

A person wearing a green shirt is looking at a document with a magnifying glass and a pen. The document contains various charts and graphs, including a pie chart and a bar chart. The background is blurred, showing a computer monitor and other office equipment.

# Managing employment tax risk in payroll outsourcing arrangements

The EY logo consists of the letters 'EY' in a bold, black, sans-serif font. A yellow diagonal line is positioned above the 'Y'.

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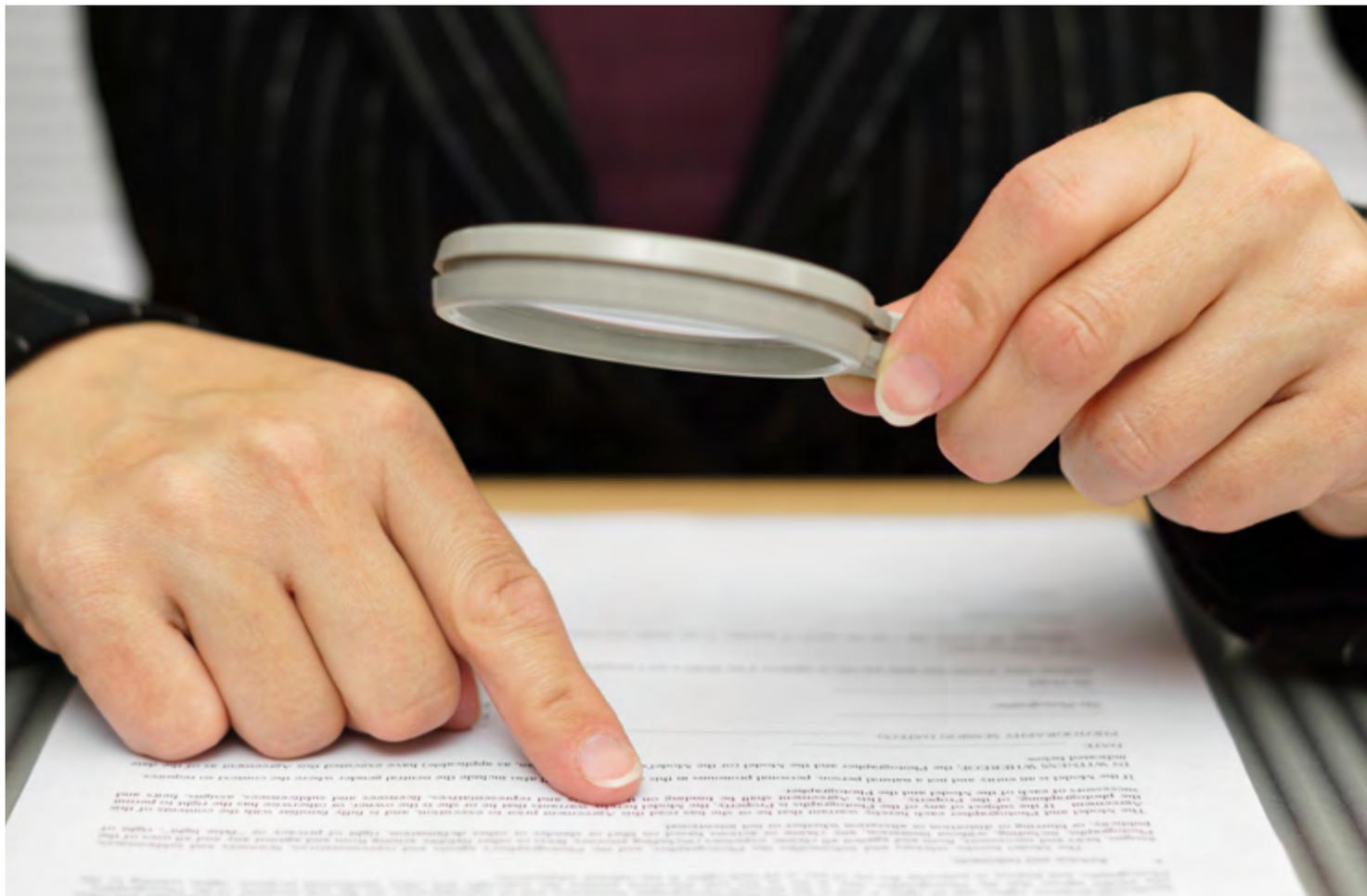
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# Managing employment tax risk in payroll outsourcing arrangements

