Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: Liability of Certain Third-Party Payers for an Underpayment of Certain Employment Taxes Resulting from Improperly Claimed Employment Tax Credits

This Generic Legal Advice Memorandum (GLAM) responds to your request for assistance. This GLAM may not be used or cited as precedent.

NOTE: When this memo was originally issued on February 16, 2024, it incorrectly discussed Notice 2021-20 as being issued before the Taxpayer Certainty and Disaster Tax Relief Act of 2020 was signed into law. However, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (referred to in the memo as the "Relief Act"), enacted as Division EE of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, 134 Stat. 1182, was signed into law on December 27, 2020, while Notice 2021-20 was issued on March 1, 2021, after the Relief Act was passed. This incorrect chronology does not affect the IRS's position or analysis discussed in this memo. The memo below is corrected so that it accurately discusses the order in which the law was signed and the memo issued.

You have asked about the liability of certain third-party payers (TPPs) for an underpayment of certain employment taxes resulting from improperly claimed credit that was claimed by the TPP for a common law employer client on an employment tax return filed by the TPP under its own Employer Identification Number (EIN). Specifically, you inquired about the liability of TPPs for underpayments of employment tax where the Employee Retention Credit (ERC) was improperly claimed.

Employers generally are required to deduct and withhold Federal Insurance Contributions Act (FICA) taxes from wages paid to their employees under section 3102 of the Internal Revenue Code (Code) and are separately liable for the employer's share of FICA taxes under section 3111. Employers of railroad employees are required to deduct and withhold Railroad Retirement Tax Act (RRTA) taxes from their employees' compensation under section 3202 and are separately liable for the employer's share of RRTA taxes under section 3221 (FICA and RRTA taxes are collectively referred to as employment taxes for purposes of this memorandum).

A common law employer may choose to enter into an agreement with a TPP pursuant to which the TPP withholds, deposits, and pays employment taxes with respect to the employees of the employer. In certain arrangements, the TPP pays wages[1] to the employees of its employer clients (clients [2]) and files employment tax returns for these clients using its own EIN rather than the EIN of the clients. The following briefly describes three different types of TPP arrangements that underly the question you have asked and the liability attributable to the parties in those relationships.

Section 3504 Agent

Section 3504 of the Code states that in situations where a TPP has the control, receipt, custody, or disposal of, or pays the wages of an employee or group of employees, employed by one or more employers, the TPP may be designated as an agent to perform such acts as are required of employers. Treas. Reg. 31.3504-1 provides that a TPP may be designated an agent by application. An employer uses Form 2678, *Employer/Payer Appointment of Agent*, to request the Service to authorize a TPP to act as an agent of the employer.

Treas. Reg. § 31.3504-1(a) provides that "all provisions of law (including penalties) and of the regulations applicable to an employer with respect to [the acts the agent is designated to perform] shall be applicable to the agent," but that "each employer for whom the agent acts shall remain subject to all provisions of law (including penalties) and of the regulations applicable to an employer with respect to such acts." This means that for an agent designated by its client to pay employment taxes on the wages the agent pays to the client's employees (section 3504 agent), both the agent and the client are liable for underpayments of employment tax related to such wages.

A section 3504 agent files an aggregate Form 941 under its own EIN, with Schedule R (Form 941) attached. The Schedule R allocates the aggregate wages reported and credits claimed (among other required items) on Form 941 to each of the section 3504 agent's customers.

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[1] Remuneration subject to RRTA is typically referred to as "compensation," but for purposes of this memo, the use of "wages" refers both to wages subject to FICA and compensation subject to RRTA.

[2] In certain rare circumstances, a client of a TPP may not actually be the common law employer of the employees paid by the TPP on its behalf. For purposes of this memo, "client" refers only to common law employers who are clients of a TPP.

Non-Certified Professional Employer Organization

Under final regulations, published at Treas. Reg. § 31.3504-2, and effective for wages paid in quarters beginning after March 31, 2014, if a TPP, such as a non-certified professional employer organization (PEO), pays wages or compensation to individuals performing services for a client pursuant to a service agreement (as defined in § 31.3504-2(b)(2)) between the TPP and the client, the TPP may be designated to perform acts of an employer, including filing employment tax returns and paying employment taxes, with respect to the wages or compensation paid by the TPP to those individuals. For purposes of this memo, all references to PEOs refer only to PEOs subject to section 31.3504-2.

Section 31.3504-2(c)(1) provides that "all provisions of law (including penalties), and the regulations applicable to an employer" are applicable to the PEO with respect to the wages paid by the PEO to the employees of its clients. Section 31.3504-2(c)(2) adds that the client of the PEO still remains subject to "all provisions of law (including penalties) and of the regulations applicable to an employer with respect to these wages or compensation." "Provisions of law applicable to an employer" includes those sections of the Code that require employers to pay employment taxes on wages paid to their employees. Therefore, for a PEO that pays wages to the employees of its client pursuant to a service agreement, both the PEO and the client are liable for underpayments of employment tax related to the wages paid by the PEO to those employees.

