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Michael Kreiter
Director, State Government Affairs
NAPEO
707 North St. Asaph Street
Alexandria, VA 22314

Re: Federal Tax Law Implications of an Entity Claiming to be a PEO Reporting Federal Employment Taxes under the Client's EIN

Dear Mr. Kreiter,

This letter responds to your request that we clarify the application of federal law to professional employer organizations ("PEOs") as it relates to the filing of federal tax returns by a PEO using either the client's employer identification number ("EIN") or the PEO's EIN, and the effect of either filing approach on the PEO's liability to the federal government for the payment of federal employment taxes.[1] You also asked that we address the efficacy of certain statements and assertions with respect to those issues that were set forth by Mr. Jay Lucarelli of Minute Men Select, Inc. and Minute Men's outside counsel, Mr. James Hadden, in June 8, 2018 letters to Todd Gropper of the Ohio Bureau of Workers' Compensation (for convenience, the Lucarelli and Hadden letters are collectively referred to herein as the "Hadden letters").

SUMMARY

In Treasury Reg. § 31.3504-2, the Internal Revenue Service ("IRS") specifically addresses situations under which a PEO will be held jointly liable (with its client) for the payment of federal employment taxes with respect to the wages paid by the PEO to work site employees performing services for such client. As outlined below (and contrary to certain erroneous assertions in the Hadden letters), Treasury Reg. § 31.3504-2 only applies when the PEO reports the wages or compensation paid by the PEO on a return filed under the PEO's EIN.

[1] Unless we indicate otherwise, our statements apply to PEO-client relationships that are not a "certified" relationship under which a PEO that has been certified by the IRS is generally solely liable for the payment of federal employment taxes with respect to remuneration paid by the PEO to work site employees. The new IRS certification program generally had no effect on the treatment of such "non-certified" relationships (i.e., the law in effect prior to enactment of the certification program continues to apply to non-certified relationships). The certification program is described further below.

Although federal law does not prohibit an entity that purports to be in a PEO relationship with a client from reporting federal employment taxes under the client's EIN,[2] there is a significant difference in the federal tax treatment that will result. In particular, the reporting of wages paid under the client's EIN would shield the PEO from IRS enforcement actions that rely on the joint liability created under Treasury Reg. § 31.3504-2. And, critically, when that happens, the PEO's client will also lose the protection afforded by that joint liability. Put simply, if the IRS cannot collect underpayments by the purported PEO filing under the client's EIN, then the PEO's client could be the sole target of any IRS collection efforts in such cases – a result that would not change even if the PEO's service agreement and/or state law provide that the PEO and client have joint liability.[3]

A state's decision to require licensed PEOs to file federal tax returns under the PEO's EIN is primarily a policy decision. As you know, NAPEO and much of the industry have supported such a requirement because it (1) helps prevent PEOs from escaping IRS liability for federal income taxes, thereby increasing protections for all small business clients that enter into a PEO relationship, and (2) reduces the confusion for small businesses that arises due to a lack of uniformity among fundamental PEO business practices that would allow entities holding themselves out as PEOs to operate in a manner more akin to a payroll provider or other type of third-party payor.

DISCUSSION AND ANALYSIS

1. A PEO is not liable for federal employment taxes unless it is treated as the "employer" under the Internal Revenue Code ("Code").

The Code requires employers to withhold and remit federal employment taxes to the federal government.[4] The determination of employer status for purposes of the Code is generally determined under the common law rules.[5] Employers generally remain responsible for the performance of such tasks, even if the tasks are performed by a third party. Thus, in order for a PEO to be liable for the payment of federal employment taxes with respect to remuneration paid to an employee, the PEO must be treated as the "employer" of such employee under the Code.

Under Treas. Reg. § 31.3504-2, all provisions of law (including penalties) and regulations applicable to an employer are applicable to a third-party payor (including a PEO) that meets

[2] See note 1. The exception to this statement is for certified PEOs, which are required to report federal taxes under the certified PEO's EIN for all clients, regardless of whether the relationship with each particular client results in sole liability on the PEO.

[3] Of course, the client may seek to incur the expense of enforcing the service agreement in a contract action, or the state may take action to enforce state law, but for purposes of the IRS, an entity is only liable for employer requirements with respect to an employee if the entity itself is treated as the employer of such employee.

[4] See, e.g., Code § 3504 ("The *employer* shall be liable for the payment of the [income] tax required to be deducted and withheld…" (emphasis added).); Code § 3102 (requiring the *employer* to deduct and collect the employee's portion of FICA taxes from wages paid).

