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Report to the Secretary of the Treasury

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TAX POLICY

Federal Tax Deposit Requirements Should Be Simplified

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GAO

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The Honorable Nicholas F. Brady
The Secretary of the Treasury

Dear Mr. Secretary:

This report discusses our evaluation of the federal tax deposit (FTD) requirements for withheld income and social security taxes and the Internal Revenue Service's (IRS) administration of the penalty assessed taxpayers who do not make sufficient and timely deposits. In fiscal year 1988 about 5 million employers made over 73 million deposits totalling $627 billion for these employment taxes. About 32 percent of these employers were penalized $2.6 billion for not making timely deposits.

Results in Brief

The frequency of deposits and when deposits are due is determined by the amount of employment taxes withheld by employers each payday and how often paydays occur. The deposit requirements are complex and difficult to understand because employers can be subject to more than one deposit requirement during a tax period and because the exceptions to the requirements can be confusing. The deposit requirements were established with different deposit frequencies to give small employers more time to pay their employment taxes while at the same time ensuring a constant flow of funds for government operations by having larger employers remit their taxes more frequently. However, the complexities inherent in the requirements have made it more difficult for small employers to comply with the requirements.

Standardizing the deposit rules by requiring all employers to deposit within 3 days of a payday could improve employer compliance and ease IRS administration. A single exception permitting small employers to deposit less frequently than after each payday could reduce the burden on both employers and IRS from the increased number of deposits the standard requirement would generate. Eighty-nine percent of the nation's employers—those with quarterly deposits up to $30,000, could be exempted and the federal government would still save almost $100 million annually in borrowing costs by requiring the employers above this threshold to deposit on the expedited 3-day basis. These larger employers account for 88 percent of the employment tax dollars.

The complexities of the FTD system also make it difficult for IRS to administer the FTD penalty. In 44 percent of the 75 manually assessed penalty cases we examined, IRS tax examiners miscalculated the flat rate penalty because in most cases they did not properly apply the deposit requirements. In addition, 1988 IRS data show that it assessed over 300,000 computer-generated deposit penalties totalling $324 million, even though it did not have information on which deposit period to apply a specific deposit to. As a result, many of these penalty calculations were wrong. IRS should revise the FTD coupon to have employers provide this information.

Background

Employers who withhold income and social security taxes are required to deposit these employment taxes under the FTD system.[1] Section 6302(c) of the Internal Revenue Code gives the Secretary of the Treasury the authority to set the deposit requirements. Employers deposit their tax payments with about 15,000 financial institutions that have been authorized by the Federal Reserve to function as federal depositaries. Employers are required to submit FTD coupons (Form 8109) showing the deposit amount and date and the quarterly tax period that the deposit should be applied against. Employers show on a Form 941, Employer's Quarterly Federal Tax Return, when their paydays occurred during a deposit period and the amount of employment tax liabilities they had each payday.

The frequency of deposits and when the deposits are due is determined by the amount of taxes withheld and how often paydays occur. An employer owes employment taxes when employees are paid their wages, not when the payroll period ends. Employers accumulate their employment tax liabilities from payday to payday until one of the following deposit rules is triggered, unless they qualify for one of the exceptions to the rules discussed in appendix I.

Rule 1 (End-of-return period or quarterly deposit rule): If the total accumulated employment taxes are less than $500 in a calendar quarter, no deposit is required. Instead, the taxes can be paid directly to IRS when the business files Form 941, which is due 1 month after the end of each calendar quarter.

Rule 2: If the total accumulated undeposited employment taxes are less than $500 at the end of any month, the taxes are carried over to the

[1] Corporation and exempt organization income taxes, federal unemployment taxes, and businesses' excise taxes are also required to be deposited under the FTD system. For the purposes of this report, employment taxes do not include federal unemployment taxes, which are also considered employment taxes but are filed on Form 940 with separate requirements.

following month within the quarter and added to that month's taxes until one of the deposit requirements in Rule 3 or Rule 4 is triggered.

Rule 3 ($500 or monthly deposit rule): If the total accumulated undeposited employment taxes are $500 or more but less than $3,000 at the end of any month, the taxes are to be deposited within 15 days after the end of the month.

Rule 4 ($3,000 or 3-banking-day rule): If the total accumulated undeposited employment taxes are over $3,000 at the end of one of eight deposit periods within each month, the taxes are required to be deposited within 3 banking days after the end of the period. For deposit purposes, each month within the quarter is divided into eight deposit periods ending on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th, and last day of the month.

In addition to the deposit requirements set by the Secretary of the Treasury through regulation, the Omnibus Budget Reconciliation Act of 1989 requires employers with employment tax liabilities of $100,000 or more each payday to make deposits within 1 banking day, beginning August 1, 1990.[2]

FTD Penalty

If employment tax deposits are not timely or of sufficient amount, IRS can assess a failure-to-deposit penalty. For deposits made prior to January 1, 1990, the penalty is 10 percent of the undeposited tax regardless of the length of time the deposit was late. For deposits made after this date, the Omnibus Budget Reconciliation Act of 1989 changed the penalty from a flat rate to a four-tier, time-sensitive penalty. Under the act, an employer is subject to a penalty of 2 percent of the underpayment if taxes are late but deposited within 5 days of the due date; 5 percent if deposited after 5 days but within 15 days; 10 percent if deposited after 15 days; and 15 percent if not deposited before the earlier of 10 days after the date of the first delinquency notice or the day on which notice and demand for immediate payment is given. The penalty can be abated if taxpayers submit proof that they had reasonable cause not to make sufficient or timely deposits.

[2]Under the act, these employers must make deposits within 2 banking days in 1991, within 3 banking days in 1992, and within 1 banking day in 1993 and 1994. This provision expires at the end of 1994. For calendar year 1995 and thereafter, the Secretary of the Treasury can then issue regulations on when these deposits are to be made.

The number and amount of deposit penalties assessed and abated on employment taxes for fiscal years 1984 through 1988 are shown in table 1.

Table 1: Failure-to-Deposit Penalty Assessment/Abatement Statistics, Fiscal Years 1984-88

Dollars in thousands

	Assessments		Abatements	
Fiscal year	**Number**	**Amount**	**Number**	**Amount**
1984	5,169,096	$1,622,536	981,943	$800,604
1985	2,445,454	1,367,076	936,576	793,885
1986[a]	984,776	620,180	356,230	444,775
1987	3,477,077	2,447,103	519,755	790,192
1988	3,545,691	2,612,727	726,335	1,206,943

[a]Deposit penalty assessments and abatements decreased in fiscal year 1986 because IRS temporarily raised its tolerance for assessing the penalty in order to reduce the amount of taxpayer correspondence it received.

About 90 percent of the penalties are assessed by a computer program, which compares deposit dates and amounts shown on FTD coupons with the dates and amounts of tax liability for each payday shown on Form 941. The remaining 10 percent of the penalties are manually assessed by tax examiners in IRS' service centers.

Objectives, Scope, and Methodology

Our objectives were to determine whether (1) IRS appropriately and accurately assesses and abates deposit penalties, (2) IRS guidance to employers on complying with the deposit requirements is adequate, and (3) changes are needed to the FTD system to improve penalty administration and employer compliance.

To find out whether IRS appropriately and accurately assesses and abates deposit penalties, we reviewed a random sample of 150 FTD penalty actions that were taken in fiscal year 1987 at three IRS service centers—Fresno, California; Brookhaven, New York; and Austin, Texas. The sample cases consisted of 25 manual assessments and 25 manual abatements for each service center. For each of our sample cases, we analyzed the employer's Form 941, business master file record, and available taxpayer and IRS correspondence. We discussed the results of our case analysis with IRS service center officials in those cases where we disagreed with either the assessment or abatement action taken.

We also reviewed the computer programs used to administer the FTD penalty as well as a small number of computer-generated penalty case files to identify and analyze potential problems with the programs.

