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Navigating CARES Act Social Security Tax Deferral Payments

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Many employers are likely to find the rules for repayment of employer-share social security tax deferrals under the Coronavirus Aid Relief and Economic Security, or CARES, Act to be confusing.

Employers may also be surprised to learn that a 10% penalty on the entire deferral is assessed in the case of underpayments and late deposits. Employers should plan to repay deferred amounts timely and be certain to designate the quarter for which each payment is intended.

Thousands of U.S. employers took advantage of the program under the CARES Act to defer the deposit and payment of the employer's share of Social Security taxes owed on wages paid from March 27, 2020, through December 31, 2020.[1] The due date for half the deferred amount, Jan. 3, 2022 — not Dec. 31 — is fast approaching, and many outside payroll providers are insisting that employers pay weeks earlier if the provider is expected to facilitate electronic payments.

This article outlines some key components of these complex repayment rules, with the goal of timely and properly paying the deferred amounts due and avoiding potentially significant penalties.

Timing and Allocation of Repayments

Section 2302 of the CARES Act states that half of the deferred amount is due Dec. 31, extended administratively to the next business day, Monday, Jan. 3, 2022, and the remainder due Dec. 31, 2022. The Dec. 31, 2022, deadline likewise has been extended to Jan. 3, 2023.

The Internal Revenue Service issued an FAQ about the deferrals.[2] The answer to question 20 indicates that the IRS intends to issue a reminder notice to employers before each due date. These notices — designated CP256V Notices — were not sent until late October. Many companies have not yet received or located the mailing.

The notice states the following:

> What you need to know. The first installment amount, due December 31, 2021, is half the employer's share of Social Security taxes that you could have deferred (which includes any amount of the employee's share of Social Security taxes deferred under Notice 2020-65, as modified by Notice 20201-11) minus all deposits and payments we've received. For more information please review Q&A 18.

The answer to question 18 explains that "if an employer pays any amount before the applicable dates, any such payment is first applied to reduce the employer's liability for an amount due on December 31 ... and then to the amount due on December 31, 2022." The examples provided, however, do not address how quarterly payments — underpayments, payments in full, or overpayments — will be allocated.

Some companies have raised concerns that the language in question 20 means that overpayments for a particular quarter made by Dec. 31 will be applied to payments due in the same quarter of 2022, leaving taxpayers with a shortfall for the Dec 31 amounts due this year.

Unofficial IRS Guidance On 10% Penalty on Deferred Amounts

The stakes for proper allocation of employer repayments are high. Unofficial IRS guidance released in August, legal advice to program managers, or PMTA, 2021-07(), warns that if full repayment of the amount deferred in 2020 is not deposited by Dec. 31 of this year or Dec. 31, 2022, as applicable, the IRS considers the deferral completely invalid and can assess the 10% Internal Revenue Code Section 6656 failure to deposit penalty on 100% of the amounts deferred.[3]

There is no mention of the PMTA in the IRS FAQ.

The PMTA uses a hypothetical $50,000 deferral to illustrate the penalty consequences of an underpayment as of Dec. 31 of this year, and of a payment made after the Dec. 31, 2022 deadline.

In the first instance, the employer only deposits $5,000 by Dec. 31 of this year. Because the $25,000 due was not paid, the entire $50,000 deferral is invalidated and the 10% failure to deposit penalty applies to the entire $50,000, in the amount of $5,000. Further, if the employer receives an IRS notice demanding payment of the balance on Feb. 7, 2022, and does not pay the full amount by Feb. 17, 2022, the penalty rate increases to 15% of the total deferred amount.

In the second scenario, the employer deposits timely the $25,000 due Dec. 31 of this year, but does not deposit the remaining $25,000 until after the Dec. 31, 2022, deadline, on Feb. 28, 2023. If, on Feb. 6, 2023, the IRS issues a notice demanding payment of the second installment of $25,000, and the employer does not pay the full amount by Feb. 16, 2023, the penalty rate increases to 15% of the total deferral of $50,000. In other words, the penalty applies to the full amount deferred even though the first installment was paid on time.

