

Background and Considerations in Regulation of the Payroll Services Industry

What is the Payroll Services Industry?

The payroll services industry¹ helps U.S. employers comply with laws and regulations governing payroll and employment tax administration, serving an important role in our nation's tax collection system as a conduit between employers and government tax authorities, improving efficiency of tax collection as well as tax compliance. Businesses, non-profits and government entities have increasingly relied on payroll service providers since the early 1980s. There are over 13,000 active payroll Reporting Agents registered with the IRS who provide services to over 1.5 million employers, covering between 35% - 40% of the private sector work force.

Employers hire payroll service providers to help them comply with laws governing overtime calculations, forms of payment, payroll deduction statements, new hire reporting, child support and other garnishments, COBRA and leave administration, payroll recordkeeping and various "on-boarding" activities such as background checks and Immigration/work authorization. Clients and their employees benefit from access to direct deposit and electronic payroll administration systems (such as electronic pay stubs, W-2s and timekeeping), as well as retirement savings plans, pre-tax cafeteria plans, health and welfare plans, medical spending accounts, and other employee benefits.

Tax Administration is Often the Primary Reason for Hiring a Payroll Service Provider

- Clients rely on payroll service providers to comply with complex federal, state and local tax deposit requirements, which vary significantly by jurisdiction and tax type in terms of deadlines, electronic formats and filing requirements.
- Payroll firms also typically handle quarterly state unemployment insurance wage and tax reporting and payment and annual W-2 filings and reconciliations.
- Clients must otherwise make significant investments in legal assistance, technology and staff support to keep up with frequent regulatory changes.
 - According to the IRS, "*there have been approximately 4,680 changes to the tax code since 2001, an average of more than one a day.*"² In addition, states enact thousands of legislative bills affecting employers each year.

¹ This paper reflects the consensus recommendations of each of the relevant payroll industry associations:

- American Payroll Association, the nationally recognized professional association, with nearly 21,000 members. www.americanpayroll.org
- Independent Payroll Providers Association, an association of over 300 independent providers of payroll and other related services throughout the United States. www.ippa.net
- National Payroll Reporting Consortium, whose member organizations provide payroll processing and related services to over 1.4 million employers nationwide, covering over one-third of the private sector work force. www.nprc-inc.org
- The Payroll Group, a national network of independent payroll service providers. www.thepayrollgroup.org

² IRS National Taxpayer Advocate, [Annual Report to Congress](#), December 31, 2012, p.6

- The IRS and most states also require payroll taxes to be filed and paid electronically, in diverse formats and protocols which often change annually.
- Clients hire payroll service providers to prevent costly IRS and state tax penalties. Statistically, *each* U.S. employer receives at least one IRS payroll tax deposit penalty *every year*, with an average penalty of nearly \$700³.
- Payroll service providers are historically at least 10 times more accurate in tax filings than the employer population (i.e., incur less than one-tenth the number of penalty notices per return filed).

What Has Been the Track Record of Payroll Service Providers?

In recent years there have been incidents in which a payroll processing firm collected but failed to pay the employment taxes of its clients. The effect of these incidents unquestionably has been very damaging to the affected businesses, which has led to consideration of additional regulatory measures.

The fact is, however, that 99.99% of reporting agent clients nationwide have suffered no losses and have benefited significantly from the specialized knowledge and sophisticated systems of payroll service providers. Moreover, the annual amount lost nationwide due to the fraud or failure of a payroll service is approximately 4 cents per thousand dollars⁴ in federal taxes deposited by payroll service providers.

Based on careful tracking of public news sources and comparisons with IRS data on the topic, most states (28) had no problems in the past ten years. Maryland has unfortunately had more than its share, with one incident in 2003 (FirstPay) and another in 2012 (AccuPay).

Over the past ten years, on average one out of every thousand payroll service firms (0.1% or 0.001) over the course of a year fails to remit the taxes of some clients. Consumers/employees are not harmed by such incidents. Employees are still credited with all tax withholding on their Forms W-2. Any shortfall is the responsibility of the employer.

What is at Risk? How is it Managed Today?

Although payroll service providers handle other types of payroll funds, such as net wages, retirement plan contributions, child support withholding, etc., only payroll taxes have been subject to loss or diversion. This is because only taxes can be diverted for more than a short time without detection. All payroll funds are reconciled and self-correcting. For example, employees complain immediately if their wages are not received when due, and families call immediately if child support payments are late.

³ IRS Data Book FY2012, Table 17. Civil Penalties, Fiscal Year 2012

⁴ 4 cents is overstated. Generally all known perpetrators have been apprehended, sentenced to significant prison time and ordered to pay restitution. How much was ultimately repaid is unknown.

