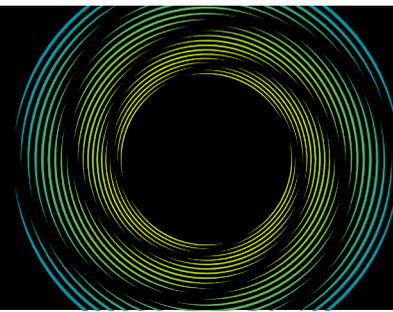


M&A Tax Talk

Distressed market series



Addressing payroll and employment tax considerations under the CARES Act

The CARES Act provides employers of all sizes with potential options to address liquidity concerns through payroll and employment-related tax provisions. These options include a refundable tax credit connected to employee retention and the ability to defer the payment of employer Social Security payroll taxes. While providing liquidity, these tax provisions may lead to issues that should be addressed in each transaction.

Employee Retention Credit

The CARES Act includes an Employee Retention Credit (ERC) of up to \$5,000 per employee for “eligible employers” that continue to pay “qualified wages” to employees despite having operations fully or partially suspended or have experienced a significant decline in gross receipts due to the COVID-19 outbreak. The ERC is a fully refundable credit equal to 50 percent of the qualified wages with respect to each eligible employer for each calendar quarter. The maximum amount of qualified wages allowed to be considered for the credit is \$10,000 total per employee for all calendar quarters (not per quarter). The credit is allowed against the Social Security tax imposed with respect to all employees and the portion of taxes imposed on railroad employees for such calendar quarter. To the extent the credit exceeds the applicable employment taxes owed, as well as any other employment taxes for the quarter, it is treated as an overpayment and may be refundable.

Employer eligibility

An eligible employer must have been carrying on a trade or business during calendar year 2020, and must have:

- Experienced a full or partial suspension of trade or business operations due to orders from an appropriate government authority due to COVID-19 or
- Experienced a significant decline in 2020 gross receipts (more than a 50 percent decline in quarterly gross receipts)

For purposes of making the eligible employer determination for a calendar quarter, the employer must apply certain tax aggregation rules to treat all affiliated entities as a “single employer.”

Qualified wages

Qualified wages are determined based on wages as defined under the act and paid, along with health care expenses, between March 13, 2020, and December 31, 2020, by an eligible employer to an employee and cannot exceed \$10,000 per employee.

The method to quantify qualified wages varies based on the number of full-time employees employed by an eligible employer in calendar year 2019. The employer must apply the above-mentioned aggregation rules to determine the number of employees (all employees of affiliated entities or of the same consolidated group are treated as employed by a “single employer”).

Application of credits and refunds

To claim the ERC, the eligible employer must report the total qualified wages and the related credits, as well as the FFCRA payroll tax credits for Qualified Sick and Family Leave Wages for each calendar quarter, on their federal employment tax returns. If the amount of the credit exceeds the employer Social Security tax on all wages paid to the employees for a quarter, then the excess is treated as an overpayment and is refundable.

However, in anticipation of receiving the ERC for qualified wages and the FFCRA payroll tax credits for Qualified Sick and Family Leave Wages, an employer can monetize

such credits by accessing federal employment taxes that are required to be deposited to the IRS or by requesting an advance of the credit from the IRS.

In other words, an eligible employer that pays such qualified wages to its employees in a calendar quarter, before it is required to deposit federal employment taxes with the IRS for that quarter, may reduce the amount of federal employment tax deposits by the amount of the credits claimed for that quarter. If the employment tax deposits that are otherwise required are less than the amount of the credit for which the employer is eligible, the eligible employer may receive the remaining credit in advance.

Limitations

Taxpayers considering the ERC should be aware of two specific limits.

