

NATIONAL PAYROLL REPORTING CONSORTIUM, INC.

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PAYCHEX, INC • PAYROLL PEOPLE, INC • PRIMEPAY, INC • PROBUSINESS SERVICES, INC
PO Box 850 HENRIETTA, NY 14467-0850
WWW.NPRC-INC.ORG¹

How Should Payroll Service Providers Be Regulated? **Background and Issues Related to the Maine Proposal LD 1843**

Payroll service providers serve a critical role in our nation's tax collection system facilitating accurate and timely tax payments from employers to federal, state and local tax authorities. They provide payroll and employment tax administration services for a large percentage of this nation's employers and transmit over \$500 Billion in employment and income taxes to the federal government annually, representing roughly one-third of all such taxes paid each year. Services provided generally include filing quarterly employment tax returns, depositing income tax withholding and other payroll-related taxes, and filing quarterly wage reports and annual W-2 reports to the applicable federal, state and municipal agencies.

Periodically over the years, rare instances of the failure of a small payroll service provider and related failure to transmit client tax funds has prompted state or Federal policymakers to propose safeguard measures for payroll service providers. The intent of such proposals has been to protect employer-clients from the risk that an employer will incur tax liabilities because its defaulting service provider has collected tax funds from the employer but has not transmitted such funds to state and Federal tax authorities.

The National Payroll Reporting Consortium is sympathetic to the plight of affected businesses, and recognizes the potentially devastating effect of such losses. NPRC applauds state lawmakers for their proactive efforts to protect businesses and prevent these types of incidents. However, the issues should be considered within the overall context of an industry in which 99.99% of clients do not suffer any losses, but rather benefit significantly from the specialized knowledge and sophisticated systems that payroll service providers employ to administer employment taxes.

Today, almost 20% of employers (over one million), covering one-third of the private sector work force, outsource payroll and payroll tax administration to a NPRC member. Payroll and tax administration are among the most heavily regulated and complex U.S. business activities, and the ability to outsource payroll and tax administration frees business owners to concentrate on improving their businesses².

¹ The National Payroll Reporting Consortium (NPRC) is a non-profit trade association whose member organizations provide payroll processing and related services to over one million employers nationwide, covering over one-third of the private sector work force. NPRC members file and pay employment taxes in every state.

² See appendix I for a description of typical services performed by payroll services.

There are several safeguard measures that could be implemented that would help prevent the relatively few incidents of small payroll service providers failing to transmit tax obligations. One proposal, however, that has periodically been suggested -- requiring payroll service providers to post a bond to insure against default of the obligation to transmit client funds -- may not achieve this result, and could in fact increase the risk to employers by providing a false sense of security.

Background on the Payroll Service Industry and Safety of Client Funds

In the late 1970's, improvements in financial and computer systems sparked a period of significant growth in the payroll service industry. Service offerings were expanded to include automatic depositing and filing of employment taxes, initiation of payroll direct deposits and other payments and reports. These new services simplified payroll administration for employers, who were able to rely on highly specialized payroll service firms to administer the payment and reporting of payroll and tax obligations. The industry is dominated by a handful of service providers that each serve thousands of employer-clients, but there are also hundreds of smaller service providers with smaller client bases.

Despite having access to client payroll and tax funds, incidents of misappropriation or mishandling of payroll funds by payroll service providers have been remarkably rare. The vast majority of payrolls that are processed through such service providers are conducted by large and financially stable publicly held corporations that are already subject to outside audit and oversight by the SEC and other regulatory bodies. These are businesses with secure financial foundations and with expectations of maintaining and expanding their business base over the long-term. Clearly, each payroll service provider would rapidly lose their business reputation and their client base if their clients suffered losses due to mismanagement or malfeasance by the payroll service provider. The fact is that these businesses have operated successfully and professionally while transmitting billions of tax dollars from their clients to state and federal tax authorities. More than one million employers, covering over one-third of private sector employment, rely on payroll service providers to help them comply with payroll and employment tax rules.

