



*Processes Are Needed to Link Third-Party
Payers and Employers to Reduce Risks
Related to Employment Tax Fraud*

March 2, 2015

Reference Number: 2015-40-023

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



HIGHLIGHTS

PROCESSES ARE NEEDED TO LINK THIRD-PARTY PAYERS AND EMPLOYERS TO REDUCE RISKS RELATED TO EMPLOYMENT TAX FRAUD

Highlights

Final Report issued on March 2, 2015

Highlights of Reference Number: 2015-40-023 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed Division and the Wage and Investment Division.

IMPACT ON TAXPAYERS

Employers can appoint or enter into an agreement with a third party to take over some or all of the employer's Federal employment tax withholding, tax return preparation, reporting, and tax payment responsibilities. Approximately 40 percent of small firms use a third-party payer for tasks ranging from paying employees to Federal employment taxes. There are four common types of third-party payer arrangements: Payroll Service Provider (PSP), Reporting Agent, Section 3504 Agent, and Professional Employer Organization (PEO).

WHY TIGTA DID THE AUDIT

Third-party payer arrangements usually work as intended; however, there have been instances in which third-party payers receive funds from employers for payment of payroll taxes, but they have not remitted those taxes to the IRS. This causes significant problems for employers because the funds have been expended but the taxes are still due. TIGTA evaluated whether controls are adequate to protect the taxpayer's and Government's interests when third-party payroll providers are not compliant with payment and filing requirements.

WHAT TIGTA FOUND

Processes still have not been established to link employers with all third-party payers. Of the four most common types of third-party payer arrangements, only Reporting Agents and Section 3504 Agents are required to submit an authorization form that discloses the relationship

between an employer and a third-party payer. The IRS does not require a similar authorization for employers that use a PSP or a PEO. The inability of the IRS to identify employers that use the services of a PEO is a concern TIGTA raised in prior reports.

In addition, authorization forms are not always accurately processed. Our review of 85 agent authorization forms processed in Calendar Year 2013 identified 11 forms with errors. Because of these errors, authorizations provided by employers to their Reporting Agents were incorrectly reflected in IRS systems.

Finally, the IRS has not established an effective process to ensure that indicators are accurately assigned to Section 3504 Agent and employer tax accounts. Our review of the tax accounts associated with Section 3504 Agents filing 78 Forms 2678, *Employer/Payer Appointment of Agent*, identified 13 that contained erroneous indicators. The errors incorrectly identified Section 3504 Agents as employers and vice versa.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS partner with the Bureau of the Fiscal Service to develop a plan to use the Electronic Federal Tax Payment System[®] to link a PSP with an employer; establish a program in which employers can inform the IRS of the PEOs they authorize to file and pay employment taxes; require those PEOs with a service agreement to attach a Schedule R (Form 941), *Allocation Schedule for Aggregate Form 941 Filers*, to employment tax returns; and, develop processes and procedures to ensure authorization information and Section 3504 Agent indicators are accurate.

The IRS agreed with three of TIGTA's five recommendations and partially agreed with two. The IRS is working on establishing the voluntary certification program for PEOs that was enacted into law in December 2014. While the voluntary certification program will link PEOs that certify to employers, it will have no effect on PEOs that do not certify. The IRS will continue to be unable to readily identify noncompliance with payment and filing requirements on the part of these non-certifying PEOs.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 2, 2015

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Processes Are Needed to Link Third-Party Payers
and Employers to Reduce Risks Related to Employment Tax Fraud
(Audit # 201340024)

This report presents the results of our review to determine whether controls are adequate to protect the taxpayer's and Government's interests when third-party payroll providers are not compliant with payment and filing requirements. This audit was included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VII.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Russell P. Martin, Acting Assistant Inspector General for Audit (Returns Processing and Account Services).



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Abbreviations

BRTF	Business Return Transaction File
EFTPS	Electronic Federal Tax Payment System®
EIN	Employer Identification Number
IRS	Internal Revenue Service
PEO	Professional Employer Organization
PSP	Payroll Service Provider
RAF	Reporting Agents File
TIGTA	Treasury Inspector General for Tax Administration



Processes Are Needed to Link Third-Party Payers and Employers to Reduce Risks Related to Employment Tax Fraud

Background

Employers are generally required by law to withhold employment taxes from wages paid to their employees and to report and submit the taxes withheld. Employment tax includes Federal income tax, Social Security and Medicare tax, and Federal unemployment taxes. An employer reports Federal taxes to the Internal Revenue Service (IRS) on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*; Form 941, *Employer's QUARTERLY Federal Tax Return*; Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*; or Form 944, *Employer's ANNUAL Federal Tax Return*. Employers¹ can appoint or enter into an agreement with a third party to take over some or all of the employer's Federal employment tax withholding, tax return preparation, reporting, and tax payment responsibilities. A survey completed by the National Small Business Association² found that approximately 40 percent of small firms³ use a third-party payer for tasks ranging from paying employees to Federal employment taxes. There are four types of third-party payer arrangements that are the most common:⁴

- **Payroll Service Provider (PSP)** – A PSP typically prepares employment tax returns for signature by the employer and processes the withholding, deposit, and payment of associated employment taxes. An employer's use of a PSP does not relieve the employer from its responsibility of ensuring that all of its Federal employment tax responsibilities are met.
- **Reporting Agent** – A Reporting Agent is a type of PSP. An employer and a third party file Form 8655,⁵ *Reporting Agent Authorization*, with the IRS to designate a PSP as a Reporting Agent. An employer may authorize a Reporting Agent to sign and file certain tax returns. The Reporting Agent files separate employment tax returns for each employer and may also deposit and pay taxes on the employer's behalf.

¹ For the purpose of this report, we will use the term “employer” to designate the client or business being represented by the third-party payer.

² National Small Business Association, *2012 Small Business Taxation Survey* (Apr. 2012). The National Small Business Association is a national nonprofit membership organization representing all sectors and industries of the U.S. economy from retail to trade to technology and advocates on their behalf before the Executive Branch, the Small Business Administration, Congress, and State regulatory and legislative bodies.

³ Small firms are independently owned and operated, and depending on the industry, size standard is based on the average number of employees for the preceding 12 months or on sales volume averaged over a three-year period.

⁴ The Internal Revenue Manual defines other third-party arrangements to include Temporary Staffing Service; Section 3401(d)(1) Employer; and Section 3505 Lender, Surety, or Other Person.

⁵ Form 8655 can be transmitted to the IRS electronically or via paper, fax, or mail. See Appendix IV.



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- **Section 3504 Agent** – An employer and a third party file Form 2678,⁶ *Employer/Payer Appointment of Agent*, with the IRS to authorize the third party as a Section 3504 Agent of the employer. Under Section 3504⁷ of the Internal Revenue Code, an agent performs acts such as withholding, reporting, and paying of employment taxes.
- **Professional Employer Organization (PEO)** – A PEO, sometimes referred to as an employee leasing organization, enters into an agreement with an employer to perform some or all of the employment tax withholding, reporting, and payment activities related to workers performing services for the employer.

Figure 1 provides roles and responsibilities for third-party payer arrangements.

Figure 1: Third-Party Payer Arrangements Roles and Responsibilities

Third-Party Payer Arrangement	Filing Employment Tax Return	Paying Employment Tax	Who is Liable? - Filing and Payment of Tax
PSP	Return signed by the employer and filed under the employer's Employer Identification Number (EIN).	Tax paid under the employer's EIN.	Employer is solely liable for timely filing and payment of tax.
Reporting Agent	Return is signed by the Reporting Agent and filed under the employer's EIN.	Tax paid under the employer's EIN.	Employer is solely liable for timely filing and payment of tax.
Section 3504 Agent	Aggregate return is filed under the Section 3504 Agent's EIN for all employers using the agent.	Aggregate tax paid under the Section 3504 Agent's EIN.	Both the employer and the Section 3504 Agent are liable for timely filing and payment of tax.
PEO	Aggregate return is filed under the PEO's EIN for all employers using the PEO.	Aggregate tax paid under the PEO's EIN.	Employer is solely liable for timely filing and payment of tax. ⁸

Source: Internal Revenue Manual, IRS's Third-Party Arrangement Chart.

⁶ Form 2678 is only available in paper format requiring manual entry of the employer/agent transactions that designate Section 3504 Agent authorization on the Master File. See Appendix V.

⁷ I.R.C. § 3504.