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As payroll rules increase in complexity, so has the migration to third-party payroll service providers. *The Journal of Accountancy* reported that in 2014 alone, 42% of respondents said they outsourced their payroll tax obligations, a sharp increase from 30% in 2013 with 73% of those respondents reporting revenues of \$5 billion or more. A 2017 survey of the [National Small Business Association](#) found that approximately 42% (up from 40% in 2015) of small firms use a third-party payer for tasks ranging from paying employees to paying employment taxes and filing returns.

The benefits of payroll outsourcing are clear – businesses can realize lower technology costs and reduce staff time devoted to repetitive and time-consuming tasks such as those associated with tax payments and return filing. In fact, with so much of the payroll infrastructure transferred to a third party it is often the tendency, due to overzealous marketing or complacency, to redirect or remove trained and experienced in-house staff who are vital to the oversight role.

In this special report, we explain why it is important to oversee third-party arrangements and review some of the tasks integral to the overall governance process.

# Managing employment tax risk in payroll outsourcing arrangements

Continued



## Who is liable for employment tax errors?

Sadly, it is only after a significant tax assessment is paid that some businesses learn the hard reality that, except under limited contractual arrangements, they cannot outsource their liability for payroll tax errors. (See *Figure 1, page 3*, for arrangements where the employer is not solely liable for federal employment taxes.)

The tax courts have routinely held it is the employer, and not the third-party payroll provider, that is ultimately liable for federal employment taxes, consistent with the 1985 U.S. Supreme Court decision in *U.S. v. Boyle*. In that case, a bright line was established concerning the extent to which outsourcing tax work relieves a business of the risk of assessments for errors and omissions by the third party. As a matter of principle, the Boyle decision discards the notion that reliance on a third party is “reasonable cause” for purposes of abating the late-filing penalty. In arriving at its decision, the court stated, “it requires no special training or effort on the taxpayer’s part to ascertain a deadline and ensure that it is met. That the attorney, as respondent’s agent, was expected to attend to the matter does not relieve the principal of his duty to meet the deadline.” (*U.S. v. Boyle*, 469 U.S. 241; 105 S. Ct. 687; 83 L. Ed. 2d 622(1985); see also *Janet M. Nesse v. Internal Revenue Service*, RWT-03-CV-2223.)

The IRS [explains](#) that depending on the facts and circumstances and the type of third-party arrangement, an employer that uses a third party to perform federal employment tax functions on its behalf may remain solely liable for federal employment taxes, may become jointly and severally liable for such taxes, or may be relieved of liability for such taxes.

The types of third-party arrangements and the federal payroll tax liabilities that apply are shown in *Figure 1* on the following page.

“While the employer’s service agreement may stipulate that the third party will bear responsibility for employment tax assessments, this clause will generally not apply when the employer is at fault nor in those rare cases where the third-party payer is committing fraud or unexpectedly ceases operations such as in a bankruptcy.”

**Figure 1**

**Third-party payer arrangements: roles and responsibilities\***

Third-party payer arrangement	Filing employment tax return	Paying employment tax	Who is liable for tax payment and return filing?
Payroll service provider (PSP)	Return is signed by the employer and filed under the employer's Employer Identification Number (EIN).	Tax is paid under employer's EIN.	Employer is solely liable for timely filing and payment of tax.
Reporting agent (RA)	Return is signed by the reporting agent and filed under the employer's EIN.	Tax is paid under the employer's EIN.	Employer is solely liable for timely filing and payment of tax.
IRC §3504 agent (Agent)	Aggregate return is filed under the IRC §3504 agent's EIN for all employers using the agent.	Aggregate tax is paid under the IRC §3504 agent's EIN.	Both the employer and the IRC §3504 agent are liable for timely filing and payment of tax.
Professional employer organization (PEO)	Aggregate return is filed under the PEO's EIN for all employers using the PEO.	Aggregate tax is paid under the PEO's EIN.	Employer is solely liable for timely filing and payment of tax.
Certified professional employer organization (CPEO)	Aggregate return is filed under the CPEO's EIN.	Aggregate tax is paid under the CPEO's EIN.	Generally, the CPEO is solely liable for timely filing and payment of tax in connection with remuneration it pays to worksite employees (as defined in IRC §7705(e)). Both the CPEO and employer may be liable in connection with remuneration the CPEO pays to non-worksite employees (Pub. 15, Circular E; Rev. Proc. 2012-32; Rev. Proc. 2013-39; Treas. Reg. 31.3504-1; Rev. Proc. 201)

