its tax return.

Short-term disability payments

Generally, STD plans may qualify for the tax credit, assuming they do not have any coverage exclusions or a term of service eligibility provision that would disqualify the plan. However, only STD payments that are taxable to employees qualify for the credit. This applies to both self-funded and insured STD plans. The tax credit relies on the [IRC section 3306\(b\)](#) definition of wages, which includes the first six months of sick pay received from an insurance company.

The taxability of disability payments to employees depends on how the coverage is paid for:

- *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 disability 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 (see [Rev. Rul. 2004-55](#)).

Tax-exempt organizations

As noted earlier, the term wages for purposes of Section 45S is defined by [Section 3306\(b\)](#) (without regard to the wage limit). Thus, a tax-exempt organization may not be eligible for the credit because employment with such an employer is generally not considered employment for purposes of the Federal Unemployment Tax Act (FUTA) tax under Section 3306(c)(8), and compensation paid is not considered FUTA wages within the meaning of Section 3306(b).

Earlier [guidance](#) provides that if an employer doesn't pay FUTA wages within the meaning of Section 3306(b), compensation paid by the employer doesn't constitute wages for purposes of Section 45S. As a result, amounts paid by the employer to an otherwise qualifying employee while on PFML are not eligible for the credit.

No double tax benefit

Wages taken into account to determine the PFML tax credit can't be used to determine any other general business credit. In addition, employers must reduce their annual tax deduction for compensation paid to employees or their annual deduction for premiums paid or incurred — whichever is applicable — by the PFML credit amount (see [26 IRC §280C\(a\)](#)).

Employers within a controlled group

Beginning in 2026, the law requires that all employers within the same controlled group under IRC sections 414(b) and (c) are treated as a single employer and must meet all requirements in order for any employer in the controlled group to claim the credit. There's an exception to this rule for an entity within the controlled group if the employer can establish a substantial and legitimate business reason for not providing a written policy meeting the law's requirements. A "substantial and legitimate business reason" *does not include* the operation of a separate line of business, the rate of wages or category of jobs for employees (or any similar basis), or the application of State or local laws relating to family and medical leave; it may include the grouping of employees of a common law employer.

Each member of a controlled group of corporations and each member of a group of businesses under common control generally must make a separate election to claim or not to claim the credit. For a consolidated group, the agent of the group makes the election.

Employer considerations

Employers should review their current paid leave programs to determine whether they are entitled to the tax credit for 2025 or 2026. Some employers may want to consider expanding or modifying their programs to take advantage of the new opportunities under the law beginning in 2026.

Several factors to consider in this evaluation include:

- *Expanding paid leave programs.* Employers offering paid leave for one but not all FMLA-allowed uses (such as only parental leave for new child bonding) might consider expanding or adding paid leave benefits to increase the potential tax credit value. Employers offering an otherwise qualifying paid leave benefit to only full-time employees may want to expand eligibility to part-time employees (e.g., customarily employed for not less than 20 hours per week) in order to access the credit.
- *Short-term disability plans.* Employers may want to revisit how they provide STD benefits. If the cost of STD 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.
- *State and local mandates.* Employers in a state or locality that requires or provides PFML (or STD) will need to calculate how much, if any, paid leave they offer can be used to calculate the tax credit. Paid leave provided to employees in states without a mandate should garner a larger tax credit than the same paid leave provided to employees in locations with a mandate, assuming the voluntary employer-provided benefit is offset by the state-mandated benefit.
- *Insured PFML policies.* Employers subject to state PFML mandates may want to consider an insured private plan where available now that premiums can be used for the tax credit. Similarly, employers in states without a mandate but with voluntary paid family leave insurance products may want to consider adding the benefit as a rider to a current STD policy or as a stand-alone benefit.
- *Tax impact.* Employers and their tax advisers should determine the value of the tax credit relative to the corresponding reduction in their corporate deductions.
- *Written policy, recordkeeping, credit calculations.* Employers will need to ensure their written policies contain all provisions detailed above, including FMLA-like employee protections to employees who aren't covered by the FMLA. Employers will also need to ensure that payroll and leave administrators can provide the records needed to calculate the amount of the credit. Employers claiming the credit will need to document their paid leave program and substantiate that paid leave wages used to calculate the credit were paid to qualifying employees who used paid leave for an FMLA purpose.

All employers interested in taking the tax credit should watch for IRS guidance clarifying what's involved in calculating the credit, particularly as it applies to insured plans. However, in order to maximize the credit opportunity beginning in 2026, employers may want to amend current PFML policies without waiting for guidance on the credit calculations.

Related resources

Non-Mercer resources

- [26 U.S. Code § 45S](#), Employer credit for paid family and medical leave
- [Pub. L. No. 119-21](#), One Big Beautiful Bill Act, [Section 70304](#) (July 4, 2025)
- [Section 45S employer credit for paid family and medical leave FAQs](#) (IRS, May 29, 2025)
- [Paid family and medical leave in the United States](#) (Congressional Research Service, March 26, 2025)
- [In focus: Employer tax credit for paid family and medical leave](#) (Congressional Research Service, Feb. 27, 2023)
- [Pub. L. No. 116-260](#), Consolidated Appropriations Act, 2021 (Congress, Dec. 27, 2020)
- [Pub. L. No. 116-94](#), Further Consolidated Appropriations Act, 2020 (Congress, Dec. 20, 2019)
- [Notice 2018-71](#), Employer credit for paid family and medical leave (IRS, Sept. 24, 2018)

Mercer Law & Policy resources

- [State paid family and medical leave contributions and benefits](#) (Sept. 23, 2025)
- [One Big Beautiful Bill includes employer-friendly provisions](#) (July 8, 2025)
- [IRS clarifies taxation of state and DC PFML contributions, benefits](#) (April 29, 2025)
- [Congress extends tax credit for paid family and medical leave](#) (Feb. 12, 2021)
- [Employers seeking tax credit for paid family and medical leave get IRS guidance](#) (Dec. 5, 2018)

Other Mercer resources

- [FMLA tax credit: A chance to expand benefits and still save money](#) (Nov. 13, 2025)
- [Life, absence and disability benefits](#)

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