⁸ Use of a PEO does not relieve an employer from its employment tax obligations. A PEO typically does not exhibit the degree of direction and control over workers providing services to the employer and, thus, is not liable for the employment tax liability.



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Figure 2 provides estimates of the number of different types of third-party payers.

Figure 2: Number of Third-Party Payers

Third-Party Payer Arrangement	Number of Third-Party Arrangements
PSP	Number not tracked by the IRS ⁹
Reporting Agent	21,000
Section 3504 Agent	18,047
PEO	700 - 900

Source: IRS Reporting Agents File Project Narrative (Reporting Agents), Treasury Inspector General for Tax Administration (TIGTA) analysis of the IRS's appointed Section 3504 Agents data (3504 Agents), and the National Association of Professional Employer Organizations, as reported on its website (PEOs).

This review was performed at the Cincinnati Submission Processing Center in Cincinnati, Ohio, and the Ogden Submission Processing Center and the Accounts Management function in Ogden, Utah. The review was also performed with information obtained from the Wage and Investment Division Headquarters in Atlanta, Georgia, and the Small Business/Self-Employed Division Headquarters in Lanham, Maryland, during the period August 2013 through September 2014. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

⁹ While the IRS does not track the number of PSPs, a 2012 National Small Business Association survey reported that the PSPs that are members of the National Payroll Reporting Consortium represented 1.4 million employers with more than 35 million employees, exceeding one-third of the private sector workforce.



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Results of Review

Processes Still Have Not Been Established to Link Employers With All Third-Party Payers

Of the four most common types of third-party payer arrangements, the IRS only requires that Reporting Agents and Section 3504 Agents submit an authorization form that discloses the relationship between an employer and a third-party payer. The IRS does not require a similar authorization for employers that use a PSP nor does the IRS track or document the relationships between the PSPs and the employers they represent. The IRS also does not require a PEO to submit an authorization form disclosing the employers for whom it provides tax filing and employment tax payment services.

Although the IRS does not have a way to link employers with a PSP, the risk of an employer not being aware of filing or payment improprieties on the part of the PSP is not as significant as it is for those employers that enter into a relationship with a PEO. For example, when employers use the services of a PSP, their employment taxes are filed and paid under the EIN of the employer. In contrast, employers that use the service of a PEO are not associated with the tax returns and payments that a PEO makes on their behalf. The inability of the IRS to identify employers that use the services of a PEO is a concern we previously raised in September 2007 and September 2011 reports.¹⁰

A targeted outreach strategy was developed to communicate risks related to certain types of third-party payer arrangements

Recognizing the potential risks associated with certain types of third-party payer arrangements, the IRS developed a targeted outreach strategy. This includes conducting outreach sessions with IRS employees and external stakeholders (such as industry groups). Key messages outlined in its communication to employers about third-party payers include:

- Exercising normal business care and prudence in selecting third-party payer arrangements. For example, checking references or the Better Business Bureau.

¹⁰ TIGTA, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* pp.17 – 20 (Sept. 2007) and TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* p. 25 (Sept. 2011).



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- Continuing to remain responsible for ensuring compliance with tax responsibilities, including timely filing of returns and payment of taxes when using the services of a third-party payer.
- Enrolling in the Electronic Federal Tax Payment System (EFTPS)^{®, 11} which can be used to monitor payments made on an employer's behalf. It should be noted that the ability to monitor payments via the EFTPS is only possible for those employers whose payments are submitted using their EIN, *i.e.*, those through PSPs and Reporting Agents.
- Refraining from substituting a third-party payer's address as the employer address of record. When there are issues with a taxpayer's account, the IRS sends correspondence to the employer at the address of record, which is generally the address that posted from the most recently filed tax return. If an employer substitutes the address with the third-party payer address, it will prevent the employer from being informed when issues arise with its tax account, *i.e.*, nonfiling and/or nonpayment of employment taxes.

Processes and procedures are being developed to link employers with a PSP

IRS management explained they are developing processes and procedures to link a PSP to an employer through the EFTPS. The IRS's plan is to develop programming within the EFTPS that will link a PSP to an employer after the enrollment process is successfully completed by the PSP. This information will be verified against the IRS's tax records. Once the employers are verified as legitimate, the PSP will receive approval to use the EFTPS. IRS management explained that they are in the process of submitting this proposal to the Bureau of the Fiscal Service,¹² the owner of the EFTPS. The IRS anticipates sending the proposal by June 15, 2015. However, an implementation date is dependent upon the Bureau of the Fiscal Service's approval, available funding, and other priorities. IRS management believes that once the modifications to the EFTPS are made, this will provide an effective way to link employers to the PSPs.

Deficiencies still remain with the ability to link employers with the PEOs

The IRS is still unable to link employers with the PEOs. Actions taken in response to prior TIGTA reviews have not adequately addressed the risks associated with employers that use the services of a PEO. Prior TIGTA reviews identified concerns with the IRS's inability to identify businesses that use the services of a PEO. For example:

- In September 2007,¹³ we reported that current regulations do not protect employers when

¹¹ A free service for making electronic tax deposits, available online or by telephone, provided by the Department of Treasury. It is quick, secure, and 99.9 percent accurate.

¹² The Bureau of the Fiscal Service was formed from the consolidation of the Financial Management Service and the Bureau of the Public Debt.

¹³ TIGTA, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (Sept. 2007).



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the PEOs default on paying employment taxes. In many States, the PEOs are required to provide a financial instrument to protect the State and the employer against loss. However, the Federal Government currently does not require bonding¹⁴ of the PEOs.

- In September 2011,¹⁵ we again reported that the IRS was unable to identify employers that use the services of a PEO, as well as when employers terminate the use of those services. We recommended that the IRS should track PEO relationships by inputting cross-referenced EINs on the employer business tax accounts.

The previously reported deficiencies still exist. Although IRS management agreed to each of the five following recommendations from our prior reports, to date, actions taken by the IRS have not adequately addressed the deficiencies we reported. Figure 3 provides a summary of the recommendations included in our prior reports, agreed upon corrective action, and the status of corrective actions taken to date.

Figure 3: Summary of TIGTA's Prior Recommendations and the IRS's Corrective Actions Concerning the PEOs

TIGTA, Ref. No. 2007-30-169, Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done (Sept. 2007)		
TIGTA Recommendation	IRS Response	Status of Corrective Action Taken
The IRS should work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal requiring all current and future PEOs to meet the requirements for becoming certified. ¹⁶	The IRS agreed to work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal applicable to the PEOs, including certification and bonding requirements.	The IRS closed this corrective action as completed noting that a legislative proposal was submitted to the Office of Tax Policy in 2008. In February 2008, the Department of Treasury submitted a proposal to set forth standards clarifying when the PEOs can be held liable for employment taxes. In March 2014, regulations were issued which partly addressed this matter.

¹⁴ A three-party agreement that legally binds together a principal who needs the bond, an obligee who requires the bond, and a surety company that sells the bond. The bond guarantees the principal will act in accordance with certain laws. If the principal fails to perform in this manner, the bond will cover resulting damages or losses.

¹⁵ TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (Sept. 2011).

¹⁶ To be certified by the IRS, a PEO would be required to meet certain financial and other standards, including having no criminal record, having no unpaid taxes, and posting a bond up to \$1,000,000 for the payment of employment taxes.



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TIGTA, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (Sept. 2007)

TIGTA Recommendation	IRS Response	Status of Corrective Action Taken
The IRS should work with the Department of the Treasury to explore all options, including use of the revised Form 2678, to establish accurate links between the PEOs and their employers.	The IRS agreed to work with the Department of the Treasury to explore all options to establish accurate links between the PEOs and their employers. This may include use of the revised Form 2678 or a similar form.	The IRS closed this corrective action as completed noting that the Form 2678 was revised and systemic changes were made to link employers to Section 3504 Agents on Form 2678. The IRS initially indicated it would evaluate implementing a schedule that would also link the tax liabilities and deposits of the PEOs and their employers. However, the IRS subsequently stated that the PEOs do not consider themselves as agents and, therefore, are not required to file Form 2678. The IRS noted that even if required, it has no enforcement tool to compel the PEOs to file one.
The IRS should fully implement the proposal that Form 941 require attachment of a specific schedule filed by a PEO that will list every taxpayer on whose behalf the PEO is filing.	The IRS agreed to explore a proposal for the PEOs to list every employer whose wages the organization is reporting. The IRS will work to develop a mechanism requiring this information.	The IRS closed this corrective action as completed noting that a legislative proposal was submitted to require the PEOs to file a schedule that lists employers associated with their aggregate Form 941. However, this proposal has yet to be enacted.
The IRS should ensure that outreach efforts are adequate to sufficiently inform employers of the potential risks of using a PEO.	The IRS agreed to develop an outreach initiative to small business and industry groups to provide a key message and talking points which address employment tax obligations when the services of a PEO are used.	The IRS completed this recommendation in 2008. The IRS developed a communications plan that informs employers of the risks and responsibilities associated with entering into a third-party payer arrangement. The IRS has conducted outreach sessions with its employees and externally, e.g., the IRS Tax Forum, industry groups, etc.



