

February 5, 2008

Ms. Nina Olson  
National Taxpayer Advocate  
1111 Constitution Avenue NW  
Room 3031, C: TAS  
Washington, DC 20224

Dear Ms. Olson:

Re: 2007 Report to Congress Issue and Recommendations: Third Party Payers

Dear Ms. Olson,

We would like to commend you and your organization on your continued attention to the problem encountered by business taxpayers who rely on third party payers. As noted in your report, there have been some incidents in recent years in which small payroll processing firms have collected but failed to pay the employment taxes of their clients. The effect of these incidents unquestionably has been very damaging to the affected businesses, which has led to a discussion of whether there should be greater oversight of the industry.

The payroll service industry<sup>1</sup> provides human resources administrative services to employers, including payroll processing and employment tax payment and filing services. There are over 5,600 active, registered Reporting Agents, which provide services to an estimated 1.5 million employers, covering well over one-third of the private sector work force. The industry has long served 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.

You may recall that the referenced payroll industry trade associations have been working on proposals to improve the safety of client funds. We have met with the IRS, including TAS, Treasury and congressional staff on numerous occasions over the past few years to develop consensus on the most effective solution, and we have made specific recommendations.

We are writing to you now to announce a newly strengthened consensus recommendation that would effectively protect taxpayers who rely on third party payers. We believe that this proposal would be more effective in protecting taxpayers than the IRS licensing and regulatory oversight approach suggested in the TAS report. Further, it would impose no burdens, risks or costs on the IRS, while improving IRS efficiencies and accuracy of tax deposits. It would impose minimal costs on industry participants.

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<sup>1</sup> The relevant payroll industry associations include:

- American Payroll Association, the nationally recognized professional association, with over 23,000 members. [www.americanpayroll.org](http://www.americanpayroll.org)
- Independent Payroll Providers Association, an association of over 200 independent providers of payroll and other related services throughout the United States. [www.ippa.net](http://www.ippa.net)
- National Payroll Reporting Consortium, whose member organizations provide payroll processing and related services to over 1.3 million employers nationwide, covering over one-third of the private sector work force. [www.nprc-inc.org](http://www.nprc-inc.org)
- The Payroll Group, a national network of independent payroll service providers. [www.thepayrollgroup.org](http://www.thepayrollgroup.org)

As you know, the IRS released an Internet version of the Electronic Federal Tax Payment System (EFTPS) in 2002, which made it easy for businesses to verify federal tax payments. However, as your report notes, few employers are aware of this feature of EFTPS. If employers had been aware of it, every past incident would have been detected almost immediately and losses minimized. *Obviously, 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 regularly checks its own account.

An IRS licensing approach would weaken this protection, because businesses would believe that the IRS, having granted a license, will assume responsibility for licensed Reporting Agents and will effectively guarantee full compliance by such licensed Reporting Agents. As a result, businesses may perceive that there is no need to verify their tax payments.

The payroll industry associations have agreed that payroll firms should be required to disclose to existing clients at least quarterly, and to new clients prior to or at the time of contracting for services, that the employer remains liable for the payment of its payroll taxes, and how to verify that federal and state tax payments have been made on behalf of the client. The industry group asked the IRS in March, 2007 to revise the regulations that apply to Reporting Agents to require such disclosures. We understand that the IRS is supportive, but the regulations have not been amended as yet.

We are pleased to announce a new consensus that further strengthens protections for taxpayers. In addition to the disclosure requirements described above, the industry has agreed that *Reporting Agents should be required by regulation to remit all federal taxes electronically*. The fact is that employers are *only* able to view and verify tax payments made on their behalf if their service provider uses EFTPS to make their deposits. However, even though Reporting Agents are currently required to file tax returns electronically, they are not currently required to pay federal taxes electronically.

EFTPS is far easier to use than the IRS electronic filing systems that Reporting Agents are required to use to file employment tax returns (Forms 941, 940, etc.). EFTPS is free of cost, even for tax professionals who may be high-volume users. Reporting Agents, who are in the business of paying and filing employment taxes on behalf of employers, should be required to pay electronically, so that their clients will be able to view and confirm that tax payments are being credited to their account with the IRS.

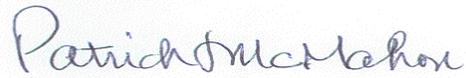
These measures would improve IRS efficiencies, reduce errors, and provide all employers who rely on Reporting Agents with the knowledge, incentive and means to easily verify that their tax payments have been properly made. Additional details may be found in the attached paper. Members of the referenced payroll industry associations would like to meet with you and your staff to discuss this in more detail.