Profile of Payroll Service Misappropriations

Over the past ten years, there have been nine publicized incidents in which a payroll service provider³ failed to pay employment taxes to the IRS and state tax authorities. It is

³ Defined as service providers that present themselves as being primarily in the business of providing payroll and payroll-related services to employers. This excludes the thousands of small bookkeeping and accounting services that administer payroll for fewer than 25 clients as part of a broad range of accounting, tax and other business services. No information is available as to the incidence of failures or fraud involving such firms, but the IRS estimates that there may be five or six incidents annually, each involving a small number of clients. The definition also excludes Professional Employer Organizations (PEOs), also known as employee leasing firms, which assume the position of employer for clients' employees in administering health and other benefits, retirement plans, workers compensation, payroll and employment taxes. For more background on PEOs, see www.NAPEO.org.

estimated that the nine incidents affected a total of 1,300 employers, who suffered aggregate losses of \$42 million, or \$32,000 each.

Each of the nine incidents was perpetrated by a small service provider, often a bookkeeping service that expanded into payroll preparation. Most involved one or two individuals who were able to act without appropriate accounting safeguards such as separation of duties, which are well established in corporate business environments. Each of nine incidents could have been detected and stopped sooner, both by clients who could have checked the status of their accounts, and by tax authorities who could have reconciled accounts sooner or pursued nonfiling incidents more diligently. Warning signs were also available in many cases; e.g., FirstPay lost their corporate status in 1999, and Harmon-Baert ceased registering as required after 2000.

Each of the nine situations appears to have involved intentional fraud; either underpaying and under-reporting employment tax liability, or ceasing to file any tax payments or reports. Perpetrators often elongated the window of opportunity by changing the employers' addresses with the IRS and state revenue agencies, so that deficiency notices were not received by the businesses.

Statistically, in any given year the chances that a client of a payroll service might be affected by misappropriation or failure of the service provider is roughly *one in 10,000*. In other words, clients and tax authorities have come to expect 99.99% reliability from the industry. The annual amount lost nationwide due to the fraud or failure of a payroll service provider is .00092% (.0000092) of total federal taxes deposited, or less than one cent per thousand dollars deposited to the IRS by payroll services. It is estimated that the annual cost of a bond to protect against losses, if such bonds could be arranged, would be in the ballpark of 1% of the funds to be protected - - a thousand-fold cost increase.

Known Instances of Payroll Service⁴ Malfeasance/Failures in the Past Ten Years

| <u>Year</u> | <u>State</u> | <u>Payroll Service Provider</u> | <u>Clients Affected</u> | <u>Approximate Value (millions)</u> |
|-------------|--------------|---------------------------------|-------------------------|-------------------------------------|
| 1996 | MN | CFS Office Automation | 151 | \$5.7 |
| 1996 | ME | Mainely Payroll | 33 | \$2.5 |
| 1997 | CT | KPM Inc./Compusystems | 100 | \$10.0 |
| 1997 | NY | AAPEX Payroll | 700 | \$10.0 |
| 1999 | CO | Snowmass Village PR Svc | 15 | \$0.4 |
| 2001 | CA | The Payroll Store | 27 | \$0.6 |
| 2002 | KS | Acculine Consulting | | \$1.0 |
| 2003 | MD | FirstPay Inc | 250 | \$11.0 |
| 2003 | ME | Harmon-Baert Assoc | 34 | \$1.1 |
| | | | <u>1,310</u> | <u>\$42.3</u> |

⁴ Companies that operate primarily as a payroll service provider; i.e., excludes bookkeepers, accountants and others whose payroll processing activities are incidental to other core services, and Professional Employer Organizations (PEOs, AKA 'Employee Leasing' companies).

Legislative Responses to Date

In response to two of these incidents, Maine⁵ and Minnesota enacted legislation to guard against misappropriation by payroll service providers. Maine's law included a bonding requirement, but its effect on the safety of client funds is uncertain because it was not enforced. In December 2003, another small payroll service in Maine was found not to have paid payroll taxes for some 34 clients. The Maine Tax Assessor, which implemented the 1997 law regulating payroll services, noted that the agency did not actively enforce the law. The payroll processor in question had not registered with the agency since 2000, and had not submitted proof of bond or insurance as required.