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TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* p. 25 (Sep. 2011)

TIGTA Recommendation	IRS Response	Status of Corrective Action Taken
The IRS should track PEO relationships by inputting cross-referenced EINs on the employer business tax accounts.	The IRS agreed to revise affected form instructions to require reporting that will closely track relationships between businesses and the PEOs.	The IRS closed this recommendation as completed noting that a cross-referenced EIN line was added to Form 8941, <i>Credit for Small Employer Health Insurance Premiums</i> . However, the IRS is only using this information to track compliance with the PEOs making payments for the credit. No cross-referenced EIN is required for the filing of the employment tax returns.

Source: Analysis of recommendations and corrective actions from prior TIGTA reports.

Legislation would be needed to set forth requirements for PEO certification

IRS management acknowledged that there continue to be challenges with their ability to link employers with the PEOs. Although IRS management previously agreed to take corrective action to address deficiencies identified in our prior reports, the IRS has no authority to require certification of a PEO. The IRS has proposed legislation that provides for joint and several liability¹⁷ of employers and their PEOs.

The IRS noted that each year since Fiscal Year 2007, it has included a legislative proposal in the Department of the Treasury's Greenbook¹⁸ seeking to implement standards clarifying when the PEOs can be held liable for the Federal employment taxes for those employers that use their services. The IRS believes that legislation is needed to define when a PEO is liable for unpaid Federal employment taxes. Members of Congress introduced legislation in July 2011¹⁹ to amend the Internal Revenue Code to clarify the employment tax treatment and reporting of wages paid by the PEOs. This bill was re-introduced in November 2013.²⁰ This latest legislation set forth IRS certification requirements for the PEOs, including financial review and reporting requirements. The proposed legislation also requires a PEO to post a bond each year, up to \$1 million, to guarantee payment of employment taxes. These proposals have not been enacted.

¹⁷ Joint and several liability means that each party is legally responsible for the entire tax liability.

¹⁸ A compilation of revenue proposals.

¹⁹ H.R. 2466, *Small Business Efficiency Act of 2011*.

²⁰ H.R. 3581, *Small Business Efficiency Act*.



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A recently issued Internal Revenue Bulletin provides clarification that both the PEO and the employer are jointly liable for the filing and payment of employment taxes in those situations in which a service agreement²¹ exists. On April 14, 2014, the IRS issued Internal Revenue Bulletin 2014-16, which contained final regulations under Section 3504 of the Internal Revenue Code, *Designation of Payor to Perform Acts Required of an Employer*. The final regulations clarify the employment tax obligations of a third party (payor) when the payor enters into a service agreement with an employer which includes the payor filing returns and paying taxes on behalf of the employer. Under the final regulations, both the employer and the payor are liable for the employer's employment tax obligations.

PEO authorization is needed that is similar to the authorization required for Reporting Agents and Section 3504 Agents

The IRS maintains that, under existing laws and regulations, it cannot require the PEOs to complete authorization forms similar to those completed by Reporting Agents and Section 3504 Agents. According to the IRS, a PEO is not defined by the Internal Revenue Code for purposes of Federal tax law. As a result, there is no law that requires a PEO to operate its business in a particular way. Further, the PEO business model is to market itself as either the company employing or co-employing the individuals working as employees. As such, the PEO would not voluntarily file Form 2678 to become an agent of an employer.

In contrast, the Internal Revenue Code specifically provides that returns may be signed for a taxpayer by a duly authorized agent,²² *i.e.*, a Reporting Agent, or by a fiduciary, agent, or other person who has the control of, receives, or pays the wages of an employee or group of employees, to perform certain specified acts required of employers,²³ *i.e.*, a Section 3504 Agent. For example:

- Reporting Agents complete Form 8655, which authorizes the Reporting Agent to sign and file tax returns; make deposits and payments; receive copies of tax information, notices, *etc.*; and provide information to the IRS. Completing the Form 8655, the employer is authorizing the Reporting Agent to complete certain actions and obtain confidential tax information that it otherwise would not. Once approved, the agent's authorization is updated on the Reporting Agents File (RAF).²⁴ The RAF interfaces with

²¹ A written or oral agreement to which the payor a) asserts it is the employer, b) pays wages or compensation to individuals for services performed, and c) assumes responsibility to collect, report, and pay any employment taxes with respect to the wages or compensation paid.

²² I.R.C. § 31.6011 (a)-7.

²³ I.R.C. § 3504.

²⁴ The RAF contains authorizations by business taxpayers designating a third-party representative to receive information for business returns filed by the taxpayer as well as correspondence. The taxpayer may also designate a third party to make Federal tax deposits and payments on behalf of the business. Some businesses are required by law to file electronic payments and therefore, their third party must be recorded on the RAF.



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the IRS's Master File²⁵ to update the indicators on the employer's tax account that show the tax forms and types of payments that the Reporting Agent is authorized to file for the employer. The Reporting Agent's authorization becomes effective on the beginning date indicated on the Form 8655. The Reporting Agent can revoke its authorization by sending in a copy of the previously executed Form 8655 and writing "revoke" across the top.

- The Section 3504 Agent is also required to obtain authorization from the IRS. The employer and the party it wants to authorize as a Section 3504 Agent complete the Form 2678 that authorizes the Section 3504 Agent to file tax returns and make deposits and payments on behalf of the employer. The IRS reviews the Form 2678 for completeness and then enters the required transactions on the Master File. When the employer's and agent's tax accounts on Master File have been updated with the appropriate transactions, the IRS sends a letter notifying the Section 3504 Agent that its request has been approved. The authorization becomes effective once approved by the IRS and remains in effect until revoked, which is completed by sending in a new Form 2678 to indicate revocation.

Without some form of authorization similar to that for Reporting Agents and Section 3504 Agents, the IRS will continue to be unable to readily identify noncompliance with payment and filing requirements on the part of the PEOs. Requiring PEO authorizations would provide the IRS with the ability to link the PEOs with the employers they represent and would allow the IRS to be more proactive in identifying potential noncompliance of the PEOs in filing and paying taxes on behalf of employers. When we raised this concern, the IRS responded that a PEO does not consider itself as an agent but rather the employer. As such, the IRS does not believe it can require PEO agent authorizations.

Notwithstanding, the IRS could provide employers with the ability to authorize/designate a PEO. This would allow an employer to be notified when the PEO does not comply with tax filing and payment requirements on the employer's behalf. Because the PEOs use their own EINs when filing tax returns on behalf of employers, the IRS would also need the ability to determine which employers are being included on the PEOs' Forms 941 similar to the information listed on a Schedule R (Form 941): *Allocation Schedule for Aggregate Form 941 Filers*. This would allow the IRS to identify which portion of the wages and employment taxes reported on the PEO's return are attributable to each individual employer and to identify potential filing and payment noncompliance.

IRS management stated that, in order for the IRS to require the PEOs to include Schedule R (Form 941) with their Form 941, legislation would be needed to establish that employers and the PEOs are jointly and severally liable for the filing and payment of employment taxes. As such,

²⁵ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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the IRS has submitted a related legislative proposal. However, in this regard, a recent IRS regulation established that both the employer and the PEO are jointly liable for employment taxes in those situations in which a service agreement exists.²⁶ The IRS defines a service agreement as a written or oral agreement between an employer and the PEO confirming a joint responsibility to collect, report, and pay any employment taxes with respect to the wages or compensation paid.

The information provided on Schedule R (Form 941) allocates wages and taxes reported on the return to the employers represented by the Section 3504 Agent. Figure 4 provides an example of the Schedule R (Form 941).

Figure 4: Schedule R (Form 941)

Schedule R (Form 941): Allocation Schedule for Aggregate Form 941 Filers 950413
OMB No. 1545-0029

(Rev. January 2014)
Department of the Treasury — Internal Revenue Service

Employer identification number (EIN) -

Name as shown on Form 941

Read the instructions before you complete Schedule R (Form 941). Type or print within the boxes. Complete a separate line for the amounts allocated to each of your clients.

