Improper ERC Claims: Liability for Third-Party Payers, Employers, or Both?

by Hale E. Sheppard

Hale E. Sheppard

Hale E. Sheppard is a shareholder in the tax controversy section of Chamberlain, Hrdlicka, White, Williams & Aughtry in Atlanta.

In this article, Sheppard examines IRS guidance on whether employers, third-party payers, or both are liable in cases of employment tax underpayments triggered by improper employee retention credit claims.

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I. Introduction

Employers generally are required to withhold, deposit, and remit to the IRS certain taxes on wages they pay to their employees. They are also obligated to file various returns with the IRS documenting their actions. Many employers do not handle their own employment tax duties for several reasons — they might lack the time, expertise, personnel, or some other critical element. Thus, they hire a third-party payer. Things normally proceed with few hiccups, but problems can arise when situations become more complicated. A great example is when employers file an employee retention credit claim through their third-party payer, the IRS disallows it, and then the IRS starts looking for persons against whom to assess taxes and penalties. This article, the latest in a series by the author, explains the various ERC laws and analyzes the four main sources of IRS guidance regarding liability for tax underpayments and penalties resulting from improper ERC claims.

II. Summary of Relevant Laws

Congress enacted four laws focused on the ERC in less than two years. A summary of those legislative actions follows.

Congress first enacted, in March 2020, the Coronavirus Aid, Relief, and Economic Security Act.[1] That law generally provided that an eligible employer could get an ERC against certain employment taxes equal to 50 percent of the qualified wages it paid to each employee.[2] Coverage of the ERC changed several times, but it originally applied to the second, third, and fourth quarters of 2020.[3] Congress realized that it could not anticipate and respond to everything, so it instructed the IRS to issue "such forms, instructions, regulations and guidance as are necessary" to accomplish a long list of things related to the ERC.[4]

In late December 2020, Congress passed the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the Consolidated Appropriations Act, 2021.[5] It expanded the period during which eligible employers could benefit, adding the first and second quarters of 2021.[6] Eligible employers could also get increased amounts of ERCs because two things changed

[1] Joint Committee on Taxation, "Description of the Tax Provisions of P.L. 116-136, the Coronavirus Aid, Relief, and Economic Security Act," JCX-12R-20 (Apr. 23, 2020); *see also* Notice 2021-20, 2021-11 IRB 922.

[2] CARES Act, section 2301(a).

[3] CARES Act, section 2301(m).

[4] CARES Act, section 2301(1).

[5] JCT, "Description of the Budget Reconciliation Legislative Recommendations Relating to Promoting Economic Security," JCX-3-21, at 66-70 (Feb. 8, 2021); *see also* Notice 2021-23, 2021-16 IRB 1113.

[6] Notice 2021-23, Section III.A.

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under the relief act: The percentage of qualified wages for which the ERC could be claimed increased from 50 percent to 70 percent, and that amount was calculated per quarter, not per year.[7]

Next, in March 2021, Congress enacted the American Rescue Plan Act of 2021.[8] That legislation codified the ERC, making it section 3134. ARPA also enlarged the ERC, allowing benefits for the third and fourth quarters of 2021.[9]

Things ended in November 2021 with the introduction of the Infrastructure Investment and Jobs Act.[10] That law retroactively shortened the periods for which eligible employers could claim ERC benefits. With one narrow exception, eligible employers could no longer solicit ERCs for the fourth quarter of 2021.

III. Assigning Employment Tax Duties to Others

As noted earlier, employers normally must withhold, deposit, and remit to the IRS certain taxes on the wages they pay to their employees.[11] They also must file various employment tax returns. Many employers elect to outsource these duties to a third-party payer. There are several different types of third-party payers, including so-called section 3504 agents, professional employer organizations (PEOs), and certified professional employer organizations (CPEOs). Each functions in a different manner and is subject to different rules.[12]

The big questions, for purposes of this article, are which party is liable in cases of employment tax underpayments generally, and which party bears the burden when underpayments are triggered by improper ERC claims. The IRS broadly states that "the filing and payment responsibilities are dependent on the type of third-party payer the employer uses."[13]

IV. Evolution of IRS Guidance

The IRS has issued four main items for employers and their third-party payers regarding tax underpayments caused by improper ERC claims. This guidance is explored below in chronological order.

