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IRS Determines Third-Party Payers Liable for Clawback of Improper Employee Retention Credit Refunds to Clients

On Feb. 16, the IRS Office of Chief Counsel released a [legal memorandum](#) concluding that third-party payers, such as professional employer organizations (PEOs), certified professional organizations, and Section 3504 Agents (collectively, “TPPs”) are liable for underpayments of payroll taxes resulting from improper claims for the employee retention credit (ERC) that the TPPs filed on behalf of clients.

The ERC was enacted under the CARES Act to provide a refundable tax credit to encourage employers to retain employees during the pandemic. The original credit under the CARES Act – if the employer qualified – was 50% of wages paid to employees, with a maximum of \$5,000 per employee for 2020. The ERC was extended and expanded for 2021 by the Consolidated Appropriations Act to allow a 70% credit for wages paid, with a maximum credit per employee of \$7,000 per employee per quarter. The ERC program lasted through Sept. 30, 2021. Accordingly, the theoretical maximum credit – assuming the employer was eligible to claim the ERC for all six available quarters (Q2 through Q4 2020 and Q1 through Q3 2021) – was \$26,000 per employee. However, many businesses filed ERC claims even though they might not have been eligible to do so, because to be eligible, the business had to either have (1) suffered a significant decline in gross receipts (for 2020 quarters, more than a 50% decline in gross receipts compared to the same quarter in 2019, and for 2021 quarters, more than a 20% decline in gross receipts compared to the same quarter in 2019); or (2) had their business operations either fully or partially suspended as a result of a COVID-19-related governmental order. Many businesses claimed the credit, frequently upon the advice of ERC consulting firms, even though they did not pass either the decline in gross receipts test or the governmental order test.

Because the ERC is a credit against payroll taxes, a claim for the ERC was made on the quarterly payroll tax return (Form 941, if the ERC claim was filed as wages were paid, or a Form 941-X amended return, if the ERC claim was filed for prior quarters after the company became aware of the credit). However, if the company used a TPP who filed the payroll returns, then the TPP was required to claim the ERC on behalf of its clients.

Legal memorandum [AM 2024-001](#), dated Feb. 5, 2024, discusses the legal obligations of three different types of TPPs: (1) Section 3504 Agents (firms appointed by a company that files a Form 2678 as its agent who has control, receipt, custody or disposal of, or pays the wages of the company's employees); (2) Non-certified professional employer organizations; and (3) Certified professional employer organizations. The legal memorandum concludes that all three types of TPPs are liable for any underpayments of payroll taxes as a result of improper claims, together with clients on whose behalf the TPPs file the claims for the ERC by filing the Form 941 or 941-X amended return.

Although the agreements that most TPPs have with their clients provide for a tax indemnity where the client agrees to reimburse the TPP for payroll tax deficiencies, due to the large number of improper ERC claims, whether a TPP could be reimbursed for all of its potential liabilities for back taxes clawed back due to improper claims is questionable. To make matters worse for TPPs, [HR 7024](#), which the House has passed and the Senate is considering, would extend the statute of limitations for the IRS to assess underpayments of ERC claims by two years, giving the IRS plenty of time to audit ERC refunds. (This bill would also impose preparer penalties on certain firms who helped prepare ERC claims, except certified professional employer organizations would be exempt – but noncertified PEOs and Section 3504 agents would potentially be subject to such penalties).

Since [October 2022](#) the IRS has been publishing guidance to warn companies against taking advice from aggressive ERC consulting firms, but this legal memorandum is the first time the Service has given notice to TPPs of their potential liability for improper ERC claims.¹ In December 2023 the IRS announced a [voluntary disclosure program](#) for companies that have received improper ERC refunds, but the program requires the company that received the refund to pay back 80% of the refund received. Many TPPs probably filed ERC refund claims at their clients' request. The IRS may wish to consider a similar voluntary disclosure program for TPPs that would require them to relinquish a portion of the fees they received for filing improper claims. [According to the National Association of Professional Employer Organizations](#), 17% of businesses with 10 to 99 employees use a PEO. The importance of the PEO industry to small businesses should warrant some type of remedial relief for potential ERC liabilities.

Authors

This GT Alert was prepared by:

- [Scott E. Fink](#) | +1 212.801.6955 | finks@gtlaw.com
- [Barbara T. Kaplan](#) | +1 212.801.9250 | kaplanb@gtlaw.com
- [Marvin Kirsner](#) | +1 954.768.8224 | kirsnerm@gtlaw.com

¹ IRS Notice 2021-20 published March 2, 2021, Question 67 did note that both the Third Party Payer and its client will each be liable for employment tax due as a result of any improper claim for the ERC; however, this guidance also states that “*third party-payers may rely on the client employer’s information regarding the client employer’s eligibility to claim the employee retention credit*” which is a very mixed message, which may have caused confusion regarding a Third Party Payer’s liability when it relies on information provided by its client. The numerous IRS Notices and other releases after Notice 2021-20 was published say nothing further to clear up this issue, until the just-published legal memorandum.

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