First, if an eligible employer receives a small business loan (that has not been repaid by May 18, 2020) as part of the Paycheck Protection Program (PPP loan), the employer is no longer treated as an eligible employer in the same calendar quarter that the employer receives the PPP loan. In addition, the employer will no longer be eligible for the ERC in subsequent calendar quarters in 2020 from that point forward. There will likely be a recapture of the ERC benefit from any prior periods as well, but such rules have not yet been promulgated.

Second, the employer tax deduction for compensation expense for the taxable year must be reduced by the amount of any ERC claimed under rules, like in Section 280C.

M&A tax considerations

Strategic buyers should review whether target entities have received or intend to receive a PPP loan. If buyer acquires more than 50 percent of vote or value of a Target which is a corporation, or more than 50 percent of the profits interest or capital interest of a Target which is a partnership, Target is likely treated as part of a “single employer” with the buyer, as well as other members of the same consolidated group. Consequently, the buyer and other members of the same consolidated group may become ineligible for the ERC because one of its members (Target) received a PPP loan. Additionally, ERC eligibility is determined on a calendar basis, such that if Target were acquired July 1, 2020, (calendar Q2) or after, then the other members may likely be prohibited from claiming the ERC beginning in the calendar quarter the Target is acquired (calendar Q2) and for all subsequent quarters remaining in the calendar year. Furthermore, there is uncertainty as to whether any previously claimed credits would be required to be recaptured, as those rules are pending IRS release.

Private equity buyers should evaluate whether acquired entities would be treated as a “single employer” with the private equity buyer, particularly for middle-market and family-owned funds. As such, the buyer could face similar limitation described above and be ineligible for the ERC for postacquisition quarters.

Buyers should consider delaying the closing of Target acquisition until calendar 2021 or acquiring as an asset purchase as a means of mitigating potential ERC recapture risk.

If an ERC was taken by the company, an evaluation of the accuracy of the amount of the credit and the availability of the supporting records should be completed as the credit may be subject to IRS audit.

Payroll tax deferral

The CARES Act includes a delay in payment of employer Social Security taxes (payroll tax deferral) applicable to eligible employers. The payroll tax deferral permits all employers (including self-employed individuals) to defer (without interest) any remaining payments of the employer portion of Social Security tax (6.2 percent on wages subject to a maximum wage base of \$137,700 for 2020) due from the effective date of the CARES Act (March 27, 2020) through December 31, 2020. Any payments deferred will be due as follows:

- 50 percent due by December 31, 2021
- 50 percent due by December 31, 2022

Employers are eligible to defer the employer portion of the Social Security tax. This is done prior to determining whether the employer is entitled to FFCRA payroll tax credits for Qualified Sick and Family Leave Wages or the ERC. This includes, prior to calculating the amount of employment tax deposits that it may retain in anticipation of these credits, the amount of any advance of these credits, or the amount of any refunds with regard to these credits.

The payroll tax deferral applies to all employers regardless of the number of employees. However, the delay in payment provision will cease to apply to any taxpayer that receives a PPP loan for which all or a portion of such loan is forgiven beginning in the period the loan is forgiven by the lender. Once a taxpayer receives this decision, the taxpayer is no longer eligible to defer deposit and payment of the employer’s share of the Social Security tax due after that date. However, the amount of the deposit and payment of the employer’s share of Social Security tax that was deferred through the date that the PPP loan is forgiven continues to be deferred and due on the applicable dates described above.

M&A tax considerations

Buyers should confirm that deferred payroll taxes are included in net indebtedness or otherwise considered in the purchase price mechanism.

Conclusion

A business should consider the full implications and related impact the CARES Act may have on its business and/or an M&A deal. Specifically, the availability of new retention credits and payroll tax deferrals may generate an additional case for businesses, but will need to be evaluated in connection with other available funding options under the CARES Act. Additionally, prospective sellers may have liabilities previously not seen, risk for payroll tax credits that have to be evaluated, and implications for the buyer on its own credits. Accordingly, a business should consult their tax adviser to evaluate liquidity concerns and potential opportunities in relation to their business or a business they’re acquiring.

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