A. Notice 2021-10

Soon after enactment of the CARES Act, the IRS issued its initial guidance as Notice 2021-20, 2021-11 IRB 922. The meat of Notice 2021-20 came in the form of frequently asked questions, a few of which focused on third-party payers.[14]

FAQ 62, for example, asked whether an employer that uses a third-party payer could get ERCs. The IRS confirmed that an employer that is otherwise eligible to receive ERCs is entitled to them, regardless of whether it personally complies with its employment tax obligations or relies on a third-party payer.[15]

FAQ 66 pondered what type of information a third-party payer must obtain from an employer to make an ERC claim on its behalf. The IRS said that the payer must collect from the employer "any information necessary to accurately claim" the ERC for the employer, including data about claims for other credits or benefits by the employer, as well as whether it received a loan under the Paycheck Protection Program.[16]

FAQ 67 questioned whether a third-party payer can rely on the data provided by its employer-clients regarding ERC issues. The IRS indicated that it could.[17]

FAQ 67 also explained that either a third-party payer or an employer can maintain "all records" to substantiate ERC eligibility. It clarified that if the employer safeguards the records, and the IRS requests them from the third-party payer during an audit, then the payer "must obtain" them from the employer and provide them to the IRS.[18] What does "all records" mean? According to a related FAQ, the employer, and presumably the third-

[7] *Id.* at Section III.D.

[8] ARPA section 9651; *see also* Notice 2021-49, 2021-34 IRB 316.

[9] Notice 2021-49, Section III.A.

[10] *See also* Notice 2021-65, 2021-51 IRB 880.

[11] Common-law employers ordinarily must deduct and withhold from wages paid to their employees certain income taxes and FICA taxes, as well as separately pay their share of FICA taxes and all the FUTA taxes. *See* sections 3402, 3102, 3111, and 3301.

[12] 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.

[13] IRM 4.23.5.13.

[14] Notice 2021-20, Section III.

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

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

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

[18] *Id.* at Section III, FAQ 67; *see also* Notice 2021-20, Section III, FAQ 68.

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party payer in some instances, must keep many different things. Those include copies of governmental orders that suspended business operations, proof that more than a "nominal portion" of operations were halted, calculations showing a sufficient decrease in gross receipts, records of qualified wages paid, indicators of whether employees receiving payments were providing services during the relevant periods, copies of all employment tax returns filed with the IRS, and, in situations involving a third-party payer, records and information provided to the payer regarding the employer's entitlement to ERCs.[19]

Lastly, when it comes to potential liability, FAQ 67 warned that the employer and the third-party payer "will each be liable for the employment taxes" resulting from any improper ERC claim "in accordance with their liability under the [IRC] and applicable regulations."[20]

B. Regulations

The IRS next issued regulations concerning its ability to reclaim certain ERCs.[21] They emphasized that a "refund, credit, or advance of any portion of [an ERC] to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund for which the IRS must seek repayment."[22]

The IRS has always enjoyed the right to recoup excess ERCs through litigation.[23] However, the CARES Act and ARPA specifically contemplate the "administrative recapture" of ERCs. The IRS implemented that congressional mandate through regulations.[24] They clarify that the "assessment and administrative collection procedures *do not replace* the existing recapture methods, but rather represent an *alternative method* available to the IRS" (emphasis added).[25] The regulations also establish the following rule:

> Any amount of [ERCs] for Qualified Wages . . . that is treated as an overpayment and refunded or credited to an employer [by the IRS] and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall be treated as an underpayment . . . and may be assessed and collected by the [IRS] in the same manner as the taxes.[26]

Officials explained that, under the new regulations, the IRS can "treat what is normally an erroneous refund as an underpayment of tax subject to regular assessment and administrative collection practices."[27]

The proposed version of the regulations contained relatively little information about their application to employers using third-party payers. 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, consistent with their liability for employment taxes against which the credits applied."[28]

The final version of the regulations offered more lucidity on the duties and liabilities of employers and third-party payers. They contained the same language as the proposed regulations about section 3504 agents, PEOs, and CPEOs. They added the following to avoid any ambiguities:

> These final regulations clarify that employers against which an erroneous refund of [ERCs] may be assessed as an underpayment include [section 3504 agents, PEOs, and CPEOs] consistent with their liability for the employment taxes against which the credits applied. In addition, these final regulations clarify the

[19] Notice 2021-20, Section III, FAQ 70.

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

[21] T.D. 9905; REG-111879-20; T.D. 9904; REG-109077-21; T.D. 9953, Background, Section V — Assessment Authority.

[22] T.D. 9904, Background, Section III — Advance Payment of Credits and Erroneous Refunds.

[23] *Id.* at Background, Section IV — Assessment Authority.

[24] *Id.* at Explanation of Provisions.