The reconciliation process for taxes, however, can take eighteen months or more. When a business authorizes a third party to pay and file its payroll taxes, there is risk. Businesses have the responsibility to perform due diligence and ensure that tax payments are properly made. Additionally, strengthened IRS regulations effective in November 2012 were strengthened to address this risk, and are expected to resolve the problem.

How does the IRS Regulate the Payroll Services Industry? What is the IRS Doing?

The IRS oversees and regulates the industry. Among other things, “Reporting Agents” must:

- Register with the IRS as a Reporting Agent and Electronic Return Originator, which involves a background check with fingerprints⁵. The background check identifies any problems with criminal background, credit history, tax compliance and compliance with e-file requirements, and includes all principals and responsible persons.
- Report client lists periodically and send client authorization forms to the IRS.
- Pay and file all federal taxes electronically.
- Furnish initial and quarterly disclosures to clients (discussed below).

IRS Enforcement Measures

Payroll firms may be suspended for any failure to meet these requirements. Suspended Reporting Agents are prohibited from providing any covered services. Reporting Agents must provide written notice to clients of any suspension within 10 days.

Other IRS regulations⁶ prescribe procedural and other requirements for payroll service firms. The IRS aggressively enforces the 100% “Responsible Person” penalty under IRC Section 6672 against any person, whether an employee of the employer, or a third party, who is responsible for remitting taxes to the IRS and fails to do so.

Recent Improvements to Federal Regulations Are Expected to Minimize Risk

To detect a diversion of tax funds, a person would need to know two things: (1) the amount of current tax liabilities; and (2) whether these amounts were actually being paid to the government. A critical point is that only the employer - - the business taxpayer itself - - can know the current tax liabilities of the business. Thus, only the business itself can view current tax payments and know whether they are sufficient. No regulatory agency could ever protect against losses as effectively as a business that periodically checks its own account.

For example, an employer who processes a payroll on February 1, 2014 will know, on February 1, the exact amount of taxes due. The IRS would not know until May 2014 - - *at the earliest* - - if taxes were underpaid. Additionally, if the payroll service provider files a false tax return (Form 941), the IRS would not know of an underpayment until roughly July 2015.

Fortunately, the IRS Electronic Federal Tax Payment System (EFTPS) enables businesses to

⁵ See Publication 3112, IRS e-file Application and Participation, for details

⁶ *E.g., IRS Revenue Procedures 1998-32; 1999-39; and 2001-9*

easily verify federal tax payments by viewing their IRS EFTPS account online. State tax authorities generally offer similar ways to verify tax payments. However, few employers have been made aware of this technology. If employers had been aware of it and had utilized it, every past incident would have been detected almost immediately and losses minimized.

With technology in place, only publicity is needed. To that end, the payroll industry associations referenced worked with congressional staff, the IRS and the National Taxpayer Advocate to consider how to improve the safety of client funds. It was agreed that standard disclosures could be very effective in preventing losses. The following disclosure language was agreed upon:

IMPORTANT INFORMATION FROM THE IRS:

The employer is ultimately responsible for the deposit and payment of federal tax liabilities, even if a third party is making the deposits. The IRS recommends that employers enroll in and use EFTPS (Electronic Federal Tax Payment System) to confirm payments made on their behalf. Enroll online at www.eftps.gov, or call 800-555-4477 for an enrollment form.

State tax authorities generally offer similar means to verify tax deposits. Contact the applicable state offices directly for details.

Effective November 19, 2012, IRS guidance⁷ requires all Reporting Agents to provide this disclosure to all clients at the time of contracting and at least quarterly thereafter. These disclosures remind employers to be cautious in the selection and monitoring of any service provider entrusted with employment taxes.

Future IRS Systems Enhancements Are Planned

The IRS and the Treasury Financial Management Service (FMS) are working on systems to:

- Automatically issue EFTPS inquiry PIN codes to clients of Reporting Agents upon notice of new clients from a Reporting Agent.
- Issue email notices confirming scheduled EFTPS deposits. When implemented, rather than having to periodically check the EFTPS website, clients will receive affirmative confirmation of scheduled tax payments from the IRS.
- Send letters to businesses to confirm any request for an address change.

What are the State Regulatory Alternatives?