A PEO files an aggregate Form 941 under its own EIN. In general, there is no statutory requirement for a PEO to attach Schedule R (Form 941) to its aggregate Form 941. However, for purposes of claiming certain employment tax credits,[3] a PEO must attach Schedule R to its Form 941 allocating the aggregate wages and claimed credits (among other required items) to each of its clients.

Certified Professional Employer Organizations (CPEO)

The Stephen Beck, Jr., Achieving a Better Life Experience (ABLE) Act of 2014, enacted on December 19, 2014, as part of The Tax Increase Prevention Act of 2014 (Pub. L. 113-295), required the establishment of a voluntary program for TPPs to apply to the Internal Revenue Service (IRS) to become certified as a CPEO and added new Code sections 3511 and 7705 relating to the federal employment tax consequences and certification requirements, respectively, of a CPEO. Under these provisions, a TPP who becomes certified as a CPEO will be treated as the employer of any employee

[3] These credits include the paid sick and family leave credits under the Families First Coronavirus Response Act of 2020 and under sections 3131 and 3132 of the Code, the Employee Retention Credit under the CARES Act and under section 3134 of the Code, and the Qualified Small Business Payroll Tax Credit for Increasing Research Activities under sections 41(h) and 3111(f).

performing services for any customer[4] of the TPP, but only with respect to wages paid by the TPP to the employee.

Under section 3511(a)(1), a CPEO is treated as the only employer and the CPEO assumes all employment tax liability and responsibilities for the wages it pays to work site employees of its customers, including liabilities arising from underpayments of employment tax. Under section 3511(c)(1), a CPEO is treated as the employer for all wages it pays to its customer's non-work site employees, but the customer may also be liable[5] for any underpayments of employment tax on wages paid to non-work site employees.[6]

A CPEO files an aggregate Form 941 under its own EIN, with Schedule R (Form 941) attached allocating the aggregate wages and credits (among other required items) to each of its clients.

TPPs and Employment Tax Credits

Until recently, statutes providing for employment tax credits did not typically address TPP situations. Absent any specific legislative exception concerning TPP liability for employment tax credits, the IRS must apply the existing statutory and regulatory rules regarding TPP liability to liabilities arising from improperly claimed employment tax credits claimed by a TPP for its client on the TPP's employment tax return.

As noted above, for PEOs and section 3504 agents, both the TPP and its client are liable for underpayments related to the wages paid by the TPP to its clients. When improperly claimed credits are claimed by a PEO for its client, and the credit claim is based on the wages paid by the PEO to the client's employees and reported on the PEO's employment tax return, both the PEO and its client are liable for any underpayment of tax resulting from the improperly claimed credits. Similarly, when improperly claimed credits are claimed by a section 3504 agent for its client, and the credit claim is based on the wages paid by the section 3504 agent to the client's employees and reported on the agent's employment tax return, both the section 3504 agent and its client are liable for any underpayment of tax resulting from the improperly claimed credits.

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[4] While employers who utilize the services of a TPP are typically referred to as "clients" of the TPP, under regulations and other guidance, employers who enter into a CPEO contract with a CPEO are referred to as "customers."

[5] Section 3511(c)(1) provides that the CPEO is *an* employer of a non-works site employee for employment tax purposes without providing that the CPEO is treated as the only employer, as is the case for work site employees under section 3511(a)(1). If the customer is the common law employer of the non-work site employees, then the customer will also be liable. However, in rare situations the customer may not be the common law employer and therefore may not be liable.

[6] The term "work site employee" means, with respect to a customer, a covered employee who performs services for such customer at a work site where, at any time during a calendar quarter, at least 85 percent of the individuals performing services for the customer are covered employees of the client. Rev. Proc. 2023-18.

Section 3511 of the Code does address credits as they apply to CPEOs and their customers. Section 3511(d)(1) provides that, for certain specified credits (listed in section 3511(d)(2)), any such credit "with respect to a work site employee performing services for the customer applies to the customer, not the [CPEO]." In addition, this section provides that "the customer, and not the [CPEO], shall take into account wages and employment taxes – (i) paid by the [CPEO] with respect to the work site employee, and (ii) for which the [CPEO] receives payment from the customer." Finally, section 3511(d)(1)(C) provides that the CPEO "shall furnish the customer and the Secretary with any information necessary for the customer to claim such credit."

