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Federal Tax ADVISORY ■

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Year-End Sellers Take Note: Planning Considerations with CARES Act Deferred Payroll Taxes

The CARES Act allows employers to defer the deposit and payment of certain employer payroll taxes owed on wages paid from March 27, 2020, through December 31, 2020 (self-employment taxes incurred during this period can also be deferred). Fifty percent of the deferred payroll taxes must be paid by December 31, 2021, and the remaining 50% must be paid by December 31, 2022. December 31, 2021 and 2022 each fall on the weekend, so the due dates are actually January 3, 2022 and January 3, 2023 under the weekend/holiday rule under Section 7503, as confirmed by the IRS in a recent Chief Counsel Memo.

Generally, employers are allowed a deduction for their portion of the payroll taxes deposited and paid each year, but the timing of the deduction depends on the employer's method of accounting. For cash method taxpayers, the deduction is deferred until the deferred payroll taxes are deposited and paid. For accrual method taxpayers, the deduction is generally permitted when the "all events" test is met and economic performance occurs. The "all events" test is generally met as the employees perform services and the liability for the employer's portion of payroll taxes becomes fixed and determinable, while economic performance occurs when the taxes are actually deposited and paid. Accrual method taxpayers that have adopted the "recurring item exception" under Section 461 for payroll taxes could nevertheless deduct in 2020 (and 2021, as applicable) the deferred payroll taxes, so long as they are actually paid within eight and a half months of year-end.

The CARES Act does not prohibit early payments of deferred payroll taxes. Sellers contemplating a sale late in 2021 (or 2022) should consider paying all or part of these deferred payroll taxes before the sale if the sale could close before year-end 2021 or 2022 (and if sufficient cash is available) to accelerate deductions. The purchase price calculation provisions in most purchase agreements generally follow a similar pattern and adjust base purchase price for cash on hand, debt, net working capital, and sometimes other items. Cash on hand is typically an increase to the base purchase price, and debt and debt-like items reduce the base purchase price. In many purchase agreements, payroll taxes deferred under the CARES Act are treated either as debt-like items that reduce the base purchase price or as current liabilities in net working capital. The additional cash outlay used to pay deferred payroll taxes before closing should have a net neutral impact on the base purchase price – decrease to cash on hand, with a corresponding decrease to debt or current liabilities (in net working capital).

Sellers can prepay the deferred payroll taxes before their due date using the Electronic Federal Tax Payment System by selecting IRS Form 941 and designating the calendar quarter the payment relates to. Importantly, sellers must submit a separate payment for each calendar quarter in which they deferred payroll taxes. Sellers with available cash on hand may benefit from paying the deferred payroll tax liability before closing and accelerating the deductions to the pre-closing tax period. The deduction should either flow through to the seller of a target classified as a partnership, disregarded entity, or S corporation or otherwise reduce taxable income of a target classified as a C corporation, which can either increase a net operating loss or reduce its tax liability for the pre-closing period. In the case of a C corporation target, if the deduction is expected to reduce cash tax liabilities for the pre-closing period (rather than increase a net operating loss) and the seller is otherwise contractually liable for such taxes for the pre-closing period under the purchase agreement, the accelerated deduction could produce an economic benefit to the seller. In each case, such benefit can be obtained without otherwise impacting the base purchase price because of the neutral impact of the payment on debt or current liabilities in net working capital and on cash. Before deciding to prepay these taxes, Sellers should consider the overall tax impact of the additional deductions (such as their effect on interest expense limitations under Section 163(j)).

Sellers and their advisors should carefully consider cash and accrued tax liability positions for sales that may close late in 2021 (and 2022). With careful planning, sellers may be able extract additional value out of the sale by paying deferred payroll taxes under the CARES Act before the closing.

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