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Applicability of Surety Bonds to the Payroll Services Industry

Representatives of the National Payroll Reporting Consortium, the Independent Payroll Providers Association and The Payroll Group recently met with The Surety & Fidelity Association of America to assess the utility of Surety bonds in regulating payroll service organizations.

Surety bonds are often a central element of many regulatory oversight requirements, and are often invoked when a government seeks to regulate an industry to protect customers and/or the state. Surety bonds are an effective measure in many regulatory contexts, but bond amounts must be meaningful. Such bonds are intended to screen out applicants that do not meet the underwriting criteria so policymakers must be mindful of the effect on the regulated industry and its customers.

Surety bonds are preventative in nature. Premiums are typically 0.5% to 2.0% of the bond amount annually, depending on creditworthiness and risk presented by the applicant. This is primarily an underwriting fee, reflecting the cost to conduct due diligence and evaluate the qualifications and fitness of the applicant and their capacity to fulfill the activity; e.g.,

- Internal controls, separation of duties, separation of client funds from operating funds
- Sufficient working capital
- Experience and competence in the area
- Credit verification and criminal background check

Premiums have a smaller loss component, compared to other lines of insurance. The loss component (the loss cost) reflects the loss experience of that particular type of bond. However, with respect to surety bonds, losses are addressed most effectively by trying to avoid a loss and writing the bond for only principals who, in the surety's estimation, have the qualifications to fulfill the obligation being bonded. It is more akin to a letter of credit - - a third party is guaranteeing payment if a specified event occurs.

When writing a surety bond, a surety requires the bond's principal's indemnity and possibly collateral, so if there is a loss the surety firm pays and then collects from the principal. In Maine, many service providers complained that surety bonds were not commercially available to small businesses. The Surety Association believes that such bonds are available to qualified businesses; however it may be a matter of willingness on the part of the principal. In addition to the annual cost of the bond (e.g., $10,000 annually for a $1 million bond), businesses may be required to set aside substantial collateral which is then not available for investment or working capital. Principals must also personally guarantee the bonds, and some individuals are not willing to do so because it affects their personal creditworthiness. Real estate is pledged in rare cases; typically liquid assets are required.

Surety bonds are generally available amounts over $2 million for certain applicants. From the perspective of obtaining the prequalification benefit of the bond, the obligee likely is obtaining the same amount of underwriting and prequalification for a $2 million bond that it receives for a $5 million bond. The due diligence review does not increase in scope/depth or intensity.

Surety bonds usually are continuous unless terminated, and surety firms refresh due diligence once or twice a year. If financial standing or other qualitative measures deteriorate they may terminate the bond and notify the payee. Surety firms routinely track notice requirements and notify covered entities of any termination. Bond provisions often require notice and continued coverage for a specified time; e.g., 90 days.

Fidelity or other bonds might also be relevant as an additional measure (with surety bonds). Fidelity coverage insures the firm (i.e., the payroll company) against crimes of its employees, and is more in the nature of insurance, although such coverage also involves an evaluation of internal controls. Such coverage includes a deductible and loss limit, and third parties are typically not covered. Principals are not covered. Maine requires fidelity coverage ("or liability insurance, including crime coverage") in addition to a surety bond.

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Proposals to Regulate Payroll Service Companies:
Bond Amounts Should Establish Meaningful Standards

In regulatory proposals, policymakers must define the risks and assess the amounts at risk. In the case of payroll service firms, the companies in question may administer many types of payroll and employee benefit amounts. However, the risk of diversion is unique with respect to taxes. That is, payroll taxes can be diverted for as long as one to two years before it becomes apparent to the IRS. In contrast, employees and other recipients of payroll deductions generally raise flags immediately if payments are delayed. It is suggested that the amounts in question be limited to payroll taxes, which was the source of recent difficulties in Maryland.

State regulatory measures typically involve surety bonds, which serve to ensure that only those with demonstrable character, capability and financial stability qualify for a state license. A key consideration is: *"What bond amount would provide meaningful protection?"*

There is a precedent to consider. Maine remains the only state to regulate payroll processing firms, in addition to regulation by the federal government (IRS). Maine requires a surety bond "*in an amount equal to the total of all local, state and federal tax payments and unemployment insurance premiums processed by the payroll processor on behalf of employers in this State in the 3-consecutive-month period of highest volume during the previous calendar year or $50,000, whichever is greater, but not to exceed $500,000*."

In Maine, many existing payroll processing businesses could not qualify for a bond. The legislature enacted successive legislative bills in the two years following enactment of the initial law to reduce the minimum bond amount from $100,000 to $50,000, and finally to permit the agency to accept a $10,000 letter of credit instead of a surety bond.

Even relatively small payroll firms can handle significant amounts. Most (60%) of the Reporting Agents registered with the IRS have fewer than ten clients. Yet firms with just ten clients can handle over $1 million in taxes in a year if each client has just six employees[1].

Indeed, under Maine's bond amount, firms with just 20 clients with 6 employees each would be required to post the maximum bond amount of $500,000, at an annual premium cost of $5,000, in addition to committing collateral of up to $500,000. It is not surprising that smaller firms found this infeasible, yet the fact remains that the small firm in this example handles $2 million in taxes over a year, and the window for malfeasance can be 18 months or more.

Clearly, many payroll firms have more than 20 clients, and many clients have more than six employees. Bonds in amounts of $50,000 or less would probably not provide meaningful protection, and would be misleading to clients.

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[1] U.S. average weekly wage, 3Q2012

U.S. average weekly wage, 3Q2012		$906.00
Federal employment taxes only (incl. employer taxes)		$262.30
State income and UI taxes - assume 5% & 2%		$ 63.42
Federal and state taxes, est.		$325.72
$325.72 times 60 employees times 52 weeks	=	$1,016,259

Assumes a single taxpayer with one withholding allowance.