

Current Federal Tax Developments

May 15, 2023

Kaplan Financial Education



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This Week We Look At:

IRS email discusses issues that arise with payroll tax refunds when a PEO is involved who itself has unpaid tax liabilities

Letter ruling provides that Forms 1099-C must be filed by a credit union due to writing off certain debts as part of a legal settlement

IRS plans to add more detail to partnership K-1 liability disclosures on 2023 returns

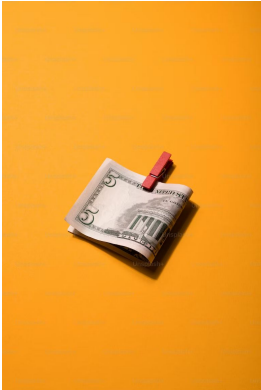
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Customer ERC Payroll Tax Refunds Will Be Applied by IRS Against Outstanding PEO Liabilities



- ECC 202319015, May 12, 2023
 - In an email response (ECC 201319015), the Internal Revenue Service (IRS) examined the scenario where a Professional Employer Organization (PEO) submits a claim for refund on behalf of one of its clients regarding the Employee Retention Credit (ERC).
 - The IRS specifically explored the implications when the PEO possesses outstanding tax liabilities.
 - The conclusion reached in the response asserts that the IRS holds the authority to allocate the refund towards the PEO's outstanding tax obligations.

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Customer ERC Payroll Tax Refunds Will Be Applied by IRS Against Outstanding PEO Liabilities

The Question:

You asked whether the IRS is authorized to offset certain COVID-19 employment tax credits (e.g., employee retention credit (ERC)) to any existing tax liabilities of a Professional Employer Organization (PEO) that pays wages to individuals as part of the services provided to a client employer pursuant to a service agreement, although the credits being claimed on the Form 941 Schedule R are attributable to wages paid to a client employer's employees.

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IRS Authority to Apply Overpayments Against Outstanding Taxes

IRC §6402(a) grants the IRS discretion to credit any overpayment against “any liability in respect of an internal revenue tax on the part of the person who made the overpayment.” **With respect to the COVID-19 employment tax credits, the IRS made the business decision to offset excess refundable COVID-19 employment tax credits to any existing tax liabilities on the employer’s account (see COVID-19-Related Employee Retention Credits: General Information FAQs, FAQ #12 and COVID-19-Related Tax Credits: Basic FAQs, FAQ #14).** This decision applies to all types of refundable COVID-19 employment tax credits including the ERC, the credit for paid sick and family leave wages, and the COBRA credit.

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IRC 6402(a)

(a) General rule. In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of **the person who made the overpayment** and shall, subject to subsections (c), (d), (e), and (f), refund any balance to such person.

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Who is the “Person”?

For taxpayers who use third-party payors (TPPs), the process for claiming credits against employment tax liabilities and liability for erroneously claimed credits differs depending on the type of TPP used. For taxpayers who use a section 3504 agent, Certified Professional Employer Organization (CPEO) or PEO that pays wages to individuals as part of the services provided to a client pursuant to a service agreement, although the credits being claimed on the Form 941 Schedule R are attributable to wages paid to a client’s employees, the 3504 agent, the CPEO or **PEO is the taxpayer** who is actually claiming the employment tax in an aggregate amount on a single line on a Form 941 filed under its own EIN. If a refund is ultimately issued to the TPP aggregate filer, **it is then between the TPP aggregate filer and the client to ensure the TPP remits any portion of the refund it received to the client in the appropriate amount.**

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Customer ERC Payroll Tax Refunds Will Be Applied by IRS Against Outstanding PEO Liabilities

IRS Rationale - The Employer Decided to Work With These Guys...

The IRS is not a party to those agreements and has no legal obligation to refund any portion of the TPP filer's refund to a client identified on Schedule R. In addition, when the IRS conducts an audit of a Form 941 filed by these types of TPPs, the IRS is examining the aggregate total amount of the line item credit claimed by the TPP on the Form 941, using the client by client allocation information provided on Schedule R as part of the examination. The IRS does not issue refunds or make credit adjustments to the client entities themselves, but rather any credits/refunds are paid to TPP. Any credits claimed against the employment taxes reported on the Form 941, reduce the reported liability of the TPP.

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IRS Rationale - The Employer Decided to Work With These Guys...