The Problem with Bonding Proposals

Proposals to require payroll service companies to post a small bond may appear harmless, but these requirements generally provide a false sense of security to employers without providing true protection. Most bonding proposals would require a bond for either a net amount applicable to all providers -- regardless of their relative size, or for a variable amount based on total client tax liability of the particular provider with a ceiling on the total amount of the bond that could be required. The problem with such initiatives is that if required bond amounts are large enough to cover client tax liabilities, they would be prohibitively expensive. If the bond were too small, however, these requirements would not result in any true protection for employer-clients and could actually provide inexpensive opportunities for marginally solvent service providers, or even criminals with intent to defraud customers, to create a false impression of government oversight and government financial backing.

Further, bonding requirements could provide employers with the false impression that tax payments made through payroll service providers are fully insured or even backed by the state or federal government. The terms "Bond", "Bonded", licensed, registered, etc., are rarely explained and poorly understood, yet are very powerful assurances that would certainly be emphasized to gain the confidence of employers. Advertisements and storefront banners could emphasize claims such as "Registered and bonded as an approved Payroll Service Provider." Service providers may even interpret or explain these terms verbally with the implication of government financial backing (e.g., "similar to the FDIC for banks"). Thus, while trying to provide greater stability to a mature and reputable industry, such bonding proposals might result in more unstable newcomers entering the business and less security for employer tax funds.

What Would The Proposed Bond Requirement Cost?

A broad bonding requirement would have the undesired effect of making payroll services infeasible for Maine employers. The proposed bond, if defined as ALL payroll processed by a

⁵ See Appendix II for a summary of the elements of the Maine enactments

payroll service, not just Maine wages⁶, would necessitate the posting of bonds totaling roughly two ***Trillion*** dollars, which would cost about ***\$20 Billion*** annually.

If the definition is clarified to relate to the employment taxes of Maine employees⁷ only, the aggregate of required bonds would exceed \$6.7 Billion, and would cost \$67 million annually, or nearly \$8,000 per Maine employer (that used a payroll service). The required coverage could be further reduced to equal the tax liability for one year rather than four, but even then, the cost would be nearly \$2,000 annually, and the result would be that few Maine employers could afford to hire a payroll service to administer their employment taxes.

As an example, if a Maine employer paid Maine's average weekly wage of \$566⁸ to ten employees who were married and claimed 2 withholding allowances, his total annual federal and state employment tax payments would be \$76,304, and the annual cost to provide a bond would be about \$763 (assuming the bond covered total taxes incurred for one year). For 25 employees, the total tax would be \$190,759 and the cost of the bond would approach \$2,000 a year.

Any significant bonding requirement for payroll services providers would inevitably cause them to incur additional costs that would be passed on to clients. Such increased costs would raise the barriers to entry and shift the economics of the industry, thereby reducing the competition that maintains a balanced market for affordable payroll services. Of course, the cost of any bond would reflect the credit-worthiness of the payroll service organization to be bonded. The differential cost (e.g., 2% or 3%) reflecting the additional risk related to small payroll processors would effectively drive them out of the business in Maine.

In addition, increased cost of payroll services would lead more employers to administer payroll and employment taxes internally, imposing additional administrative burdens on employers and increasing compliance error rates. Such reduced use of payroll service providers by employers would negatively impact government tax collection. Because payroll service providers invest in sophisticated systems to ensure timely and accurate employment tax deposits, according to the IRS they are about fifteen times more accurate in tax filings than self-reporting employers, and incur far fewer penalties than employers as a whole. In addition, payroll service providers stay attuned to the latest IRS and state requirements. Many business owners are unaware of recent dramatic growth in electronic tax filing mandates, and may be unprepared to comply without the assistance of a payroll service provider. For example, the IRS and most states now require employment taxes to be paid and reported electronically, in diverse and often-changing formats.