However, while this section discusses eligibility for credits in the CPEO context, it does not address liability for improperly claimed credits. Rather, the focus of section 3511(d) is to ensure that:

> (1) credits that relate to the services performed by the CPEO customer's employees for the customer apply only to the customer, regardless of the fact that the wages for those services were paid by the CPEO to the customer's employees; and
>
> (2) for purposes of those income tax and employment tax credits for which credit amounts are determined based on the amount of wages paid by an employer to its employees, an employer who is a customer of a CPEO can include the wages paid by the CPEO to its employees in determining the amount of credit for which it is eligible.

Unless a credit-specific statutory provision provides otherwise, the existing statutory and regulatory rules regarding CPEO liability apply to liabilities arising from improperly claimed employment tax credits claimed by a CPEO for its customers. Per section 3511(a)(1), a CPEO is solely liable for employment tax liabilities on remuneration the CPEO pays to worksite employees of its customers, which means a CPEO is solely liable for underpayments resulting from improperly claimed credits that were based on wages paid by the CPEO to the worksite employees of its customers and reported on the CPEO's employment tax return (absent specific legislative authority that provides differently).

Under section 3511(c)(1), both the CPEO and its customer are liable for underpayments of tax related to the wages paid by the CPEO to the customer's non-work-site employees (assuming the customer is the common law employer of such employees, or otherwise liable). Therefore, both the CPEO and the customer are liable for underpayments resulting from improperly claimed credits that were based on wages paid by the CPEO to the non-worksite employees of its customer and reported on the CPEO's employment tax return.

<u>TPP Liability for the Employee Retention Credit under the CARES Act as Originally Enacted</u>

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. 116-136, 134 Stat. 28, enacted on March 27, 2020, and later amended and extended by the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Relief Act), which was enacted as Division EE of the Consolidated Appropriations Act, 2021, provided relief to taxpayers from economic hardships resulting from the Coronavirus Disease 2019 (COVID-19), including an employee retention credit (ERC) with respect to qualified wages paid after March 12, 2020, and before July 1, 2021, respectively. The American Rescue Plan Act of 2021 (ARP), Pub. L. 117-2, 135 Stat. 4 (March 11, 2021), provided a substantially similar ERC under section 3134 of the Code, enacted by section 9651 of the ARP, with respect to qualified wages paid after June 30, 2021, and before January 1, 2022.

The ERC provisions under the CARES Act as originally enacted included two provisions addressing TPPs. Section 2301(h)(3) of the CARES Act provides that "[a]ny credit allowed under this section shall be treated as a credit described in section 3511(d)(2) of such Code." As discussed earlier, the purpose of section 3511(d) of the Code is to ensure that credits related to the services performed by a CPEO customer's employees apply to the customer and that the customer can include wages paid by the CPEO to the customer's employees in determining the amount of credits for which it is eligible. Section 2301(h)(3) of the CARES Act therefore ensures that, for an ERC claim that is based on the services performed by a CPEO customer's employees for the customer, the ERC applies to the customer and the ERC amount is determined using the wages paid by the CPEO to the customer's employees. This provision does not address liability for an improperly claimed ERC.

Section 2301(l)(4) of the CARES Act provides that the IRS shall issue the forms, instructions, regulations, and guidance that are necessary "with respect to the application of the [ERC] to TPPs (including [PEOs], [CPEOs], or [section 3504 agents]), including regulations or guidance allowing such [TPPs] to submit documentation necessary to substantiate the eligible employer status of employers that use such [TPPs]."

The IRS complied with this directive in Notice 2021-20, which provided information specific to TPPs in section M, "Special Issues for Employers: Use of Third-Party Payers."[7] Specifically, Question and Answer (Q&A) #66 provides that "[i]f a [TPP] (such as a CPEO, PEO, or other section 3504 agent) is claiming the employee retention credit on behalf of the employer client, it must collect from the employer client any information necessary to accurately claim the employee retention credit on its employer client's behalf."

Q&A #67 provides that if a TPP is "claiming the employee retention credit on behalf of the employer client, the [TPP] may rely on the employer client's information regarding the employer client's eligibility to claim the employee retention credit" and that "[e]ither

[7] The IRS also provided information concerning the ERC and TPPs in various forms and instructions and information provided on irs.gov.

the [TPP] or the employer client may maintain all records which substantiate the employer client's eligibility for the employee retention credit." But this Q&A also notes that "if the employer client maintains the records, upon request by the IRS, the [TPP] must obtain from the employer client and provide to the IRS records that substantiate the employer client's eligibility for the employee retention credit.

Finally, Q&A #68 provides that "If a [TPP] is claiming the employee retention credit on behalf of the employer client, it must, at the IRS's request, be able to obtain from the [client] and provide to the IRS records that substantiate employer client's eligibility for the employee retention credit."

