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Improper ERC Claims: IRS vs. Taxpayers vs. Payroll Companies

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In this article, Sheppard explains the main types of payroll companies and analyzes four recent sources of IRS guidance explaining which party or parties will be on the hook when employee retention credit claims get disallowed.

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I. Introduction

When people think about tax enforcement, they often picture the IRS assailing taxpayers — auditing them, threatening taxes and penalties, litigating, and more. Depending on the circumstances, others might envision the IRS pursuing alleged "promoters" of bad behavior by taxpayers. What rarely comes to mind is the IRS attacking payroll companies based on benefits they claimed for taxpayer-clients, but this is already happening with the employee retention credit. What makes it more interesting is that the IRS — grounded in recent authorities — is frequently dogging both the payroll companies and their taxpayer-clients, thanks to their joint liability for tax underpayments resulting from improper ERC claims. This reality sets the stage for primary battles against the IRS, accompanied by secondary clashes between payroll companies and their taxpayer-clients. The finger-pointing has started, and it will no doubt intensify as ERC enforcement escalates.

This article, which builds on an earlier one by the same author, explains the main types of payroll companies and then analyzes four recent sources of IRS guidance about which party or parties will be on the hook when ERC claims get disallowed.[1]

II. Outsourcing Payroll Obligations

Employers normally must withhold, deposit, and remit to the IRS certain taxes on the wages they pay to their employees.[2] They also have to file various employment tax returns, such as Form 941, "Employer's Quarterly Federal Tax Return," and Form 941-X, "Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund." Many employers choose to outsource these duties to a payroll company, known as a third-party payer (TPP), because compliance requires lots of time, resources, and expertise. There are several different types of TPPs, including professional employer organizations (PEOs), certified professional employer organizations (CPEOs), and section 3504 agents. Different rules apply to each.[3]

III. IRS Guidance About ERC Liability

Employment tax issues can be complicated under normal circumstances. Things get even more convoluted when employers want to make ERC claims through a TPP by having it file Forms 941 or 941-X on their behalf. One of the biggest questions is exactly who is liable if the IRS or a court later determines that the ERC claims were improper or excessive. The IRS continues to

[1] Hale E. Sheppard, "Improper ERC Claims: Liability for Third-Party Payers, Employers, or Both?" *Tax Notes Federal*, May 27, 2024, p. 1569.

[2] Sections 3402, 3102, 3111, and 3301.

[3] IRS Publication 15, "Circular E — Employer's Tax Guide," at 51-52 (2024); AM 2024-001; Internal Revenue Manual 4.23.5.13; IRM 5.1.24.

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publish different types of guidance addressing the issue, and this article examines the most pertinent ones so far.

A. Notice 2021-20

The IRS issued its initial guidance in Notice 2021-20, 2021-11 IRB 922, which supplied the following insight regarding TPPs.[4]

The IRS confirmed that an employer that is eligible for ERCs is entitled to them, regardless of whether it personally handles its employment tax obligations or relies on a TPP.[5]

In terms of what information a TPP must obtain from an employer-client to make an ERC claim on its behalf, the IRS stated that it must collect "any information necessary" to make an accurate claim, including data about prior claims by the employer-client for other tax benefits and whether it received a loan under the Paycheck Protection Program.[6] The IRS underscored that a TPP generally may rely on data supplied by the employer-client.[7]

The IRS explained that either the TPP or the employer-client can maintain "all records" to substantiate ERC eligibility and amounts. It warned, however, that if the employer-client safeguards the records and the IRS requests them from the TPP during an audit, then the TPP "must obtain" them from the employer-client and provide them to the IRS.[8] What does "all records" mean in this context? It encompasses copies of the governmental orders that suspended business operations, proof that more than a "nominal portion" of the business operations were halted, calculations of the decreases in gross receipts, records of wages paid, indicators of whether the employees receiving payments were providing services, copies of all employment tax returns, and, in situations involving a TPP, "records and information provided to the [TPP] regarding the employer's entitlement" to ERCs.[9]

The IRS broadly cautioned in Notice 2021-20 that the employer-client and the TPP "will each be liable for the employment taxes" resulting from any improper ERC claim "in accordance with their liability under the [Internal Revenue Code] and applying regulations."[10] More specifics on this topic follow.

