Tax Flash

New Federal Tax Developments
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Employee payroll tax deferral guidance creates risk

The IRS issued guidance on Aug. 28 (Notice 2020-65) implementing a White House directive to defer certain employee payroll taxes, but the guidance raises more questions than it answers and appears to expose employers to potentially significant repayment obligations and other risks.

The guidance was prompted by a memo issued by President Donald Trump on Aug. 8. The Trump Administration spent several weeks exploring administrative mechanisms for forgiveness and ways to encourage employer participation without forgiveness. The guidance itself does not offer any mechanism for forgiveness, but Trump has pledged to enact legislation forgiving the deferred taxes if he is re-elected.

As written, the guidance imposes significant responsibilities and potential future liability on employers. It is also fairly brief, and leaves many areas of uncertainty. Accordingly, employers should carefully consider their potential obligations and risks before any decision to defer withholding on behalf of employees.

Details

Notice 2020-65 postpones the due date for withholding the 6.2% employee share of Social Security tax on certain wages and compensation paid to employees from Sept. 1, 2020, through Dec. 31, 2020. The applicable period is determined by the "pay date," not when the services were performed related to the wages. There is no further guidance on the definition of pay date.

The notice states that the "due date for withholding and payment" is "postponed," but clarifies in a footnote that the notice intends to directly postpone only the withholding obligation. The footnote states that the obligation to deposit only arises when the tax is withheld, so the due date for deposits is postponed automatically until withholding occurs. This appears designed to prevent employers from using the relief for their own short-term liquidity by continuing to withhold the tax but deferring its later deposit.

Participation

It is our view that participation in the Social Security tax deferral is voluntary by the employer. In authorizing the voluntary payroll tax deferral, the notice relies on Sec. 7805A and the COVID-19 emergency declaration, similar to the manner in which the Treasury Department permitted voluntary deferral of tax payment, filing and other actions that otherwise were required to be taken by Apr. 15, 2020, to July 15, 2020.

The notice provides no specific mechanism for employees to elect whether their own taxes are deferred. Although this issue is not explicitly addressed, it appears employees have no administrative recourse to force employers one way or the other, and that the deferral decision is at the sole discretion of the employer.

Wage cap

The deferral is only allowed if the employee's wages and compensation total less than $4,000 over the biweekly pay period (or an equivalent amount for pay periods of other lengths). The determination is made separately for each pay period, so employees with variable compensation or bonuses could be eligible in some pay periods and ineligible in others. The $4,000 threshold is also designed as a "cliff" and not a "cap." If wages are exactly $4,000, or any amount exceeding $4,000, no deferral at all is allowed for that pay period.

The notice does not address how to calculate an amount equivalent to $4,000 when the employer's payroll period is not biweekly. If an employer has a semimonthly payroll period for example, it appears the employer must develop its own method for calculating the cap. One method may be to multiply $285.71 ($4,000 divided by 14 days) by the number of days in the pay period.

Repayment

The notice requires employers to "withhold and pay" the deferred taxes "ratably" from wages and compensation paid between Jan. 1, 2021, and April 30, 2021. The notice does not provide any examples or other guidance on how this ratable withholding requirement can be met. For example, it would appear that the total amount deferred from 2020 would have to be ratably recovered from the payroll periods in the first four months of 2021, without regard to the actual amount of wages paid during that quarter. In many cases, the wages paid during that first four months of 2021 will not match the wages paid in the last four months of 2020 upon which the taxes were deferred, and therefore, the required withholdings could exceed or represent a significant portion of the actual wages paid in 2021.

In addition, the notice does not address how this ratable withholding applies if an employee receives no wages for a pay period or terminates employment before or during the first four months of 2021, other than to provide that, "if necessary," the employer can "make arrangements to otherwise collect" the total deferred taxes from the employee. It is unclear what mechanisms may be available or allowable to compel payment from former employees, or employees with reduced wages on which to withhold. For example, it is unclear whether certain state laws would require an employer to obtain employee consent before withholding any additional amounts.

Employer obligations

To the extent an employer could not collect any remaining deferred taxes from an employee, the obligation to repay remains with the employer. Employers would accrue interest, penalties, and additions to tax for any deferred amounts not repaid by April 30, 2021. In addition, to the extent an employer pays an employee's Social Security tax obligations on the employee's behalf, the employer, under current rules, would have to report the payment as additional taxable income to the employee and may have to gross up the payment to satisfy the regular employment tax withholding obligation on the additional income. The notice does not address this issue, and it would appear that additional guidance or new legislation would be required to eliminate these additional tax consequences.

Beginning implementation

It may be challenging for many taxpayers to adjust their payroll tax function by the Sept. 1 start date. Because participation is voluntary, employers don't necessarily need to begin deferral on that date, but the guidance itself does not provide any mechanism to retroactively defer amounts withheld and deposited before a taxpayer could adjust their withholding process. However, under the general employment tax withholding rules, employers may be able to make certain adjustments in future amounts to be withheld through the end of the third quarter (Sept. 30, 2020) to retroactively implement the deferral in some manner. In addition, it is possible the IRS provides retroactive deferral through its quarterly payroll tax forms.

Next steps

Employers should carefully consider all the potential consequences before making any decision to defer withholding Social Security tax. There are important reasons to be very cautious. The employer itself remains liable for the deferred withholding if it cannot recover those amounts from employees. Employers may want to consider input from employees before deferring the payroll tax. However, this would create an added administrative step in an already complex payroll systems change.

Employers should consider communicating their decision to employees. If implementing deferral, employees should understand that there is an obligation to reduce an employee's take home pay in 2021 to recoup the deferred amounts. If declining to defer, employers should give employees the reason, such as not wanting to impose a future obligation on either the employee or the employer.

Trump has pledged to ensure the tax is forgiven, but faces an election in November. Even if re-elected, he may still have to work with Democrats in Congress to enact this pledge. Democrats themselves may feel pressure to forgive the deferral either before or after the election, especially if participation is widespread. But many business groups have already indicated strong reluctance to participate, and the legislative process is always uncertain. A payroll tax cut has been widely unpopular with members of Congress in both parties, and Democrats have so far heavily criticized the executive action and pledged not to forgive the tax.

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