TPP Liability for the Employee Retention Credit under the CARES Act as Amended by the Relief Act

The Relief Act amended section 2301(l) of the CARES Act to include the following flush language: "Any forms, instructions, regulations, or guidance described in paragraph (2)[8] shall require the customer to be responsible for the accounting of the credit and for any liability for improperly claimed credits and shall require the [CPEO] or other [TPP] to accurately report such tax credits based on the information provided by the customer.'' This amendment applies only to the ERC claimed on wages paid in the first two quarters of 2021. Section 3134(m), enacted under ARP, contained an almost identical provision. Section 3134 applies only to ERC claimed on wages paid in the third quarter of 2021, and, for recovery startup businesses only, to wages paid in the fourth quarter of 2021.

While the amended section 2301(l) does address the liability of a TPP client for improperly claimed credits (namely the liability of a CPEO customer, who would typically not bear responsibility for such liabilities), it does not address the liability of the TPP; therefore, the TPP remains liable under existing law. This is in contrast to how the CARES Act addresses the deferral of the employer portion of FICA taxes under section 2302. Specifically, section 2302(c)(1) provides, "if [a client of a Section 3504 agent or PEO subject to the regulations under section 3504] directs such [TPP] to defer payment of any applicable employment taxes during the payroll tax deferral period under this section, such employer shall be *solely liable* for the payment of such applicable employment taxes…" (emphasis added). Similarly, section 2302(c)(2) provides, "if [a CPEO customer] directs [a CPEO] to defer payment of any applicable employment taxes during the payroll tax deferral period under this section, such customer shall, notwithstanding subsections (a) and (c) of section 3511, be *solely liable* for the payment of such applicable employment taxes…" (emphasis added).

The "solely liable" language in section 2302 of the CARES Act addresses TPP liability by providing that *only* the client or CPEO customer is liable for FICA tax liabilities deferred under this section. Section 2302(m) was included in the CARES Act as

[8] "Paragraph 2" in the CARES Act section 2301(l) is the same as section 2304(l)(4) in the CARES Act as originally enacted.

originally enacted. Later, when Congress amended section 2301(l) to discuss the liability of a client or CPEO customer for improperly claimed credits, Congress chose not to include this "solely liable" language. For this reason, it is Counsel's position that the Relief Act amendment to section 2301(l) of the CARES Act, while providing for TPP client liability for improperly claimed credits, and specifically for CPEO customer liability for improperly claimed credits (for which, without such language, a CPEO customer would not typically be liable), does not change preexisting rules concerning TPP liability for improperly claimed credits that are based on wages paid by the TPP to its client's employees and reported on the TPP's employment tax return.

Notice 2021-20, released on March 1, 2021, was issued a little over two months after the Relief Act was enacted. The Relief Act, with its amendments to section 2301 of the CARES Act, was signed into law on December 27, 2020, and Notice 2021-20 addressed many of the amendments in the Relief Act. One such amendment was the amendment to section 2301(l) concerning TPP client liability for improperly claimed credits. Specifically, Q&A #67 in section M provides that "[t]he client employer and the [TPP] will each be liable for employment taxes that are due as a result of any improper claim of [ERC] amounts that are improperly claimed in accordance with their liability under the Code and applicable regulations for the employment taxes reported on the federal employment tax return filed by the [TPP] on which the credit was claimed."

The IRS has consistently maintained this position in guidance and information issued subsequent to Notice 2021-20, including in the regulations issued under sections 3111, 3131, 3132, 3134, and 3221 that provided for the administrative recapture of erroneously refunded COVID-19 credits (TD 9978, 88 FR 48118 (July 26, 2023), 2023-32 IRB 415 (August 7, 2023)). For instance, § 31.3134-1(c) provides:

> For purposes of the section, employers against whom an erroneous refund of the credits under section 3134 can be assessed as an underpayment of the taxes imposed under section 3111(b) and so much of the taxes imposed under section 3221(a) as are attributable to the rate in effect under section 3111(b), as applicable, include persons treated as the employer under sections 3401(d), 3504, and 3511, consistent with their liability for the section 3111(b) or 3221(a) taxes against which the credit applied, and also include those persons' common law employer clients that remain subject to all provisions of law applicable to employers with respect to the payment of wages or compensation, as applicable.

Conclusion

As described above, a TPP that is a section 3504 agent, PEO subject to section 31.3504-2, or CPEO is liable for any underpayment resulting from an improperly claimed employment tax credit that the TPP claimed for the client on the TPP's employment tax return filed under the TPP's EIN, where the credit was claimed based on wages paid by the TPP to the client's employees. This rule applies to the ERC as it would any other employment tax credit.

Please call Andrew Holubeck at (202) 317-4774 if you have any further questions.