Report for calendar year:
Check the quarter (same as Form 941):
☐ 1: January, February, March
☐ 2: April, May, June
☐ 3: July, August, September
☐ 4: October, November, December

(a) Client's Employer identification number (EIN)	(b) Wages, tips, and other compensation allocated to the listed client EIN from Form 941, line 2	(c) Federal income tax withheld from wages, tips, and other compensation allocated to the listed client EIN from Form 941, line 3	(d) Total social security and Medicare taxes allocated to the listed client EIN from Form 941, line 5e	(e) Section 3121(q) Notice and Demand- Tax due on unreported tips allocated to the listed client EIN from Form 941, line 5f	(f) Total taxes after adjustments allocated to the listed client EIN from Form 941, line 10	(g) Total deposits from Form 941, line 11, plus any payments made with the return allocated to the listed client EIN
1
2
3

Source: Schedule R (Form 941) revised January 2014.

²⁶ Designation of Payor To Perform Acts Required of an Employer, 79 Fed. Reg. 17,860 (March 31, 2014) (to be codified at 26 C.F.R. pt. 31).



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Cases involving diversion of employment tax funds indicate that steps are needed to reduce this risk

Third-party payer arrangements usually work as intended; however, there have been instances in which third-party payers receive funds from employers for payment of payroll taxes, but they have not remitted those taxes to the IRS. This causes significant problems for employers because the funds have been expended but the taxes are still due. Between Fiscal Years 2007 and 2012, because of the IRS's recommendations, the Department of Justice criminally prosecuted at least 24 owners of different types of third-party payers that collected about \$300 million in employment taxes from thousands of client employers and did not pay the funds over to the IRS.²⁷ The IRS continues to identify the PEOs involved in the diversion of employment tax funds. For example:

- In February 2014, three individuals in San Antonio, Texas, were sentenced to prison and ordered to pay millions in restitution for their roles in a \$133 million employment tax fraud scheme. The individuals participated in a scheme in which they stole more than \$133 million through the PEOs they operated. The three individuals diverted the funds that should have been used to pay employment taxes for their personal use.
- In June 2013, in Greeneville, Tennessee, an individual was sentenced to 36 months in prison, three years of supervised release, and ordered to pay more than \$2.5 million in restitution. This individual formed a PEO, employing 500 individuals for 23 employer companies. During a 17-month period, this individual calculated and collected the correct amount of withholding and payroll taxes, but reported and paid a much smaller amount to the IRS and the Social Security Administration. This individual pocketed more than \$2.5 million paid by his employer companies and the employees.²⁸

Recommendations

The Commissioner, Small Business/Self-Employed Division, should:

Recommendation 1: Partner with the Bureau of the Fiscal Service on the development of a formal plan that includes action items, system requirements, time frames, *etc.* for the implementation of the process to use the EFTPS to link the PSPs with the employers that use their services.

Management's Response: The IRS agreed with this recommendation. The IRS has discussed with officials from the Bureau of the Fiscal Service the feasibility of using the EFTPS to link the PSPs with the employers that use their services. The IRS is continuing these discussions with the Bureau of the Fiscal Service and the IRS will determine

²⁷ National Taxpayer Advocate, 2012 Annual Report to Congress.

²⁸ These case examples were located on the IRS's website and were from public record documents on file in the courts within the judicial district where the cases were prosecuted.



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whether it has the resources to implement such a process. If the IRS can implement a process, it will work with the Bureau of the Fiscal Service on the development of a formal implementation plan.

Recommendation 2: Establish a program in which employers can inform the IRS of the PEOs that they authorize/designate for filing and payment of employment taxes (similar to the procedures for those employers using the services of a Reporting Agent and Section 3504 Agent). Once in place, ensure that tax account records are updated to reflect this information.

Management's Response: The IRS partially agreed with this recommendation. The IRS is working on establishing the voluntary certification program that was enacted into law as Internal Revenue Code Section 3511 in December 2014. The IRS does not currently have the budget or resources to establish a compliance program that is outside the scope of newly enacted Section 3511, *i.e.*, for the PEOs that choose not to be certified. However, if a PEO chooses not to be certified as provided in the new Internal Revenue Code Section 3511, the PEO will fall under the designated agent provisions of Treasury Regulation 31.3504-2.

Office of Audit Comment: While establishing the voluntary certification program will help for those PEOs that choose to certify, it will have no effect on the PEOs that do not certify. The IRS will continue to be unable to readily identify noncompliance with payment and filing requirements on the part of these non-certifying PEOs.

Recommendation 3: Require those PEOs with a service agreement to attach a Schedule R (Form 941) to their Form 941 tax return listing the employers on whose behalf the PEOs are filing.

Management's Response: The IRS partially agreed with this recommendation. The new legislation does not address any reporting or recordkeeping requirements of the PEOs that do not become certified PEOs. If a PEO chooses not to be certified as provided in Internal Revenue Code Section 3511, the PEO will fall under the designated agent provisions of Treasury Regulation 31.3504-2. The IRS does not have the authority or ability to require the PEOs to attach a Schedule R (Form 941) to their Form 941 tax return listing the employers on whose behalf the PEO is filing.

Office of Audit Comment: Although Treasury Regulation 31.3504-2 establishes joint liability when a service agreement exists, without the Schedule R (Form 941) information, the IRS will continue to be unable to link a PEO with each individual employer. As a result, the IRS will continue to be unable to proactively identify noncompliance with payment and filing requirements on the part of the PEOs.



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Authorization Forms Are Not Always Accurately Processed

Our review of 85 Form 8655 agent authorization forms²⁹ processed in Calendar Year 2013 identified 11 forms (13 percent) with errors in which the information on the authorization forms differed from the information input to the IRS's systems. For example, on three authorization forms, the employer did not provide the agent with authorization to disclose tax information, yet IRS systems inaccurately reflected that these agents had this authorization. This means that if an IRS employee responsible for answering taxpayer inquiries received a call from an agent inquiring about one of these employers, the IRS employee would see the employer provided authorization to discuss the tax account with the agent. Figure 5 summarizes the types of errors we identified for these 11 authorization forms.

Figure 5: Errors on Agent Authorization Forms

Description of Error	Number of Forms With Errors
IRS system was incorrectly updated to provide authorization to disclose tax information to Reporting Agent or provide authorization for Reporting Agent to make employment tax payments.	4
Employer tax account was not updated to reflect Reporting Agent authorization.	5
The RAF was not updated to include the Reporting Agent that filed a Form 8655.	2
Total	11

Source: TIGTA analysis of Form 8655 sample.

IRS management indicated that the errors we identified likely occurred because the authorization forms are manually input by IRS employees. When information from agent authorization forms is not entered into the IRS's systems correctly, the IRS employees who rely on these data may unknowingly make an unauthorized disclosure of confidential tax information.

²⁹ Our systematic random sample of 85 Forms 8655 was selected using a random start of 933 and a skip interval of 2,400 from a population of approximately 204,000. Based upon the sample, we estimate the error exception rate for the Form 8655 population to be 12.94 percent (11/85). The precision for our estimate of the error exception rate is 7.18 percent at the 95 percent confidence level. Thus, we are 95 percent confident that the true error exception rate for the population is between 5.76 percent (12.94 percent - 7.18 percent) and 20.12 percent (12.94 percent + 7.18 percent). We are also 95 percent confident that the true number of error exceptions for the population is between 11,760 and 41,040.



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Recommendation

Recommendation 4: The Commissioner, Wage and Investment Division, should develop processes and procedures to ensure that Form 8655 authorization information captured in the IRS's systems is accurate, and correct the errors associated with the 11 Forms 8655 we identified.

Management's Response: The IRS agreed with this recommendation. The IRS issued a Servicewide Electronic Research Program Alert on December 4, 2014, to reinforce the procedural requirements for processing Form 8655 and will coordinate with affected stakeholders to explore systemic or procedural changes that may result in improved accuracy of posted data. The errors identified have been corrected.

