

Locke Lord QuickStudy: Initial Thoughts Regarding the IRS' Employee Payroll Tax Deferral Guidance in IRS Notice 2020-65

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On August 8, 2020, President Trump issued the Presidential Memorandum on Deferring Payroll Tax Obligations in Light of the Ongoing COVID-19 Disaster (the "Executive Order"). The Executive Order instructed the Treasury Department to provide guidance authorizing employers to defer the collection and deposit of employee payroll tax obligations. On August 28, 2020, the Internal Revenue Service ("IRS") issued IRS Notice 2020-65 (the "Notice"), which provides guidance to employers regarding how they may implement the Executive Order.

Overview of the Rules

The Notice authorizes employers to defer the withholding, deposit, and payment of the employee portion of the Old Age, Survivors, and Disability Insurance segment of FICA taxes (i.e., the 6.2% payroll tax)¹ on wages paid from September 1, 2020 through December 31, 2020 (the "Applicable Period").

The tax deferral applies to employees with wages and compensation below \$4,000 for a bi-weekly payroll period during the Applicable Period, as determined based on Box 3 of IRS Form W-2 (which includes elective deferrals to an employer's 401(k) plan but excludes amounts deducted under Section 125 of the Internal Revenue Code to fund benefit plan premium payments, contributions to an employee's health savings account, or contributions to a flexible spending account). This amount is adjusted for employers who use a different payroll cycle. The Notice provides that the deferral is determined based on the specific payroll period and does not look to the amount of wages in prior payroll periods.

- **Note:** since this determination is made on a payroll period basis, an employee who receives variable compensation (e.g., overtime, bonuses or commissions) may be eligible for this deferral during some payroll periods but not others. This may create issues for an employer's payroll system.

An employer is required to collect and deposit the deferred tax amount during the period between January 1, 2021 and April 30, 2021. The Notice contemplates that the employer will collect the deferred taxes from employees through increased wage withholding occurring ratably during the four month collection period. To the extent the deferred tax amount is not deposited during that period, interest and penalties will begin to accrue

on the unpaid amount on May 1, 2021.

Following the release of the Notice, the IRS released a draft version of a revised Form 941, Employer's Quarterly Federal Tax Return, to take into account the Social Security withholding that is deferred.

Key Issues and Questions

1. Is this mandatory? The Notice does not state whether employers are required to implement this payroll tax deferral for their employees. Section 7508A of the Code, which is the basis for this guidance, permits the IRS to postpone deadlines for various acts (including, as stated in the guidance, tax withholding) but does not permit the IRS to prohibit timely withholding and payment of taxes. As such, this should be optional for employers. That conclusion is consistent with the press releases issued by the IRS and the Treasury Department, which state that this form of relief is "available" to employers, and statements from Administration officials.

- Due to the high level of publicity regarding this issue, the availability of payroll tax deferral may create a communications issue for an employer who does not elect to implement deferrals. As a result, employers who do not implement payroll tax deferrals may decide to prepare an explanation for their employees regarding the decision not to defer payroll taxes.

2. Can employees require an employer to permit them to defer their taxes? As noted above, the Notice authorizes employers to defer withholding, deposit and payment of the employee portion of payroll taxes. It does not contain any guidance allowing employees to elect to defer these tax payments. As a result, an employer has a right to decide whether to use this form of relief.

3. Can an employer allow employees to elect to defer their taxes? Probably. The Notice does not address whether the election to defer withholding, deposit and payment of the employee portion of payroll taxes must be made on a uniform basis for all employees. It also does not contain any guidance regarding whether an employer can allow an employee to elect to defer these tax payments. As a result, an employer may be able to permit deferrals based on an employee's election.

- If an employer makes this deferral elective, it also could require an employee to agree that the employer is permitted to withhold the unpaid portion of any deferred taxes from an employee's final paycheck. As noted below, however, an employer should review its ability to enforce that type of agreement under applicable state law.

4. What happens if the employer cannot withhold the deferred taxes from an employee? The Notice requires the employer to repay such deferred taxes by withholding such amounts from an employee's future compensation payments. As a result, the employer will be required to pay this amount on or before April 30, 2021, even if an employee with deferred taxes is terminated, is furloughed, or goes on an unpaid leave of absence, before the deferred taxes are collected. If that occurs, the Notice provides that an employer may make arrangements to "otherwise collect" this amount from its employees.

- Employers may elect to withhold this amount from an employee's severance payment or final paycheck. This action, however, may be limited by applicable state wage payment laws or collective bargaining arrangements. That issue should be considered carefully by an employer who wishes to adopt this type of action.

- An employer might address this situation by allowing its employees to elect to participate in a payroll tax deferral program and conditioning such participation on execution of a repayment agreement. That type of agreement should be reviewed for compliance with applicable state law.
- If an employer ultimately pays the deferred tax obligation on behalf of the employee, the payment would be considered additional compensation to the employee. As such, it is likely that the employer will need to increase the payment amount to fund income and employment taxes on this amount.

5. How will this work? The mechanical aspects associated with implementing payroll tax deferrals under the Notice are critical. At a minimum, an employer's human resources information system and/or payroll tax provider will need to revise the employer's payroll system to not withhold payroll taxes from payments which are below the \$4,000 limit provided in the Notice. Given the timing involved, that may be difficult to accomplish and it may require manual intervention to make this work from an operational perspective.

6. How does this affect the employee retention credits and payroll tax deferral under the CARES Act and the paid sick and family leave credits under the Families First Coronavirus Response Act? It is unclear how this payroll tax deferral will affect payroll-related credits. The Notice did not provide any guidance regarding this issue.

7. Is this worth the effort? Maybe. Under the current guidance, the Notice effectively provides an interest-free loan to employees by allowing them to defer payment of their payroll taxes for four months. As such, there is a "time value of money" benefit for an employee.

- If there is a future change in law, this deferral opportunity could become permanent. That future change in law would, most likely, address the treatment of employees who did not benefit from the deferral opportunity. While we would anticipate that those individuals would be able to obtain a refund of payroll taxes paid during the Applicable Period, it is possible that the relief provided by a future change in law will be more limited.
- If there isn't a change in law to make this deferral opportunity permanent, the administrative complexity involved in making a significant change to an employer's payroll system, combined with the risk that an employer will be unable to collect the deferred tax amount from terminated and/or furloughed employees, may outweigh the fairly limited value received by the employees.

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¹ Section 3101(a) of the Internal Revenue Code of 1986, as amended, and the equivalent amount under the Railroad Retirement Tax Act under Section 3201(a) of the Internal Revenue Code of 1986, as amended.

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