[5] See, e.g., Code § 3121(d) (defining "employee" in part as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee").

certain requirements of Treas. Reg. § 31.3504-2. In that situation, the PEO is jointly liable with the client and the IRS may proceed against the PEO without the determination of actual employer status. The PEO's liability can thus be determined with much greater certainty – either the requirements of the regulation are met (resulting in treatment as an employer), or they are not. This IRS enforcement option does not require a robust common law employer analysis (or judicial determination) based on the particular facts and circumstances at hand.

2. A PEO is <u>not</u> treated as an "employer" under Treas. Reg. 31.3504-2 if it reports wages and compensation under the client's EIN.

The pivotal contention in the Hadden letters is the erroneous assertion that allowing a PEO to file federal tax returns under the client's EIN would be consistent with the PEO's treatment as an employer under Treas. Reg. § 31.3504-2. That regulation is clear on its face that a PEO would <u>not</u> be treated as an employer if it filed under the client's EIN.

Our summary and analysis of Treas. Reg. § 31.3504-2 and our responses to the Hadden letters' analysis of the regulation are set forth below.

Basic rule: Treas. Reg. § 31.3504-2(a) states in part that:

> "[a] person…that pays wages or compensation ('payor') to the individual(s) performing services for any client pursuant to a service agreement, *except as provided in paragraph (d) of this section*, is designated to perform the acts required of an employer with respect to the wages or compensation paid" (emphasis added).

The effect of such designation is that the payor (e.g., a PEO) must perform the acts required of an employer under applicable federal law with respect to remuneration paid by the payor, and all provisions of such law (including penalties) applicable to the employer are applicable to the payor with respect to such remuneration.[6] In addition, each employer (e.g., client) for whom the payor is designated <u>remains subject to</u> all provisions (including penalties) applicable to an employer (i.e., joint liability applies).[7]

Treas. Reg. § 31.3504-2 does not apply to wages reported under the client's EIN: As indicated above, a PEO (or any other payor) will not be treated as an employer under Treas. Reg. § 31.3504-2(a) if any of the situations described in paragraph (d) are met. Section 31.3504-2(d) very clearly states that:

> "[a] payor is not designated to perform the acts required of an employer under this section…if…[t]he wages or compensation are reported on a return filed under the client's [EIN]…."

[6] Treas. Reg. § 31.3504-2(c)(1).
[7] Treas. Reg. § 31.3504-2(c)(2).

Treas. Reg. § 31.3504-2 thus could not be more clear that a PEO will not be treated as an employer under that regulation if it reports federal taxes under the client's EIN. The Hadden letters acknowledge that paragraph (d) "could appear to prohibit a PEO from filing under the client's EIN," but then attempts to explain away the clear language of the regulation. The Hadden letters' arguments, and the reasons we find those arguments wholly unpersuasive, are as follows:

- *Argument 1:* The Hadden letters state that paragraph (d) must be read in harmony with § 31.3504-2(b)(2)(ii)(A)-(C), which "provides that the use of the PEO's EIN to file returns is merely one method in which a PEO asserts co-employer status" (emphasis in original). The Hadden letters note that the cited language provides a list of alternative methods for a PEO to assert that it is a co-employer, and that the regulation's failure to require the PEO to assert its status by filing returns under the PEO's EIN means that filing in such manner is not an absolute requirement in order for the PEO to be treated as an employer under Treas. Reg. § 31.3504-2.

- *Response 1:* We find that the exclusion in paragraph (d) for PEOs that file under a client's EIN is entirely consistent with the language in § 31.3504-2(b)(2)(ii)(A)-(C), and that the Hadden letters appear to have misunderstood the application of § 31.3504-2(b)(2).

  As noted above, the basic rule under which a payor may be treated as an employer is premised on the existence of a service agreement between the payor and the client. Section 31.3504-2(b)(2)(i)(A) defines the term "service agreement" in part as an agreement under which the payor "[a]sserts it is the employer (or 'co-employer') of the individual(s) performing services for the client." Section 31.3504-2(b)(2)(ii) then provides what it means for a service agreement to "assert" that the payor is an employer as follows:

  > "[T]he payor may implicitly or explicitly assert it is the employer (or 'co-employer') of the individual(s) performing services for the client, including by agreeing to—
  >
  > (A) Recruit and hire employees for the client or assign employees as permanent or temporary members of the client's work force, or participate with the client in these actions;
  >
  > (B) Hire the client's employees as its own and then provide them back to the client to perform services for the client; or
  >
  > (C) File employment tax returns using its own employer identification number that include wages or compensation paid to the individual(s) performing services for the client" (emphasis added).