To determine whether IRS guidance to employers is adequate, we reviewed IRS' tax form instructions and publications and Treasury regulations on the deposit requirements. We also discussed the deposit requirements and IRS' policies and procedures with IRS National Office officials and the deposit regulations with Treasury officials.

To determine whether changes to the FTD system are needed, we used the results of our sample cases to analyze the deposit requirements and the penalty procedures. We also discussed the deposit requirements and the draft report with officials of the Small Business Administration and National Federation of Independent Business (NFIB). The NFIB represents 570,000 small businesses nationwide.

We did our field work between January 1989 and May 1990 using generally accepted government auditing standards.

Complex Deposit Requirements Make Compliance Difficult

About a third of the nation's employers are assessed at least one FTD penalty annually. While some may be penalized because they do not have sufficient funds to make timely deposits, others may be penalized because they do not understand the complexities of the deposit requirements. The deposit requirements are complex because they can vary from month to month depending on the amount of employment taxes withheld each payday and because the exceptions to the requirements can be confusing.

Variable Deposit Requirements Cause Uncertainty

Variable deposit dates coupled with the fluctuating nature of some employers' payrolls make it difficult for such employers to predict with certainty when their deposits are due. The use of eight monthly deposit periods also adds complexity. The eight periods vary in length from 3 to 6 days, depending on the specific period and the month involved. Accordingly, the amount of time an employer has after a payday to make a deposit can actually vary from 3 to 8 days depending upon the length of the deposit period as well as where in the eighth-monthly period the payday falls. To comply with the changing deposit requirements the employer must monitor undeposited employment taxes from payday to payday and know when changes in payroll amounts will trigger a different deposit requirement that requires an earlier deposit as well as when each eighth-monthly period ends. Otherwise, the employer could unintentionally make a late deposit and be penalized.

In 31 percent of our sample cases, employers were faced with at least one change in their deposit requirement during the quarter. In over half of these 47 cases, the employers made timely deposits under their initial deposit requirement but were penalized when their payroll and associated employment taxes increased later in the quarter and triggered a different deposit requirement.

Deposit Exceptions Are Confusing and Unnecessary

The deposit requirements are further complicated by exceptions. For example, employers with large payrolls are allowed more time to make particular deposits than smaller employers. This exception relates to the deposit rule that requires undeposited taxes of more than $500 but less than $3,000 at the end of the month to be made within 15 days after the end of the month. The exception allows employers with large payrolls, who were required to make a deposit of $3,000 or more during the third month of the quarter, to have until the end of the next month to deposit any balance of $500 or more but less than $3,000. This exception appears to confuse employers. In 11 percent of our 150 sample cases, the employers were penalized when they made their third-month deposits by the end of the next month as is allowed by the exception for large payrolls. However, they did not qualify for this exception because they were not required to make a $3,000 deposit during the third month.

Likewise, exceptions to the deposit requirements that were established to provide relief to certain employers may no longer be necessary. For example, the "safe haven" exception allows employers with undeposited taxes of $3,000 or more at the end of a deposit period to deposit 95 percent of these taxes within 3 banking days and the remaining 5 percent after the 15th day of the following month. This exception was intended to benefit large employers who could not determine their actual employment tax liability in time to deposit the exact amount within the required 3 banking days.

However, according to IRS, two reasons prompting the creation of the safe haven exception in 1972 may no longer be applicable. First, businesses today have computerized payroll systems that can accurately and efficiently determine the correct amount of employment taxes that must be deposited. Second, it affects relatively few employers. IRS data show that for the fourth quarter of 1988 about 19,300 employers with quarterly employment taxes of $10,000 or more claimed the safe haven on their Forms 941—approximately .3 percent of the total Forms 941 filed. A Treasury official estimated that Treasury loses about $25 million in interest income annually because its use of the safe haven deposits is delayed. Similarly, IRS estimates its cost to process and analyze safe haven tax returns and related correspondence is about $1 million annually.

The safe haven provision is also open to abuse. Studies by IRS' Internal Audit Division and the Railroad Retirement Board have recommended eliminating the safe haven provision because large employers receive unintended benefits by taking advantage of the safe haven provision even though they can accurately determine their actual tax liability. In a 1984 report on the use of the safe haven provision by 78 large corporations in the Midwest Region, Internal Audit found that in 74, or 39 percent, of the 192 quarterly employment tax returns it reviewed, the employers deposited the full 100 percent while in 118 returns, or 61 percent, the employers claimed the safe haven. However, in 29, or 25 percent, of the 118 safe haven returns, the employers consistently deposited exactly 95 percent of their tax liability. Internal audit concluded that if these employers could deposit exactly 95 percent of their tax liability, they had the capability to deposit the full 100 percent.

In a 1989 study on the use of the safe haven provision by the 10 largest railroads, the Inspector General for the Railroad Retirement Board found that 6 of the 10 railroads deposited 100 percent of their tax liability, while the remaining 4 claimed the safe haven. It also found that of the four that claimed the safe haven, one railroad consistently deposited 95 percent and a second railroad consistently deposited 96 percent of its total employment tax liability.

These studies indicate to us that the safe haven is being abused by businesses to delay deposit of their taxes. Other administrative procedures less prone to abuse could be established to provide the needed flexibility to accommodate genuine cases where employers cannot accurately determine their tax liability. For example, penalty abatement criteria could be established or waivers to the deposit requirements submitted by employers prior to a quarter could be granted for those employers who submit evidence that they could not accurately calculate their employment tax liability.

Changes Needed to Deposit Requirements

The employer compliance problems associated with the complexities of the deposit requirements could be substantially reduced if all employers had the same number of days to make their deposits and if there were no exceptions to the requirements. For example, requiring that all deposits be made within 3 banking days of a payday would be fairly consistent with current deposit requirements and familiar to most employers. If all employers were required to deposit their employment taxes within 3 banking days of a payday, employers would always know when their deposits were due and could plan their operating expenditures around this requirement. In addition to reducing the uncertainty faced by employers, such a change would also make it easier for IRS to administer the deposit requirements and to more efficiently and accurately assess penalties for insufficient or untimely deposits. Standardizing the requirements would, however, increase the number of deposits employers would have to make and IRS would have to process.

The deposit requirements were established with different deposit frequencies to give small employers more time to pay their employment taxes while at the same time ensuring a constant flow of funds for government operations by having larger employers remit their taxes more frequently. However, the complexities inherent in the requirements may have made it more difficult for small employers to comply with the requirements. According to IRS data in 1988, about 72 percent of the deposit penalties were assessed against employers who had undeposited taxes of less than $3,000 at the end of a deposit period.

Simplification Options

Having one standard deposit requirement for all employers would eliminate many of the problems in tax administration and employer compliance that result from the current varying requirements. If after each payday all employers were required to deposit their taxes within some set time interval, such as within 3 banking days after they paid their employees their wages, employers would know with certainty when to make deposits. This would also eliminate the complexity and uncertainty associated with the existing eighth-monthly deposit periods. These advantages led the American Institute of Certified Public Accountants to recommend recently that deposit requirements be simplified by replacing the eighth-monthly period system with a simpler one that provides for deposits 3 days after a payday.

While this deposit requirement would be easier for IRS to administer and employers to comply with, it would speed up small employer deposits as well as increase the number of deposits employers would have to make.

Correspondingly, it would increase the number of deposits IRS would have to process. The impact could be reduced by allowing employers with quarterly tax liabilities below some threshold to pay their employment taxes (1) each quarter when they file their Form 941 or (2) within a certain number of days of the end of each month.