Although rare, the few occurrences of failure over the years have created significant problems for the affected clients, and have led to a discussion of whether there should be greater state oversight of the industry. States typically consider the following to be necessary elements of any regulatory oversight measures:

- Registration/licensing
- Disclosure of client lists
- Audit and enforcement oversight
- Posting of Surety and other bonds

⁷ IRS Revenue Procedure 2012-32, 2012-34 IRB 267

- Periodic reporting

Over the last fifteen years, ten states have considered legislation to regulate the industry (Alabama, Arizona, California, Maine, Minnesota, Nevada, New York, Oklahoma, Utah & Virginia). Of those, only Maine adopted legislation to address the safety of client funds.

Concerns with Traditional Regulatory Approaches

Given the ability of employers to verify tax payments in real time, traditional regulatory approaches could be counterproductive. Businesses may perceive any licensed service provider to have been subject to thorough scrutiny by the state, and consequently safety will be assumed to be the state's responsibility. As discussed above, a regulator would need to know the total payroll tax liabilities of each client of a payroll service provider on an ongoing basis, the required deposit schedule for each client, and whether the amounts due are actually received by the tax authorities. Employers may have little incentive to verify tax payments if they perceive the state to be responsible for the soundness of licensed service providers.

Indeed, if a licensed service provider fails to remit taxes, clients who relied on a state license may understandably hold the state responsible for failing to protect them. In practice, registration, licensing, bonding and audits may establish that a service provider is in good standing at a point in time, but would not have a significant impact in deterring criminal activity.

State licensing laws also necessarily include lengthy procedures for investigation, notice and hearings to properly administer suspension and revocation provisions. Consequently, even if clients complain to the licensing authority, an errant payroll service provider may be able to continue operating for another six months to a year or even longer. In contrast, existing IRS regulations permit the IRS to issue cease and desist orders, and require the service provider to notify clients of any suspension within ten days.⁸

Problems with Bonding Requirements

Requirements to post bonds, whether fidelity, fiduciary, performance or surety, are an important core component of regulatory proposals. However, businesses often misunderstand any bond as equivalent to insurance; i.e., effectively protecting 100% of any exposure they may have in entrusting their employment taxes to a third party. This is not the case. A surety bond provides for compensation up to a capped amount, such as \$2 million or \$5 million, in case a principal fails to perform as promised. However, businesses that believe that such bonding protects them may become less diligent in selecting a service provider and monitoring their performance.

Surety firms also typically require owners and spouses to pledge personal assets to obtain a surety bond, and many service providers have been unable or unwilling to pledge sufficient collateral to qualify for a bond. Indeed, the inability of many existing and reputable payroll service providers to qualify for required bonds was a significant problem in Maine. (Maine, as discussed below, is the only state which regulates the payroll services industry.)

One State's Experience in Regulating the Industry

In 2003, a small payroll service provider in Maine diverted \$1.1 million in payroll taxes from 34

⁸ Rev. Proc. 2012 – 32

clients. In an attempt to protect small businesses from similar incidents, the state legislature in 2004 enacted LD 1843, An Act To Require Surety Bonding by Payroll Processing Companies. Among other things, the law required payroll firms to obtain a surety bond in an amount not less than \$100,000 nor more than \$500,000.

Surety bonds are preventative in nature, ensuring that only those with sufficient means and experience to safely provide given services qualify for a bond. Not surprisingly, Maine later found that many current payroll service businesses could not qualify for the required bond and, as a result, in 2005 the legislature enacted LD 633, An Act To Improve the Surety Bond Requirement for Small Payroll Companies. LD 633 reduced the minimum surety bond to \$50,000 and permitted alternative forms of security. Even then, many applicants could not qualify for a surety bond, and in 2006, the legislature enacted LD 1878, An Act To Protect Small Payroll Processors, which authorized the state to accept a \$10,000 letter of credit instead of a surety bond. The absence of a surety bond component means that there is no third party prequalification of firms in Maine.

In its weakened form, Maine permits virtually anyone to qualify as a state-sanctioned payroll processor. Licensing is a misleading exercise if every applicant qualifies. The weakened regulatory oversight in Maine affords little protection to businesses, while conveying a powerful appearance of legitimacy and security in the form of a state license. Maine remains the only state to enact regulatory oversight over the industry.

Surety bonds remain a key element in many state regulatory arrangements. Surety bonds would serve to ensure that only qualified persons are able to administer payroll taxes for employers, but only if bond requirements are enforced and minimum amounts are set at meaningful levels sufficient to invoke a thorough assessment of character and capabilities⁹. It would be very difficult politically, as evidenced in Maine, to adopt this approach given that some existing and reputable payroll service businesses may not qualify for bonds.