Putting this together, § 31.3504-2(b)(2) requires that a service agreement include an assertion that the payor is the employer/co-employer, and the rule simply provides examples of ways that the payor may implicitly or explicitly assert its status. As one example, a payor could make this assertion by agreeing in the service agreement to file tax returns under the payor's EIN. But the payor is not required to explicitly agree to file under the payor's EIN in the service agreement – the payor could choose to assert its employer status in another manner. Regardless, these requirements only pertain to the content of the service agreement – the rules in § 31.3504-2(b)(2) have nothing to do with, and in no way are in conflict with, the separate provision in paragraph (d) that makes clear that § 31.3504-2 only applies if the PEO payor files under the PEO payor's EIN.

- *Argument 2:* The Hadden letters suggest that its reading of § 31.3504-2(b)(2) (described above) is supported by Example 6 under § 31.3504-2(e) because the example describes a situation under which the IRS concludes that the payor is not treated as an employer because the payor "did not assert it was the employer and filed Forms 941 using [the employer's EIN]."

- *Response 2:* We believe that a more straightforward reading of Example 6 is that the example simply describes a situation in which the payor is not considered an employer because it failed to meet the conditions of Treas. Reg. § 31.3504-2 for two separate reasons (i.e., (1) failing to assert that the payor is the employer under the service agreement and (2) filing forms under the client's EIN). Either reason on its own would have yielded the same result. As explained above, we do not believe that the Hadden letters' reading of § 31.3504-2(b)(2) is correct, and we further find no basis in Example 6 for supporting the Hadden letters' view.

- *Argument 3:* Last, the Hadden letters cite Example 4 under § 31.3504-2(e) as more analogous to the Hadden letters' proposed model because, under Example 4, the PEO is found to be designated as an employer under the regulation "despite the fact that the client-employer is paying its own taxes on its own EIN" (emphasis added).

- *Response 3:* Again, we believe that the Hadden letters have misread the regulation. Example 4 expressly states that it uses the "[s]ame facts as *Example 1*," except that the client provides only net payroll (as opposed to gross payroll) to the payor. Under the facts of Example 1, the payor "reports the wage and tax amounts on Form 941…under [the payor's EIN]" (emphasis added). As indicated above, the exclusion in paragraph (d) applies when the payor reports taxes under the client's EIN. For purposes of this exclusion, it is irrelevant who actually pays the taxes to the IRS. Thus, the Hadden letters' conclusion that the client paid its own taxes under Example 4 (a point that we believe is nevertheless unclear in Example 4), has no relevance for purposes of the exclusion in paragraph (d) and thus does not support the Hadden letters' position.

To conclude this section, a plain reading of Treas. Reg. § 31.3504-2 provides that a PEO will not be treated as an employer under that regulation if it reports taxes under the client's EIN.

3. The new voluntary PEO certification program has no effect on the above analysis.

In late 2014, Congress enacted new Code §§ 3511 and 7705, which directed the Secretary of the Treasury to develop a voluntary certification program for PEOs under which a certified PEO ("CPEO")[8] would be treated as the sole employer for federal employment tax purposes of any work site employee performing services for a client of the CPEO (but only with respect to remuneration paid by the CPEO to such employee). In mid-2017, the IRS announced the first group of PEOs that had been approved as certified, and those PEOs had an effective date of certification that was retroactive to January 1, 2017.

The certification program creates a new situation under which the CPEO is solely liable (and the CPEO's client is not liable) with respect to certain remuneration paid by the CPEO under the CPEO's EIN. But the new provisions do not alter the rules of Treas. Reg. § 31.3504-2, and they were certainly not intended to remove the joint liability protections provided to the IRS and PEO clients through those regulations in the case of non-certified PEO arrangements.

Although the certification program imposes a number of requirements on CPEOs, it generally has no effect on non-certified PEOs,[9] and such non-certified PEOs remain subject to the same federal law that applied prior to the certification program. In addition, prior law also generally applies to those CPEO-client relationships that do not meet the requirements under Code § 3511 for sole liability to apply to the CPEO (i.e., non-certified relationships).