We appreciate your work on behalf of taxpayers, and look forward to working with you to improve the safety of tax funds administered by third party payers. Please call Pete Isberg at (610) 827-1591 or Patrick McMahon at (202) 466-5006 if we can be of service.

Sincerely,



Pete Isberg  
National Payroll Reporting Consortium



Patrick McMahon  
Independent Payroll Providers Association  
The Payroll Group

Cc: Kathy K. Petronchak, Commissioner, Small Business/Self-Employed Division  
David Williams, Director, Electronic Tax Administration  
Robert Meighan, Chair, Electronic Tax Administration Advisory Committee

## **Regulation of Payroll Service Providers: *A Limited Approach May Be Most Effective***

The payroll service industry<sup>2</sup> provides human resources administrative services to employers, including payroll processing and employment tax payment and filing services. There are over 5,600 registered payroll service businesses, who provide services to an estimated 1.5 million employers, covering over one-third of the private sector work force. The industry has long served 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.

In recent years, there have been a very few incidents in which small payroll processing firms have collected but failed to pay the employment taxes of their clients. The effect of these incidents unquestionably has been very damaging to the affected businesses. 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 1 cent per thousand dollars in federal taxes deposited by payroll service providers. Thus, the incidence of such failures is extremely rare and the effect on federal tax collection has been negligible.

Nevertheless, the few occurrences of failure have created significant problems for the affected clients, and have led to a discussion of whether there should be greater oversight of the industry. Enacting regulatory oversight for this industry has proven difficult, in part because many payroll service providers are small businesses themselves, and legislators hesitate to create standards that might force small payroll firms out of business. Under an active regulatory agency oversight approach, however, the difficult reality is that to improve the safety of client funds, minimum standards and qualifications for performing such services are needed, and, inevitably, there will be some who are unable to meet such standards and qualifications.

### **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 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.

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<sup>2</sup> This paper reflects the consensus recommendations of each of the relevant payroll industry associations:

- American Payroll Association, the nationally recognized professional association, with over 22,000 members. [www.americanpayroll.org](http://www.americanpayroll.org)
- Independent Payroll Providers Association, an association of over 200 independent providers of payroll and other related services throughout the United States. [www.ippa.net](http://www.ippa.net)
- National Payroll Reporting Consortium, whose member organizations provide payroll processing and related services to over 1.3 million employers nationwide, covering over one-third of the private sector work force. [www.nprc-inc.org](http://www.nprc-inc.org)
- The Payroll Group, a national network of independent payroll service providers. [www.thepayrollgroup.org](http://www.thepayrollgroup.org)

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, the State of Maine later found that about 10% of registrants 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, roughly ten registrants remained unable to qualify, and so in 2006, the legislature enacted LD 1878, *An Act To Protect Small Payroll Processors*, which reduced the bond to \$10,000 and made the state the bonding agency of last resort for those who could not qualify for the required bond on the open market.

In its weakened form, the law in Maine permits virtually anyone to qualify as a state-sanctioned payroll processor, which may be misleading to clients who rely on the presumably thorough scrutiny of the state licensing authority. Clients undoubtedly reason that they no longer need to take precautions (such as verifying that tax payments are being made), because the state has assumed responsibility for ensuring that licensed firms are qualified. In truth, 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.

Requirements for surety bonds would ensure that only qualified persons are able to administer payroll taxes for employers, but only if bond requirements were enforced, and minimum amounts were set at meaningful levels, sufficient to invoke a thorough assessment of character and capabilities. It would be very difficult politically, as evidenced in Maine, to adopt this approach given that some payroll service businesses may not qualify for bonds and may be forced to discontinue such services. There are, however, alternate approaches that would effectively minimize risk, cost little, and be relatively easy to implement.

### **Publicity Regarding Existing Technology Would Effectively Eliminate Risk**

Part of the reason that past losses occurred is that perpetrators were able to divert tax funds for a considerable period of time -- a year or more -- without detection. To detect any such diversion, 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, 2007 will know, *on February 1*, the *exact amount* of taxes due. The IRS would not know until May 2007 - - *at the earliest* - - if taxes were underpaid. Additionally, if an inaccurate quarterly tax return (Form 941) is filed, the IRS would not know of an underpayment until roughly *July 2008*.

Fortunately, new technology has already been implemented to address the problem. In 2002, the IRS released an Internet version of the Electronic Federal Tax Payment System (EFTPS) that made it easy for businesses to verify federal tax payments. State tax authorities generally offer similar ways to verify tax payments. However, few employers have been made aware of this technology. If the technology had been available, and 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 already in place, only publicity is needed. To that end, the payroll industry trade associations referenced on page one worked together to consider how to improve the safety of client funds. It was agreed that standard disclosures could be very effective in preventing future 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](http://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.