The Cost of Bonds May Be Prohibitive

As a ballpark estimate, bond premiums are roughly 0.5% to 2.0% of the face value amount annually. Using U.S. average weekly wages and assuming for simplicity that employees are not married and claim one withholding allowance, a payroll service provider would handle over \$1 million in payroll taxes over the course of a year if they had just ten clients, each of which had six full-time employees.

For small payroll firms, the cost of a bond could add \$1,000 annually to the cost of payroll processing for each client. This could more than double the cost of payroll processing for some clients. Given the choice of paying \$1,000 annually or checking one's own EFTPS account with the IRS periodically, businesses would most likely opt for self-check rather than face a 100% price increase.

State versus Federal Oversight

Roughly half of the U.S. workforce is employed by multistate employers, which makes the federal government the most appropriate regulator. State-level regulation would result in

⁹ See also the separate "Applicability of Surety Bonds to the Payroll Services Industry" for a discussion of how such bonds function and what bond amounts would be sufficient to invoke an appropriate review of qualifications and capacity to fulfill the obligations.

overlapping and conflicting regulation which would be difficult for states, employers and industry participants. Maine has had to register firms from at least 22 states.

Multistate employers and payroll firms from nearby states pose challenges as well. For example, some payroll firms had no operations or employees in Maine, and their clients initially had no employees in the state, but then hired a Maine employee. It has been difficult to uniformly apply licensing and bonding requirements to firms with an incidental or emerging presence. Many payroll firms declined to provide services to clients with Maine employees.

Summary and Recommendations for Further Action

In summary, past consideration by other state legislative bodies has resulted in a consensus understanding that the most effective solution is to promote heightened awareness that businesses must exercise diligence by periodically checking their tax accounts. Businesses now have the means and the incentive to easily verify tax deposits. No regulatory agency could ever protect against losses as effectively as a business that periodically checks its own account.

Rather than rely on a single regulatory agency, businesses should be empowered with real-time tax information online, and would represent thousands of vigilant eyes overseeing the industry and guarding against losses in the most effective way possible. In addition, there are other measures that the IRS and states could put in place to improve the safety of tax funds:

1. Ensure Compliance with the Recent IRS Regulations

- The IRS should ensure that all Reporting Agents are aware of the new disclosure, registration and electronic filing obligations.
- The IRS and state tax authorities should educate the business community about the risks of outsourcing employment tax compliance, which would encourage diligence in the selection and monitoring of reputable payroll service providers. The IRS National Taxpayer Advocate is developing a new brochure to this effect. Educational materials should explain that verification of payroll tax deposits is an expected measure to demonstrate appropriate diligence.

2. Provide Secure Online Visibility of Employment Tax Accounts

- State tax authorities and Labor departments should ensure that businesses are able to view their tax accounts to verify receipt of tax payments. Most states have done so already. This feature should be promoted to raise awareness that periodic verification is necessary to demonstrate diligence in tax administration.
 - The Maryland Department of Labor, Licensing and Regulation (DLLR) currently has an on-line program known as Maryland Unemployment Insurance WebTax. Employers enrolled in this program have access to four years of account history, and can view all tax payments.
 - The Maryland Comptroller's office does not currently provide online access for employers to verify payments or filings on their behalf; however they can call the Comptroller's office to confirm payments.

- Optimally, tax authorities should email confirmations of electronic deposits to employers. These confirmations need not include confidential tax information such as tax amounts, but could merely acknowledge payments initiated. This would remind taxpayers that they should visit the agency website to check their account status periodically.

3. Issue Notices of Address Changes

- One problem is that, in some instances, an employer may not be aware of tax delinquencies because an agent, without the knowledge or consent of the employer, has changed the address of the employer with the government authorities.
- While it is impractical to prohibit an agent from receiving correspondence related to client accounts, tax authorities should notify employers when such address changes occur. Notices should be sent to both the employer's new and/or former address.

4. Increase Criminal Penalties

- Existing criminal laws should be evaluated. Theft, fraud, or other improper appropriation by a payroll service provider is already a crime and punishable under penalty of the criminal law. Virtually every past incident was successfully prosecuted with significant jail terms and restitution.
- Licensing, bonding and similar regulatory measures would likely not add significantly to the deterrent effect of existing criminal laws. Policymakers may want to consider increasing the severity of criminal sanctions in these circumstances.

5. Develop IRS Procedures and Rapid Response Teams

- The IRS should provide easy-to-find guidance and procedures for taxpayers who determine that their taxes have not been deposited. It may not be effective to rely on the normal IRS toll-free number for tax questions to report a serious allegation.
- There should be dedicated and trained IRS staff to quickly follow up with a service provider. The IRS should be empowered to check with other clients of a service provider to verify timely deposits, if credible evidence suggests a problem.