Table 2 shows the impacts of standardizing the deposit rule by requiring all employers, regardless of size, to deposit within 3 banking days of payroll. The impacts addressed are the number of employers that would be making deposits, the number of deposits that would be made annually, and changes in federal borrowing costs. The table analyzes the impact of providing for exceptions that would allow employers with less than $3,000, $10,000, or $30,000 in quarterly tax liabilities to deposit their taxes within 3 banking days of the end of the month. The table also analyzes the impact on deposits and federal borrowing costs if employers with quarterly tax liabilities of less than $3,000 could pay their taxes when they file Form 941.

Table 2: Estimates of the Number of Employers Making Deposits, Number of Deposits Made, and the Revenue Impact of a Standard Deposit Rule

Dollars in millions

	Number of employers making deposit (millions)	Number of deposits annually (millions)	Borrowing costs savings
Current deposit rules	3.9	56	$n/a
Standard 3-day rule	4.5	171	367
Exceptions to the standard rule:			
<$3,000 paid with 941	2.3	85	209
<$3,000 deposited monthly	4.5	111	334
<$10,000 deposited monthly	4.5	80	248
<$30,000 deposited monthly	4.5	60	94

Note: Estimates are based on first quarter 1989 IRS data on the number of Forms 941 filed and the employment tax liability for these returns. About 5.1 million employers filed Forms 941 in the first quarter of 1989, but about 630,000 of these employers had no tax liability.

We selected a threshold of less than $3,000 in quarterly tax liability because under the current deposit requirements these employers do not have to make deposits more frequently than monthly. The $30,000 in quarterly tax liability was suggested by the National Federation of Independent Business to reduce the paperwork burden on small businesses and to mitigate the financial impact of accelerated deposits on "cash poor" companies. Since this represents an expansion of the exemption beyond the current rules, we also analyzed exempting employers with less than $10,000 in quarterly tax liability, which is roughly the current threshold for depositing monthly as opposed to using eight monthly periods.

When compared with the current rules, a standardized provision with no exceptions would increase the number of employers making deposits from 3.9 million to 4.5 million. About .6 million employers that have quarterly tax liabilities of less than $500 make no deposits. Further, it would accelerate deposits for all employers because they would be depositing after each payday instead of after either the end of an eighth-monthly period, month, or quarter. Accordingly, the number of deposits per quarter would increase from the current 56 million to 171 million.[3] Because of the accelerated receipt of these taxes, about $367 million annually in federal borrowing costs could be saved.

In comparison to the proposed standardized rule, the exceptions would delay the receipt of taxes owed for all employers with quarterly tax liabilities of less than $3,000, $10,000, and $30,000. If these smaller employers were allowed to file monthly, the number of deposits per quarter would fall from 171 million under the standard rule to 111 million for employers with less than $3,000 in quarterly taxes, 80 million for less than $10,000, and 60 million for less than $30,000. In addition, federal savings would drop from $367 million to $334 million for employers whose taxes are less than $3,000, $248 million for less than $10,000, and $94 million if less than $30,000. If employers with less than $3,000 in quarterly taxes were allowed to file and pay quarterly, the number of deposits would drop to 85 million and federal savings would fall to $209 million.

As shown in table 3, the different exemption options can exempt up to 89 percent of the nation's employers from the 3-day deposit rule, with comparatively little financial impact on the government's employment tax receipts.

[3]The number of deposits is calculated on the basis of the assumption that 58 percent of the employers pay wages weekly, 24 percent pay bi-weekly, 8 percent pay semi-monthly, and 10 percent pay monthly. These assumptions are based on unpublished data we obtained from the Bureau of Labor Statistics on the payroll frequency of 79,588 nonagricultural business establishments in 15 states. These data have limited statistical value because they were derived from a highly stratified sample and are not weighted sample-based estimates. However, since these are the only data available on payroll frequency, we used these raw data to develop our nationwide estimates of deposit frequencies.

Table 3: Estimates of the Number of Employers and Amount of Employment Taxes Affected by Exemption Options to the Deposit Rules

	Number of employers (millions)	Percent of employers	Amount of tax liability (billions)	Percent of total employment tax liability
Total employers and taxes	4.5	100	659.5	100
Exemptions to deposit rule:				
<$3,000 paid with 941	2.2	49	10.0	1.5
<$3,000 deposited monthly	2.2	49	10.0	1.5
<$10,000 deposited monthly	3.4	76	35.8	5.4
<$30,000 deposited monthly	4.0	89	80.6	12.2

Nevertheless, when compared with the current rules, more taxpayers would be paying faster than they do now, even with the exceptions, resulting in federal borrowing savings under any of the options. For example, if employers with less than $30,000 in quarterly liabilities were allowed to pay taxes within 3 banking days of the end of the month, the remaining .5 million employers with more than $30,000 in quarterly tax liability would have to deposit at least within 3 banking days of their paydays instead of after the eighth-monthly periods. As a result, the total number of deposits would increase slightly from 56 to 60 million. Similarly, the deposits for the 3.4 million employers with quarterly tax liabilities of less than $10,000 would be accelerated because they would be required to make deposits within 3 banking days after the end of the month instead of either after 15 days after the end of a month or when they filed their Forms 941. The only employers whose deposits would not be accelerated under this option would be the .7 million employers with quarterly tax liabilities of more than $9,000 and less than $30,000. These employers, who pay about 7.4 percent of the employment taxes and represent about 16 percent of the employers who pay employment taxes, currently deposit taxes within 3 banking days of an eighth-monthly period and would, if exempted, be able to pay monthly. However, one concern with this option is whether allowing these employers to deposit monthly would increase their employment tax delinquency rate, thereby exacerbating the accounts receivable problem IRS faces.

Look Back Provision Needed

Any exception to the standard rule should contain a "look back" provision that will allow employers to know before a quarter begins when deposits have to be made. This will avoid the existing uncertainties over when individual employers are required to deposit their taxes. For example, one possible look back provision would base the entire year's deposit frequency on the employer's experience in the first quarter of the year. If an employer is exempted from making deposits during the first quarter and instead can pay the taxes when the Form 941 is filed because the quarterly tax liability was less than $3,000, the employer would be exempted from making deposits for the next four quarters even if these quarterly taxes exceed $3,000. Another possible basis for look back would be to base the current year's deposits on the deposit rule used most frequently by the employer in the previous year.

Even under the existing deposit requirements, a look back provision would help eliminate uncertainties currently facing employers whose deposit requirements may change. As stated earlier, in 31 percent of our sample cases, employers were faced with at least one change in their deposit requirement during the quarter. Small businesses have long advocated a look back provision. Treasury has historically rejected the idea because of difficulties with seasonal and new businesses. We do not believe these types of businesses present an insurmountable problem. Seasonal businesses could be required to deposit on the basis of their prior-year experience, while new businesses could be asked to estimate their first-quarter tax liabilities and deposit accordingly.

Improvements Needed in Administering Deposit Requirements and Penalties

Placing all employers under the same deposit requirement would enhance employer compliance and IRS' administration of the FTD system. However, IRS could also improve its administration of the current deposit requirements and the FTD penalty by revising the FTD coupon, clarifying tax forms and instructions, and developing computer programs to calculate the FTD penalty. This would not only strengthen administration of the current requirements but also enhance IRS' ability to implement any new requirements promulgated.

FTD Coupon Changes Are Needed

In 1988, IRS assessed 317,000 deposit penalties totalling $324 million, even though it did not know the specific deposit period that the employers' deposits should have been applied to when calculating the penalties. IRS' computer can make inaccurate assessments in cases where employers are subject to more than one deposit rule during the quarter, because it cannot determine which deposit period the employer wanted specific deposits to be applied against. As a result, IRS cannot be assured that its penalty calculations are accurate.

IRS does not currently get information linking a specific deposit to a specific deposit period from employers. Having employers provide information on which deposit periods to apply their deposits to will be essential for IRS to efficiently and accurately administer the four-tier, time-sensitive penalty that was enacted in the Omnibus Budget Reconciliation Act of 1989. Unless IRS obtains specific deposit period data from employers, it will not know for certain which of the four-tiered penalty rates will apply to many late deposits.

