Office of Chief Counsel
Internal Revenue Service
memorandum

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POSTU-114200-23

UILC: 6201.07-03

date: May 13, 2024

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subject: Recapture of Excess Credits from Common Law Employer in certain Third-Party Payer Relationships

This memorandum responds to your request for assistance and was drafted in coordination with the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations and Employment Tax). This advice may not be used or cited as precedent.

ISSUES

How may the Service assess and collect an employment tax underpayment in the following factual scenarios?

(1) A professional employer organization (PEO)[1] that is not designated under Treas. Reg. § 31.3504-2(b)(2) and that is not an employer under section 3401(d)(1) filed a Form 941, *Employer's QUARTERLY Federal Tax Return*, with an attached Schedule R (Form 941) *Allocation Schedule for Aggregate Form 941 Filers*,[2] on behalf of multiple clients that are common law employers[3] (CLEs). The Service accepted the PEO's Form 941 and assessed the reported amount of tax liability. Later, the Service examined the

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[1] A PEO is an example of a third-party payer (TPP). A PEO contracts to perform the employment tax obligations of the employer-client, and files employment tax returns and makes payments under its own employer identification number (EIN).

[2] The Service developed the Schedule R (Form 941) to simplify the aggregate reporting process for employers, aggregate filers and the Service.

[3] 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 analysis, the TPP client is assumed to be the common law employer of the employees whose wages the TPP pays on the client's behalf and reports on an employment tax return filed under its own EIN.

Form 941 and determined that it claimed excessive amounts of the non-refundable portion of the Employee Retention Credits (ERCs)[4] and as a result there was an employment tax underpayment attributable to one or more of the CLEs listed on the Schedule R (Form 941).

(2) Same facts as above, however, the TPP filing the Form 941 was engaged under a different type of TPP arrangement (for example, as a certified professional employer organization) where the TPP files an aggregate employment tax return for its employer-clients under its own EIN.

(3) Same facts as in both issues 1 and 2 above, respectively, however, in each situation the Service determined that the Form 941 reported excess credits other than the non-refundable portion of the ERCs.

CONCLUSIONS

Under I.R.C. § 6201(a), the Service may summarily assess any previously unassessed federal employment tax liability that it determines as a result of an examination. Like any assessed liability, the Service may administratively collect or initiate judicial collection against the taxpayer who owes the liability. The Service may collect from the taxpayer liable for the assessed tax regardless of whether the taxpayer is the TPP, the CLE, or both. The Service must identify which party or parties are the "taxpayers" liable for the assessed tax, and this identification is a determination that depends on the third-party payer relationship at issue. The Service 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.

LAW AND ANALYSIS

Section 6201(a) authorizes and requires the Service to "make the inquiries, determinations, and assessments" of all taxes imposed by the Internal Revenue Code,

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[4] The section 3134 ERC has non-refundable portions that are allowed against the claimant's "applicable employment taxes" per section 3134(a) and (b)(2) and a refundable portion that is treated as an overpayment and may be refunded to a taxpayer per section 3134(b)(3). The ERC under section 2301 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) contains similarly structured provisions. For the purposes of this memorandum we will refer to the two portions of the ERC as the non-refundable and refundable portions of the ERC.

including employment taxes.[5][6] Section 6201(a)(1) authorizes the Service to assess all taxes as to which returns are made that are determined either by the taxpayer or by the Service. Subtitle C of the Code imposes certain employment taxes on employers including the employer portion of FICA tax, the obligation to withhold the employee portion of FICA tax, and the obligation to withhold federal income tax. See sections 3111, 3102, and 3402. Section 6011 and its underlying regulations require employers to file returns that determine and report employment taxes. See Treas. Reg. §§ 31.6011(a)-1(a)(1) and 31.6011(a)-4(a)(1). Employers generally file a Form 941 to report the wages that the employer paid during a particular quarter of a calendar year subject to federal income tax withholding and FICA taxes. Section 7701(a)(14) defines the term "taxpayer" to mean any person subject to any internal revenue tax. Accordingly, an employer is a "taxpayer" with respect to the employment taxes that are imposed on such employer. A Form 941 reports and determines the employer/taxpayer's tax liability, thereby providing the Service the authority to assess the taxes reported.

The CARES Act provided the ERC with respect to qualified wages paid after March 12, 2020, and before July 1, 2021. The American Rescue Plan Act of 2021 provided a substantially similar ERC under section 3134 with respect to qualified wages paid after June 30, 2021, and before January 1, 2022. The ERC available under the CARES Act was a refundable credit allowed against the taxes imposed on employers by section 3111(a) (social security tax), or so much of the taxes imposed on employers under section 3221(a) (Tier 1 tax under the RRTA) as are attributable to the rate in effect under section 3111(a). The ERC available under section 3134 was allowed against the taxes imposed on employers under section 3111(b) (Medicare tax), or so much of the taxes imposed on employers under section 3221(a) as are attributable to the rate in effect under section 3111(b).