Processes Are Not Effective to Ensure That Indicators Are Accurately Assigned to Section 3504 Agent and Employer Tax Accounts

Our review identified that the IRS has not established an effective process to ensure that indicators are accurately assigned to Section 3504 Agent and employer tax accounts. Review of the tax accounts associated with Section 3504 Agents filing 78 Forms 2678 during the period January 2, 2013, to December 7, 2013,³⁰ identified 13 (17 percent) that contained erroneous indicators. For example, eight indicators were erroneously added to the employer tax account that should have been input to the Section 3504 Agent's tax account. This means that the employer would be erroneously identified as being the Section 3504 Agent. The remaining five indicators were erroneously input to a Section 3504 Agent's tax account. This means that the Section 3504 Agent would be erroneously identified by the IRS as the employer.

IRS procedures require employees processing Forms 2678 to input an indicator on the Section 3504 Agent's tax account to identify the entity as a Section 3504 Agent and to input an indicator on the tax account of the employer that specifies the responsibilities assigned to a Section 3504 Agent. Figure 6 lists the indicators that can be assigned to an agent or employer tax account.

³⁰ Our systematic random sample of 78 Forms 2678 was selected using a random start of 97 and a skip interval of 636 from a population of 49,600. We selected a systematic random sample to ensure that the sample results could be projected to the population. Based upon the sample, we estimate the error exception rate for the Form 2678 population to be 16.67 percent (13/78). The precision for our estimate of the error exception rate is 8.32 percent at the 95 percent confidence level. Thus, we are 95 percent confident that the true error exception rate for the population is between 8.35 percent (16.67 percent - 8.32 percent) and 24.99 percent (16.67 percent + 8.32 percent). We are also 95 percent confident that the true number of error exceptions for the population is between 4,141 and 12,392.



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Figure 6: Action Codes (Indicators) Used for Section 3504 Agents or Employers³¹

Action Code	Description of Action Code
381	Input to the Section 3504 Agent's tax account and identifies an employer's appointment of a Section 3504 Agent.
382	Input to the employer's tax account and indicates that the Section 3504 Agent pays all employment tax for home health care employers.
383	Input to the employer's tax account and indicates that the Section 3504 Agent pays all employment tax for employers (not home health care).
384	Input to the employer's tax account and indicates that the Section 3504 Agent is paying all tax for employers' Form 945, ³² CT-1, ³³ or CT-2 ³⁴ filing requirement codes.
385	Input to the employer's tax account and indicates that the Section 3504 Agent is paying some of the employment tax for employers.

Source: *IRS Processing Codes and Information (Document 6209)* and *IRS Product Catalog Information*.

IRS management indicated that the erroneous indicators were caused by employee processing errors. The accuracy of these indicators is key to the IRS's ability to identify Section 3504 Agents and the employers they represent. In addition, these indicators identify specific actions that an employer authorizes on the part of a Section 3504 Agent. When indicators are not accurate, IRS employees who rely on them can unknowingly make an unauthorized disclosure of confidential tax information.

Recommendation

Recommendation 5: The Commissioner, Wage and Investment Division, should develop processes and procedures to ensure that employees processing Forms 2678 accurately assign indicators to both Section 3504 Agent tax accounts and associated employer tax accounts,

³¹ These action codes are used with Transaction Code 971. A transaction code is used on taxpayer accounts to perform different actions based on the action code.

³² Payers of nonpayroll payments use Form 945, *Annual Return of Withheld Federal Income Tax*, to report income tax withheld.

³³ Form CT-1, *Employer's Annual Railroad Retirement Tax Return*, is used to report and pay railroad retirement taxes (including Additional Medicare Tax) imposed on compensation paid to railroad employees.

³⁴ Form CT-2, *Employee Representative's Quarterly Railroad Tax Return*, is used to report railroad retirement taxes (including Additional Medicare Tax) imposed on compensation received by employee representatives.



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including correcting the errors associated with the 13 Forms 2678 we identified as having inaccurate information.

Management's Response: The IRS agreed with this recommendation. The IRS issued a Servicewide Electronic Research Program Alert 14A0447 on November 4, 2014, regarding Internal Revenue Manual 3.13.2, Business Master File Account Numbers, to reinforce the procedural requirements for processing Form 2678. The errors identified have been corrected.

Recently Enacted Legislation Will Ensure That Employers Are Notified of Address Changes

Our review identified 1,609 Reporting Agents who filed 28,635 Tax Year 2012 Forms 941 in which the Forms 941 listed the address of the Reporting Agent rather than the address of the employer. In each of these instances, the employer was not notified by the IRS that its address was replaced with the address of the Reporting Agent. The replacement of the employer address with the Reporting Agent's address commonly results from the filing of a Form 941 with the Reporting Agent's address. When the tax return is processed, the address from the 941 tax return, *i.e.*, Reporting Agent's address, is automatically updated on the employer tax account if different from the existing address. Subsequently, the employer will no longer receive notices or other types of correspondence from the IRS alerting it of items such as that its employment taxes were not paid.

Congress recognized the risk of potential improprieties when an employer's address is changed based on the filing of a tax return without notification to the employer. As such, Congress passed legislation requiring the IRS to notify employers of address changes. The Consolidated Appropriations Act of 2014³⁵ under Title I, Section 106, states that:

The Internal Revenue Service shall issue a notice of confirmation of any address change relating to an employer making employment tax payments, and such notice shall be sent to both the employer's former and new address and an officer or employee of the Internal Revenue Service shall give special consideration to an offer-in-compromise from a taxpayer who has been the victim of fraud by a third-party payroll tax preparer.

Notices will be sent to the employer's former and new address when implementation of the legislation is complete. The issuance of dual address change notices will affect all employers with an open employment tax filing requirement. The IRS is in the process of implementing these changes. The IRS created a team that has drafted notice language, which is currently undergoing review and approval. In addition, the team submitted a work request to make the necessary changes to the IRS's computer systems. Once implementation of these initiatives is complete, the IRS plans to develop a communication plan to notify the business community of

³⁵ Pub. L. No. 113-76, 128 Stat. 5 (2014).



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the impact of the legislative changes from the Consolidated Appropriations Act of 2014. The IRS stated that it will begin issuing the dual notices on January 23, 2015.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether controls are adequate to protect the taxpayer's and Government's interests when third-party payroll providers are not compliant with payment and filing requirements. To accomplish our objective, we:

- I. Evaluated the effectiveness of the IRS outreach strategy to inform businesses of the risks involved when using third-party payroll providers and the processes that should be followed to reduce those risks.
 - A. Evaluated IRS communication materials available to inform the business community about the risks and processes associated with outsourcing payroll duties to third-party payroll providers.
 - B. Determined the status of the proposed IRS Regulation 102966-10 under Section 3504 of the Internal Revenue Code and how the IRS plans to communicate the impact of these changes to the business community.
 - C. Determined the status of the proposed legislation (Small Business Payroll Protection Act of 2013)¹ and passed legislation (Consolidated Appropriations Act of 2014)² and how the IRS plans to notify the business community of the impact of these legislative changes.
- II. Assessed the effectiveness of IRS controls to identify and monitor the compliance of third-party payroll providers.
 - A. Reviewed prior TIGTA³ and Taxpayer Advocate Service reports to determine the status of prior recommendations and corrective actions pertaining to the monitoring and compliance of third-party payroll providers.
 - B. Reviewed Internal Revenue Manual instructions and met with the IRS to identify the processes and procedures the IRS has established to ensure that payroll providers are compliant in filing and paying employment taxes on behalf of the employer companies they represent.

¹ S. 900, 113th Cong. (2013 – 2014).

² Pub. L. No. 113-76, 128 Stat. 5 (2014).

³ TIGTA, Ref. No. 2007-30-169, *Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done* (Sept. 2007) and TIGTA, Ref. No. 2011-40-103, *Affordable Care Act: Efforts to Implement the Small Business Health Care Tax Credit Were Mostly Successful, but Some Improvements Are Needed* (Sept. 2011).



