



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

SMALL BUSINESS/SELF-EMPLOYED DIVISION

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MEMORANDUM FOR DIRECTORS, COLLECTION AREA OPERATIONS

FROM: Kristen E. Bailey /s/ *Kristen E. Bailey*
Acting Director, Collection Policy

SUBJECT: Interim Guidance for the Correction of Professional Employer
Organization Accounts Not Liable for Employment Taxes

This memorandum issues interim guidance for Collection employees working cases involving a professional employer organization (PEO). This guidance supplements the procedures found in Internal Revenue Manual (IRM) 5.1.24, Third-Party Payer Arrangements for Employment Taxes, and will be incorporated into the next revision of this IRM section.

Background

A professional employer organization, sometimes referred to as an employee leasing company, enters into an agreement with a client to perform some or all of the federal employment tax withholding, reporting, and payment functions related to workers performing services for the client. If the contractual documents provide that the PEO assumes some or all of the employer rights and obligations, in particular with regard to payroll and applicable taxes, a client may believe he is not liable for federal employment tax obligations. However, the rules established in the Internal Revenue Code (Code) determine which party is liable for employment taxes, and the IRS is not bound by any agreement between an employer and a third party.

Use of a PEO does not relieve a client from its employment tax obligations if the client is the common law employer of the workers who perform services for the client (see IRM 5.1.24.3.1, Common Law Employer) and the PEO is not the section 3401(d)(1) employer (see IRM 5.1.24.3.2, IRC 3401(d)(1) Employer). A third party is the section 3401(d)(1) employer only if it has exclusive control over the payment of wages. An employer cannot

contract away its responsibility to withhold, report and pay applicable employment taxes. In any employment tax case, a determination of who is the employer must be made to determine employment tax liability.

H.R. 5771 Tax Increase Prevention Act of 2014 (TIPA) was signed by the President on December 19, 2014. The TIPA provides that a certified PEO be treated as the employer of any work site employee performing services for any customer of such organization. Two new I.R.C. Sections were enacted, §§ 3511 and 7705, which provide requirements and definitions for certified PEOs. A certified PEO (and no other person) shall be treated as the employer liable for employment taxes with respect to wages paid by the certified PEO to a work site employee performing services for any customer of the certified PEO. The TIPA requires the IRS to establish a certification program by July 1, 2015, which would be effective for wages paid on or after January 1, 2016.

A PEO is not required to become certified under the new legislation. Those that do not will be subject to current law and enforcement. Under final regulations, published at Treas. Reg. § 31.3504-2, and effective for wages paid after March 31, 2014, if a payor, such as a non-certified PEO, pays wages or compensation to individuals performing services for a client pursuant to a service agreement between the payor and the client, the payor may be designated to perform acts of an employer, including liability for the employer's employment taxes, with respect to the wages or compensation paid by the payor to those individuals. If a payor is designated under the regulations, both the payor and employer are liable for the employer's employment taxes.

Service agreement is defined in the regulations as an agreement pursuant to which the payor -

- Asserts it is the employer (or "co-employer") of the individual(s) performing services for the client;
- Pays wages or compensation to the individual(s) for services the individual(s) perform for the client; and
- Assumes responsibility to collect, report, and pay, or assumes liability for, any taxes applicable under subtitle C of the Code with respect to the wages or compensation paid by the payor to the individual(s) performing services for the client.

Collection Procedures

When a PEO has failed to pay employment taxes on wages attributable to any client employees prior to April 01, 2014, if the facts and circumstances indicate that the client(s) remained the employer(s), the IRS should attempt to identify the client(s) with unpaid liabilities and assess the appropriate amount of employment taxes against the client(s). Each client will be assessed for the full amount of its employment tax liability. See IRM 5.1.24.6.1, Impact of a PEO Arrangement on Client, and IRM, 5.1.24.6.3, Pursuing Collection from PEO Clients, for additional information.

Once the tax is assessed against the client, any corresponding tax liability previously assessed against the PEO under its name and EIN is considered excessive in amount or erroneously assessed and must be abated. Code section 6404 authorizes the IRS to abate the unpaid portion of the assessment of tax or any liability in respect thereof, which is: (1) excessive in amount; (2) is assessed after the expiration of the period of limitations properly applicable thereto; or (3) is erroneously or illegally assessed.

In the absence of a Form 941-X or amended Form 940 submitted by a PEO to remove the excessive or erroneously assessed tax of its client(s) for a tax period ending prior to April 01, 2014, the revenue officer must prepare a separate Form 3870, Request for Adjustment, for each client to abate the excessive or erroneously assessed tax. In the Reason for Adjustment box, include the following information:

PEO Employment Tax Adjustment per IRC 6404

Requested action: Abate tax (TC 150) dated (MM-DD-YYYY) in the amount of (provide amount equal to tax assessed against the PEO client) and abate FTD Penalty (TC 186) dated (MM-DD-YYYY) in amount of (provide amount of FTD penalty).

Justification: There can be only one party liable for employment tax prior to April 01, 2014. Tax was subsequently assessed under this PEO's common law employer client under EIN. Client TXMOD attached. (If available, a client allocation schedule from PEO may also be attached.)

Example 1. XYZ PEO entered into an agreement with Employer A, effective January 1, 2013. Under the agreement, XYZ PEO hired Employer A's employees as its own employees and provided them back to Employer A to perform services for Employer A. XYZ PEO also assumed responsibility to make payment of the individuals' wages and for the collection, reporting, and payment of applicable taxes. For all pay periods in the first quarter of 2013, Employer A provided XYZ PEO with an amount equal to the gross payroll (that is, wage and tax amounts) of the individuals, and XYZ PEO paid wages (less the applicable withholding) to the individuals performing services for Employer A. XYZ PEO also reported the wage and tax amounts on Form 941 filed for the first quarter of 2013 under XYZ PEO's employer identification number (EIN). Employer A's wage and tax amounts were \$500,000.00 and \$176,500.00 respectively. XYZ PEO did not make any federal tax deposits or payments for the first quarter of 2013, which resulted in unpaid tax of \$176,500.00 for Employer A.

An IRS investigation of XYZ PEO's 941 balance due of \$1 million for the first quarter of 2013 determined the PEO was not the common law employer or section 3401(d)(1) employer of the individuals and Employer A had yet to file a Form 941 for this tax period. The revenue officer assigned the PEO 941 balance due contacted Employer A, advised the employer it remained responsible for the reporting and payment of the taxes for its employees and secured a Form 941 for the first quarter of 2013 under Employer A's EIN. Employer A's Form 941 for the

first quarter of 2013 reported \$500,000.00 in wages and tax due of \$176,500.00. Once Client A's 941 was assessed, the revenue officer prepared Form 3870 to have \$176,500.00 in tax abated from the PEO's liability.

If you have any questions regarding these procedures, please feel free to contact me, or a member of your staff may contact Andra Kullman, Senior Program Analyst. Field personnel should direct any questions through their management staff.

cc: Director, Headquarters Collection
Director, Field Collection
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