Modifying the deposit coupon to require employers to provide this information would resolve this problem. (See app. II for an example of a modified coupon.) It would also allow IRS to more accurately calculate penalties when employers fail to fill out the "wages paid" section of their Form 941.

Form 941 Instructions Should Be Clarified

In many cases, an incorrect penalty amount was calculated because employers did not complete the section of the Form 941 that shows when they paid wages. This section is important because IRS uses it to determine whether the deposits were sufficient and timely. Without this information, IRS assesses the penalty after averaging the quarterly tax liability. (The method IRS uses to do this is described in detail in app. III.)

IRS penalty calculations under these circumstances will be wrong in many cases. For example, in 91 of the 121 sample cases where we had wage paid data, the averaging method produced variances ranging from $1 to $3,160 of what the correct penalty amount should have been. For the remaining 30 cases, there was no difference between the penalty amount calculated using the averaging method and the wages paid data shown on the employers' Forms 941.

According to IRS data, in 1988 this section was not completed on 8.3 million, or 41 percent, of the 20 million Forms 941 filed. We believe that IRS should clarify its instructions for completing the wages paid section of the Form 941, which shows the deposit periods that the employer paid wages and the amount of employment taxes owed for those periods, to emphasize the importance of providing this information.

Instructions on the FTD Requirements Are Difficult to Understand

IRS' instructions on the deposit requirements could be made clearer so that employers could more readily determine when they should make deposits. Circular E, Employer's Tax Guide, is the IRS publication that provides taxpayers with instructions and guidance on when to make their deposits. This publication lists the four rules for depositing taxes and gives five examples on how to apply the rules. The examples are in narrative form and contain various dates and dollar amounts, which makes it difficult to visualize exactly when deposits should be made. The examples do not include charts or tables to illustrate the narrative descriptions.

IRS could make it easier for taxpayers to understand the deposit requirements if Circular E contained clear and comprehensive examples of each deposit rule. IRS' Publication 539, Employment Taxes, which discusses an employer's responsibility for employment taxes, gives one such example. This comprehensive example traces an employer's paydays and deposit dates for each month of the quarter and uses several charts to illustrate the narrative. IRS could use this example as a model for explaining the deposit rules in Circular E.

Manual Calculation of the FTD Penalty Should Be Computerized

IRS' computers are programmed to calculate the FTD penalty for the majority of Forms 941 processed. However, the penalty must be manually calculated under certain situations, such as when a taxpayer responds to a proposed penalty notice. In 1988, IRS manually assessed over 325,000 FTD penalties at a cost of about $4 million.

We found that 33 of the 75 manually assessed penalties we reviewed were incorrectly calculated. This occurred in most cases because tax examiners did not correctly apply the deposit rules when they calculated the penalty.

To overcome the errors that tax examiners make when manually calculating FTD penalties, we had Fresno Service Center staff develop a computer program that would calculate the penalty for the examiners. We tested this computer program and found that it accurately calculates FTD penalties. An IRS Fresno Service Center official estimated that, using this computer program, a tax examiner could accurately calculate an FTD penalty in 7 minutes, which, according to IRS data, is less than one-half the time it takes to manually calculate the penalty. This program was developed to be used on Fresno's local computer system, which is similar to computer systems maintained in IRS' other nine service centers.

Conclusions

The deposit requirements are complex, contain several unnecessary exceptions, and for many employers may be difficult to understand. The frequency of required deposits for a given employer can vary over the tax period so that the employer cannot always predict when deposits are due. The complexity and uncertainty of the deposit requirements may be part of the reason why over 30 percent of all employers in fiscal year 1988 received at least one FTD penalty. Although some of the exceptions began as well intended efforts to ease the compliance burden for small employers, the resulting complexity may have made it more difficult for these employers to comply and more likely they will be penalized.

The deposit requirements should be simplified. The employer compliance problems associated with the complexities of the deposit requirements could be substantially reduced if all employers had the same number of days after a payday to make their deposits and if there were no exceptions to the requirements. A standard deposit requirement would, however, increase the number of deposits some employers would be required to make as well as the number of deposits IRS would have to process. If Treasury determines the increase would be burdensome, a single exception for small depositors could greatly reduce the number of deposits while minimizing the added complexity. For example, a threshold exempting employers with quarterly tax liabilities of up to $30,000 from depositing taxes within 3 banking days of their paydays would permit 89 percent of the nation's employers to deposit monthly. At the same time, federal borrowing costs savings would be about $100 million annually because about 93 percent of the employment taxes would be required to be deposited sooner than under the current deposit rules.

Any change to the deposit requirements should include the repeal of the safe haven exception for larger employers needing time to calculate their tax liability. This exception is subject to abuse, and any flexibility needed can be provided through waving penalties. In addition, a look back provision should be added so that employers know what their deposit requirements are at the beginning of the quarter.

The variable deposit requirements and the exceptions to them also make it difficult for IRS to administer the requirements and accurately assess deposit penalties. IRS cannot always accurately assess the 10-percent flat-rate deposit penalty because it does not receive information from employers to accurately associate the deposits with the correct deposit period. This problem will be exacerbated under the multi-tier, time-sensitive penalty enacted in the Omnibus Budget Reconciliation Act of 1989. Modifying the FTD coupon to capture this information should resolve the problem. IRS also assesses erroneous penalties because it has tax examiners manually calculate some penalties instead of developing computer programs to more accurately calculate the penalties.

Employers may not comply with the current deposit requirements because IRS' employment tax publications do not adequately explain the requirements or the need to fully complete the returns.

Recommendations

To make it easier for employers to understand and comply with the deposit requirements and for IRS to administer the requirements, we recommend that you change the deposit requirements so that all employers are required to make employment tax deposits within some specific time interval of each payday. Requiring all deposits within 3 banking days of a payday would be fairly consistent with current deposit requirements and familiar to most employers. This change should include the repeal of the safe haven provision and all other exceptions but not affect the statutory deposit requirements contained in the Omnibus Budget Reconciliation Act of 1989.

If an exception is granted to this standard deposit requirement to reduce the number of deposits made by small employers, we recommend that a single exception be provided to minimize confusion and administrative burdens. A threshold of $30,000 in tax deposits per quarter is one option to consider in that it covers 89 percent of the employers but only 12.2 percent of the employment tax revenues.

We also recommend that a look back procedure be included, which will allow employers to know what their deposit requirement will be before the start of a quarter. This procedure, which should be adopted even if the deposit requirements are not changed, should also apply to employers required to deposit employment taxes within 1 banking day of each payday under the 1989 Omnibus Budget Reconciliation Act.

To improve employers' compliance with the current deposit requirements and IRS' administration of the four-tier, time-sensitive deposit penalty, we recommend that you direct the Commissioner, Internal Revenue, to

- modify the FTD coupon to have employers indicate the specific deposit period to apply the deposit to,
- clarify IRS' guidance to employers on the FTD requirements and instructions for completing the Form 941, and

- require all service centers to use computer programs to calculate the FTD penalty.

Agency Comments and Our Evaluation

Treasury and IRS provided written comments on a draft of this report. Treasury limited its comments to our recommendation to change the deposit requirements. IRS limited its comments to our recommendations to modify the FTD coupon, clarify tax forms and instructions, and develop a computer program to eliminate the need to manually calculate the FTD penalty.

Treasury's March 13, 1990, comment letter responded negatively to our recommendation that the deposit requirements be simplified. Specifically, Treasury opposed elimination of the eighth-monthly periods and the safe haven provision. In subsequent discussions, Treasury officials agreed with us that the deposit requirements should be simplified and the need for the eighth-monthly periods and safe haven rule should be reconsidered. In addition, on May 7, 1990, IRS, with Treasury's approval, issued a notice requesting public comments on replacing the eighth-monthly system with a less complex deposit system, such as the one discussed in our draft report, i.e., based on employers' paydays. Comments were also requested on eliminating the safe haven rule. A more detailed response to Treasury's comments and the comment letter is in appendix IV. A copy of the IRS notice is provided in appendix V.