Time Period Covered by a Bond

⁶ "Q: I perform payroll processing activities in multiple states. Do I calculate the highest weekly payroll on my Maine clients only, or do I include the payroll of all of my clients nation wide? A: You must use the highest weekly payroll of ALL your clients for whom you process payroll" ...<http://www.state.me.us/revenue/incomeestate/payroll.htm#3>

⁷ Assuming annual Maine wages of \$17 Billion (Bureau of Labor Statistics, December 2003), a total tax rate of 30%; that one-third of employment taxes are remitted by payroll processors, and a bond cost estimate of one percent. More than twelve thousand of Maine's 39,000 employers rely on a payroll service to administer employment taxes.

⁸ BLS, December 2003

The time period to be covered would largely define the cost of any solution. Payroll Service Providers often administer many types of payments arising from payroll administration, including net payroll check amounts to employees, tax withholding, employer taxes, garnishments, insurance and retirement plan deductions and so on. Is it necessary to protect each of these against loss? The answer depends on the systems in place to detect funding shortfalls; for example, employees will immediately notify their employer if 100% of their funds are not received on pay date. On the other hand, because of the reconciliation processes used by the tax authorities for withholding taxes, it is conceivable that losses resulting from an intentional fraud could continue for two or three years without detection.

The Window of Opportunity for Malfeasance is Limited, and Justice is Certain

Existing IRS and state revenue department reconciliation processes should ensure that non-payment and underpayment schemes are detected within two years, which should be apparent to anyone in the business. Federal and state agencies reconcile income tax withholding payments and reports to annual withholding filings (usually copies of W-2s), in order to detect any imbalances. However, this reconciliation takes place after February 28th of the year following the tax year, which is the date by which employers must file copies of all Forms W-2 issued to employees.

In Maine, it was reported that as many as 34 businesses may have had shortfalls or even no tax payments made on their behalf for as much as four years. This seems unlikely, since Maine businesses report tax withholding for each employee and reconcile on a quarterly basis. If the tax agency reconciled employer accounts quarterly and followed up on any non-filing by previously active employers, the longest any employer or service provider should be able to hide underpayments should be one year. (By which time a comparison of employer-reported withholding to taxes withheld according to the related individual income tax returns and W-2s would show a difference.) It is possible that the IRS did not fully reconcile employer withholding accounts during the approximate time period of the alleged Harmon-Baert incident, according to a recent report by the U.S. Treasury Inspector General for Tax Administration⁹.

Policymakers can expect businesses to use ordinary and prudent business care to protect themselves. Businesses can also be prompted to take action through required disclosure statements. For example, a required disclosure could state that businesses remain liable for taxes, and recommend that the client periodically confirm that taxes are being paid. Disclosure statements can describe how to check with the tax authority directly, in order to reduce the time period in which clients are exposed to losses.

Existing Criminal and Civil Laws Protect Businesses

Appropriate criminal and civil provisions already exist in every state to protect employers against fraud and breach of contract committed by payroll service companies. In cases involving fraudulent diversion of client funds, appropriate criminal and civil charges, including restitution, have been brought against perpetrating individuals. Almost every perpetrator was imprisoned.

⁹ A Reliable Management Information System is Needed Before Making Funding Decisions to Address Underreporting of Taxes on Employer's Quarterly Tax Returns; TIGTA Report 2003-30-175, September 2003

The individual involved in the most recent alleged fraud in Maine faces a twenty-year prison sentence, fines of \$250,000 per incident and restitution. In terms of preventing fraudulent diversion of client funds, other potential regulatory measures (e.g., registration, audit, prohibited actions, etc.) would have relatively little effect in comparison to the deterrent effect of the prospect of imprisonment. One alternative for state policymakers would be to increase the degree of specified crimes, as Maine¹⁰ did in 1997. The failure of a payroll services provider to perform would also be a breach of contract.

The Degree of Government Oversight Must Be Clear

Mandatory registration of payroll service providers may discourage such providers from wrongful actions, and may discourage individuals with criminal histories from registering. However, like bonding and other government oversight, even a simple registration requirement can be misleading to businesses, who are likely to see only banners and advertisements such as “Approved by the state of Maine as a registered Payroll Tax Filing Service Provider”. Businesses may assume, or may be led to believe, that the state has enforced strict criteria for qualifications and testing to achieve the approval and endorsement of the government. They may assume that a state or federal agency insures or otherwise guarantees funds held by a “registered” service provider.