[25] T.D. 9953, Explanation of Provisions; T.D. 9978, Summary of Comments and Explanation of Revisions.

[26] 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).

[27] Lauren Loricchio, "New ERC Withdrawal Process Coming From IRS," *Tax Notes Federal*, Oct. 23, 2023, p. 745.

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

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> proposed regulations by expressly stating that the common-law employer clients of these third-party payers that remain subject to all provisions of law applicable to employers with respect to the payment of wages or compensation, as applicable, may also be assessed for an erroneous refund of [ERCs]. This clarification makes clear to employers what had been implicit in the proposed regulations, that the existing rules in Sections 3504 and 3511(c) concerning the liability of common-law employer clients of third-party payers remain applicable in this situation . . . While Sections 3504 and 3511 applied in the same manner as a matter of law under the proposed regulations, the final regulations expressly state these rules to avoid any confusion and help employers better understand their legal responsibilities.[29]

C. Proposed Legislation

The issue of ERCs and third-party payers next arose in connection with some proposed legislation. Before getting to that, some foundation is needed on the types of penalties the IRS frequently tries to impose in situations involving what it deems abusive transactions.

The IRS often threatens so-called promoter penalties under section 6700. Persons might get hit with promoter penalties if they organize, help with organizing, directly sell, or indirectly sell interests in an entity, plan, or arrangement, and they personally make or cause another person to make (1) a false or fraudulent statement about the tax benefits that a taxpayer will obtain from participating, or (2) a "gross valuation understatement." Congress anticipated broad applicability, saying that "persons subject to the penalty may include not only the promoter of a classic tax shelter partnership or tax avoidance scheme, *but any other person* who organizes or sells a plan or arrangement with respect to which there are material inaccuracies affecting the tax benefits to be derived from participation" (emphasis added).[30] The size of the penalty depends on the behavior. In situations involving false or fraudulent statements, the penalty equals 50 percent of the income that the promoter has already derived, or will derive, from the activity.[31] Congress clarified that the mere promotion of an abusive transaction suffices to trigger the penalty under section 6700; it is not necessary that a taxpayer actually engage in the transaction or claim the tax benefits from it.[32]

The IRS brandishes other civil penalties, too. It can sanction a person under section 6701 for aiding and abetting a tax understatement in certain instances. This penalty applies when three criteria are met. First, a person assists in, procures, or advises regarding the preparation of any portion of a return, affidavit, claim, or other document. Second, the person knows or has reason to know that it will be used in connection with a material tax matter. Third, the person knows that it will result in a tax understatement to the IRS.[33] The type of person against whom the IRS may impose this penalty is expansive, not limited to traditional accountants, enrolled agents, and other return preparers.[34] In terms of numbers, the aiding and abetting penalty generally equals $1,000 per person, per period, per taxpayer.[35] The courts have confirmed that, like promoter penalties under section 6700, there is no time limit on when the IRS may assess the aiding and abetting penalty.[36]

This article now turns to the proposed legislation. Congress recently considered, and still might be contemplating, enacting a new law that would have serious consequences for some

[29] 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).

[30] Section 6700; ILM 200402008; JCT, "General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982," JCS-38-82, at 211 (Dec. 31, 1982).

[31] Section 6700(a) (flush language).

[32] JCT, *supra* note 30, at 212; *see also Gardner v. Commissioner*, 145 T.C. 161 (2015), *aff'd* 120 AFTR 2d 2017-6699 (9th Cir. 2017).

[33] Section 6701(a).

[34] *Nielsen v. United States*, 976 F.2d 951, 955 (5th Cir. 1992); TAM 200243057.

[35] Section 6701(b)(1). The penalty increases to $10,000 when corporations are involved.

[36] *Mullikin v. United States*, 952 F.2d 920, 928 (6th Cir. 1991); *Lamb v. United States*, 977 F.2d 1296, 1297 (8th Cir. 1992).

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persons encouraging ERC claims.[37] The legislation, called the Tax Relief for American Families and Workers Act (H.R. 7024), was approved by the House in late January of this year. The Senate has not yet passed it, though.