In its letter dated March 20, 1990, IRS stated it would take action on our recommendations, but is considering an alternative to modifying the FTD coupon. The alternative IRS is considering is to revise the deposit regulations to require that deposits be applied in deposit date order against the oldest periodic liability first. We do not endorse this alternative because we believe that it could lead to penalties that exceed the amount intended by Congress. When an underpayment exists for one deposit period, IRS would automatically apply the tax payment for the next period to the prior period's underpayment, thereby creating another underpayment for the next period. This would then prompt IRS to assert a second penalty covering this second underpayment. Essentially, this would subject a single underpayment to at least two separate penalties. An illustration of this situation and a more detailed discussion of our concerns is in appendix IV.

As you know, 31 U.S.C. 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report. A written statement must also be submitted to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Joint Committee on Taxation; the Subcommittee on Private Retirement Plans and Oversight of IRS, Senate Committee on Finance; the Subcommittee on Oversight, House Committee on Ways and Means; the Commissioner of Internal Revenue; and other interested parties. We will make copies available to others on request.

Major contributors to this report are listed in appendix VII. Please contact me on 272-7904 if you have any questions concerning the report.

Sincerely yours,

Paul L. Posner
Associate Director, Tax Policy and
Administration Issues

Contents

Tables

Abbreviations

FTD	Federal Tax Deposit
IRS	Internal Revenue Service
NFIB	National Federation of Independent Business

Exceptions to Federal Tax Deposit Requirements

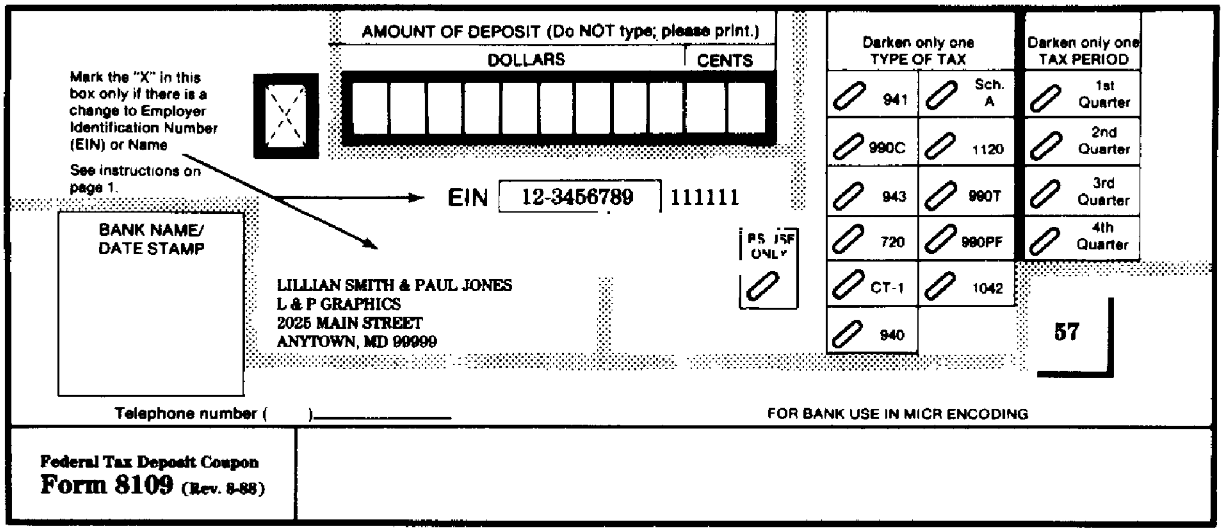
There are several exceptions to the deposit rules. For example, the "safe haven" exception allows employers required to make eight monthly deposits to deposit 95 percent of their accumulated taxes within 3 banking days of one of the eight deposit periods. The remaining 5 percent can be deposited with the first deposit that is otherwise required after the 15th of the following month. This exception was made to accommodate employers who are unable to accurately determine their employment tax liability in time to make timely deposits.

One exception allows employers with large payrolls more time to make particular deposits than smaller employers. This exception relates to the deposit rule that requires undeposited taxes of more than $500 but less than $3,000 at the end of the month to be made within 15 days after the end of the month. However, this rule does not apply to employers who were required to make a deposit of $3,000 or more during the last month of the quarter. If these employers have a balance of $500 or more but less than $3,000 at the end of the last month of the quarter, they have until the end of the next month to make this deposit.

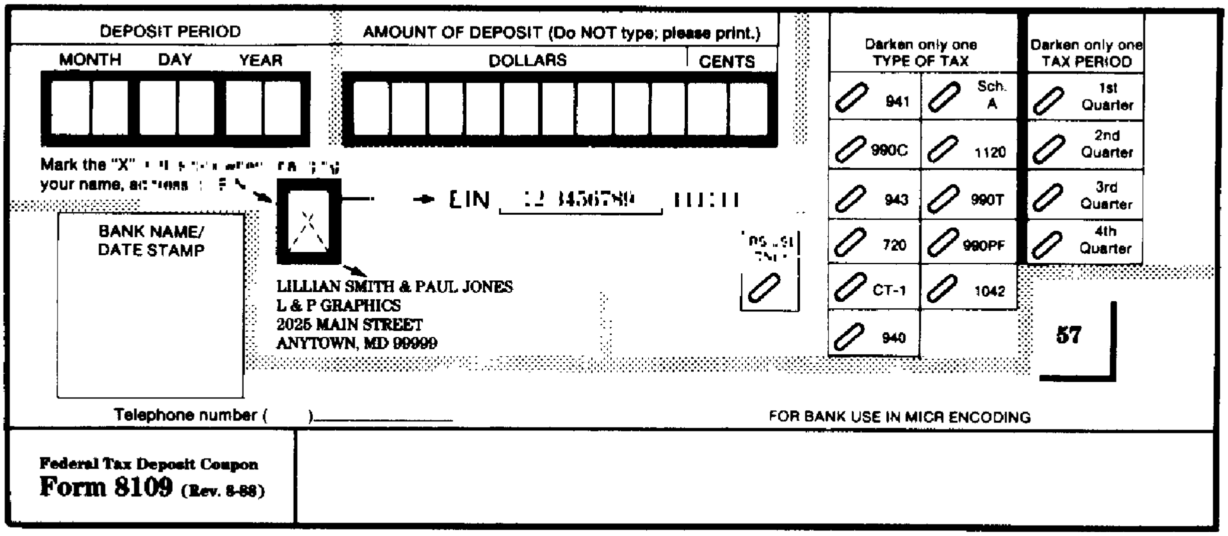
Another exception allows certain employers to deposit taxes by the 15th day of the month following a deposit period that has a tax liability of $3,000 or more instead of within the required 3 banking days. This exception applies if (1) the employer was not required to make a $3,000 deposit during the four preceding quarters and (2) the deposit is less than $10,000.