Moreover, any adjustment to a credit claimed by a TPP on the Form 941 will affect the total employment tax liability on the TPP aggregate filer's employment tax return. Schedule R only provides a portion of the information (the allocable share of wages and credits on a client-by-client basis) which was used by the TPP, in part, to determine its own total tax liability on the return. Since the Schedule R information is not itself determinative of the TPP's ultimate tax liability, the IRS would not be able to determine the appropriate refund to issue to the TPP based solely on the Schedule R information on a client-by-client basis for any particular employment tax credit. Rather, until the IRS determines entitlement to the entire line item amount claimed on the Form 941, no refunds or credits are paid out to the TPP. Please note that offsetting a TPP's outstanding tax liability is, in fact, providing the credit to the TPP by way of a reduction in the TPP's liability.

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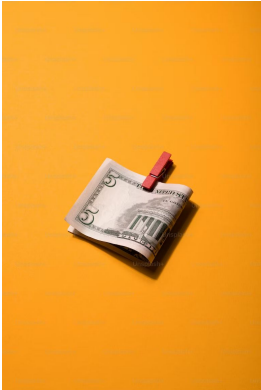
IRS Nod to the Practical Problem

Although employers who utilize TPPs (such as PEOs in the fact pattern examples provided by TAS) may encounter difficulties receiving payment of the refundable tax credits they may be entitled to if the TPP they have chosen has outstanding federal tax liabilities, this is a civil matter strictly between the TPP/PEO and the client employer.

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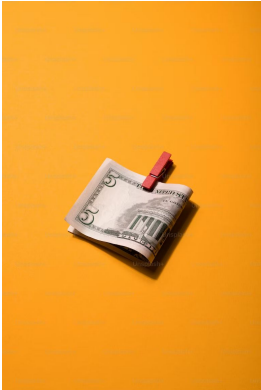


- ECC 202319015, May 12, 2023
 - This issue would not be limited solely to ERC claims
 - Client concerns if this happens:
 - They will not receive the ERC refund that they are owed.
 - They may be held indirectly responsible for the PEO's outstanding tax liabilities.
 - PEO will not be able to continue providing their services.
 - PEO will go out of business.

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Customer ERC Payroll Tax Refunds Will Be Applied by IRS Against Outstanding PEO Liabilities



- ECC 202319015, May 12, 2023
 - Potential mitigations:
 - Make sure that the PEO has a good reputation
 - Attempt to find evidence that the PEO financially stable
 - Consider using a CPEO
 - Be prepared to switch to a different PEO if necessary (and if this offset happens, it's almost certainly necessary)

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Credit Union Must File Forms 1099-C Due to Legal Settlement



Photo by [Cytonn Photography](#) on [Unsplash](#)

- PLR 202319009, May 12, 2023
 - Credit settled a class action suit related to alleged defects in the entity's presale notices when planning to seize debt security
 - Eventually the parties settled the lawsuit with the credit union agreeing to write off any deficiency
 - Asked for ruling that this was not an "identifiable event"
 - IRS disagreed, ruling it was such an event that requires file Form 1099-C

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Credit Union Must File Forms 1099-C Due to Legal Settlement

Regulation §1.6050P-1(b)(2) Identifiable Events

Discharge of indebtedness under Title 11 of the United States Code (bankruptcy)

Cancellation or extinguishment of indebtedness rendered unenforceable in a receivership, foreclosure, or similar proceeding

Cancellation or extinguishment of indebtedness upon expiration of the statute of limitations for collection

Cancellation or extinguishment of indebtedness pursuant to an election of foreclosure remedies by the creditor

Cancellation or extinguishment of indebtedness rendering the debt unenforceable in probate or similar proceedings

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Credit Union Must File Forms 1099-C Due to Legal Settlement

Regulation §1.6050P-1(b)(2) Identifiable Events

Discharge of indebtedness pursuant to an agreement between the applicable entity and the debtor at less than full consideration

Discharge of indebtedness due to the creditor's decision or defined policy to discontinue collection activity and discharge the debt

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Credit Union Must File Forms 1099-C Due to Legal Settlement

This letter responds to your request, dated August 11, 2022, for a ruling that Entity has no reporting obligation under Section 6050P of the Internal Revenue Code for the write-off of certain account balances pursuant to a court's order granting final approval of a class action settlement. Your letter contends that there should be no reporting obligation because the discharge was not the result of an "identifiable event" listed in Treasury Regulation 1.6050P-1(b)(2), but rather was required by the operation of state law.[]

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Credit Union Must File Forms 1099-C Due to Legal Settlement

Entity is a credit union organized in State X. When certain debtors defaulted on loans, Entity sent presale notices to the debtors stating that the collateral for the loans was being repossessed. **Two of these debtors filed a class-action lawsuit in State X circuit court. In the lawsuit, the debtors alleged that defects in the presale notices Entity sent violated State X Law for failing to clearly state whether a borrower would owe the deficiency balance.** After the filing of an amended petition, the parties engaged in discovery. The debtors filed a motion for class certification on Date 1. After the motion was briefed and argued by the parties, the court certified the class on Date 2. Subsequently, the parties agreed to a settlement. The settlement agreement was executed Date 3. The joint motion for preliminary approval was entered that same day. After a fairness hearing, the court granted final approval of the settlement on Date 4.