The PMTA takes this extreme position by interpreting CARES Act Section 2302(a)(2) to condition the waiver of penalties on the deposit of all "deferred amounts by the applicable installment due dates;" failure to do so renders the deposits due on the usual monthly, semi-weekly or next-day deposit due dates defined in Treasury Regulations Sections 31.6302-1 and 31.6302-2, "which would be the due dates used in determining any penalties under section 6656".[4]

Moreover, the PMTA makes no carveout for the amounts that were repaid timely. The result is to strip away a significant portion of the deferral benefit, while seemingly punishing taxpayers that made payments before the PMTA was issued.

Methods of Repayment, Changes and Corrections

Repayments of deferred amounts can be made electronically through the Electronic Federal Tax Payment System, or EFTPS, by credit or debit card, or by check or money order.[5] Importantly, taxpayers must designate the quarter to which the payment relates.

For any payment through the EFTPS, the employer is required to designate the quarter to which the payment relates. For any payment by check, the employer is supposed to include a 2020 Form 941-V payment voucher with a darkened circle identifying the quarter for which the payment is being made. Additionally, taxpayers should write their employer identification number, the words "Form 941," and the calendar quarter in which the amount was originally deferred, e.g., 2nd Quarter 2020. These instructions are consistent with the need to reconcile amounts due or owing on an employer's quarterly federal tax return Forms 941.

Employers have raised concerns about the treatment of payments made without proper designation of the quarter to which the repaid amounts should be applied, or payments made to cover amounts due for multiple tax periods. A recent update to the Internal Revenue Manual provides some reassurance.[6]

The update addresses a range of topics concerning payments for CARES Act tax relief provisions, including employer Social Security tax deferral amounts. Inquiries and cases concerning deferred Social Security tax payments will be handled by designated employees who have received training on the relevant procedures.[7] It also provides IRS agents with instructions on how to respond to a wide range of questions from employers about deferred amounts due, e.g., the treatment of overpayments, employer failures to properly report the amounts of taxes deferred and paid on Form 941 and penalty abatement.

Throughout, the update recognizes that limitations in the IRS computer system may result in a variety of errors that should be manually corrected and recorded.

The update states that the IRS computer system cannot apply a single payment to multiple quarters, which means separate payments are required for each calendar quarter.[8] Nevertheless, the update appears to allow taxpayer requests to reapply payments to another quarter, and lays out detailed instructions for its agents to carefully consider and properly order any corrective transactions.[9]

While there is no guarantee the IRS will agree to apply a single payment to multiple quarters, reallocation according to taxpayer intent would be consistent with instructions elsewhere in the Internal Revenue Manual. For example recently added Section 3.12.10.3.7 on special payment perfection procedures instructs IRS agents to use taxpayer intent when applying payments.

Amount of Repayment

Consistent with the statute, the answer to question 18 indicates that the amount to be paid by Dec. 31 is half of the eligible deferred amount. The IRS reminder notices may not reflect amounts employers already repaid, whether because of delays in updating IRS records, or because the IRS computations are based on half the amount an employer could have deferred, and the employer actually paid some amount in 2020 that it could have deferred.

If an employer believes it owes more than the amount listed in the notices, we recommend that the employer pay the higher amount to avoid the penalties described above.

Paying Less than the Amount Owed

Employers that fail to meet the January 2022 and 2023 deposit deadlines discussed above risk exposure to penalties under IRC Section 6651 on failure to pay and Section 6656 on underpayment of deposits, as well interest on late payments.

The IRS advised informally that employers that are unable to meet the deadlines will be allowed to request installment agreements with the IRS.[10] Under an installment agreement, the employer can repay its deferred taxes over a longer period of time but will owe interest and penalties on the late payments.

In addition, an employer that wishes to enter into an installment agreement must submit a substantial amount of paperwork to the IRS disclosing its financial condition, and the IRS can file a notice of federal tax lien, which may affect the employer's access to credit. Because of this, employers may be better off borrowing from a third party to pay the deferred taxes on time. The cost of borrowing would have to be significant to exceed the interest and penalties the IRS would assess, and the employer would not have to deal with an IRS lien.