In addition, there are few appropriate models by which tax authorities could regulate payroll service organizations. The model¹¹ used by the IRS to establish the qualifications and testing of attorneys, Enrolled Agents and CPAs would not apply to payroll service providers. Only two states (CA & OR) even regulate income tax return preparers, with unclear results. (The IRS does not regulate tax return preparers at all.) Unlike almost any other category of tax professionals, Payroll Services do not advise clients. Payroll Service providers employ highly automated, highly specialized systems to perform the ministerial tasks of reporting and paying the payroll funds and information resulting from client interpretations. Payroll services personnel do not rely upon specialists to apply advanced training, judgment or discretion; e.g., in determining whether a worker is an employee or an independent contractor, whether a payment represents taxable compensation or an expense reimbursement, or whether a particular transaction should be treated as an Incentive Stock Option, or a Nonqualified Stock Option.

It may be appropriate to establish certain qualifications for handling client funds, such as capitalization requirements. An agency can also require audited financial statements annually, or may conduct audits. Each action taken, however, increases the responsibility and liability for the state in identifying potential problems. As discussed more fully below, there are a number of measures that could be implemented to enhance the security of employer tax funds paid through payroll service providers that would be more effective than bonding requirements. In any event, it is important that businesses understand what any registration or other requirement means, and to what extent they can rely on the state to evaluate service providers.

The Maine Revenue Services Agency is in the Best Position to Monitor Payroll Services

¹⁰ MRSA §362, sub-§6

¹¹ E.g., IRS Circular 230, Regulations Governing the Practice of Attorneys, CPAs...

The Maine Revenue Services agency is in far better position to monitor payroll service providers than the Department of Professional and Financial Regulation. The Revenue Services agency receives withholding tax payments, tax reconciliation reports and quarterly and annual wage filings directly from payroll service providers and can detect significant changes. In addition, payroll processors already provide monthly client lists to the agency and interact frequently.

In addition, the IRS is actively working to strengthen existing Federal regulations¹² affecting payroll service providers, such as requirements to register, to report client information and enhancements to suspension provisions. The Maine Revenue Services agency already coordinates a number of compliance and other matters with the IRS, and could work with the IRS to improve the safety of payroll processing for Maine employers without assuming all of the related costs.

Safeguards That Do Make Sense

Maine already has laws regulating payroll service providers, but important elements of the law were not enforced. Enforcement and other administrative changes might have prevented the Harmon-Baert incident, and may prevent future incidents. Enhancing the stability of the payroll service provider industry would benefit the state and federal tax agencies, the clients of the industry and the industry itself. There are a number of safeguards that can be implemented:

- The existing registration requirement should be enforced.
- It may be appropriate to increase the penalty for failure to register, e.g., from the current range of \$500 to \$2,500, to a range of \$1,000 to \$5,000.
- The responsible agency should maintain a publicly accessible list of registered payroll service providers on their website, and alert employers periodically to deal only with registered payroll service providers. A website listing would be “self-enforcing”, since any payroll processor that was not on the list would quickly lose clients.
- Maine Revenue Services should make available systems to enable employers to easily monitor their tax account via secure Internet site, as the IRS does via their federal tax payment website, www.EFTPS.gov. Providing a means to easily monitor payroll service performance, and educating the business community as to its availability, would assist clients in safeguarding business assets.
- The required disclosures to clients should be enhanced to warn employers that they remain liable for employment taxes even if the related funds are transferred to a payroll processor. The disclosure statement should also provide specific instructions on how,

¹² IRS Revenue Procedures 2003-69 and 96-18

and how often, to monitor their tax account. (See appendix III for other possible disclosure elements.)

- Maine Revenue Services should notify taxpayers of all address changes by sending confirmation notices to both the old and new addresses, including a warning not to change a taxpayer address to that of any third party. In some cases, the failure to pay taxes on behalf of client businesses went undetected because the service provider changed the address of the business on the tax authority's records, so that notices from the tax agency were directed to the service provider.
- Lastly, Maine Revenue Services should review its' procedures and timing for reconciling withholding taxes to Quarterly Forms 941/C1-ME and W-2s, to determine if it could be processed sooner or could be enhanced in other ways.