\*Source: [IRS third-party arrangement chart](#)

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A payroll service provider can assist you in meeting your payroll and employment tax obligations, but it cannot replace skilled professionals within your organization who understand the complex and changing employment tax requirements and the pressure points where continuous oversight is vital.

## What are the elements of an oversight plan?

While the employer's service agreement may stipulate that the third party will bear responsibility for employment tax assessments, this clause will generally not apply when the employer is at fault nor in those rare cases where the third-party payer is engaged in fraud or unexpectedly ceases operations such as in a bankruptcy. For these reasons, a hands-on approach is necessary when working with your payroll service provider.

Following are some tasks to consider when developing an employment tax oversight plan.

### 1 Conduct service organization audits

Businesses that are subject to independent audit, such as SEC registrants, may be required to show that third parties having responsibility for processes that impact the financial statement (e.g., employment taxes) have met certain audit standards. This type of audit is referred to as *Statement on Standards for Attestation Engagements (SSAE) No. 16, Reporting on Controls at a Service Organization (SSAE 16)*. A current SSAE 16 report can provide a level of management assurance for employers that outsource their payroll and/or employment taxes that the payroll service provider has had an independent audit of its operations. Many service organizations provide this report to their customers as part of their customers' own audit requirements. However, even those businesses that do not require the SSAE 16 report to meet audit requirements may still request a copy to establish that an independent evaluation was made of the third-party's control structure, that its controls are suitably designed to meet control objectives, and that the controls are operating with reasonable effectiveness.

### 2 Be mindful of the potential for fraud

If the third-party payroll provider decides to keep the funds it collects from its clients for the payment of tax, the client may have little recourse to recover the stolen amount and could be left owing taxing authorities not only for the underlying taxes, but interest and penalty as well. (Forbes, [Even if Your Payroll Firm Steals Your Employment Taxes You Must Pay IRS](#), July 26, 2017.)

In June 2019, a [Pennsylvania school](#) was forced to sue a management firm after it learned that the third party it hired to handle its payroll processing was accused of embezzling the taxes it withheld from wages. This is not an isolated case.

The trend of payroll service bureau fraud is so concerning that the Treasury Inspector General for Tax Administration (TIGTA) issued a report in 2015 recommending the IRS implement additional controls to protect taxpayers and the government from payroll providers that fail to make required tax payments. Specifically, in the TIGTA report [Processes Are Needed to Link Third-Party Payers and Employers to Reduce Risks Related to Employment Tax Fraud](#), it was recommended that the IRS partner with the Bureau of the Fiscal Service to develop a plan using the Electronic Federal Tax Payment System to link a payroll service provider with an employer. Matching employers to their payroll service provider would allow the IRS to monitor and notify employers of noncompliance. The IRS has already put this system in place for professional employer organizations (PEOs) through its certified professional employer organization (CPEO) program. Unfortunately, the monitoring is restricted to those PEOs who certify.

"The IRS states that if you suspect your payroll service provider of improper or fraudulent activities involving the deposit of your federal taxes or the filing of your returns, you can file a complaint using [Form 14157 Complaint: Tax Return Preparer](#)."

# Managing employment tax risk in payroll outsourcing arrangements

Continued

It is important to exercise business care and prudence when selecting a payroll service provider. For some businesses, this means checking with the Better Business Bureau. Still others require that the third party provide a qualified resume that includes significant experience (e.g., a minimum of 10 years), references and a good credit history. Some businesses conduct a criminal background check of the owners, principals or officers of the service provider.

The IRS [explains](#) that if you suspect your payroll service provider of improper or fraudulent activities involving the deposit of your federal taxes or the filing of your returns, you can file a complaint using [Form 14157 Complaint: Tax Return Preparer](#). The IRS has streamlined the process to file Form 14157. You can mail the form or fax it to +1 855 889 7957. Once it is received, the PSP-identified complaints will receive expedited handling and investigation.



