DHG

ALERT

April 2021

2020 Tax Return and the ERC Wage Adjustment

In order to ensure taxpayers do not receive a double tax benefit with respect to the same expenditure, businesses claiming credits that are determined with respect to wages are, generally, required to reduce their income tax deduction for wages by the amount of the credit taken. This general rule is applicable to businesses who claim the employee retention credit (ERC). As a result, businesses who are claiming 2020 employee retention credits will be required to reduce their qualifying wages by the amount of the credit when computing their income tax liability.

Absent additional guidance from the IRS providing otherwise, the wage adjustment for ERC is applicable to the taxpayer's income tax return which includes the quarters for which the credits are claimed. For example, a calendar year business would need to reduce its 2020 wage expense deduction by the amount of ERC claimed on 2020 qualifying wages. This presents a current cash flow concern for a lot of taxpayers.

Many businesses who are eligible for 2020 ERC have not yet received the cash benefits of these credits. In some cases, the businesses may still be in the process of evaluating eligibility and quantifying the credit amounts. Meanwhile, the income tax payment deadline for 2020 calendar year taxpayers is April 15 for C corporations or May 17 for most pass-through business owners. While extensions may be filed to allow additional time for computing and reporting the adjustment, an extension does not allow additional time for payment of the income tax liability.

DHG has written a letter to the IRS and Treasury requesting additional time for taxpayers to make payment of their 2020 income tax liability associated with this wage adjustment. Under the DHG request, taxpayers would have an additional 12 months to collect their ERC related refunds and pay the income tax without any late payment penalties and associated collection actions.

In the event relief is not provided, various approaches may be taken to address the cash flow issue created by the 2020 wage adjustment. Your specific facts and circumstances will determine which approach is best suited for you.

MAKE PAYMENT ON THE DUE DATE

Taxpayers who have already claimed their 2020 ERC or can reasonably estimate their 2020 ERC amount and have adequate funds to do so, may decide to pay their income tax liability in full at the applicable due date even though they have not yet received the cash benefit of the ERC. The payment may be made with a timely filed extension or with the return if filing by the original due date.

This approach reduces the likelihood of penalty assessment and avoids the additional costs associated with a need to file an amended return or respond to IRS notices. However, once the payment has been made, the taxpayer has no way to recover the funds. A taxpayer taking this approach should be comfortable they will have sufficient funding to meet their needs until their ERC refunds are received.

FILE AND AMEND

The wage adjustment for income tax purposes is directly tied to the determination of the credits. The ERC is an elective credit, meaning taxpayers can choose not to claim the credits. As a result of this elective element, the wage deduction disallowance technically should not be applicable until the credits are claimed.

Taxpayers who have not yet claimed their 2020 ERC and will not do so by the date they are otherwise ready to file their 2020 income tax return, may wish to go ahead and file their return without the wage adjustment. These taxpayers will then need to file amended 2020 income tax returns once they have filed an amended Form 941 to claim their 2020 ERC.

This approach allows taxpayers to delay payment of the income tax associated with the wage adjustment until they file their refund claims. Additionally, in the case of a voluntarily filed amended return, the IRS generally does not assess late payment penalties on the balance due if it is paid with the amended return (or in the case of individual taxpayers within the number of days as specified in the Form 1040-X instructions).

However, there is an additional cost to this approach due to the need to prepare and file amended returns. Further, while this approach may more closely align the additional income tax payment with ERC refunds for taxpayers who are still evaluating eligibility and quantifying their 2020 ERC, payment of the additional income tax will still be due ahead of the actual ERC refund receipt. Taxpayers who delay filing the amended returns once they have submitted their ERC refund claims will run the risk of incurring a 20% accuracy related penalty on the unreported tax should the IRS propose an adjustment for the wage disallowance in the interim.

This approach is not available to taxpayers who have already claimed 2020 ERC prior to filing their income tax return. These taxpayers may wish to consider extending their income tax returns if additional time is needed to make the income tax payment.

EXTEND AND PAY BY EXTENDED DUE DATE

Taxpayers who decide to extend their income tax return, either to allow time for determination of 2020 ERC or for other reasons, may wish to delay making the additional payment of income tax at the original due date. A taxpayer taking this approach generally will not be subjected to notices or other collection actions until the earlier of 1) the date the income tax return is filed, or 2) the extension period expires. Effectively, this allows additional time to fund the additional income tax liability.

However, this additional time carries a cost. Late payment penalties will be assessed on the amount of tax owed from the original due date until the date of payment. These penalties may be abated by the IRS if the taxpayer successfully demonstrates that the failure to pay was due to reasonable cause. This determination is made based on the facts and circumstances for each taxpayer. In the case of taxes due solely as a result of the ERC wage disallowance, taxpayers may have a case for reasonable cause, particularly if they were prevented from claiming the 2020 ERC during 2020 and were still in the process of evaluating eligibility and credit amounts at the original income tax payment due date.

In cases where penalty abatement is received, taxpayers will still experience some level of increased administrative burdens and costs resulting from the need to correspond with the IRS to obtain the abatement.

The approaches outlined above represent broad categories for consideration. In some cases, additional elements, such as payment plans, may also need to be considered and factored in as part of the approach. How, and to what extent, taxpayers will want to implement a particular approach will vary based upon their specific facts and circumstances and should be proactively discussed with their tax advisor.

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