* * *

In sum, payroll service provider bonding proposals, though well intentioned, would increase the cost of payroll services and could enhance the risk to employers who use payroll service providers by providing a false sense of security. In lieu of bonding requirements, there are alternative measures, including requiring increased information disclosure by payroll providers, enhancing employer access to their tax account information and educating employers as to the importance of choosing a reliable payroll service provider, that would achieve the desired effect of enhancing the security of tax funds paid through service providers, without the associated negative aspects of bonding proposals.

Appendix I

Overview: Employment Tax Administrative Tasks Performed by Payroll Services

Payroll Service organizations provide a variety of payroll and employment tax administration services for employers, such as filing quarterly employment tax returns, depositing income tax withholding and other employments taxes, and filing quarterly wage reports and annual W-2 reports to the applicable federal, state and municipal agencies.

As automated payroll systems calculate payrolls, employment taxes and other amounts due for each employee and employer are calculated, documented, funded, scheduled, formatted and remitted to the associated federal, state or local tax authorities with any necessary related information.

The Internal Revenue Service calls such firms Reporting Agents¹³ and maintains the regulations that apply to them:

A Reporting Agent (“Agent”) is an . . . entity authorized to perform one or more of the following on behalf of a taxpayer:

- (1) Prepare and electronically file Form 941, Employer’s Quarterly Federal Tax Return;
- (2) Prepare and use magnetic tape to file Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return . . . and
- (3) Make FTD payments and submit FTD information electronically for the taxes deposited and reported on Forms 940, 941, and 945, and the other returns . . .

Payroll Services are authorized to sign and file employment tax returns, and to receive a copy of notices concerning client accounts, by IRS Form 8655, Reporting Agent Authorization. Not all payroll service providers take responsibility for paying the employment taxes of their clients, and not all of those who do register with the IRS as a Reporting Agent. These are usually small bookkeeping businesses that provide payroll services to a handful of clients as part of their offerings.

Overview of Employment Tax Payment and Reporting Requirements

Federal Tax Payment (Deposit) Requirements

Federal income and Social Security/Medicare taxes must be withheld and deposited based on schedules assigned to each employer by the IRS. These Federal Tax Deposit (FTD) schedules are assigned annually and may change over time, with or without notice from the IRS. Most FTDs must be remitted to the IRS within one to three days of each payroll date. Regardless of the assigned deposit schedule, deposits may be required one day after pay date depending on the cumulative amount of taxes incurred. Large employers must make all tax payments electronically, via the IRS EFTPS system.

Federal employment tax rules are stringently enforced. For example, in 2002, the IRS issued about 8 million penalty notices for employment taxes, assessing \$6.2 Billion in penalty. Eight million notices is more than one penalty notice per U.S. employer, averaging about \$800 per notice. Payroll Service Providers typically assume responsibility for any errors or penalties they may cause, relieving clients from substantial penalty risk. Penalties ranging from 2% to 15% are automatically assessed for FTDs that

¹³ IRS Revenue Procedure 96–17; Section 4. Definitions - .01 Reporting Agent.

are remitted late, based on the degree of lateness. In addition, for large employers who are required to remit employment taxes electronically, ten-percent penalties apply for payments made by check.

Federal Employment Tax Returns

Employers must generally file Form 941, Employer's Quarterly Federal Tax Return; and Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, to the IRS.

In addition, Forms W-2, Wage and Tax Statement, and Form W-3, Transmittal of Wage and Tax Statements, must be filed annually with the Social Security Administration. Forms W-2 are IRS Information Returns, which are subject to stringent regulations defining format and content, and which must be provided to each employee by January 31. Electronic filing of Forms W-2/W-3 (and W-2C, which are corrections to Forms W-2) is required for more than 250 forms. The IRS and SSA jointly publish detailed requirements for the timing, content and format electronically filed W-2s.