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Credit Union Must File Forms 1099-C Due to Legal Settlement

The identifiable event of primary relevance here is found in section 1.6050P-1(b)(2)(F). **When an applicable financial entity and a debtor agree to discharge indebtedness for less than full consideration, this constitutes an identifiable event, and the discharge must be reported.** To establish consideration, there must be a performance or a return promised which has been bargained for by the parties. Restatement (Second) Contracts §71(1) (1981). In this case, Entity and the debtor class members agreed to the entry of a judgment, approved and supervised by the court, which incorporates the parties' settlement agreement by which Entity agreed to write off debt balances as part of the overall settlement of the pending litigation. This is an identifiable event described in section 1.6050P-1(b)(2)(F).

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Credit Union Must File Forms 1099-C Due to Legal Settlement

Entity's request for a ruling contends that the settlement agreement does not reflect a mere agreement of the parties, or any other identifiable event, but rather is a recognition that the write-off of the deficiency balances was required under state law.

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Credit Union Must File Forms 1099-C Due to Legal Settlement

While the application of State X Law regarding the sufficiency of the presale notices may have been a factor in the parties' decision to settle the litigation, **such considerations are typical of parties' assessment of litigation hazards in arriving at a negotiated settlement.** The Agreement states that "[Entity] disputes the claims but desires to settle the claims being asserted against it on the terms and conditions in this Agreement to avoid the burden, expense, and uncertainty of continuing litigation." The fact that the terms of the settlement agreement were approved and incorporated into the court's Preliminary Order and Final Order does not serve to convert the discharge of the debt from being entered into voluntarily to one forced by operation of state law.

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Credit Union Must File Forms 1099-C Due to Legal Settlement

Entity also argues that there was no identifiable event because the court in its Final Order stated that the court had made an independent judicial investigation into the legal sufficiency of the presale notices and held that the presale notices are unenforceable. But **Entity vigorously pursued the litigation, including contesting class certification, throughout the pendency of the case. It was only by entering into a settlement agreement with the class members that Entity gave up its disputed claims to deficiency amounts.** It was as part of this settlement agreement that the parties agreed to seek a judicial determination into a matter that they had already resolved, a determination made not as a result of the adversarial litigation process, but by mutual request of the parties as part of the settlement agreement. **The debt write-off is due to the settlement agreement, not the court's subsequent order.**

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Credit Union Must File Forms 1099-C Due to Legal Settlement



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- PLR 202319009, May 12, 2023
 - Note - this ruling is solely related to whether a Form 1099-C must be issued, not an ultimate resolution of whether a taxable debt cancellation has taken place
 - Taxpayers can still argue this was a non-recourse debt and, thus, no cancellation of indebtedness.

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IRS Plans to Revise Schedule K-1, Form 1065 for 2023: Draft Scheduled to Be Released in the Fall



Photo by [Brad Starkev](#) on [Unsplash](#)

- Kristen A. Parillo, "ABA Section of Taxation Meeting: IRS to Tweak Schedule K-1 Reporting of Recourse Debt," *Tax Notes Today Federal*, May 9 2023
 - ABA Taxation Section meeting - speaker was Adrienne Mikolashek, the IRS Deputy Associate Chief Counsel for Passthroughs and Special Industries
 - Announced plans to revise Schedule K-1, Form 1065
 - Plans to change information requested on debt allocated to each shareholder

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IRS Plans to Revise Schedule K-1, Form 1065 for 2023: Draft Scheduled to Be Released in the Fall

From Ms. Parillo's article:

"According to Mikolashek, the reason for revising the form to **separately report a partner's share of recourse liabilities from deficit restoration obligations or partner debt guarantees** is to not only get better information reporting from the IRS's perspective, but also to do the partners a service so that they are fully aware of this obligation, as the partnership might consider that the partners should have an obligation to pay."

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IRS Plans to Revise Schedule K-1, Form 1065 for 2023: Draft Scheduled to Be Released in the Fall



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- Kristen A. Parillo, "ABA Section of Taxation Meeting: IRS to Tweak Schedule K-1 Reporting of Recourse Debt," *Tax Notes Today Federal*, May 9 2023
 - Draft instructions will be of special interest along with the draft K-1 itself
 - May also give a clue on what the IRS is looking for
 - May be interested due to concerns partnerships are improperly handling:
 - Partner guarantees and
 - Debt restoration obligations

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