Your choice: To ditch Social Security tax withholding or not

President Trump's executive order suspending the employee portion of Social Security taxes, issued two weeks ago, left many employers wondering what to do. Then, the Treasury Department offered some clarity on the payroll tax. According to Treasury Secretary Steven Mnuchin, deferring employees' share of Social Security taxes will be optional for employers.

We've spent the better part of this week reading other tax lawyers' opinions about this. So far, the general consensus forming around the executive order deferring the employees' share of Social Security taxes is don't do it or don't do it until the IRS issues guidance.

And speaking of IRS guidance, there are exactly 16 days, counting today and weekends, before the EO's Sept. 1 effective date. Employers and third-party payroll providers generally need more than 19 days to make major changes to payroll systems.

Understanding Trump's new Executive Order: Can the employee portion of Social Security taxes really be suspended?

Let's start with the details of the executive order.

Here are the key portions of the order, verbatim (we've highlighted what's important):

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Sec. 2. Deferring Certain Payroll Tax Obligations. The Secretary of the Treasury is hereby directed to use his authority pursuant to 26 U.S.C. 7508A to defer the withholding, deposit, and payment of the tax imposed by 26 U.S.C. 3101(a), and so much of the tax imposed by 26 U.S.C. 3201 as is attributable to the rate in effect under 26 U.S.C. 3101(a), on wages or compensation, as applicable, paid during the period of September 1, 2020, through December 31, 2020, subject to the following conditions:

(a) The deferral shall be made available with respect to any employee the amount of whose wages or compensation, as applicable, payable during any bi-weekly pay period generally is less than $4,000, calculated on a pre-tax basis, or the equivalent amount with respect to other pay periods.

(b) Amounts deferred pursuant to the implementation of this memorandum shall be deferred without any penalties, interest, additional amount, or addition to the tax.

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Sec. 4. Tax Forgiveness. The Secretary of the Treasury shall explore avenues, including legislation, to eliminate the obligation to pay the taxes deferred pursuant to the implementation of this memorandum.

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This suspension wouldn't apply to everyone. Annualized, $4,000 per biweekly pay period is $104,000. If you paid semimonthly, the amount is "generally" less than $4,333.33 ($104,000 ÷ 24).

This suspension would become effective Sept. 1, which is the last month of the third quarter. The IRS would need to specify how employers would account for the suspension on their third-quarter 941s.

The IRS would also need to specify how this suspension would be reported on employees' W-2s.

The Internal Revenue Code and regulations

We've taken a romp through the Internal Revenue Code and regulations so you won't have to. We are not providing any legal or tax advice. We are simply recounting what the code and regulations say.

Internal Revenue Code § 7508A refers back to § 7508 and authorizes the IRS to suspend the filing any return of income, estate, gift, employment or excise tax; or the payment of any income, estate, gift, employment or excise tax.

Section 7508 was amended in 2005, by the Katrina Emergency Tax Relief Act (P.L. 109-73). Before the amendment, the IRS couldn't suspend the filing of employment tax returns or the payment of employment taxes.

There's a difference between paying employment taxes and depositing employment taxes, as the preamble to the regulation implementing IRC § 7508—§ 301.7508—notes. This regulation specifically excludes the deposit of payroll taxes from the list of actions the IRS is authorized to take in response to an emergency. Instead, it allows the IRS to waive failure-to-deposit penalties. The regulation also doesn't specifically allow the IRS to suspend tax withholding.

The defect could be cured if payment was interpreted to include depositing and withholding.

IRC § 3102 and reg. § 31.3102-1 say employers must withhold FICA taxes as and when employees are paid.

Under IRC § 3102(f), if employers don't withhold Social Security taxes, employees must still pay them.

And finally, if withholding is suspended and the amounts remitted to employees, which, presumably, is the point, employees will owe income taxes on those amounts (and additional Social Security taxes), as well.

The APA's perspective

Understandably, issues like this are a major concern to the American Payroll Association. Here's what it had to say:

APA supports measures to provide relief to employees and businesses during the COVID-19 crisis. APA is concerned, however, with the financial burden and implementation timeline the proposed payroll tax holiday would place on American businesses and employees. This is an issue APA previously raised concerns about in March in a letter to members of Congress.

"Payroll professionals can't just push the easy button to adjust payroll systems to accommodate quick changes to withholding; they must make sure that employees' tax withholding is accurate. If employees are burdened with deferred payroll taxes later, then we haven't provided relief, we have postponed the tax payment at best, all at a significant expense to employers." – Alice Jacobsohn, Esq., Director of Government Relations for APA

The bottom line

Based on the statutory and regulatory framework, it's not clear whether the EO can accomplish its goal of suspending the collection of employees' Social Security taxes. This is a tax suspension, not a tax holiday.

So employees would still owe their share of Social Security taxes, and the debt would become due on or after Jan. 1, 2021, unless Congress enacts a law wiping out their liability. The IRS doesn't have the authority to forgive the taxes on its own.

This should sound pretty familiar—the CARES Act allows you to suspend the employer's portion of Social Security taxes through the end of the year. But you're still on the hook for the taxes.

The case against deferrals

Let's recap the major pitfalls:

- Under the current regulatory framework, the IRS doesn't appear to have the authority to postpone the deposit of payroll taxes, let alone the authority to suspend withholding.
- Employers opting to suspend withholding will be left holding the bag if an employee terminates.
- As it is configured now, employees will still owe their Social Security taxes, sometime.

The IRS, of course, can waive away those concerns in any guidance. But those actions could be legally dubious, and it would take so much time for the legalities to be adjudicated that the issues would probably become moot.

Damned if you do, damned if you don't

Employees may not understand how withholding works, but they watch the evening news. That means they're probably aware that something is up, even if they don't know the details. And, let's face it, the optional nature of this deferral, if it sticks when the IRS does issue guidance, puts you in a bad spot, because employees will think you're denying them a tax cut.

So what should you say to employees if you choose not to defer?

Don't say it's too expensive to reprogram your payroll software at this late date, that the deferral will wreak havoc with your year-end reporting or that they won't be getting as much as they think. You don't know what their financial situation is, and for some, every little bit might help.

Do be up front with employees about the risk involved. Here are some talking points:

- It doesn't apply to everyone—employees who have already maxed out on the 2020 $137,700 taxable wage base get nothing. Employees who generally earn more than $4,000 per biweekly pay period get nothing.
- It's not a tax cut, but a deferral of your Social Security taxes. The risk is that until the IRS says otherwise, you will still owe the taxes and your take-home pay next year may need to be reduced to pay for the deferral.
- If your employment terminates, you may be responsible for paying back the deferral in a lump sum.
- How this shakes out is even less clear for dual-income couples or for employees with two jobs.

We suggest reaching out to your HR department about this issue. HR is accustomed to communicating with employees and they will be able to help you craft your messaging to employees.

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