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Protect Taxpayers and the Public Fisc from Third-Party Misappropriation of Payroll Taxes

PROBLEM

The payroll processing industry provides a valuable service to employers, especially small businesses, by helping them comply with complex federal, state, and local employment tax requirements. The industry also plays a significant role in tax administration by facilitating employment tax processing and collection, which can be costly and burdensome to the employer.¹ The industry has created various contractual arrangements with third party payers (TPPs) in which a TPP performs some or all of the employer's federal employment tax withholding, reporting, and payment obligations.²

While most TPPs are legitimate and trustworthy companies, a few “bad actors” have defrauded their clients and tarnished the image of the industry.³ Because employers remain liable for payroll taxes, those victimized in these situations (especially self-employed and small business taxpayers) can experience significant burden. This burden includes not only being forced to pay the amount twice — once to the TPP that embezzled or dissipated the funds and a second time to the IRS — but also being liable for interest and penalties. Some small businesses may not be able to recover from these financial setbacks and will be forced to cease operations. Moreover, because the Internal Revenue Code (IRC) does not protect taxpayers from TPP failures, the IRS faces difficult decisions about how to handle these cases and often compounds the harm to victims of misappropriation, particularly small businesses that use smaller TPPs.⁴ Although the payroll tax industry has evolved in the more than 60 years that have passed since employment taxes were enacted, the law has not kept up with this evolution.

EXAMPLE

A small business taxpayer hires a TPP to withhold, report, and pay employment taxes. The TPP collects payroll tax deposits from the taxpayer but does not turn them over to the IRS, and without the taxpayer's knowledge changes the taxpayer's mailing address on file with the IRS to TPP's address. Thus, when the IRS sends delinquent payroll tax notices to the taxpayer, the TPP receives and withholds them from the taxpayer. The TPP's owner uses the funds deposited by the taxpayer and other clients to fund a lavish lifestyle and pay old debts. Lacking sufficient assets to function as a going concern, the TPP is forced into

¹ IRS data show a steady increase in use of paid preparers for employment tax returns. While approximately 32 percent used preparers in tax year (TY) 2009, the number increased to 34.6 percent in TY 2011. IRS Compliance Data Warehouse (CDW), Business Return Tax File Table (Oct. 2012).

² See fn. 26, *infra*.

³ See IRS, Employment Tax Fraud, Case Examples, FY 2007 – FY 2012.

⁴ For almost a decade, the National Taxpayer Advocate has addressed the problem of TTP failures and recommended measures that could prevent or minimize the negative impact of these failures on employers. See, e.g., National Taxpayer Advocate 2009 Annual Report to Congress 261-262; National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*); 2004 National Taxpayer Advocate Annual Report to Congress 394-399.

bankruptcy. The taxpayer then discovers the TPP never deposited the full amount of the payroll taxes it collected with the IRS, and the small business is now liable for delinquent taxes, interest, and penalties.

RECOMMENDATIONS

To protect taxpayers from third party misappropriation of payroll taxes, the National Taxpayer Advocate recommends that Congress:

- Amend the IRC to require any person who enters into an agreement with an employer to collect, report, and pay any employment taxes to furnish a performance bond that specifically guarantees payment of federal payroll taxes collected, deducted, or withheld by such person from an employer and from wages or compensation paid to employees.
- Amend IRC § 3504 to require agents with an approved Form 2678, *Employer/Payer Appointment of Agent*, to allocate reported and paid employment taxes among their clients using a form prescribed by the IRS and impose a penalty for the failure to file absent reasonable cause.
- Amend the U.S. Bankruptcy Code to clarify that IRC § 6672 penalties survive bankruptcy in the case of non-individual debtors.

PRESENT LAW

Employers that pay wages for services of an employee are required to deduct and withhold Social Security, Medicare, and income taxes from the wages.⁵ Employers are also responsible for their share of the Social Security and Medicare tax and for tax under the Federal Unemployment Tax Act (FUTA).⁶ Employers who fail to collect and deposit these taxes timely and in the correct manner are subject to penalties ranging from two percent to 15 percent of the amount of the underpayment.⁷ When the monies collected from employee payroll are not paid as required, the law also provides for the assessment of a trust fund recovery penalty against individuals deemed “responsible persons.”⁸ The penalty is equal to the amount of Social Security, Medicare, and income taxes withheld from employees. Such taxes are referred to as “trust fund” taxes because employers hold the employees’ money in trust until it is paid over to the government.⁹

Under present law, the determination of who is liable for withholding, paying, and reporting federal employment taxes depends on the existence of a common-law

⁵ See IRC §§ 3101, 3102(a) and 3402(a).

⁶ See IRC §§ 3111(a) and (b) and 3301.

⁷ IRC § 6656(a).