The Hadden letters cite the certification program's requirement that CPEOs file federal taxes under the CPEO's EIN as "further evidence that traditional PEOs may choose to file taxes under the client-employers [sic] EIN." The Hadden letters explain that, if the case was otherwise, "the requirement on certified PEOs would be entirely duplicative and superfluous." Instead of being duplicative and superfluous, we find this requirement entirely consistent with the employer responsibilities that apply to any person that is considered an employer (regardless of the legal basis on which they are considered an employer). A CPEO is required to report federal employment taxes under the CPEO's EIN because the CPEO is treated as the employer under Code § 3511 (whether it is treated as the sole employer or not) – just as a PEO is only treated as an employer under Treas. Reg. § 31.3504-2 if it reports under the PEO's EIN. To read more into this requirement would stretch the meaning of the CPEO program well beyond what was intended by Congress and the IRS.[10]

The Hadden letters also suggest that the fact that a CPEO files tax returns under the CPEO's EIN is the reason why the CPEO becomes solely liable for federal employment taxes. This is

[8] The Hadden letters refer to certified PEOs as "Registered" PEOs.
[9] The Hadden letters refer to non-certified PEOs as "Traditional" PEOs.
[10] In this regard, the Hadden letters also cite a statement on NAPEO's website that "IRS PEO certification is important because it: confirms the [CPEO] can pay federal employment taxes under its EIN" (emphasis by the Hadden letters). NAPEO's statement is intended to address some of the confusion that arises because federal law does not expressly contain the concept of "co-employment." The point of the statement is that, as with other employers, a CPEO files taxes under the CPEO's EIN because it is treated as the employer under the IRS certification program. The statement has no bearing on other situations.

incorrect. Sole liability arises when a work site employee performs services for a client pursuant to a service contract that meets certain requirements specific to CPEOs.[11] The filing method used by the CPEO is of no consequence in this regard – filing under the CPEO's EIN is simply a requirement of maintaining certification.

Finally, the Hadden letters suggest that the fact that Treas. Reg. § 31.3504-2 predates the Code's certification program is significant. Although it is true that the regulation predates the certification program, this fact is of no consequence.

4. Although a state that allows PEOs to file federal taxes under the client's EIN would not enable PEOs to violate federal law, it would substantially reduce important federal protections for clients and could cause greater confusion for small businesses in the state.

As we mentioned at the outset, a state's decision to allow PEOs to file federal tax returns under the client's EIN comes down to a matter of policy. One of the most significant considerations that a PEO relationship raises for small businesses is, if the PEO fails to pay federal taxes on behalf of its client, who will the IRS go after? Unless the PEO is treated as an employer under Treas. Reg. § 31.3504-2 (which, as explained above, requires the PEO to report under the PEO's EIN), then we believe in the vast majority of cases that the IRS would find the client solely responsible for the underpayments of the PEO. At a minimum, the IRS would first seek to collect the funds from the client, thus forcing the client to seek redress from the PEO through other and more expensive means.

If a third-party entity files taxes under the client's EIN, and then is allowed to treat itself as a PEO with respect to that client relationship, the IRS's ability to collect from the purported PEO would be severely compromised and the risks to the client could be substantially increased. The IRS may enforce neither state laws that impose joint liability on PEOs and clients nor contracts under which the PEO agreed to assume joint liability with the client. But, critically, if a state law were to permit an third-party paying taxes under the client's EIN to be treated as a PEO for state law purposes, it would lead clients to believe that the PEO's joint liability would extend to any future disputes with the IRS. Furthermore, the lack of a clear way to distinguish among the various types of third-party administrative service and payroll providers could create confusion for small businesses in a state. A state law that requires PEOs to file under the PEO's EIN would help to provide continued uniformity to the PEO industry and help to ensure that clients have similar protections under a PEO relationship at the federal level.

CONCLUSION

The Hadden letters' basic premise is that joint liability is not affected by a PEO filing federal employment taxes under the client's EIN. For the reasons described above, we believe that it is very clear that such premise is incorrect in the context of federal tax law. A PEO that files under the client's EIN is precluded from being treated as an employer under Treas. Reg. § 31.3504-2 and is unlikely to be considered an employer under other theories or Code provisions. As a

[11] Code § 7705(e)(2).

result, in most cases where a PEO fails to be treated as an employer under Treas. Reg. § 31.3504-2, the IRS would not be able to hold the PEO liable for its failure to pay taxes on behalf of the client even if state law and the PEO service agreement provide for joint liability.

Sincerely,

Randolf H. Hardock

cc:
Farrah Fielder
Thom Stohler