Types of Third-Party Payer Arrangements

In third-party payer relationships, the Code may impose liabilities for withholding, depositing, reporting, and paying employment taxes on the CLE, TPP, or both depending on the particular relationship at issue. Some third-party payers are treated as an "employer" for certain employment tax purposes. For these purposes, such "employers" therefore are also "taxpayers." Generally the CLE remains liable for the underlying employment tax, but some third-party payers are made liable for the underlying employment taxes jointly with the CLE whereas others are made liable *in lieu* of the CLE. The following table identifies who is a liable party, and therefore who is a "taxpayer," under several common third-party payer relationships:

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[5] The term "employment taxes" refers to taxes imposed on employers and employees under Subtitle C of the Code, including taxes on both employers and employees under the Federal Insurance Contributions Act (FICA) (FICA includes both social security and Medicare taxes) and the Railroad Retirement Tax Act (RRTA), as well as taxes imposed on employers under the Federal Unemployment Tax Act (FUTA) and the obligation of employers to deduct and withhold federal income tax.

[6] Section 6201(b)(2) provides an exception, not relevant here, for certain federal unemployment taxes.

	Type of TPP Arrangement	Is the TPP liable for employment taxes, including underpayments, on wages it pays to the CLE clients' employees?	Does the CLE remain liable for employment taxes, including underpayments?
1	CPEO* * for work site employees * for non-work site employees See I.R.C. §§ 3511 and 7705	 Yes Yes	 No Yes
2	PEO (designated per Treas. Reg. § 31.3504-2)	Yes	Yes
3	PEO* (that is not designated per Treas. Reg. § 31.3504-2, and that is not an I.R.C. § 3401(d)(1) employer)	No	Yes
4	I.R.C. § 3504 Agent See Treas. Reg. § 31.3504-1	Yes	Yes
5	I.R.C. § 3401(d)(1) Employer	Yes	No

Scenario 1

The third-party payer relationship in Scenario 1 involves a PEO that is neither designated under Treas. Reg. § 31.3504-2 nor a section 3401(d)(1) employer (row 3 of the table). Therefore, only the CLEs are liable as taxpayers for the employment taxes at issue. A PEO in this situation is not a third-party payer that is made to have or share liability for the reported employment taxes.

The PEO in Scenario 1 filed a return reflecting employment tax liabilities of its client CLEs. The return reported a tax liability as credited by some amount of non-refundable portion of an ERC. We understand from the Service that under current practices, the Service would have made an assessment in the amount of the reported liabilities as reduced by the non-refundable portion of ERCs that the Service initially allowed. This initial assessment would have been authorized by section 6201(a)(1).

When the Service later determines through examination that the claimed non-refundable portions of the ERCs were excessive and the employment tax liabilities exceed those previously assessed, section 6201(a) authorizes the Service to assess the amount of the reported liability that was not initially assessed because of the

excessively claimed credit. When the Service assesses this marginal amount as a taxpayer-reported liability, the Service does so as a supplemental assessment because the earlier assessment based on the initially filed return would clearly be imperfect or incomplete. See I.R.C. § 6204.

For some types of taxes, the distinction between a Service-determined liability and a taxpayer-determined liability implicates the deficiency procedures in Subchapter B of Chapter 63 of the Code. See I.R.C. §§ 6201(e), 6211, and 6213(a). The concept of a deficiency and its related pre-assessment procedures, however, do not apply to employment taxes. See sections 6211(a) (defining the term "deficiency" to mean an amount with respect only to income, estate, and gift taxes as well as certain excise taxes, but conspicuously excluding employment taxes) and 6213(a) (providing that the deficiency notices do not apply to employment taxes).[7] Without the requirement of a deficiency notice, section 6201 authorizes and requires the immediate assessment of any Service-determined employment tax liability in the same manner as it does with respect to a taxpayer-determined liability that is reported on a return.[8]

Section 6203 provides that an assessment "shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary." The Service complies with section 6203 by having an assessment officer timely[9] sign a summary record of assessment (Assessment Certificate). See Treas. Reg. § 301.6203-1, *Method of Assessment*. The Assessment Certificate only must contain a total amount assessed and it may be associated with "supporting records," through which the different elements of a valid assessment are provided. Id. In the context of employment taxes, the supporting records will identify the tax (e.g., an employment tax liability), the tax period (e.g., the quarter(s) listed on the respective Form 941), and, importantly, the identity of the taxpayer(s) (on the Form 941 and its attached Schedules R). This mechanism of assessment, the signing of an Assessment Certificate to record a tax liability in the Service's books and records, may be contrasted with the later recording of the fact that there was an assessment in the Service's computer systems. A particular Transaction Code (TC), such as a TC 150, is

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[7] None of the underpayments at issue in this advice result from the reclassification of a worker's employment status or otherwise implicate section 7436. Note that even with respect to a section 7436 proceeding in which the Tax Court may redetermine a worker classification determination, and in which the Tax Court may also redetermine the employment tax liability, the employment tax itself would still not be a deficiency tax. Rather, the liability determined by the Tax Court would be summarily assessable pursuant to section 6215 because of the remedy in subsection 7436(a), which provides that a Tax Court redetermination of the proper amount of employment tax "shall have the force and effect of a decision of the Tax Court."