## 3 Monitor tax accounts regularly

It is important to remember that mistakes happen, no matter how reputable or otherwise competent the service provider is. For this reason, perpetual monitoring of tax accounts is vital to managing risk. Monitoring tax accounts is prudent whether employment tax processes are handled internally or outsourced. In fact, some businesses ask their accounting firm to take a periodic review of tax accounts as an additional step in uncovering unknown risks.

An employer's taxpayer identification number (e.g., the Employer Identification Number or EIN), is the key to accessing information in federal, state and local employment tax accounts. The payroll service provider must post all activities to individual employer accounts. Account histories are generally available from all taxing authorities, including the IRS. The IRS transcript, for instance, shows all activities on the employer's account, including returns filed, taxes deposited and assessments, if any. State and local taxing authorities can provide similar account information.

The IRS suggests that employers enroll in [EFTPS](#) so that they can view payments and deposits made under their EIN by the payroll service provider.

- ▶ **Confirm wages reported to the Social Security Administration.** At least once each year, more frequently if Forms W-2c are filed, many businesses contact the Social Security Administration and request a similar history of total dollars and taxes posted for a tax year, and any open issues that will, if left unresolved, be referred to the IRS for enforcement.
- ▶ **Confirm that the tax jurisdiction correspondence is sent to you and not just the payroll service provider.** The IRS [instructs](#) its audit examiners to instruct employers to verify that when they work with a payroll service provider, they should verify that their address (and not the payroll service provider) is the address of record with the IRS. Employers can confirm their address of record with the IRS by calling the IRS Business and Specialty Tax Line at +1 800 829 4933. ([IRS Tips for Employers Who Outsource Payroll Duties.](#))

A similar process should be performed for each state and local taxing authority where the employer incurs payroll tax liabilities.

#### 4 Maintain reconciliation spreadsheets

The best way to confirm that employment tax deposits and returns are accurate is to maintain reconciliation spreadsheets that are updated each time wages are paid or when other transactions have occurred that impact tax accounts. Reconciliations should be designed to test that:

- ▶ Period-to-date, quarter-to-date and year-to-date accumulators of all wage and tax data are accurate for all jurisdictions.
- ▶ Wage and tax data logically reconcile among all taxing jurisdictions and tax types. For instance, do the total Social Security wages as reported on Form W-2 agree to Social Security wages as reported on Form 941, and if not, is the reconciling difference explained?
- ▶ Taxes are remitted and returns filed according to the taxing jurisdictions in which employees live and/or work. Such reconciliation generally takes the form of a master checklist wherein it is verified that accumulators are set, deposits made and returns filed for all taxing jurisdictions as compared to the employee tax Masterfile.
- ▶ The amounts reflected in the general ledger, and ultimately, the organization's financial statement, agree with the information contained in payroll and employment tax reports and records.

#### 5 Confirm taxability configurations

The payroll service provider generally maintains routines that determine the federal, state and local tax treatment of elements of compensation and pre-tax contributions; however, only the employer knows the nature of its payments and deductions. Accordingly, the payroll service provider is not responsible for a client's misuse of its taxability configuration templates or errors in correctly labeling pay and deduction components. For instance, if a client incorrectly characterizes a health savings contribution as a health flexible spending account contribution, the tax rules applied by the payroll service provider will result in errors in Form W-2 reporting and likely, incorrect taxation across federal, state and local taxing jurisdictions.

The laws and regulations governing the tax treatment of wages and deductions are complex and are subject to change.

Considering the employer is ultimately liable for employment tax compliance, it is similarly important to confirm that the payroll service provider is applying the correct and tax and reporting rules.

Employers are responsible for complying with information requests from taxing authorities that support their tax calculations and payroll tax returns. Adequate documentation for taxability purposes includes plan documents and policies that support each pay and deduction code and the tax configuration assigned, taxability configuration tables from the payroll system, and annual summaries that show the total wages and deductions for each pay and deduction code and the tax treatment that applied. Maintaining processes that perpetually compile this information for review and reconciliation increases the odds for more favorable tax audit outcomes.