The proposed rules are found in a section of the act called "Tax Administration and Eliminating Fraud."[38] The act would create a special penalty for so-called ERC promoters. This is a misnomer, really, because it does not involve the promoter penalties under section 6700 discussed above, but rather the aiding and abetting tax understatement penalties under section 6701. If the act passes, the existing penalty for aiding and abetting would increase for ERC promoters. Today, the penalty for individuals is essentially $1,000 per violation. That would swell under the act to the larger of $200,000, or 75 percent of the gross income derived from providing aid, assistance, or advice regarding any "ERC document."[39] An ERC document is any return, affidavit, claim, or other document related to any ERC claim.[40]

The term "ERC promoter" has three categories. First, it covers any person that provides aid, assistance, or advice regarding an ERC document, if that person charges or receives a contingency fee (that is, a fee based on the amount of ERCs), and the aggregate gross receipts related to those services constitute more than 20 percent of the gross receipts of that person for the year the services were provided or the preceding one.[41] Interestingly, the act, in its original form, contained no language about a revenue threshold or percentage — doing ERC-related work in exchange for a contingency fee alone sufficed.[42]

Second, ERC promoter also encompasses any person that provides aid, assistance, or advice regarding an ERC document, and the aggregate gross receipts related to those services constitute more than 50 percent of the gross receipts of that person for the year the services were provided or the preceding one.[43] Lastly, the meaning of ERC promoter embraces any person that provides aid, assistance, or advice regarding an ERC document, the aggregate gross receipts related to those services exceeds 20 percent of the gross receipts of that person for the year the services were provided or the preceding one, and those receipts surpass $500,000.[44]

The act would also obligate ERC promoters to comply with due diligence requirements. It says that any ERC promoter that fails to meet the applicable duties regarding any ERC claim will face a penalty of $1,000 for each violation.[45]

Moreover, the act provides that in situations involving ERC promoters, the ERC claim generally would be treated as a listed transaction, and the ERC promoter would be considered a material adviser thereto.[46] Those characterizations could trigger many negative results for ERC promoters, such as the need to file Form 8918, "Material Advisor Disclosure Statement," record-keeping duties, and penalties for transgressions.

What is perhaps most interesting about the act, at least for purposes of this article, is that it expressly carves out CPEOs from the definition of ERC promoter. It says that the term "ERC promoter" "shall *not* include a certified professional employer organization (as defined in Section 7705)" (emphasis added).[47] Interestingly, it does not mention section 3504 agents, PEOs, or other types of third-party payers.

[37] Tax Relief for American Families and Workers Act of 2024; Doug Sword and Cady Stanton, "Werfel Pitches Senators on Three Legislative Fixes for ERC Fraud," *Tax Notes Federal*, Jan. 15, 2024, p. 527; Loricchio, "Tax Deal Would Bring ERC Claims to Earlier End and Curb Abuse," *Tax Notes Federal*, Jan. 22, 2024, p. 732.

[38] Tax Relief for American Families and Workers Act of 2024, Title VI; *see also* JCT, "Description of H.R. 7024, the 'Tax Relief for American Families and Workers Act of 2024,'" JCX-2-24, at 68-68 (Jan. 17, 2024).

[39] Tax Relief for American Families and Workers Act of 2024, section 602(a)(1). The figure decreases from $200,000 to $10,000 when the ERC promoter is an individual instead of an entity.

[40] *Id.* at section 602(f).

[41] *Id.* at section 602(e)(1)(A).

[42] JCT, *supra* note 38, at 69 (stating that a person could be an ERC promoter solely because that person "charges or receives a fee based on the amount of" the ERC refund or credit).

[43] Tax Relief for American Families and Workers Act of 2024, section 602(e)(1)(B)(i).

[44] *Id.* at section 602(e)(1)(B)(ii).

[45] *Id.* at section 602(c)(1) and (2) (referencing due diligence requirements found in section 6695(g)). Noncompliance with the due diligence standards also would result in a determination that the ERC promoter knew that the claim would result in a tax understatement by another person. *See id.* at section 602(b) (referencing the third prong of section 6701(a)).

[46] *Id.* at section 602(d)(1) and (2).

[47] *Id.* at section 602(e)(2).

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D. Generic Legal Advice Memorandum

The IRS chimed in just a few days after the House passed the act. It released a generic legal advice memorandum clarifying its position on the liability of third-party payers for employment tax underpayments linked to faulty ERC claims.[48]

1. General overview.

The memorandum started by explaining that employers generally are required to withhold FICA taxes from the wages they pay to their employers, and they are separately liable for their own share of FICA taxes. It went on to explain that a common-law employer can enter into an agreement with a third-party payer, under which the payer withholds, deposits, and then pays over to the IRS employment taxes for the employees of the employer. The memorandum further indicated that, in certain cases, the third-party payer pays wages to the employees of its employer-clients and files employment tax returns with the IRS using its own employer identification number, instead of the EIN of the employer-clients.