⁸ IRC § 6672(a). “Responsible person” is generally defined as an officer or employee of the organization, who has sufficient control and authority to collect, truthfully account for, or pay over the withheld taxes, but willfully fails to do so. IRC §§ 6671(b) and 6672(a).

⁹ See generally IRC § 7501.

employer-employee relationship.¹⁰ Generally, the determination whether such a relationship exists is based on all the facts and circumstances tending to show whether the service recipient has the right to direct and control the method and means by which an individual performs the services.¹¹ If such a relationship exists, the service recipient (employer) is generally liable for employment taxes.

In 1987, the IRS published a 20-factor test for use as an analytical tool in determining whether an employer-employee relationship exists.¹² This guidance was based on an examination of court decisions and rulings concerning indicators of common-law employment. Eventually, the complexity of the test and changes in certain business practices led to a new analytical approach to determining employee classification.¹³ In 2004, the IRS provided training materials for making this determination by grouping relevant facts into three general categories — behavioral control, financial control, and relationship of the parties.¹⁴

An employer may enter into an agreement with a third party in which the third party performs some or all of the employer's federal employment tax withholding, reporting, and payment obligations.¹⁵ However, the law does not require the third party to be bonded to guarantee payment to the government if the third party defaults on its obligations.

Under IRC § 3504, the Secretary is authorized to issue regulations to “designate [a] fiduciary, agent, or other person” that has the “control, receipt, custody, or disposal of, or pays the wages or compensation of an employee or group of employees, employed by one or more employers,” to perform acts required of employers.¹⁶ Both the designee and the employer remain liable for payroll taxes and all penalties as long as the agent authorization made on Form 2678, *Employer/Payer Appointment of Agent*, is in effect.¹⁷ While the IRS has created Schedule R (Form 941), *Schedule for Aggregate Form 941*, for tracking employer-agent relationships for agents with an approved Form 2678, present law does not contain specific penalties for failure to file the form.¹⁸

¹⁰ IRC §§ 3401(d); 3121(d)(2).

¹¹ Treas. Reg. §§ 31.3121(d)-1 and 31.3401(c)-1.

¹² See Rev. Rul. 87-41, 1987-1 C.B. 296.

¹³ See IRS Information Letter 2004-0087 (June 30, 2004).

¹⁴ See IRS *Independent Contractor or Employee? Training Materials*, Training 3320-102 (10-96) TPDS 84238I; IRS Publication 15-A, *Employer's Supplemental Tax Guide* (Jan. 2012); see also Present Law and Background Relating to Worker Classification for Federal Tax Purposes, Joint Committee on Taxation Report, JCX-26-07 (May 7, 2007); National Taxpayer Advocate 2008 Annual Report to Congress 375 (Legislative Recommendation: Worker Classification).

¹⁵ IRM 5.1.24.1 and IRM Exhibit 5.1.24-1 (Aug. 15, 2012). See also IRS, *Third Party Arrangements*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Third-Party-Arrangements> (last visited on Sept. 9, 2012).

¹⁶ See IRC § 3504; Treas. Reg. § 31.3504-1.

¹⁷ See *id.*; Rev. Proc. 70-6, 1970-1 C.B. 420. Although the current process to designate an agent on Form 2678 is voluntary, IRC § 3504 authorizes the IRS to impose duties of an employer on a designated third party or agent that pays the wages or compensation of employees on behalf of the employer by issuing regulations under § 3504.

¹⁸ The Schedule R includes a list of all employers using the agent with an approved Form 2678 and the payroll liabilities reported by the agent on the Form 941 for each employer. IRM 5.1.24.4.4.1 (Aug. 15, 2012); 21.7.2.4.4.3 (Oct. 1, 2012). See also the Schedule R (Form 940), designed for filers of Form 940 having approved Forms 2678. IRM 21.7.3.4.7 (Oct. 1, 2012)

Bankruptcy Code § 523(a)(1) provides that bankruptcy “does not discharge an individual debtor” from taxes given priority under 11 U.S.C. § 507(a)(8), but does not address situations where a business entity has a tax debt. The employment tax debt (including the TFRP) of individual debtors cannot be discharged in bankruptcy.¹⁹ There is no comparable provision for business entities in bankruptcy.

REASONS FOR CHANGE

Following the enactment of IRC Subtitle C, *Employment Taxes and Collection of Income Tax*, some 65 years ago, the payroll industry has established various TPP arrangements for reporting, filing, and paying employment taxes. TPPs include payroll service providers (PSPs),²⁰ agents with approved Forms 2678,²¹ Reporting Agents (Form 8655 *Reporting Agent Authorization*),²² and Professional Employer Organizations (PEOs).²³ However, Congress has not amended the IRC to reflect the evolution of the industry, nor to authorize the IRS to better regulate the growing use of various TPP arrangements.²⁴

Employment tax noncompliance by a TPP may lead to delinquent client accounts, creating a growing amount of uncollected tax liability.²⁵ Between FY 2007 and FY 2012, acting on the IRS’s recommendations, the Department of Justice criminally prosecuted at least 24 owners and operators of different types of TPPs that collected about \$300 million in employment taxes from their client employers and did not turn the funds over to the Treasury.²⁶

When a TPP goes out of business or misappropriates its clients’ funds, the employers remain liable for the unpaid taxes. Defunct TPPs usually lack sufficient assets to collect against upon default, leaving the IRS no recourse other than to collect from the employers.