FTD Coupon

Current FTD Coupon:


AMOUNT OF DEPOSIT (Do NOT type; please print.)
DOLLARS | CENTS
Mark the "X" in this box only if there is a change to Employer Identification Number (EIN) or Name
See instructions on page 1.
EIN 12-3456789 111111
BANK NAME/ DATE STAMP
LILLIAN SMITH & PAUL JONES
L & P GRAPHICS
2025 MAIN STREET
ANYTOWN, MD 99999
Darken only one TYPE OF TAX: 941, Sch. A, 990C, 1120, 943, 990T, 720, 990PF, CT-1, 1042, 940
Darken only one TAX PERIOD: 1st Quarter, 2nd Quarter, 3rd Quarter, 4th Quarter
57
Telephone number ( )
FOR BANK USE IN MICR ENCODING
Federal Tax Deposit Coupon
Form 8109 (Rev. 8-88)

Modified FTD Coupon:


DEPOSIT PERIOD
MONTH DAY YEAR
AMOUNT OF DEPOSIT (Do NOT type; please print.)
DOLLARS | CENTS
Mark the "X" ...
your name, ad...
EIN 12-3456789 111111
BANK NAME/ DATE STAMP
LILLIAN SMITH & PAUL JONES
L & P GRAPHICS
2025 MAIN STREET
ANYTOWN, MD 99999
Darken only one TYPE OF TAX: 941, Sch. A, 990C, 1120, 943, 990T, 720, 990PF, CT-1, 1042, 940
Darken only one TAX PERIOD: 1st Quarter, 2nd Quarter, 3rd Quarter, 4th Quarter
57
Telephone number ( )
FOR BANK USE IN MICR ENCODING
Federal Tax Deposit Coupon
Form 8109 (Rev. 8-88)

IRS Methodology for Averaging FTDs

In 1988, IRS' business master file computer may have erroneously assessed 317,000 deposit penalties totalling $324 million because IRS did not know the specific deposit period that the employers' deposits should have been applied to when calculating the penalties.

In many cases, an erroneous penalty occurred because the employer did not complete the section of the Form 941 that shows when they paid wages. This section is important because IRS uses it to determine whether the deposits were sufficient and timely. If the employer does not fill out the wages paid section, IRS assumes that the employer paid wages four times each month for a total of 12 times a quarter. The total tax liability shown on the Form 941 is then allocated equally to each of the 12 assumed paydays.

The employer's actual deposit dates and accounts received are then compared by IRS to the assumed paydays to determine whether the deposits were sufficient and timely. If this comparison shows that one or more deposits were late, IRS sends the employer a notice that a penalty will be assessed unless a statement is submitted showing the actual dates the employer paid wages during the quarter. If the employer does not respond to the notice, the computer will automatically assess the penalty, which was calculated by averaging the quarterly tax liability.

These penalty calculations will in almost all cases be wrong because substantial variances can occur between penalties that are calculated by averaging the quarterly tax liability and those that are based on the wages paid section of the Form 941.

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

MAR 13 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General
Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

Thank you for the opportunity to provide comments on the draft General Accounting Office report entitled Tax Policy and Administration: Federal Tax Deposit Requirements Should Be Simplified.

The draft report summarizes a GAO review of a sample of penalties assessed by the IRS on employers for failures to comply with Federal Tax Deposit (FTD) payment schedules for FICA (social security) taxes and withheld income taxes. Because of the large numbers of employment tax penalties which are assessed each year, the GAO draft report includes a recommendation that employment tax payment schedules be simplified and that most exceptions to a single payment rule be eliminated. The report suggests that 100 percent of employment taxes be deposited three days after each payroll date, with monthly or quarterly payments permitted for very small employers.

The Treasury Department agrees with most of the GAO comments about the apparent complexity of the current payment system for employment taxes. However, we believe there are a number of negative aspects to the changes recommended by GAO. Although the recommended changes might reduce borrowing costs for the Federal government and ease administrative burden for some employers, for many employers, the recommended changes would introduce new difficulties, thereby increasing burdens and costs disproportionately to the benefits gained by the Treasury.

Employment tax liabilities are imposed when the wages are paid to employees, and government borrowing costs would be minimized if the the employment taxes were paid to the Internal Revenue Service as soon thereafter as possible. However, since employers act as collection agents for the Federal government without direct compensation, and since our entire tax system is predicated on voluntary compliance, payment rules and schedules are designed to balance the costs and burdens imposed on employers against the benefits to the government of earlier receipt of tax revenues. We believe that the current system with the changes recommended in the Administration's 1991 Budget strikes an appropriate balance between the needs of employers and government, between simplicity (with its accompanying certainty) and equity, and between the costs and the benefits of more frequent deposits. The Omnibus Budget Reconciliation Act of 1989 imposed a temporary acceleration of large employment tax deposits. The Administration's 1991 Budget proposal would make that change permanent, requiring about 95 percent of accumulated employment tax liability of $100,000 or more to be deposited within one business day.

See comment 1.

See comment 2.

See comment 3.

We doubt that the employment tax payment system proposed by GAO would be an improvement over the current system. Although the recommended payment schedule would reduce some employer costs and burdens, others would be increased, thereby offsetting the reduction in the number of penalties which is the goal of the proposed system. The proposed system would increase the aggregate number of FTDs and would require many employers to make several deposits each week, including many small deposits. Adding an exception to avoid such small deposits would require employers to keep track of accumulated but undeposited liabilities, thereby eliminating one of the main alleged advantages of the proposed system. Not permitting larger employers to estimate liabilities and to underdeposit without penalty by up to five percent of liabilities would significantly increase costs and burdens for larger employers, or would require them to overdeposit in order to avoid the possibility of penalties.

The Treasury Department's more detailed comments on GAO's recommended payment system are included in the enclosure to this letter.

The draft report includes some recommendations to the IRS for altering tax forms and instructions and for increasing the use of automated penalty computations in order to ease employer burdens, lessen employer uncertainty, and improve the efficiency and accuracy of penalty assessment. Since the IRS has special expertise in administration and enforcement and the Commissioner has been offered an opportunity to comment, we will not discuss penalties other than to point out that the employment tax penalty changes included in the Omnibus Budget Reconciliation Act of 1989 were an attempt to assure that the sizes of penalties are related to the magnitude of the offense committed.

We appreciate the GAO's attempt to develop a more efficient and less troublesome employment tax payment system. The Treasury Department recognizes the important role of employers in collecting most federal individual income tax and FICA (social security) tax liabilities, and we want to ease employers' burdens to the maximum extent possible, consistent with the need to collect such revenue rapidly and completely.

If you have any questions about these comments please contact Allen H. Lerman of my staff at 566-5950.

Sincerely,

Kenneth W. Gideon

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

Treasury Department Comments
on the Draft of the GAO Report Entitled
Tax Policy and Administration:
Federal Tax Deposit Requirements Should Be Simplified

- The current employment tax payment system requires that larger amounts of employment taxes be paid to the government more frequently and with a shorter average delay between the payroll date and payment to the government. Except for the very largest employers covered by the changes included in the Omnibus Budget Reconciliation Act of 1989, employers are never required to make more than eight Federal Tax Deposits a month. Moreover, even large employers do not have to make an intra-monthly deposit if accumulated but undeposited liabilities are less than $3,000.

- The GAO draft report includes a recommendation that employment tax payment rules and schedules be simplified and that most exceptions to a single payment rule be eliminated. The proposed system would require that 100 percent of employment taxes be deposited three business days after each payroll date, with monthly or quarterly payments permitted for very small employers. Each employer's payment category would be determined before the beginning of a calendar quarter. Large employers would no longer be permitted to estimate their liabilities and underpay without penalty intra-monthly deposits by up to five percent of final liability.

- The payment system recommended in the draft report would:

See comment 1.

  -- greatly increase the aggregate number of Federal Tax Deposits;

See comment 1.

  -- require many deposits of less than $3,000;

See comment 1.

  -- require many medium-sized employers to make tax deposits more than eight times a month, even daily;

See comment 3.

  -- increase the reconciliation burdens for employers with more than one payroll site; and

See comment 3.

  -- increase costs for, or require overdeposits by, larger employers who could not determine their liability precisely within three business days.

See comment 1.

- The GAO staff assumed that each employer has only one pay day every two weeks. In order to make efficient use of personnel and equipment, all but the smallest employers typically have several payrolls; many have a payroll on every business day. Under the GAO proposal, such employers would have to make a Federal Tax Deposit every business day instead of eight times a month.