### **A Minimalist Approach Would Be Most Effective**

There are ultimately two simple measures that, if enacted, would effectively curtail future problems. These measures impose minimal burdens, costs, and responsibilities on government tax authorities and compliant service providers. They would clarify and leverage existing economic incentives for businesses to safeguard their assets, while requiring Reporting Agents' federal tax deposits to be made electronically to enable employers to view and verify tax payments made on their behalf.

1. Payroll firms should be required to disclose to existing clients at least quarterly, and to new clients prior to or at the time of contracting for services, that the employer remains liable for the payment of its payroll taxes, and the means available to verify federal and state tax payments made on behalf of the client. (This is the language discussed above.)

Payroll "Reporting Agents" are already subject to IRS regulations<sup>3</sup> that prescribe procedural and other requirements for payroll service firms. The payroll industry associations involved have formally asked the IRS to amend the appropriate regulations to require Reporting Agents to furnish disclosures. Meaningful penalty provisions should be added for failure to furnish these disclosures. The proposed IRS regulatory language is attached.

2. Employers are only able to view and confirm tax payments made on their behalf if their service provider uses EFTPS to make their deposits. However, the IRS does not presently require Reporting Agents to deposit all federal taxes electronically.

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<sup>3</sup> E.g., IRS Revenue Procedures 2007-38; 98-32; 99-39; and 2001-9

Reporting Agents are currently required to *file* electronically, but not to *pay* electronically. EFTPS is far easier to use than the IRS electronic filing systems that Reporting Agents must use to file Forms 941 and 940. EFTPS is free of cost, even for tax professionals who may be high-volume users. Reporting Agents, who are in the business of paying and filing employment taxes on behalf of employers, should be required to pay electronically so that their clients will be able to view and confirm that tax payments are being credited to their account with the IRS. The IRS should amend existing Revenue Procedures 2007-38, 98-32, and/or other applicable regulations, to require Reporting Agents to make all deposits via EFTPS. This provision would improve IRS efficiencies, reduce errors, and provide all employers who utilize Reporting Agents with the opportunity to easily verify that their tax payments have been properly made.

Proposed changes to IRS Revenue Procedures 2007-38 and 98-32 are attached. Other applicable regulations may require similar revisions.

## Proposed IRS Rule for Reporting Agents: REQUIRED DISCLOSURES

.01 With respect to new taxpayer clients who contract with a Reporting Agent on or after January 1, 2009, before the taxpayer executes such service agreement and/or Form 8655, the Reporting Agent must provide the taxpayer with a disclosure statement, which must include the following language in a clear and conspicuous manner:

### *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](http://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.*

02. The specified disclosure language must also be provided to each taxpayer/client on an ongoing basis, no less frequently than quarterly. The requirement to furnish ongoing disclosures may be satisfied by including the disclosure statement within related reports or correspondence; however, the required disclosure language must remain reasonably prominent within the materials.

03. Failure to provide such disclosures constitutes sufficient reason for the IRS to initiate suspension from electronic filing privileges in accordance with Revenue Procedures 98-32 (EFTPS Batch and Bulk Filer programs); 99-39 (941 *e-file* Program) and 2001-9 (940 *e-file* Program).

## **Proposed Changes to Rev. Proc. 2007-38 for Reporting Agents: Require use of EFTPS**

### SECTION 1. PURPOSE

.01 This revenue procedure provides the requirements for completing and submitting Form 8655, Reporting Agent Authorization (Authorization). An Authorization allows a taxpayer to designate a Reporting Agent to perform the following acts on behalf of a taxpayer:

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(3) Make federal tax deposits (FTDs) and other federal tax payments (FTPs) **electronically via EFTPS** and submit FTD information and FTP information electronically as described in section 4.02(3) of this revenue procedure.

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### SECTION 4. DEFINITIONS

.02 Authorization. An Authorization allows a taxpayer to designate a Reporting Agent to:

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(3) Make FTDs and FTPs **electronically via EFTPS** and submit FTD information and FTP information electronically for the taxes deposited and payments reported on applicable returns set forth on Form 8655.

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### SECTION 5. SCOPE OF REPORTING AGENT AUTHORIZATION

.02 The scope of an Authorization for making FTDs and FTPs **electronically via EFTPS** and submitting FTD information and FTP information electronically is as follows:

(1) A taxpayer may authorize a Reporting Agent to make FTDs and FTPs **electronically via EFTPS** for any taxes reported on any of the returns listed on Form 8655 and to submit FTD information and FTP information electronically on the taxpayer's behalf.