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- C. Determined the effect on both the IRS and taxpayers when a process does not exist for identifying and monitoring the compliance of payroll providers.
- III. Evaluated the effectiveness of the IRS's controls over processing Form 8655, *Reporting Agent Authorization*, and Form 2678, *Employer/Payer Appointment of Agent*.
- A. Identified the processes and procedures that the IRS has established for processing Forms 8655 and 2678.
 - B. Participated in a walkthrough at the Cincinnati and Ogden Accounts Management functions and the Cincinnati and Ogden Entity functions to identify the processes established for processing Forms 8655 and 2678.
 - C. Selected a systematic random sample of 85 Forms 8655 from a population of 204,000 forms processed in Calendar Year 2013 to determine whether the information from the forms was accurately processed to the RAF,⁴ and whether the information was accurately processed to the taxpayer/employer Business Master File⁵ entity modules⁶ on the Master File.⁷ Our systematic random sample of 85 Forms 8655 was selected using a random start of 933 and a skip interval of 2,400. A systematic random sample, a probability sampling technique, was used because the IRS does not maintain an electronic list to track each form. The population of approximately 204,000 Forms 8655 was stored by the IRS in 85 boxes. Thus, a simple random sample was not feasible. We selected a systematic random sample to ensure that the sample results could be projected to the population. Based upon the sample, we estimate the error exception rate for the Form 8655 population to be 12.94 percent (11/85). The precision for our estimate of the error exception rate is 7.18 percent at the 95 percent confidence level. Thus, we are 95 percent confident that the true error exception rate for the population is between 5.76 percent (12.94 percent - 7.18 percent) and 20.12 percent (12.94 percent + 7.18 percent). We are also 95 percent confident that the true number of error exceptions for the population is between 11,760 and 41,040. The contracted statistician assisted with developing the sampling plan for Forms 8655.

⁴ The RAF contains authorizations by business taxpayers designating a third-party representative to receive information for business returns filed by the taxpayer as well as correspondence. The taxpayer may also designate a third-party to make Federal tax deposits and payments on behalf of the business. Some businesses are required by law to file electronic payments and, therefore, their third party must be recorded on the RAF.

⁵ The IRS database that consists of Federal tax-related transactions and accounts for businesses. These include employment taxes, income taxes on businesses, and excise taxes.

⁶ The entity module is the portion of the Master File record that identifies the taxpayer. It contains the taxpayer's name, address, RAF Indicators, and other information.

⁷ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.



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- D. Selected a systematic random sample of 78 Forms 2678 from a population of 49,600 forms processed in Calendar Year 2013 to determine whether the information from the forms was accurately processed to both the Section 3504 Agent and taxpayer/employer Business Master File entity modules on the Master File. Our systematic random sample of 78 Forms 2678 was selected using a random start of 97 and a skip interval of 636. A systematic random sample, a probability sampling technique, was used because the IRS does not maintain an electronic list to track each form. The population of approximately 49,600 Forms 2678 was stored by the IRS in 50 boxes. Thus, a simple random sample was not feasible. We selected a systematic random sample to ensure that the sample results could be projected to the population. Based upon the sample, we estimate the error exception rate for the Form 2678 population to be 16.67 percent (13/78). The precision for our estimate of the error exception rate is 8.32 percent at the 95 percent confidence level. Thus, we are 95 percent confident that the true error exception rate for the population is between 8.35 percent (16.67 percent - 8.32 percent) and 24.99 percent (16.67 percent + 8.32 percent). We are also 95 percent confident that the true number of error exceptions for the population is between 4,141 and 12,392. The contracted statistician assisted with developing the sampling plan for Forms 2678.
- IV. Evaluated the effectiveness of the IRS's controls for processing address changes submitted by third-party payroll providers.
- A. Interviewed IRS officials regarding actions taken to implement recommendations that appear in the Information Reporting Program Advisory Committee's 2013 report.
 - B. Determined whether taxpayer addresses are being improperly changed to the address of the payroll provider representing them.
 - 1. Obtained Reporting Agent addresses from the RAF.
 - 2. Obtained a file of Forms 941, *Employer's QUARTERLY Federal Tax Return*, filed for taxpayers using Reporting Agents in Tax Year⁸ 2012 on the Business Return Transaction File (BRTF)⁹ for Processing Years¹⁰ 2012, 2013, and 2014 through March 20, 2014. We validated the accuracy of the data by comparing a randomly selected sample of 30 Forms 941 on the BRTF to the IRS information residing on the Integrated Data Retrieval System.¹¹

⁸ A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

⁹ The BRTF programs receive business tax return data, reformat and post returns to the Return Transaction File, and do periodic file maintenance.

¹⁰ Processing year is the calendar year in which the tax return was processed by the IRS.

¹¹ IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.



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3. Matched the Reporting Agent addresses on the RAF to the addresses listed on the Forms 941 filed for taxpayers using Reporting Agents.
4. For any addresses changed from the taxpayer's address to the agent's address, determined if there was a legitimate reason for the change (change of address requested by the taxpayer, Power of Attorney, *etc.*).

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: the IRS's processes and procedures for processing agent authorization forms and monitoring the compliance of third-party payroll providers. We evaluated these controls by interviewing management and analysts, conducting walkthroughs of processing operations, reviewing samples of agent authorization forms, performing analyses of Schedules R (Form 941): *Allocation Schedule for Aggregate Form 941 Filers*, and examining independent reports, legislation, regulations, and instructions.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Operations Support OS
Deputy Commissioner for Services and Enforcement SE
Chief Technology Officer OS:CTO
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Deputy Commissioner, Wage and Investment Division SE:W
Director, Customer Account Services, Wage and Investment Division SE:W:CAS
Director, Specialty Programs, Small Business/Self-Employed Division SE:S:SP
Director, Communications and Stakeholder Outreach, Small Business/Self-Employed Division
SE:S:COSS:CSO
Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP
Deputy Director, Submission Processing, Wage and Investment Division SE:W:CAS:SP:D
Field Director, Submission Processing (Cincinnati), Wage and Investment Division
SE:W:CAS:SP:C
Field Director, Submission Processing (Ogden), Wage and Investment Division
SE:W:CAS:SP:O
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
 Chief, Program Evaluation and Improvement, Wage and Investment Division
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 Division SE:S:COSS:CSO



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Appendix IV

Form 8655, Reporting Agent Authorization

Form 8655 (Rev. December 2012) <small>Department of the Treasury Internal Revenue Service</small>	Reporting Agent Authorization ► Information about Form 8655 is at www.irs.gov/form8655 .	OMB No. 1545-1058
Taxpayer		
1 a Name of taxpayer (as distinguished from trade name)	2 Employer identification number (EIN)	
1 b Trade name, if any	4 If you are a seasonal employer, check here <input type="checkbox"/>	
3 Address (number, street, and room or suite no.)	5 Other identification number	
City or town, state, and ZIP code		
6 Contact person	7 Daytime telephone number	8 Fax number
Reporting Agent		
9 Name (enter company name or name of business)	10 Employer identification number (EIN)	
11 Address (number, street, and room or suite no.)		
City or town, state, and ZIP code		
12 Contact person	13 Daytime telephone number	14 Fax number
Authorization of Reporting Agent To Sign and File Returns		
15 Use the entry lines below to indicate the tax return(s) to be filed by the reporting agent. Enter the beginning year of annual tax returns or beginning quarter of quarterly tax returns. See the instructions for how to enter the quarter and year. Once this authority is granted, it is effective until revoked by the taxpayer or reporting agent.		
940 _____	941 _____	940-PR _____
943-PR _____	944 _____	945 _____
		1042 _____
		CT-1 _____
		943 _____
		941-SS _____
		990-T _____
		990-PF _____
Authorization of Reporting Agent To Make Deposits and Payments		
16 Use the entry lines below to indicate the starting date (the first month and year) of any tax return(s) for which the reporting agent is authorized to make deposits or payments. See the instructions for how to enter the month and year. Once this authority is granted, it is effective until revoked by the taxpayer or reporting agent.		
940 _____	941 _____	943 _____
1041 _____	1042 _____	1120 _____
		CT-1 _____
		720 _____
Disclosure of Information to Reporting Agents		
17 a Check here to authorize the reporting agent to receive or request copies of tax information and other communications from the IRS related to the authorization granted on lines 15, 16, and/or line 18 <input type="checkbox"/>		
b Check here if the reporting agent also wants to receive copies of notices from the IRS <input type="checkbox"/>		
Disclosure Authorization		
18 a The reporting agent is authorized to receive otherwise confidential taxpayer information from the IRS to assist in responding to certain IRS notices relating to the Form W-2 series information returns. This authority is effective for calendar year forms beginning _____.		
b The reporting agent is authorized to receive otherwise confidential taxpayer information from the IRS to assist in responding to certain IRS notices relating to the Form 1099 series information returns. This authority is effective for calendar year forms beginning _____.		
c The reporting agent is authorized to receive otherwise confidential taxpayer information from the IRS to assist in responding to certain IRS notices relating to the Forms 3921 and 3922. This authority is effective for calendar year forms beginning _____.		
State or Local Authorization		
19 Check here to authorize the reporting agent to sign and file state or local returns related to the authorization granted on line 15 and/or line 16 <input type="checkbox"/>		
Authorization Agreement		
I understand that this agreement does not relieve me, as the taxpayer, of the responsibility to ensure that all tax returns are filed and that all deposits and payments are made. If line 15 is completed, the reporting agent named above is authorized to sign and file the return indicated, beginning with the quarter or year indicated. If any starting dates on line 16 are completed, the reporting agent named above is authorized to make deposits and payments beginning with the period indicated. Any authorization granted remains in effect until it is revoked by the taxpayer or reporting agent. I am authorizing the IRS to disclose otherwise confidential tax information to the reporting agent relating to the authority granted on line 15 and/or line 16, including disclosures required to process Form 8655. Disclosure authority is effective upon signature of taxpayer and IRS receipt of Form 8655. The authority granted on Form 8655 will not revoke any Power of Attorney (Form 2848) or Tax Information Authorization (Form 8821) in effect.		
Sign Here	I certify I have the authority to execute this form and authorize disclosure of otherwise confidential information on behalf of the taxpayer.	
►	Signature of taxpayer	Title
►	Date	Date
For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 10241T Form 8655 (Rev. 12-2012)		