B. Regulations on Administrative Recapture

The IRS next issued regulations concerning its ability to reclaim certain ERCs.[11] They established the rule that any excessive ERC claim that the IRS initially treated as an overpayment and refunded or credited to an employer "shall be treated as an underpayment . . . and may be assessed and collected by the [IRS] in the same manner as taxes."[12]

The proposed regulations contained little information about their application to employer-clients using TPPs. They merely explained that "employers against which an erroneous refund of credits may be assessed as an underpayment include persons treated as an employer under Sections 3401(d), 3504, and 3511."[13] Those provisions deal with PEOs, CPEOs, and section 3504 agents. The final regulations offer more clarity on the liabilities of employer-clients, TPPs, or both. They added the following language to eliminate ambiguities:

> These final regulations clarify that employers against which an erroneous refund of [ERCs] may be assessed as an underpayment include [PEOs, CPEOs, and section 3504 agents] consistent with their liability for the employment taxes against which the credits applied. In addition, these final regulations clarify the proposed regulations by expressly stating that the common-law employer clients of these [TPPs] that remain subject to all provisions of law applicable to employers

[4] Notice 2021-20, 2021-11 IRB 922, Section III.

[5] *Id.* at Section III, FAQ 62.

[6] *Id.* at Section III, FAQ 66.

[7] *Id.* at Section III, FAQ 67.

[8] *Id.* at Section III, FAQ 67 and FAQ 68.

[9] *Id.* at Section III, FAQ 70.

[10] *Id.* at Section III, FAQ 67.

[11] REG-111879-20; T.D. 9904; REG-109077-21; T.D. 9953, Background, Section V.

[12] T.D. 9978; reg. section 31.3111-6(b) and (c); reg. section 31.3134-1(a) and (b); reg. section 31.3221-5(b) and (c); Lauren Loricchio, "New ERC Withdrawal Process Coming From IRS," *Tax Notes Federal*, Oct. 23, 2023, p. 745.

[13] T.D. 9953, Explanation of Provisions; reg. section 31.3131-1T(c); reg. section 31.3132-1T(c); section 31.3134-1T(c).

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with respect to the payment of wages or compensation, as applicable, may also be assessed for an erroneous refund of [ERCs]. This clarification [in the final regulations] makes clear to employers what had been implicit in the proposed regulations, that the existing rules in sections 3504 and 3511 concerning the liability of common law employer clients of [TPPs] remain applicable in this situation. . . . The final regulations expressly state these rules to avoid any confusion and help employers better understand their legal responsibilities.[14]

C. Generic Legal Advice Memorandum

The IRS later released a generic legal advice memorandum (GLAM) clarifying its position on the liability of TPPs for employment tax underpayments linked to faulty ERC claims.[15]

1. Three arrangements.

The GLAM described three main types of TPP arrangements.

a. Section 3504 agents.

In situations in which a TPP pays wages to employees of its employer-clients, section 3504 provides that the TPP can be designated as an agent of the employer-clients. The relevant regulation generally dictates that "all provisions of law (including penalties) and of the regulations applicable to an employer with respect to [the acts performed by the agent] shall be applicable to the agent."[16] According to the GLAM, this means that "both the [section 3504 agent] and the [employer-client] are liable for underpayments of employment tax related to such wages."

b. PEO.

The regulations provide that if a PEO pays wages to individuals performing services for an employer-client under a "service agreement," then the TPP can be designated to perform acts of an employer-client, like filing employment tax returns and paying the corresponding taxes. The regulations also state that "all provisions of law (including penalties) and the regulations applicable to an employer" are applicable to the PEO. The regulations add that the employer-client remains liable, too, despite the designation. Based on the preceding, the GLAM concluded that, in situations involving a PEO that pays wages to the employees of its employer-client under a service agreement, "both the PEO and the [employer-client] are liable for underpayments of employment tax."[17]

c. CPEO.

Under relevant law, a CPEO is treated as the only employer and assumes all employment tax liabilities and responsibilities for the wages it pays to worksite employees of its employer-client. A CPEO is also treated as the employer for all wages it pays to non-worksite employees, but the employer-client might remain liable for tax underpayments regarding those employees.[18]

d. Summary chart.

The IRS also offered a chart summarizing the effects of the three TPP arrangements.[19]

Program Manager Technical Advice 2024-005 Chart

Type of TPP Arrangement	Is TPP Liable for Tax Underpayments on Wages Paid to Employees of Its Employer-Clients?	Does the Employer-Client Remain Liable for Tax Underpayments on Wages Paid to Its Employees?
CPEO and worksite employees	Yes	No
CPEO and nonworksite employees	Yes	Yes
PEO	No	Yes
Section 3504 agent	Yes	Yes

[14] T.D. 9978, Summary of Comments and Explanations of Revisions. *See also* reg. section 31.3131-1(c); reg. section 31.3132-1(c); reg. section 31.3134-1(c); reg. section 31.3221-5(d).