**“Adequate documentation for taxability purposes includes plan documents and policies that support each pay and deduction code and the tax configuration assigned, taxability configuration tables from the payroll system and annual summaries that show the total wages and deductions for each pay and deduction code and the tax treatment that applied.”**

# Managing employment tax risk in payroll outsourcing arrangements

Continued



## 6 Identify requirements not met by the third party

It is important to identify all the tax and reporting requirements that apply and to identify those that will not be fulfilled by the payroll service provider. Keep in mind that laws and regulations change frequently; therefore, reviewing roles and responsibilities is not only important at the time the payroll service provider is engaged but throughout the contractual relationship.

Following are examples of requirements frequently not met by the payroll service provider:

- ▶ Submitting copies of certain withholding allowance certificates to the state or local taxing authority
- ▶ Obtaining certificates of non-residence from employees to support state income tax withholding exemptions under reciprocal agreements
- ▶ Obtaining and retaining documents to support an employee's claim of tax exemption (e.g., Social Security tax exemptions, income tax treaty exemptions)
- ▶ Payment of license fees ("head taxes") that are paid only by employers
- ▶ Filing of change-of-status forms with states and localities when all or a portion of the business is sold or purchased or when the business has terminated operations
- ▶ Registering for a new tax account in a state or locality
- ▶ Complying with agency information requests or inspection of record notices (e.g., copies of payroll registers, proof of tax deposits/payments, tax returns, withholding certificates, daily time records)
- ▶ Return filing under special reporting arrangements such as common paymaster or in connection with a merger/acquisition
- ▶ International tax and reporting requirements for US employees working abroad
- ▶ Mandatory surveys such as the [Occupational Employment Statistics Report](#)

## 7 Obtain appropriate level of review and signatures

As a matter of adequate internal control, the ultimate authority for approving returns, information statements and cash transfers to the payroll service provider should be either an officer of the company or a designee of the officer having a general knowledge of employment tax and independence from the day-to-day payroll and employment tax operations.

Appropriate review and authorization of third-party payroll and employment tax transactions, including regular reconciliation, are further emphasized for SEC registrants subject to the more stringent internal control requirements under Section 404 of [Sarbanes-Oxley](#).

## What is the health of your oversight plan?



A payroll service provider can assist you in meeting your payroll and employment tax obligations, but it cannot replace skilled professionals within your organization who understand the complex and changing employment tax requirements and the pressure points where continuous oversight is vital.

Complete the questionnaire below to identify areas where you may need to enhance or strengthen your management of the payroll service provider arrangement.

### Payroll service provider employment tax oversight scorecard

Category	Query	No	Yes
<b>1. Vendor review</b>			
1a.	Do you regularly confirm that your payroll service provider is in good standing by checking with sources such as the Better Business Bureau and, where appropriate, do you perform criminal backgrounds checks of the owners/operators?	<input type="checkbox"/>	<input type="checkbox"/>
1b.	If an SEC registrant, does the payroll service provider make available to you their <a href="#">SSAE 16</a> report?	<input type="checkbox"/>	<input type="checkbox"/>
1c.	Do you maintain a detailed employment tax requirements checklist that identifies which are the responsibility of the payroll service provider and which are met by you?	<input type="checkbox"/>	<input type="checkbox"/>
1d.	Pursuant to 1c, do you update this list at least annually?	<input type="checkbox"/>	<input type="checkbox"/>
1e.	Pursuant to 1c, do you subscribe to an independent news service or otherwise monitor your taxing jurisdictions for new or changing employment tax requirements?	<input type="checkbox"/>	<input type="checkbox"/>