[8] Although the Service 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 may be determined. For example, a marginal liability may be determined by Counsel during refund litigation and such a 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.

[9] For purposes of this advice we are assuming that there are no issues with respect to the timeliness of the assessment or supplemental assessment. See section 6501(a) for applicable period of limitations on assessment.

the recordation of the fact that there was an assessment. However, the TC is not an assessment, nor is the taxpayer's electronic module on any business system an assessment. A TC reflected in an electronic module is simply a mechanism by which the Service tracks assessments, liabilities, and other matters relevant to ensure the satisfaction of the liabilities.

The fact that the PEO filed the return that reported the liabilities and claimed the credits on behalf of a client-CLE does not alter the Service's authority or responsibility to assess the employment tax liabilities reported or later determined. Moreover, there should be no issue with respect to the "identification of the taxpayer" as long as the examination workpapers and assessment request forms correctly identify the relevant CLE that was under examination as the taxpayer. We understand that the Service has a current practice to create a new module solely in the name of the liable CLE to track supplemental assessments for which only the CLE is liable, and we continue to believe that this is a well-advised procedure.

With respect to collection, there should be no issues with respect to any administrative or judicial collection activities that ensue with respect to a newly-created CLE module that only names the liable CLE as the taxpayer in the TC 150. Current programming ensures that the supplemental assessment will have its own section 6502 period of limitation on collection after assessment, which is the correct period applicable to the supplemental assessment. If the liability remains unpaid, then a section 6321 federal tax lien will arise with respect to the amount of the supplemental assessment once the elements of section 6321 otherwise are satisfied, which will allow for all avenues of administrative collection (e.g., levies and overpayment refund offsets). Accordingly, no further protections are needed for any lien or levy notices or decisions to refer the matter to the Justice Department for judicial action.

Scenario 2

In Scenario 2, the TPP in fact is treated as an "employer" and therefore is liable as a "taxpayer." This would be the case with respect to all of the third-party payer relationships that are listed in the table above on all rows other than row 3, which was addressed in scenario 1. The assessment analysis we provided above for Scenario 1 is no different here. For assessments, the bottom line is that any assessment of a liability that is determined by the taxpayer/employer (e.g., reported on a filed return), and any assessment of a liability that is determined by the Service (e.g., determined by an examination) would be accomplished once the assessment officer signs the summary record of assessment per section 6203. Provided that this act is accomplished timely, supported, and procedurally valid, then the assessment would be valid as against any "taxpayer" liable for the tax that can be identified through the records that support the assessment including the return and all accompanying attachments as well as any examination file.

There are several downstream considerations that the Service should take into account when implementing processes and procedures to monitor jointly-owed balances that

remain due, including how to best protect taxpayer rights and how to best preserve the Service's ability to engage in collection. For example, the fact that both the TPP and the CLE are jointly liable for the employment tax liabilities means that both are entitled to section 6303(a) notice and demand and that without individual notices and demands there may be complications with respect to the federal tax lien. Related collection matters are addressed in Part 5 of the IRM, but please feel free to contact us if you have collection-related questions not already addressed therein.

Scenario 3

Scenario 3 addresses a different set of complications that might arise with respect to third-party payer relationships that result from the fact that different credits impact the assessment differently. In Scenarios 1 and 2, the Form 941 overstated the entitlement to the non-refundable portion of an ERC. As discussed above, under current practice the Service assesses the reported liabilities as reduced by the non-refundable portion of ERCs that the Service initially allowed. The newly-determined liability that arises from the denial of those claimed credits would represent a previously-unassessed liability. Under current practice, however, there are other credits that the Service records as credits against the reported liability post-assessment, similar to the way that a payment is applied against the remaining balance of an assessed tax liability. In these situations, the underlying liability already was subject to assessment. Because of the way the Service accounts for and records such credits, any subsequent determination by the Service with respect to the propriety of such credits only affects satisfaction of the balance that remains due, not the assessment itself. As a result, there is no further requirement to assess the liability pursuant to section 6201.[10] In practice, the Service would annotate such a determination that the credit is excessive on the module simply by reversing the credit by the amount determined to be excessive.

Therefore, in Scenario 3 there is nothing new to assess where the previously-allowed credit did not initially reduce the amount that the Service made subject to the assessment. When the Service's practice is to account for a credit that does not reduce the initially-assessable amount but is instead treated as if it were a payment partially satisfying an assessed liability, the Service should not duplicate the existing assessment. Instead, it should administratively adjust the module to reflect the correct balance that remains unpaid. The Service must ensure that any enforced collection is limited to those persons who are liable as "taxpayers" and is also limited to the extent of each person's individual liability.

[10] Indeed, there would be complications if a tax liability was reflected in multiple yet duplicative assessments. For example, the section 6502(a) period of limitation on collection after assessment generally provides a 10-year period in which collection may take place that begins on the date of assessment. With a purely duplicative assessment, it might not be clear in some situations when to properly begin the collection period calculation. And these complications might raise legal hazard to the government's ability to defend the validity of one or both of the assessments in various legal contexts.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call me directly if you have any further questions.

cc: Deputy Associate Chief Counsel (Enforcement)
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