State Income Tax Withholding Payments and Reports

State income taxes withheld and other payroll-related taxes must be deposited to the applicable state agencies in accordance with a variety of state schedules and formats. Most states require employers to make periodic deposits (i.e., weekly, semiweekly); to file quarterly and annual reconciliation tax reports, and to file annual W-2 reports. Large employers must typically make all tax payments electronically, in accordance with each state's rules and electronic reporting formats, and file all W-2 reconciliation tax reports electronically, using another state-defined reporting format. Failure to pay or file electronically typically incurs a penalty of 10% of the amount due, even if funds were paid and reported on time.

Municipal Income Tax Withholding Payments and Reports

Many municipalities levy an income tax, and require employers to withhold and report the taxes withheld. Some local income taxes are collected by the state (e.g., IN, MD), while others (e.g., KY, OH, PA) are collected by the municipalities or by professional tax collection agencies. These municipalities have their own rules for the timing, form and content of tax payments and reports. Like the IRS and states, municipalities typically also require employers to file a copy of any Forms W-2 for employee who may be subject to the municipal income tax.

State Unemployment Insurance Taxes And Quarterly Wage Reports.

In accordance with the 1935 Social Security Act, each state requires employers to pay quarterly unemployment insurance contributions, based on calculated tax rates, which vary for each employer and change annually, and on state definitions of "wages subject to contributions".

Each state also requires employers to file detailed reports of wages paid to each employee on a quarterly basis. Almost all states require large employers to file such wage reports electronically, using a state-defined reporting format similar to the format used for W-2 reports.

A Note on Electronic Filing

Many employers are also required by law to make all tax payments electronically, and different federal, state and local rules, thresholds and electronic reporting formats often apply. Failure to pay electronically typically means a penalty of 10% of the amount due, even if funds were paid on time. Payroll Services generally report all such information electronically without regard to any mandate, for improved efficiency and accuracy.

Other Payroll Related Administrative Tasks Performed by Payroll Services

New Hire Reporting

In accordance with the 1996 PRWORA (Welfare Reform) Act, each state requires employers to report newly hired employees to a designated state child support agency within 20 days of hiring a new employee. Reports are accepted in a variety of formats.

Garnishments

On average, about one in ten employees has a withholding order, such as child support or an IRS tax garnishment. Employers must comply with federal, state and local requirements on payment due dates, forms of payment, information required and procedures. Some payroll service providers administer such withholding orders, often improving the system by paying electronically, which improves government efficiency and hastens the receipt of needed funds by families.

Correspondence and Problem Resolution

Payroll Services usually also handle any related correspondence with government authorities regarding the payments and filings submitted by the Payroll Service. Payroll Services generally assume responsibility for any penalties incurred by the Payroll Service. Importantly, most large payroll service organizations do not change the address of clients with the applicable tax authorities, so that clients remain aware of the status of their tax accounts.

Pre-filing Validation

Payroll Services often verify important client information before filing any returns or making payments, in order to ensure that any electronically filed returns and payments will post correctly to clients' accounts. In addition, clients expect that Payroll Services will determine required deposit schedules, tax rates, reporting requirements and format of payments and reports, which vary from client to client and change over time. For this reason, Payroll Services interact with tax authorities to periodically confirm each client's reporting obligations.

Appendix II

Summary of Maine Existing Law: Excerpts from Chapter 222: PAYROLL PROCESSORS

§1495-A. Registration required

1. Generally. A payroll processor that conducts business in this State must register annually with the State Tax Assessor by January 30th

2. Information required. . . . the name and mailing address of the payroll processor, the physical locations where payroll processing services are performed, a list of the services performed and any other information the State Tax Assessor determines to be necessary.

3. Proof of liability insurance. Each registrant shall provide . . . proof of one of the following, at the registrant's option, in an amount 2 times the highest weekly payroll processed by the registrant in the preceding year or \$5,000,000, whichever is less: Fidelity bond; employee dishonesty bond; third-party fidelity coverage; or liability insurance, including crime coverage

§1495-B. Disclosure to employers

1. Generally. . . . a payroll processor shall provide a disclosure statement at the time of contracting and by September 1st of each even-numbered year to each employer. The statement . . . must include . . . :

A. The length of time in which the payroll processor has been in the business of providing payroll processing services; and

B. . . . whether any payroll processing services are contracted out and, if so, . . . to whom.

§1495-C. Penalties

1. Civil violations.

A. A payroll processor that fails to provide the disclosure statement . . . not less than \$50 nor more than \$250 may be adjudged. Each failure to notify a particular client constitutes a separate violation . . .