# Managing employment tax risk in payroll outsourcing arrangements

Continued

Category	Query	No	Yes
<b>2. Monitoring of tax accounts</b>			
2a.	Have you set up an EFTPS account with the IRS and do you access it to confirm that each federal employment tax deposit/payment is timely made and in full?	<input type="checkbox"/>	<input type="checkbox"/>
2b.	Do you access your state and local tax accounts to confirm that all payroll tax deposits/payments were timely made and in full?	<input type="checkbox"/>	<input type="checkbox"/>
2c.	Have you confirmed that your address is the address of record for all federal, state and local tax accounts?	<input type="checkbox"/>	<input type="checkbox"/>
2d.	Do you maintain an inventory of federal, state and local tax agency notices documenting the date received, the date resolved and the cause/resolution?	<input type="checkbox"/>	<input type="checkbox"/>
2e.	Pursuant to 2d, do you hold the payroll service provider to account for notices that are unresolved after a specified period?	<input type="checkbox"/>	<input type="checkbox"/>
2f.	Do you regularly request transcripts of your federal, state and local tax accounts to identify outstanding issues?	<input type="checkbox"/>	<input type="checkbox"/>
<b>3. Reconciliation</b>			
3a.	Do you perform a reconciliation each payroll period that confirms year-to-date accumulators maintained by the payroll service provider are accurate and that wage bases, etc. vital to tax calculations are correctly maintained?	<input type="checkbox"/>	<input type="checkbox"/>
3b.	Each quarter do you reconcile Forms W-2 to Forms 941 and federal unemployment insurance wages to state unemployment insurance returns?	<input type="checkbox"/>	<input type="checkbox"/>
3c.	Do you regularly confirm that state and local returns are filed (and taxes withheld/paid) for each work and applicable resident location based on employee Masterfile data?	<input type="checkbox"/>	<input type="checkbox"/>
3d.	Each year, do you reconcile federal Forms W-2 to state Forms W-2, federal Forms W-2 to Form 941, and Form 940 to state unemployment insurance returns?	<input type="checkbox"/>	<input type="checkbox"/>
3e.	At least annually, do you confirm that tax rates and wage bases used by the payroll service provider are correct?	<input type="checkbox"/>	<input type="checkbox"/>
3f.	Pursuant to 3e above, do you monitor for tax rate/wage base changes throughout the year and confirm the payroll service provider has implemented the change(s)?	<input type="checkbox"/>	<input type="checkbox"/>

Category	Query	No	Yes
<b>4. Taxability</b>			
4a.	Is a trained employment tax professional responsible for reviewing each pay and deduction code that is set up with the payroll service provider?	<input type="checkbox"/>	<input type="checkbox"/>
4b.	Pursuant to 4a above, is supporting documentation required for each pay and deduction code (e.g., plan document or policy) and is appropriate internal approval required?	<input type="checkbox"/>	<input type="checkbox"/>
4c.	Pursuant to 4a above, is supporting documentation maintained in your tax files?	<input type="checkbox"/>	<input type="checkbox"/>
4d.	At least once per year, do you confirm that the taxability configuration settings maintained by the payroll service provider are correct and that all special Form W-2 reporting requirements (e.g., box 10 and box 12) will be met?	<input type="checkbox"/>	<input type="checkbox"/>
4e.	Do you keep a current extract of your payroll service provider's taxability configurations in your tax files (needed in the event an agency audit)?	<input type="checkbox"/>	<input type="checkbox"/>
<b>5. Proper level of review and signatures</b>			
5a.	Is an officer of the company or an officer's designee responsible for reviewing payroll period reports before authorization of a cash transfer to the payroll service provider is granted?	<input type="checkbox"/>	<input type="checkbox"/>
5b.	Is an officer of the company or an officer's designee responsible for signing employment tax returns and information statements prepared by the payroll service provider?	<input type="checkbox"/>	<input type="checkbox"/>
<b>6. Recordkeeping</b>			
6a.	Do you store to your internal storage system all reports prepared by the payroll service provider (e.g., payroll registers, payroll summaries) and copies of all returns, information statements and tax payment confirmations?	<input type="checkbox"/>	<input type="checkbox"/>



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It is important to remember that mistakes happen, no matter how reputable or otherwise competent the service provider is. For this reason, perpetual monitoring of tax accounts is vital to managing risk. Monitoring tax accounts is prudent whether employment tax processes are handled internally or outsourced. In fact, some businesses ask their accounting firm to take a periodic review of tax accounts as an additional step in uncovering unknown risks.





## How Ernst & Young LLP can help

Our team of experienced employment tax professionals can assist you in confirming that you have adequate processes in place to manage your payroll service provider arrangement and to identify risks and opportunities within your employment tax processes.

Here are some of the services we offer:

- ▶ [Employment Tax Process Improvement](#)
- ▶ [Employment Tax Audit Defense and Risk Controversy Services](#)
- ▶ [TaxAbility™](#)
- ▶ [Short-Term Business Traveler](#)

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