[15] AM 2024-001; Caitlin Mullaney, "Third-Party Payers Liable for ERC-Related Tax Underpayments," *Tax Notes Federal*, Feb. 19, 2024, p. 1495.

[16] AM 2024-001 (citing reg. section 31.3504-1(a)).

[17] *Id.* (citing reg. section 31.3504-2(c)).

[18] *Id.* (citing section 3511(a)(1) and section 3511(c)(1)).

[19] PMTA 2024-005.

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2. Improper credits under the general rules.

The GLAM then turned to TPPs and employment tax credits. It explained that, unless a specific legislative exception exists, the IRS must apply the general law and regulations.

The IRS began with section 3504 agents and PEOs, for which specific credit rules do not exist. It explained that when one of these types of TPPs improperly claims credits for an employer-client, they, along with the employer-client, are liable for the resulting tax underpayments.

The IRS then considered CPEOs. Their governing provisions discuss which party (that is, the CPEO or its employer-client) is eligible for the credits, but not which party bears the liability for improperly claimed credits. The GLAM, citing the general rules, stated that a CPEO is solely liable for employment tax liabilities on wages that it pays to worksite and nonworksite employees of its employer-client. In other words, the CPEO, alone, is on the hook for underpayments arising from improperly claimed credits under the general rules.

3. Improper ERCs under the CARES Act.

The GLAM explained that the first ERC law, the Coronavirus Aid, Relief, and Economic Security Act, featured two provisions dealing with TPPs.[20]

One provision said that any ERC "shall be treated as a credit described in Section 3511(d)(2)." This language ensured that, when it comes to ERC claims based on services performed by an employee of an employer-client, the employer-client can claim the ERC, and the amount is determined using the wages paid by the CPEO to the employee. The GLAM emphasized that this first provision "does not address liability for an improperly claimed ERC."

The second provision in the CARES Act obligated the IRS to issue forms, instructions, regulations, and other guidance regarding the application of ERCs to TPPs. The IRS took the position in the GLAM that it had fulfilled its duty by issuing Notice 2021-20, discussed earlier.

[20]Joint Committee on Taxation, "Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security ('CARES') Act," JCX-12R-20 (Apr. 23, 2020).

4. Improper ERCs under the relief act.

The second ERC law, the Taxpayer Certainty and Disaster Tax Relief Act, added language to the effect that any forms, instructions, regulations, or other IRS guidance "shall require the [employer-client] to be responsible for the accounting of [ERCs] and for any liability for improperly claimed [ERCs]."[21]

As mentioned above, before the relief act came into existence, the general rules established that the CPEO was responsible for underpayments triggered by improperly claimed credits. The relief act clarified that the employer-client of a CPEO would also be liable for ERC-related underpayments.

5. Conclusion.

The IRS summarized its stance in the GLAM as follows: A TPP is liable for any tax underpayment resulting from an improper credit that it claimed for an employer-client on an employment tax return filed under the TPP's own employer identification number. According to the IRS, "this rule applies to the ERC as it would any other employment tax credit."

D. Program Manager Technical Assistance

The most recent IRS guidance about employers, TPPs, and underpayments stemming from improper ERC claims came in the form of the PMTA referenced in the chart above.[22] It posed several scenarios, two of which are addressed here.

1. Relevant situations.

In the first scenario, a PEO filed a Form 941 with an attached Schedule R, "Allocation Schedule for Aggregate Form 941 Filers," on behalf of several employer-clients.[23] The IRS initially accepted the Form 941, processed it, and assessed the tax liability shown on its face. Later, the IRS scrutinized the Form 941 more carefully and determined that it contained excessive ERC

[21]Consolidated Appropriations Act, 2021, division EE, section 207; JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021).

[22]PMTA 2024-005.

[23]This PEO was not "designated" under reg. section 1.3504-2(b)(2) and was not an "employer" under section 3401(d)(1).

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claims. This meant, logically, that one or more of the employer-clients listed on Schedule R had an employment tax liability.

The second scenario was the same as the first, except the party involved was a CPEO, not a PEO. Consequently, it filed an aggregate Form 941 for its employer-clients under its own EIN.