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Appendix V

Form 2678, Employer/Payer Appointment of Agent

Form **2678** **Employer/Payer Appointment of Agent**
(Rev. October 2012) Department of the Treasury — Internal Revenue Service OMB No. 1545-0748

Use this form if you want to request approval to have an agent file returns and make deposits or payments of employment or other withholding taxes or if you want to revoke an existing appointment.

- If you are an employer or payer who wants to request approval, complete Parts 1 and 2 and sign Part 2. Then give it to the agent. Have the agent complete Part 3 and sign it.

Note. This appointment is not effective until we approve your request. See the instructions for filing Form 2678 on page 3.

- If you are an employer, payer, or agent who wants to revoke an existing appointment, complete all three parts. In this case, only one signature is required.

Part 1: Why you are filing this form...
(Check one)

☐ You want to **appoint** an agent for tax reporting, depositing, and paying.

☐ You want to **revoke** an existing appointment.

Part 2: Employer or Payer Information: Complete this part if you want to appoint an agent or revoke an appointment.

1 Employer identification number (EIN) -

2 Employer's or payer's name
(not your trade name)

3 Trade name (if any)

4 Address

Number Street Suite or room number

City State ZIP code

5 Forms for which you want to appoint an agent or revoke the agent's appointment to file.
(Check all that apply.)

	For ALL employees/ payees	For SOME employees/ payees
Form 940, 940-PR (Employer's Annual Federal Unemployment (FUTA) Tax Return)*	<input type="checkbox"/>	<input type="checkbox"/>
Form 941, 941-PR, 941-SS (Employer's QUARTERLY Federal Tax Return)	<input type="checkbox"/>	<input type="checkbox"/>
Form 943, 943-PR (Employer's Annual Federal Tax Return for Agricultural Employees)	<input type="checkbox"/>	<input type="checkbox"/>
Form 944, 944(SP) (Employer's ANNUAL Federal Tax Return)	<input type="checkbox"/>	<input type="checkbox"/>
Form 945 (Annual Return of Withheld Federal Income Tax)	<input type="checkbox"/>	<input type="checkbox"/>
Form CT-1 (Employer's Annual Railroad Retirement Tax Return)	<input type="checkbox"/>	<input type="checkbox"/>
Form CT-2 (Employee Representative's Quarterly Railroad Tax Return)	<input type="checkbox"/>	<input type="checkbox"/>

*Generally you cannot appoint an agent to report, deposit, and pay taxes reported on Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, unless you are a home care service recipient.

☐ Check here if you are a home care service recipient, and you want to appoint the agent to report, deposit, and pay FUTA taxes for you. See the instructions.

I am authorizing the IRS to disclose otherwise confidential tax information to the agent relating to the authority granted under this appointment, including disclosures required to process Form 2678. The agent may contract with a third party, such as a reporting agent or certified public accountant, to prepare or file the returns covered by this appointment, or to make any required deposits and payments. Such contract may authorize the IRS to disclose confidential tax information of the employer/payer and agent to such third party. If a third party fails to file the returns or make the deposits and payments, the agent and employer/payer remain liable.

X Sign your name here

Date / /

Print your name here

Print your title here

Best daytime phone

Now give this form to the agent to complete. ➡

For Paperwork Reduction Act Notice, see the instructions. IRS.gov/form2678 Cat. No. 18770D Form **2678** (Rev. 10-2012)



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

Form 2678 (Rev. 10-2012)

Page **2**

Part 3: Agent Information: If you will be an agent for an employer or payer, or want to revoke an appointment, complete this part.

6 Agent's employer identification number (EIN) -

7 Agent's name (not trade name)

8 Trade name (if any)

9 Address

Number Street Suite or room number

City State ZIP code

☐ Check here if the employer is a home care service recipient receiving home care services through a program administered by a federal, state, or local government agency.

Under penalties of perjury, I declare that I have examined this form and any attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

X Sign your name here

Print your name here

Print your title here

Date / /

Best daytime phone

Form **2678** (Rev. 10-2012)



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

Appendix VI

*Schedule R (Form 941):
Allocation Schedule for Aggregate Form 941 Filers*

950413
OMB No. 1545-0029

Schedule R (Form 941): Allocation Schedule for Aggregate Form 941 Filers
(Rev. January 2013)
Department of the Treasury — Internal Revenue Service

Employer identification number (EIN) -
Name as shown on Form 941

Read the instructions before you complete Schedule R (Form 941). Type or print within the boxes.
Complete a separate line for the amounts allocated to each of your clients.

Report for calendar year:

Check the quarter (same as Form 941):
☐ 1: January, February, March
☐ 2: April, May, June
☐ 3: July, August, September
☐ 4: October, November, December

(a) Client's Employer Identification Number (EIN)	(b) Wages, tips, and other compensation allocated to the listed client EIN from Form 941, line 2	(c) Total income tax withheld from wages, tips, and other compensation allocated to the listed client EIN from Form 941, line 3	(d) Total social security and Medicare taxes allocated to the listed client EIN from Form 941, line 5e	(e) Section 3121(q) Notice and Demand- Tax due on unreported tips allocated to the listed client EIN from Form 941, line 5f	(f) Total taxes after adjustments allocated to the listed client EIN from Form 941, line 10	(g) Total deposits and COBRA payments from Form 941, line 13, plus any payments made with the return allocated to the listed client EIN
1	*	*	*	*	*	*
2	*	*	*	*	*	*
3	*	*	*	*	*	*
4	*	*	*	*	*	*
5	*	*	*	*	*	*
6	*	*	*	*	*	*
7	*	*	*	*	*	*
8	*	*	*	*	*	*
9	*	*	*	*	*	*
10	*	*	*	*	*	*
11	*	*	*	*	*	*
12	*	*	*	*	*	*
13	*	*	*	*	*	*
14	*	*	*	*	*	*
15	*	*	*	*	*	*
16 Subtotals for clients. Add all amounts on lines 1 through 15	*	*	*	*	*	*
17 Enter the combined subtotal from line 26 of all Continuation Sheets for Schedule R (Form 941)	*	*	*	*	*	*
18 Enter Form 941 amounts for your employees	*	*	*	*	*	*
19 Totals. Add lines 16, 17, and 18. The column totals must match the related lines on the aggregate Form 941.	*	*	*	*	*	*

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 49301K Schedule R (Form 941) (Rev. 1-2013)



*Processes Are Needed to Link Third-Party Payers and Employers
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Page _____ of _____

950513

Continuation Sheet for Schedule R (Form 941)

(Rev. January 2013)

Employer identification number (EIN) -

Name as shown on Form 941

Report for calendar year:

Check the quarter (same as Form 941):