B. A payroll processor that . . . fails to register with the State Tax Assessor . . . a penalty of not less than \$500 nor more than \$2,500 may be adjudged.

2. Criminal violations. A payroll processor is a fiduciary for purposes of Title 17-A, section 903.

17-A MRSA §362, sub-§6

Theft by . . . a payroll processor . . . is classified one step higher than it would otherwise be classified under this section based upon the value of property or services involved, except that the offense may not be classified as a Class A crime.

36 MRSA §112, sub-§1

General powers and duties. The State Tax Assessor shall administer and enforce the tax laws enacted under this Title and under Title 29-A, and may adopt rules and require such information to be reported as necessary. The assessor may investigate, enforce and prosecute activities defined as crimes in this Title and in Title 17-A, sections 358, 751 and 903. . . .

36 MRSA §112, sub-§4

Examination of records and premises. The State Tax Assessor may make an examination or investigation of the place of business, books and other documents of a payroll processor.

36 MRSA §5255-A

The State Tax Assessor may enjoin from doing business any payroll processor . . . that is responsible for truthfully accounting for, or paying over or making returns of, the tax imposed by Part 8 and fails to do so.

Appendix III
Possible Elements for Expanded Payroll Service Provider Disclosure Statements

Payroll Service providers must furnish a disclosure statement to all prospective clients prior to the time of contracting, and to all existing clients within 180 days of the effective date of this Act. The disclosure statement must include the following certifications:

- That the service provider has complied with all requirements under this subsection, and is registered and in good standing with the Department of Revenue Services as a payroll processing company.
- That the service provider is in good standing with applicable federal, state and local tax authorities with respect to their own tax obligations, and that all taxes have been paid and reported as required.
- That the service provider is in good standing with the Secretary of [State/Corporations]
- Whether the service provider is required to comply with the Sarbanes-Oxley Act of 2002, and if so, whether the service provider has on file and can provide to clients upon request:
 - ___ SAS 70 Type I reports, which document the organization's control environment
 - ___ SAS 70 Type II reports, which document the organization's control environment and test the controls.
- Whether the service provider is a publicly held corporation subject to the regulations of the U.S. Securities and Exchange Commission (SEC)
- Whether audited financial statements are available
- The length of time that the firm has been in business as a payroll tax filing service provider.
- Whether the payroll processor has declared bankruptcy in the past seven years.
- Whether the payroll processor subcontracts any payroll processing services, and if so, to whom

NOTICES FOR EMPLOYERS:

- (i) Be aware that you, as the taxpayer, will remain responsible and liable for the timely and accurate payment of all taxes and other obligations, even though you may have paid the corresponding funds to a payroll tax filing service provider.
- (ii) No state or federal agency monitors or assumes any responsibility for the financial solvency of payroll tax filing service providers.

SAFEGUARDS FOR EMPLOYERS:

- (i) Ensure that your Employer Identification Number is established with an address at which you will receive notices from the IRS and State tax agencies. Do not allow any service provider to register a change of address for your organization with any tax authority! You may be unaware of important correspondence from the tax authority that may identify a problem.
- (ii) Enroll in the IRS Electronic Federal Tax Payments System (EFTPS), at www.EFTPS.gov, and the corresponding State Department of Revenue systems, so that you can periodically confirm with the IRS, Department of Revenue, and other agencies to ensure that payments and returns are being filed in a timely manner. If you do not have Internet access, periodically call the IRS at (800) 776-1040, and the Department of Revenue at _____ to confirm that payments and returns are being filed in a timely manner.
- (iii) Check the credit rating of any potential service provider, and insist on high credit-worthiness scores. This is just common sense - - your organization may be entrusting the service provider with substantial sums.