2. General rules.

The PMTA started with this general conclusion:

> Under [section 6201], the [IRS] may summarily assess any previously unassessed federal employment tax liability that it determines as a result of an examination. Like any assessed liability, the [IRS] may administratively collect or initiate judicial collection against the taxpayer who owes the liability. The [IRS] may collect from the taxpayer liable for the assessed tax, regardless of whether the taxpayer is the TPP, the [employer-client], or both. The [IRS] must identify which party or parties are the "taxpayers" liable for the assessed tax, and this identification is a determination that depends on the [TPP] relationship at issue. The [IRS] will need to associate and potentially apportion the resulting balance due among the various parties according to their legal liability. An underpayment attributable to one party whose liability is reported on the Form 941, however, may not be collected from another party who is not liable for the underpayment, even if the liability of such other party was reported on the same Form 941.

3. First scenario: PEO.

The PMTA began by explaining that, because the first scenario involves a PEO, only the employer-client is liable for the employment taxes at issue. It then got into more detail. It stated that the PEO filed a Form 941 attaching a Schedule R showing liabilities of its employer-clients, with part of them satisfied by the non-refundable portion of the ERCs. Under current practices, the IRS would have assessed this reduced liability initially.[24] When the IRS later discovered that the ERC claims were excessive, it would have made a "supplemental assessment" because the original Form 941 was "imperfect or incomplete in a material respect."[25] The IRS would carry this out by having an authorized person execute an assessment certificate and associate it with all supporting records.[26] Next, the IRS would record this event in its computer system by inputting the relevant transaction code. The PMTA emphasized that this act is merely the "recordation of the fact that there was an assessment" and not an assessment by itself.

The PMTA also pointed out that it enjoys several tools for assessing employment taxes:

> Although the [IRS] might determine employment tax underpayments most often pursuant to examinations, there is no legal requirement that strictly requires an examination to be the sole mechanism by which a marginal liability [caused by an excessive ERC claim] may be determined. For example, a marginal liability may be determined by [government] counsel during refund litigation and such liability would be subject to valid assessment if the assessment period had not lapsed and if the assessment otherwise could be accomplished in accordance with all legal requirements.[27]

The fact that a PEO filed the Form 941, reported the employment tax liabilities, and claimed the ERCs on behalf of employer-clients does not alter the IRS's authority to assess taxes, said the PMTA. It further praised the current IRS practice of creating a new electronic module in its system solely in the name of the liable employer-client to track supplemental assessments. The PMTA predicted that collection of supplemental assessments triggered by disallowed ERC claims will not be problematic because a specialized 10-

[24] Section 6201(a)(1).

[25] Section 6204.

[26] Section 6203; reg. section 301.6203-1; Rev. Rul. 2007-21, 2007-1 C.B. 865.

[27] PMTA 2024-005, at n.8.

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year deadline will appear in the system, and the IRS can use various tools, including tax liens, levies, and administrative offsets of refunds.

4. Second scenario: CPEO or section 3504 agent.

The second scenario involves a CPEO, which means it is treated as an "employer" and thus is liable as a "taxpayer." The PMTA pointed out that the result would be identical with a section 3504 agent. It then explained that the assessment analysis used in the first scenario would apply equally here. It emphasized that, as long as an assessment certificate is "timely, supported, and procedurally valid," then the assessment is good as to any "taxpayer." The PMTA also identified "downstream considerations" to protect taxpayer rights and preserve the IRS's ability to collect, keeping in mind that the CPEO or section 3504 agent, together with the employer-client, would be jointly liable for the tax underpayment caused by the disallowed ERCs.

IV. Conclusion

All taxpayers that made ERC claims need a deep understanding of the relevant laws, IRS guidance, and applicable procedures to defend themselves adequately. Taxpayers that made claims through TPPs have an additional burden; that is, they must grasp how the potential for joint liability, along with the IRS's mechanisms for assessment and collection, might affect them. This unique circumstance likely generates many questions in the minds of taxpayers: Are their interests aligned with those of TPPs? Should taxpayers and TPPs be cooperating in IRS matters? Which party should be handling IRS audits, providing relevant documents, and answering key questions? Who should be filing protest letters if the IRS issues a notice of disallowance? Do contracts between taxpayers and TPPs address these and other critical tax, legal, and procedural issues? These are just a few of a long list of questions. Taxpayers and TPPs might have distinct concerns when it comes to improper ERC claims, and they would be wise to seek assistance from independent experts. ■

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