2. Three arrangements.

The memorandum next described three types of third-party payer arrangements. First, it focused on section 3504 agents. If a third-party payer pays the wages of an employee or group of employees of one or more employer-clients, the payer can be designated an agent of the employer-clients for these purposes. The relevant regulation generally dictates that "all provisions of law (including penalties) and of the regulations applicable to an employer" shall apply to the agent.[49] According to the memorandum, this means that "both the [section 3504 agent] and the [employer-clients] are liable for underpayments of employment tax related to such wages."

Second, the regulations provide that if a third-party payer, such as a PEO, pays wages to individuals performing services for an employer-client under a service agreement, the payer can be designated to perform acts of an employer, 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" apply to the PEO regarding the wages paid by it. The regulations add that the employer-client of the PEO remains subject to "all provisions of the law (including penalties) and the regulations applicable to an employer with respect to these wages." In situations involving a PEO that pays wages to the employees of its employer-clients under a service agreement, the memorandum concluded that "both the PEO and the [employer-clients] are liable for underpayments of employment tax related to wages paid by the PEO to those employees."[50]

Third, under relevant law, a CPEO is treated as the only employer, and it assumes all employment tax liabilities and responsibilities for the wages it pays to worksite employees of its customers (that is, its employer-clients). By contrast, a CPEO is treated as the employer for all wages it pays to the non-worksite employees of its customers, but the employer-clients may also be liable for any employment tax underpayments regarding those employees.[51]

3. Third-party payers and liabilities for improper credits.

The memorandum next explained that, when it comes to third-party payers and employment tax credits, the IRS must apply the general law and regulations concerning third-party payer liability, unless a specific legislative exception exists.

Specific credit rules do not exist for section 3504 agents and PEOs. Therefore, the memorandum explained that when credits are improperly claimed by a section 3504 agent or PEO for an employer-client, and those credits are based on the wages paid to the employees, the section 3504 agent or PEO, along with the employer-clients, are liable for tax underpayments.

The governing provisions of CPEOs address credits to a limited degree. In particular, they explain which party is eligible for the credits (that

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

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

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

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

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is, the CPEO or its employer-clients), but not which party bears the liability for improperly claimed credits. The memorandum, citing the general rules, stated that a CPEO is solely liable for employment tax liabilities on wages that it pays to worksite and non-worksite employees of its employer-clients. In other words, under the normal rules, the CPEO, alone, is on the hook for underpayments arising from improperly claimed credits.

4. Third-party payers and improper ERCs under the CARES Act.

The memorandum explained that the CARES Act featured two provisions concerning third-party payers. One 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 of a CPEO, the employer-client can claim the ERC and the amount is determined using the wages paid by the CPEO to the employees. The memorandum 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 third-party payers. The memorandum took the position that the IRS fulfilled its duty by inserting FAQs 66, 67, and 68 in Notice 2021-20.

5. Third-party payers and improper ERCs under the Relief Act.

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], and shall require the [CPEO] or other third-party payer to accurately report [ERCs] based on the information provided by the [employer-client]."

The memorandum pointed out that the relief act partially addressed liability for improperly claimed ERCs. As mentioned above, the general rules, before the relief act was enacted, provided 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.

6. Final thoughts.

The IRS summarized its position in the memorandum as follows: A third-party payer that is a section 3504 agent, PEO, or CPEO is liable for underpayments resulting from improper credits that the payer claims for an employer-client on the employment tax return filed under the payer's own EIN when the credit is based on wages paid by the payer to the employees of its employer-clients. According to the IRS, "this rule applies to the ERC as it would any other employment tax credit."

V. Conclusion

The number of ERC claims filed by third-party payers for employers must be staggering. If one were to believe the messaging from the IRS, many of those claims will be disallowed from the start (creating employment tax underpayments) or will be paid and later deemed unworthy (generating erroneous refunds). Either way, the IRS likely will seek to recoup considerable funds. Can it pursue employers, third-party payers, or both? Moreover, if Congress passes the Tax Relief for American Families and Workers Act in its current state, would third-party payers, other than CPEOs, be considered ERC promoters, potentially subject to increased aiding and abetting penalties, due diligence requirements, Form 8918 filing duties, and more?

This article contemplates those questions, but there are many others involving third-party payers and ERCs. These surely will arise as IRS enforcement intensifies, which raises a final question: Will third-party payers, as well as the employers that relied on them to submit ERC claims, passively await IRS scrutiny, or will they actively engage qualified professionals now to understand the rules, identify strategies, gather supporting documents, and implement the best defense possible? ■

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