¹⁹ See 11 U.S.C. § 507(a)(8)(C) and 523(a)(1); *United States v. Sotelo*, 436 U.S. 268, 275 (1978) (holding that debts incurred under IRC § 6672 are not dischargeable and are treated as priority taxes in bankruptcy).

²⁰ IRM 5.1.24.4.2 (Aug. 15, 2012). PSPs are third parties paid by an employer to administer payroll and employment tax responsibilities, including one or more of the following: prepare paychecks for employees; prepare employment tax returns using the employer’s Employer Identification Number (EIN); file employment tax returns for the employer, which are signed by the employer; make federal tax deposits and payments; and prepare Form(s) W-3 and Form(s) W-2 for the employees using the employer’s EIN.

²¹ Such an agent files an aggregate employment tax return on Form 941 under its own EIN reporting employment taxes related to wages paid on behalf of all of its client/employers. Both the agent with an approved Form 2678 and the employer are liable for the employer’s employment taxes while the agent authorization is in effect. See IRC § 3504; Rev. Proc. 70-6, 1970-1 C.B. 420; Form 2678, *Employer/Payer Appointment of Agent*. Only agents of home care service recipients authorized under IRC § 3504 may file an aggregate Form 940. See Rev. Proc. 80-4, 1980-1 C.B. 581; Notice 2003-70, 2003-43 I.R.B. 916; IRM 21.7.3.4.6 (Jan. 24, 2011).

²² See Rev. Proc. 2012-32, 2012-35 I.R.B. 1. Reporting Agents only report and deposit employment taxes, but are not in position of control and do not pay wages to the employees. A Reporting Agent is not liable for an employer’s employment taxes.

²³ PEOs (also known as employee leasing companies) enter into agreements with clients to provide employees to perform services for the client, pay compensation to the employees, and assume responsibility to collect, report, and pay employment taxes under their own EINs. A PEO may represent to a client that the PEO is the employer of the workers providing services to the client. IRM 5.1.24.6 and IRM Exhibit 5.1.24-1 (Aug. 15, 2012).

²⁴ See IRS, *Third Party Arrangements*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Third-Party-Arrangements> (last visited Sept. 9, 2012).

²⁵ See, e.g., IRM 5.1.24.5.1(2) (Aug. 15, 2012).

²⁶ IRS, *Employment Tax Fraud, Case Examples, FY 2010 – FY 2012*, available at <http://www.irs.gov/uac/Examples-of-Employment-Tax-Fraud-Investigations-Fiscal-Year-2012> (Last visited Sept. 11, 2012).

Each TPP failure can cause grave financial harm to multiple clients, which may be required to pay the amount of payroll taxes twice: once to the TPP and again to the IRS with interest and penalties.²⁷ Many employers also must invest significant time and additional expense for representation in attempting to resolve their liabilities with the IRS. Some small businesses that cannot recover from these setbacks may be forced to cease operations and lay off their employees.

During the past five years, the IRS, in collaboration with TAS,²⁸ has acted to address the negative impact of TPP failures on employers. Its actions include:

- Publishing a new IRM section describing TPP arrangements for employment taxes,²⁹ and
- Implementing new procedures for assessment of the TFRP against TPPs, including responsible parties within a PSP or a PEO.³⁰

Yet these provisions do not ameliorate the double burden on the employer for its share of unpaid tax due to a TPP misappropriation or bankruptcy. Absent statutory authority to require bonding and regulate TPPs that assume a responsibility to withhold, report, and pay employment taxes, the IRS has limited tools to protect employers victimized by unscrupulous TPPs.³¹

The tax system has at least two reasons to protect taxpayers harmed by TPP failures:

- First, this problem primarily affects small businesses, few of which have sufficient cash flow to pay the amount of employment taxes twice in addition to interest and penalties. This tax burden may be heavy enough to jeopardize a business's status as a going concern. Significantly, this taxpayer has done its best to comply with its tax obligations and should not be treated like a willfully noncompliant taxpayer.
- Second, TPPs have not only a contractual obligation to their clients but a responsibility to the tax system as a whole. They are in fact profiting from obligations imposed on taxpayers by the tax system. Thus, the government has a legitimate interest in ensuring that TPPs faithfully discharge this responsibility.