See comment 1.

See comment 2.

- o If even small employers were required to use the current eighth-monthly deposit system, many small deposits would be required except for the rule that allows undeposited liabilities of under $3,000 to be carried forward. Under the daily system recommended in the draft GAO report, even more small deposits would be required. It is not efficient for either employers or the IRS to handle small payments. Thus, as a practical matter, a de minimus deposit rule would be required which would eliminate small deposits and reduce the total number of deposits. That exception, however, would require employers to track accumulated, undeposited liabilities which is exactly what the GAO proposal is designed to eliminate.

See comment 5.

- o The extra deposits required under the GAO proposal could be especially burdensome for smaller businesses who mail their FTD deposits. In order to be assured that they will avoid penalties for late receipt, mailed deposits must be sent at least two days before the due date. Thus, employers would have only one day to determine the amount of their mailed deposit with complete certainty. Under the present eighth-monthly system, employers have more time to reconcile payroll records for payrolls which are not paid on the last day of the eighth-monthly period, and their deposit may be based on an estimate, since underdeposits of up to five percent are not subject to penalties.

See comment 3.

- o Even with greater payroll automation, the Treasury Department has been advised repeatedly that it is very difficult and costly for some employers, including some large employers, to determine their payroll tax liability within three banking days. Problems may stem from the use of multiple payroll sites, certain portions of payrolls (such as corrections) that still must be processed manually, etc. Thus, while some employers may not need the ability to underdeposit by up to five percent, others definitely do need such leeway.

See comment 3.

- o The draft report suggests that the underdeposit rules are no longer necessary since they are used by only 19,300 employers. The underdeposit provision is generally used by larger employers, and the largest 19,000 employers account for over 55 percent of all employment tax liability.

See comment 3.

- o In 1981, the underdeposit leeway was reduced from ten percent to five percent of liability. Even if developments since then suggest that a further reduction is warranted, complete elimination is not appropriate. Elimination would cause employers to incur additional compliance costs, to make overdeposits to avoid penalties, or to incur additional penalties.

- The underdeposit rule is optional. If its use leads to additional costs or to penalties, employers may avoid them by depositing 100 percent of liability at the end of each eighth-monthly period.

- The changes proposed in the GAO report would be most appropriate for larger employers with payroll systems capable of handling the required increase in deposit frequency. However, many of these same employers will be subject to similar rules beginning in August, 1990, as the result of employment tax acceleration provisions enacted in the Omnibus Budget Reconciliation Act of 1989.

See comment 4.

- The system recommended by GAO would provide certainty about deposit dates by determining deposit rules at the beginning of a calendar quarter based on the employment tax level of that employer in some prior quarter. Similar provisions have been rejected in the past because of problems stemming from seasonal and new businesses. In addition to the inequities from the competitive advantages or disadvantages for such businesses, there could be significant collection problems if large amounts of employment taxes were left uncollected for a month or a quarter. Employers could incur penalties, and the government could lose tax revenue.

See comment 6.

- The text of the report does not indicate an awareness that current rules provide that most employers who become subject to intra-monthly deposits for the first time within a year are not subject to penalties for the first month for which they fail to make such deposits.

See comment 7.

- Employer burdens could be reduced if deposit schedules were liberalized, but that would cause the federal government to incur significant additional borrowing costs, about $100 million a year for each one-day delay. In addition, tax revenues would be reduced by billions of dollars in the fiscal year during which liberalizations were implemented, thereby increasing the federal budget deficit. The exact revenue change would depend on the proposed schedule change and on the date on which the change would be implemented.

- The Treasury Department agrees with most of GAO's comments about the apparent complexity of the current payment system for FICA taxes and withheld income taxes. The only substantial reservation concerns GAO's assertion that most penalties are attributable to employers' inability to understand the rules. We believe that some employers' lack of attention to admittedly stringent rules is also an important factor which should not be minimized. Because employment taxes are being held in trust for the federal government, we believe that the current standards of conduct required of employers should be maintained.

See comment 8.

- The draft GAO report contains several inaccuracies, especially concerning numbers of Federal Tax Deposits and the additional borrowing costs or savings to the government from various changes. In addition, certain calculations are not consistent with the stated assumptions. Finally, certain assumptions oversimplify payroll practices to the extent that analyses which use those assumptions to compare alternative payment rules may be misleading.

Office of Tax Analysis
Department of the Treasury
March 2, 1990

The following are GAO's comments on the Department of the Treasury's letter dated March 13, 1990.

GAO Comments

1. Treasury claims the number of deposits would greatly increase with a standardized deposit requirement such as we recommended. We agree with Treasury that the number of deposits would increase under our proposed change. However, the impact of the increases could be mitigated in several ways. These include the use of a single exception to exempt small businesses from our proposed standard rule of requiring deposits to be made after each payday. The exception could be set at a level that would minimize the number of additional deposits these employers would have to make. Our draft report stated that an exception of less than $3,000 in quarterly tax liability is an option that Treasury should consider.

Comments we received from the National Federation of Independent Business, which represents 570,000 small businesses nationwide, supported our recommendation for simplifying the deposit requirements but suggested the exemption threshold be raised to $10,000 a month or $30,000 a quarter. When combined with our proposed standard requirement, excepting employers with less than $30,000 in quarterly tax liabilities would result in only a small increase in the number of deposits IRS must process. The final report analyzes this option and other options for exceptions to the standardized rule. However, Treasury could set the threshold for an exception at any level it deemed appropriate. We recommend that a look back provision be included to reduce the problems with administering the exception.

In regard to Treasury's concern that requiring a deposit to be made after each payday rather than at the end of an eighth-monthly period would increase the number of deposits that many employers who have more than one payday in an eighth-monthly period (3-6 days in duration) would have to make, neither we nor Treasury have data to verify this. However, data from the Bureau of Labor Statistics shows that about 95 percent of all employers have fewer than 50 employees. On the basis of discussions with the Small Business Administration and NFIB officials, we do not believe it is likely that these small employers would have more than one payday in a 4-day period. Large employers could very well have more frequent paydays, but many of these employers probably also have employment tax liability of $100,000 or more each payday. In that case, they would come under the Omnibus Budget Reconciliation Act of 1989 deposit provision requiring deposits be made the day after a payday. This provision would not be affected by our recommendations.

2. Treasury also argued that our recommendation that deposit requirements be tied to actual paydays rather than the end of an eighth-monthly period would create many small deposits that are currently not required. For example, if an employee is terminated immediately after a business makes a payroll and is compensated at that time for work to date, in Treasury's view, payment of wages owed to this employee would constitute a payday and under our proposal would require a deposit, no matter how small the amount. We disagree, because the regulations could be written to allow this type of deposit to be made in the next regular payroll deposit.

3. Treasury objected to eliminating the 95-percent safe haven exception because it would significantly increase the costs and burdens for large employers or require them to over-deposit in order to avoid being penalized and increase their reconciliation burden. We agree that some employers may be faced with an increased reconciliation burden because they may not have the capability to determine, within several days of paying their employees, how much taxes they withheld from the employees' paychecks. However, studies by IRS' Internal Audit division and the Railroad Retirement Board have recommended eliminating the safe haven provision because large employers receive unintended benefits by taking advantage of the safe haven provision even though they can accurately determine their actual tax liability. A more targeted way of dealing with the problem would be for IRS to grant a waiver to employers who demonstrate a legitimate need for this flexibility.

4. According to Treasury's comments, a look back provision, which would allow employers to know at the start of the quarter what their deposit requirements are, has been suggested before but rejected because of difficulties in determining when seasonal and new businesses should deposit. A standard deposit requirement would eliminate part of the problem. In addition, we believe the regulations could be written to address this problem. For example, seasonal businesses could be required to make deposits based on their prior-year deposit requirements. New businesses could be required to estimate their first quarter liabilities and deposit accordingly as they do with income taxes. Or new businesses, in light of their high failure rate and concerns over employment tax delinquencies, could be required to deposit after every payday, regardless of the amount of their deposit, until a payment history is established.