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(3) Regardless of the method designated by the taxpayer, a Reporting Agent must make FTDs **[and FTPs]**, and submit FTD **[and FTP]** information through the EFTPS for a **!!** taxpayer, **s, regardless of whether such taxpayers are that is** required to make FTDs **[and FTPs]** and submit FTD **[and FTP]** information through the EFTPS pursuant to section 6302(h).

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*[Other changes to Rev. Proc. 2007-38 may need to be made to effectuate the intended change.]*

## Suggested Revisions to Rev. Proc. 98-32 EFTPS

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### SECTION 2. BACKGROUND

.03 Some taxpayers are required by the regulations issued under § 6302(h) to make FTDs using EFTPS. See § 31.6302-1(h)(2)(i)(A). Taxpayers not required to make FTDs using EFTPS may choose to do so voluntarily. Taxpayers also may choose to make FTPs using EFTPS.

**(a) All Reporting Agents, as defined in Revenue Procedure 2007-38, must use EFTPS to remit federal taxes on behalf of all client taxpayers, regardless of whether such taxpayers are required to use EFTPS.**

.04 All Filers using the Batch Filer or Bulk Filer programs must comply with this revenue procedure, and with the Implementation Guide for EFTPS Batch Filers, or the Implementation Guide for 11 April 27, 1998 EFTPS Bulk Filers, whichever is applicable.

.05 The two primary remittance methods in EFTPS are an Automated Clearing House (ACH) debit entry and an ACH credit entry. Filers may also use an Electronic Tax Application (ETA) transaction. These remittance methods are defined in section 3 and described in sections 9, 10, and 11 of this revenue procedure.

.06 Filers participating in EFTPS must ensure that taxpayers' funds are remitted on a timely basis. See § 31.6302-1(h)(8) for rules regarding when an FTD remitted by EFTPS is deemed made. For FTDs and FTPs remitted by EFTPS, see § 31.6302-1(h)(9) for rules regarding when the tax is deemed paid.

~~.07 If a taxpayer is required by regulations to make an FTD by EFTPS, a Filer may not use a paper FTD coupon (Form 8109, Federal Tax Deposit Coupon) or the magnetic tape FTD program (described in Rev. Proc. 89-48, 1989-2 C.B. 599) to make an FTD for the taxpayer. If a taxpayer is a voluntary participant in EFTPS (that is, a participant not required by regulations to make an FTD by EFTPS) and the Filer is unable, for any reason, to make an FTD using EFTPS or chooses not to use EFTPS to make an FTD, the Filer may make a timely FTD for the taxpayer by using a paper FTD coupon, or the magnetic tape FTD program if authorized by the taxpayer.~~

[Other changes to Rev. Proc. 98-32 may be necessary.]

## Possible Legislative Changes

Industry participants have agreed that the following proposed legislative changes would assist the IRS in preventing or minimizing possible losses. They would ensure that employers are aware whenever their address is changed with the IRS, and give the IRS the power to pursue and collect from errant payroll firms in cases of willful fraud. These provisions should be considered for inclusion in federal tax legislation at the next opportunity.

1. One problem that has contributed to the few cases of failure in this industry is the fact that, in some instances, an employer may not be aware of tax delinquencies because only the employer's payroll tax deposit agent, and not the employer, has received notices of such delinquencies. This is because in many of the past instances of fraud, an agent, without the knowledge or consent of the employer, has changed the address of the employer with the government authorities, thus preventing the employer from receiving delinquency notices. While it is impractical to prohibit an agent from receiving correspondence related to client accounts directly, the IRS should notify employers when such an address change occurs so that agents will be discouraged from providing unauthorized address changes, and employers will be aware when such changes have been requested.

Possible legislative language to implement this recommendation follows:

**( ) Verification of address change. The Secretary shall issue a notice of confirmation of any address change relating to an employer making tax payments under subtitle C, and such notice shall be sent to both the employer's former and new address.**

2. A legislative change should be made to provide that Section 6672 penalties could apply to a service provider, when the employer has transferred tax funds to the service provider. The revised Section 6672 penalty provision would permit the IRS to pursue and collect from any person who assumed responsibility for payment of taxes (and who actually received such tax funds for payment), as a responsible person.

Possible legislative language to amend Section 6672 follows:

**( ) Payroll Tax Deposit Agents Subject to Penalty for Failure To Collect and Pay Over Tax, or Attempt To Evade or Defeat Tax-**

**(1) IN GENERAL- Section 6672(a) of the Internal Revenue Code of 1986 is amended by inserting — ', including any person who has assumed the obligation to pay over any tax for a taxpayer (but only to the extent that such person has received irrevocable payment of funds for the tax liabilities from such taxpayer)' after 'imposed by this title'.**

**(3) CONFORMING- Section 6672(b)(1) is amended by striking the word 'taxpayer' and inserting the word 'person' each time it appears.**