²⁷ See, e.g., IRC §§ 6656(a) and 6672(a). One TPP's executives embezzled about \$1.3 million from about 3,000 clients across the country. The Morning Call, *Two Easton-area Men Stole Nearly \$1.3 million from New Jersey Payroll Company* (Oct. 24, 2011). Another TPP's bankruptcy left about 1,500 clients with unpaid employment taxes. The Washington Post, *The Culprit Could Be Dead, But Local Tax Case Lives On* (Oct. 13, 2008).

²⁸ Acting upon recommendations in the 2007 Annual Report to Congress, the IRS established a joint task force with TAS to work on third party payer failures in spring 2008. See National Taxpayer Advocate 2007 Annual Report to Congress 337-354 (Most Serious Problem: *Third Party Payers*).

²⁹ IRM 5.1.24, *Field Collecting Procedures, Third-Party Payer Arrangements for Employment Taxes* (Aug. 15, 2012).

³⁰ See IRM 5.7.3.3.3 (July 19, 2012); SB/SE, *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer*, SBSE-05-0711-044 (July 1, 2011). This guidance is consistent with a 2004 legislative recommendation by the National Taxpayer Advocate. See National Taxpayer Advocate 2004 Annual Report to Congress 394-399.

³¹ As stated above, the process to designate an agent under IRC § 3504 is voluntary, and some TPPs, e.g., PEOs, do not take advantage of the process because they consider and represent themselves to be employers.

EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate recommends closing loopholes in the tax law that a few “bad actors” in the payroll industry use to harm others. The recommendations protect both the government’s and taxpayers’ interests in preventing employment tax misappropriation and increasing compliance.

Currently, the IRS and the courts determine who is liable for withholding, paying, and reporting federal employment taxes generally based on the identification of the common-law employer.³² Except for agents with an approved Form 2678, TPPs are not jointly and severally liable for employment taxes and applicable penalties under any provision of the IRC, including § 3504. The IRS lacks statutory authority to require bonding of TPPs.

While the IRS has taken several steps to regulate agents with an approved Form 2678 and Reporting Agents, it lacks authority to protect the public fisc and the affected employers from risks posed by PEOs and PSPs.³³ For example, even though the IRS created Schedule R for Forms 941 and 940 (Employer’s Annual Federal Unemployment (FUTA) Tax Return) to track and cross-reference employer-agent relationships, it lacks statutory authority to penalize noncompliant agents with an approved Form 2678.³⁴

Requiring bonding for any person who enters into an agreement with an employer to collect, report, and pay any employment taxes would protect the government and employers from TPP misappropriation.³⁵ The IRS should be given broad regulatory authority to exempt certain TPP arrangements, such as those involving Reporting Agents or agents with an approved Form 2678 described above, from the bonding requirement. The National Taxpayer Advocate recommends that Congress authorize the IRS to impose monetary penalties on TPPs for failure to obtain adequate bonding.³⁶

In addition, requiring agents with an approved Form 2678 to file a form with the IRS that allocates reported and paid employment taxes among their client employers, and subjecting noncompliant agents to penalty for failure to file, will minimize the risk of TPP misappropriation.

³² The courts are reluctant to hold the third party payers jointly and severally liable for embezzled payroll taxes because it is “not a corporate officer or in a position of authority” and does “not have final control over [the employer’s] taxpaying duties.” *Pediatric Affiliates, P.A. v. United States*, 2006-1 U.S.T.C. (CCH) ¶ 50,201 (D.N.J. 2006).

³³ See Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Payroll Service Provider Failures and Increase Employment Tax Compliance*, *supra*.

³⁴ Only agents of home care service recipients authorized under IRC § 3504 may file an aggregate Form 940. See Rev. Proc. 80-4, 1980-1 C.B. 581; Notice 2003-70, 2003-43 I.R.B. 916; IRM 21.7.3.4.6 (Jan. 24, 2011).

³⁵ For example, federal law requires performance bonds for contractors participating in federal construction projects. Such bonds must specifically guarantee payment of federal payroll taxes. See generally 40 U.S.C. § 3131(c)(1).

³⁶ The Secretary may also be authorized to waive the bonding requirement for payroll agents that meet certain high standards, e.g., maintaining adequate reserves or depositing withheld payroll taxes via the Electronic Federal Tax Payment System (EFTPS) or another electronic system.

Finally, the proposal to amend 11 U.S.C. § 523(a) to specifically provide that IRC § 6672 penalties are not discharged in bankruptcy with respect to non-individual responsible persons will expand the reach of victims to corporate assets of the failed TPP. This clarification would further protect taxpayers that use TPPs that fail to pay over taxes to the IRS and then declare bankruptcy.³⁷

³⁷ This legislative change would not provide relief to the employer for its share of unpaid tax due to a TPP misappropriation or bankruptcy.