☐ 1: January, February, March

☐ 2: April, May, June

☐ 3: July, August, September

☐ 4: October, November, December

(a) Client's Employer Identification Number (EIN)	(b) Wages, tips, and other compensation allocated to the listed client EIN from Form 941, line 2	(c) Total income tax withheld from wages, tips, and other compensation allocated to the listed client EIN from Form 941, line 3	(d) Total social security and Medicare taxes allocated to the listed client EIN from Form 941, line 5e	(e) Section 3121(q) Notice and Demand- Tax due on unreported tips allocated to the listed client EIN from Form 941, line 5f	(f) Total taxes after adjustments allocated to the listed client EIN from Form 941, line 10	(g) Total deposits and COBRA payments from Form 941, line 13, plus any payments made with the return allocated to the listed client EIN
1	■	■	■	■	■	■
2	■	■	■	■	■	■
3	■	■	■	■	■	■
4	■	■	■	■	■	■
5	■	■	■	■	■	■
6	■	■	■	■	■	■
7	■	■	■	■	■	■
8	■	■	■	■	■	■
9	■	■	■	■	■	■
10	■	■	■	■	■	■
11	■	■	■	■	■	■
12	■	■	■	■	■	■
13	■	■	■	■	■	■
14	■	■	■	■	■	■
15	■	■	■	■	■	■
16	■	■	■	■	■	■
17	■	■	■	■	■	■
18	■	■	■	■	■	■
19	■	■	■	■	■	■
20	■	■	■	■	■	■
21	■	■	■	■	■	■
22	■	■	■	■	■	■
23	■	■	■	■	■	■
24	■	■	■	■	■	■
25	■	■	■	■	■	■
26	Subtotals for clients. Add lines 1 through 25. Include the subtotals from line 26 on line 17 of Schedule R (Form 941).	■	■	■	■	■

Schedule R (Form 941) (Rev. 1-2013)



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

Appendix VII

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

JAN 27 2015

MEMORANDUM FOR MICHAEL E. McKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller *Mary E. Allen*
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Processes Are Needed to Link Third-Party
Payers and Employers to Reduce Risks Relating to Employment
Tax Fraud (Audit # 201340024)

Thank you for the opportunity to review the draft report titled, "Processes Are Needed to Link Third-Party Payers and Employers to Reduce Risks Relating to Employment Tax Fraud." We appreciate your recognition of our targeted outreach efforts to make taxpayers aware of the potential risks associated with certain types of third-party payer arrangements.

As your report notes, a growing number of small firms use a third party for various tasks, including paying employees and filing and payment of Federal employment taxes. The issue of employment tax fraud arises when the third-party payer receives the funds from an employer for payment of payroll taxes but does not remit those amounts to the IRS, which causes significant problems for the employer who generally remains liable for these amounts. Of the four most common types of third party payer arrangements, the IRS has the authority to require only Reporting Agents and agents authorized under Internal Revenue Code section 3504 (3504 agents) to submit an authorization form disclosing the relationship between an employer and a third party payer. The IRS does not, however, have the authority to require the filing of an authorization form by the other two common third party payer arrangements – Professional Employer Organizations (PEOs) and Payroll Service Providers (PSPs).

Nonetheless, we have worked within these limitations to accomplish key initiatives. For example, in recognition of the harm to the tax system and the burdens on taxpayers when a PEO fails to meet its requirements, we developed an Outreach and Communication Plan to help remind employers that they remain responsible for ensuring compliance with tax responsibilities, including timely filing of returns and payment of taxes when using the services of a third-party payer. Also, on April 14, 2014, the IRS and the Department of Treasury issued final regulations clarifying that when a third party payer enters into a service agreement with an employer which includes the third party filing returns and paying taxes on behalf of the employer, then both the employer and the third party are liable for the employer's employment tax obligations.



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

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Additionally, we have been exploring options for using the Electronic Federal Tax Payment System (EFTPS) as a source to link PSPs with the employers who use their services and to identify when a required federal tax deposit is delinquent.

On December 19, 2014, Congress enacted a law (H.R. 5771) that changes the landscape of the IRS' authority with respect to PEOs. Specifically, the new law requires the IRS to establish a voluntary certification program, whereby a PEO can apply to the IRS for certification and if the PEO meets the certification program requirements, the PEO is then treated as the employer and would be solely liable for the employment taxes on wages paid to employees performing services for any customer of the PEO. The law also requires the public disclosure of certified PEOs and of any PEOs whose certification is suspended or revoked, which will serve as a source of information to employers seeking the services of a PEO. Operating within the confines of our limited budget resources, we are working to develop and implement procedures to meet the requirements of the new law. However, it is important to note that this certification program is voluntary; meaning it does not change the IRS authority of PEOs that do not apply to become certified by the IRS.

In closing, we note that the IRS has plans to launch a new initiative relating to the collection of employment taxes in general, with a goal of improving voluntary compliance and protecting the Government's interest in these amounts. As part of this initiative, we will focus on taxpayers (including third party payers) who fail to deposit their payroll tax obligations, and we will use the insight and data gathered during this process to tailor our examination and compliance activities accordingly. We believe that the PEO certification in conjunction with diligent enforcement of employment taxes will help promote high quality services from third-party payers.

Attached is a detailed response outlining our corrective actions to address your recommendations. If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self-Employed, at (859) 669-5526.

Attachment



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division, should partner with the Bureau of the Fiscal Service on the development of a formal plan that includes action items, system requirements, timeframes, etc. for the implementation of the process to use the EFTPS to link PSPs with the employers that use their services.

CORRECTIVE ACTION:

We have discussed the feasibility of using EFTPS to link PSPs with the employers that use their services with officials from the Bureau of the Fiscal Service. We are continuing these discussions with the Bureau of Fiscal Service and we will determine whether we have the resources to implement such a process. If we can implement a process, we will work with the Bureau of Fiscal Service on the development of a formal implementation plan.

IMPLEMENTATION DATE:

February 15, 2016

RESPONSIBLE OFFICIAL:

Director, Collection Policy, Small Business/Self-Employed Division (SB/SE)

CORRECTIVE ACTION MONITORING PLAN:

The IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

Establish a program where employers can report to the IRS a PEO that they authorize/designate responsibilities for filing and payment of employment taxes (similar to the processes and procedures for those employers using the services of a Reporting Agent and section 3504 Agent). Once in place, ensure tax account records are updated to reflect this arrangement.

CORRECTIVE ACTION:

The IRS is working on establishing the voluntary certification program that was enacted into law as IRC section 3511 in December 2014. We do not currently have the budget or resources to establish a compliance program that is outside the scope of newly enacted section 3511 (i.e., for PEOs that choose not to be certified). However, if a PEO chooses not to be certified as provided in the new IRC section 3511, the PEO will fall under the designated agent provisions of Treasury Regulation 31.3504-2.

IMPLEMENTATION DATE:

N/A



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

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RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 3:

Similar to section 3504 Agents, require PEOs to attach a Schedule R (Form 941) to their Form 941 tax return listing the employers on whose behalf the PEO is filing.

CORRECTIVE ACTION:

The new legislation does not address any reporting or recordkeeping requirements of PEOs that do not become Certified PEOs. If a PEO chooses not to be certified as provided in IRC section 3511, the PEO will fall under the designated agent provisions of Treasury Regulation 31.3504-2. We do not have the authority or ability to require PEOs to attach a Schedule R (Form 941) to their Form 941 tax return listing the employers on whose behalf the PEO is filing.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL:

N/A

CORRECTIVE ACTION MONITORING PLAN:

N/A

RECOMMENDATION 4:

The Commissioner, Wage and Investment Division, should develop processes and procedures to ensure that Form 8655 authorization information captured in the IRS's systems is accurate and correct the errors associated with the 11 Forms 8655 we identified.

CORRECTIVE ACTION:

We issued a Servicewide Electronic Research Program (SERP) Alert on December 4, 2014, to reinforce the procedural requirements for processing Form 8655, *Reporting Agent Authorization*, and will coordinate with affected stakeholders to explore systemic or procedural changes that may result in improved accuracy of posted data. The errors identified have been corrected.



*Processes Are Needed to Link Third-Party Payers and Employers
to Reduce Risks Related to Employment Tax Fraud*

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IMPLEMENTATION DATE:

April 15, 2016

RESPONSIBLE OFFICIAL:

Director, Accounts Management, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN:

IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 5:

The Commissioner, Wage and Investment Division, should develop processes and procedures to ensure that employees processing Forms 2678 accurately assign indicators to both section 3504 Agent tax accounts and associated employer tax accounts, including correcting the errors associated with the 13 Forms 2678 we identified as having inaccurate information.

CORRECTIVE ACTION:

We issued SERP Alert 14A0447 on November 4, 2014, regarding Internal Revenue Manual 3.13.2, *BMF Account Numbers*, to reinforce the procedural requirements for processing Form 2678, *Employer/Payer Appointment of Agent*. The errors identified have been corrected.

IMPLEMENTATION DATE:

Implemented

RESPONSIBLE OFFICIAL:

Director, Submission Processing, Customer Account Services, Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN:

N/A