The IRS initially advised us that employers could not request installment agreements until after they received notice and demand for payment from the IRS, which probably will not happen until at least February 2022. But in more recent discussions, the IRS has indicated a willingness to negotiate installment agreements in advance.

Deadline for Repayments

IRC Section 7503 states that if the deadline for performing any act under the Internal Revenue laws falls on a Saturday, Sunday or legal holiday, the deadline is extended to the next weekday that is not a legal holiday. Since Dec. 31 of this year is a Friday and a federal holiday, the deferred taxes due Dec. 31 would be owed Monday Jan. 3, 2022.

Similarly, since Dec. 31, 2022 is a Saturday, and Monday Jan. 2, 2023, is a federal holiday, the remaining half of the deferred taxes would be due on Tuesday, Jan. 3, 2023.

The PMTA specifically acknowledges, in a footnote, the January deadlines, and the instructions to Form 941, revised in June, recognize these delayed deposit dates. But the IRS FAQ confusingly repeats the Dec. 3" statutory deadlines.

While this slight due date extension does not provide significant savings on interest, delaying payment until the next calendar year could result in a cashflow savings on a company's books, and, depending on an employer's accounting method, might result in a one-year deferral of the deduction for the tax payment.

Conclusion

The PMTA could effectively be seen as setting up a trap imposing a 10% nondeductible penalty on the full amount deferred in 2020 if there is even a small shortfall, or if the employer misses the payment deadlines. Lawyers at our firm have made a complaint to the IRS that we find the penalty terms in PMTA 2021-07 to be egregious for employers, and contrary the CARES Act deferral program's purpose to provide relief. Our concerns have been forwarded to the PMTA's authors. It remains to be seen if and how the IRS will respond.

Since the first payment deadline is imminent, however, we advise that employers pay the full amounts due — including where an employer's calculations are higher than the amounts owing according to a Notice CP256V on an installment payment due for IRC Section 965 tax liability. To do otherwise is to risk at least a 10% penalty on the full amount of the deferral.

Taxpayers that made a payment but failed to designate the quarter to which a repayment should be applied, or that paid an aggregate amount and did not allocate the payment across quarters, should contact the IRS to determine how the payment was allocated and request a reallocation, if possible.

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[1] Section 2302 of the CARES Act. A parallel deferral was allowed for railroad employers' Social Security equivalent taxes, and for certain self-employment taxes owed by self-employed individuals.

[2] https://www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020#what-are-applicable-dates-by-which-deferred-deposits-employers-share-social-security-tax-must-be-deposited. Per the language at the bottom of the webpage, these FAQs were last updated June 25, 2021.

[3] PMTA 2021-07, "Penalty for Failure to Deposit Taxes Deferred Under CARES Act Section 2302(a)(2)," (https://www.irs.gov/pub/lanoa/pmta-2021-07.pdf) June 21, 2021, p. 4. Hereafter, "PMTA."

[4] PMTA, p. 3.See also, Notice 2020-22, (https://www.irs.gov/pub/irs-drop/n-20-22.pdf) 2020-17 I.R.B. 664: CARES Act Section 2302(a)(2) reads: "DEPOSITS.—Notwithstanding section 6302 of the Internal Revenue Code of 1986, an employer shall be treated as having timely made all deposits of applicable employment taxes that are required to be made (without regard to this section) for such taxes during the payroll tax deferral period if all such deposits are made not later than the applicable date."

[5] See FAQ 29 and IRS Form 941 Instructions.

[6] IRM Procedural Update, (https://www.irs.gov/pub/foia/ig/sbse/sbse-05-1121-1275.pdf) Social Security Tax Deferral Guidance, IRM Subsection 21.7.2 (Employment and Railroad Tax Returns). November 16, 2021.

[7] Id., p. 64.

[8] Id., p. 92.

[9] Id., pp. 95-96.

[10] Until now, the IRS FAQs have only addressed this question with respect to repayments by self-employed individuals and household employers. See "How self-employed individuals and household employers repay deferred Social Security tax"