5. Treasury commented that our proposal could be especially burdensome for smaller businesses who mail their FTD coupons, because, to be assured that they will avoid penalties for late receipts, the deposits must be sent at least 2 days before the due date. We believe that this potential problem would be minimized if Treasury allows employers with quarterly tax liabilities of less than $30,000 to deposit within 3 banking days of the end of the month. The only time these employers would have just 2 banking days to mail their deposits would be if they paid wages on the last day of the month.

6. Treasury states that we did not recognize in the text of the report the current deposit rule exception that does not subject employers to FTD penalties for failure to deposit within 3 banking days if, in the four preceding quarters, they did not come under the 3-banking-day rule. We did discuss this exception in appendix I. We did not discuss it in the text of the report because, according to IRS data, only about 8,600 employers claimed this exception in the fourth quarter of 1988 and 5,700 employers in the first quarter of 1989.

7. Treasury stated that liberalizing deposit schedules would cause the federal government to incur additional borrowing costs. On the basis of the analysis presented in the report (see p. 8), we believe the deposit requirements can be standardized in a way that both reduces the burden on employers and generates additional federal revenue. The additional revenue comes from the acceleration of deposits through the elimination of the eighth-monthly periods for the relatively small share of employers whose deposits compose the bulk of the dollars received under the deposit program.

8. Treasury states that our methodology for calculating increases in the number of deposits and anticipated savings contained some inaccuracies and was oversimplified. On the basis of these comments, we refined our methodology to reflect actual data on how often employees are paid. We also used actual federal interest rates to calculate the potential borrowing costs savings that would occur if the deposit requirements were simplified.

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

COMMISSIONER

MAR 14 1990

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your recent draft report entitled, "Tax Policy & Administration: Federal Tax Deposit Requirements Should Be Simplified".

Because of the significance that the Federal Tax Deposit System plays in our system of tax administration, we appreciate your efforts to seek improvements. We have recently undertaken a study to simplify the rules and procedures governing federal tax deposits. Your report will be very helpful in this regard.

We have enclosed comments on the report recommendations directed to IRS regarding the modification of FTD coupons, clarifying IRS' guidance and requiring service centers to use computer programs to improve the manual calculation of the FTD penalty. Although we endorse the general concept of standardizing deposit rules when possible and simplifying the rules for small businessmen, specific comments on your proposed changes will be provided by the Department of Treasury.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"TAX POLICY & ADMINISTRATION: FEDERAL TAX DEPOSIT
REQUIREMENTS SHOULD BE SIMPLIFIED"

See comment 1

RECOMMENDATIONS TO IRS

To improve employers' compliance with the current deposit requirements and IRS' administration of the four-tier, time-sensitive deposit penalty; we recommend that the Secretary of the Treasury direct the Commissioner, Internal Revenue to:

Recommendation: Modify the FTD coupon to have employers indicate the specific deposit period to apply the deposit.

Comment:

We concur with GAO that the proper crediting of payments is critical to solving the problems in this area. However, we would like to carefully consider the suggestion to revise the FTD coupon along with other suggestions under consideration by our study group. We have some concerns that additional handwritten information on the FTD coupon will make it more difficult for the optical character recognition equipment to scan the documents. This could increase, rather than decrease, the errors in coding.

As an alternative, we are considering whether we should revise the deposit regulations to require the application of deposits and credits against the oldest liability based on the due date. Under this approach, the taxpaying public will know exactly how deposits will be applied.

Recommendation: Clarify IRS' guidance to employers on the FTD requirements and instructions for completing the Form 941.

Comment:

We agree with the recommendation to clarify the instructions for completing the "Record of Federal Tax Liability" section of Form 941. Appropriate action will be taken, either in the Form's instructions or in Publication 15, Employer's Tax Guide.

Recommendation: Require all service centers to use computer programs to calculate the FTD penalty.

Comment:

We agree that improvements are needed in manual calculations of FTD penalties. We will review the program developed by our Fresno Service Center to determine if it is appropriate for nationwide implementation. The program has the potential to be used not only in our service centers but also our district offices to improve the accuracy of calculations field employees make when full payment is secured or adjustments must be made.

The following are GAO's comments on the Internal Revenue Service's letter dated March 14, 1990.

GAO Comments

1. In regard to modifying the FTD coupon, the Commissioner stated that as an alternative, IRS is considering revising the deposit regulations to require that deposits be applied against the oldest periodic liability first. IRS is concerned that additional hand-written information on the FTD coupon could increase errors in coding. We believe the advantages of modifying the coupon outweigh any potential increase in errors employers may make in completing the modified coupon.

We believe that applying deposits against the oldest liability first could lead to inconsistent penalty assessments and to penalties that exceed the amount intended by Congress in cases in which an employer underpays one employment tax liability period early in the quarter and does not make up this underdeposit until several liability periods later.

For example, suppose an employer pays wages once a month or three times a quarter and each payday has a $10,000 employment tax liability. However, the employer, for whatever reason, makes a timely deposit of $7,000 instead of the $10,000 that is required for the first month's tax liability. Therefore, the $3,000 underpayment is subject to the FTD penalty. A month later the employer makes a timely deposit of $10,000 to cover the second month's employment tax liability. Under IRS' alternative, it would apply $3,000 of the second month's deposit against the $3,000 underpayment for the first month. While resolving the first underpayment, this would create an underpayment for the second month. The employer would be assessed a 10-percent, or $300, FTD penalty for the $3,000 first month's underpayment. A month after the second deposit, the employer makes a timely deposit of $13,000 to cover both the third month's $10,000 tax liability and the $3,000 that was underdeposited for the first month's taxes. However, IRS would apply $3,000 of the third month's deposit against the $3,000 underpayment that was created for the second month and assess the employer another $300 FTD penalty for making a late deposit for the second month. In this example, the employer would receive a total FTD penalty of $600, or two $300 penalties—$300 for the first month's $300 underpayment and $300 for the second month's $3,000 underpayment caused by IRS' applying the $3,000 to the first month's underpayment. We believe that this double penalty is contrary to the intent of Congress in that it subjects a single violation to two separate penalties.

INTERNAL REVENUE SERVICE ADVANCE NOTICE 90-37, DEPOSITS OF WITHHELD TAXES, ISSUED MAY 7, 1990 (TEXT)

(Note: Notice 90-37 will appear in Internal Revenue Bulletin 1990-21, dated May 21, 1990.)

Notice 90-37

I. SCOPE

This notice provides guidance on changes made by Congress in the Revenue Reconciliation Act of 1989 (the "Act"), Pub. L. No. 101-239, 103 Stat. 2106, to the rules governing deposits of income tax withheld (including backup withholding) and taxes under the Federal Insurance Contributions Act (FICA) on an eighth-monthly basis.

II. BACKGROUND

A. CHANGE IN DEPOSIT RULES

In subtitle F (section 7632) of the Act, Congress revised the provisions under section 6302 of the Code for the deposit of withheld income taxes and FICA taxes, effective with respect to amounts required to be deposited after July 31, 1990.

New section 6302(g) of the Code, as added by the Act, provides as follows:

(1) *In General.* - If, under regulations prescribed by the Secretary, a person is required to make deposits of taxes imposed by chapters 21 and 24 on the basis of eighth-month periods, such person shall, for the years specified in paragraph (2), make deposits of such taxes on the applicable banking day after any day on which such person has $100,000 or more of such taxes for deposit.

(2) *Specified years.*- For purposes of paragraph (1)-

In the case of:	The applicable banking day is:
1990	1st
1991	2nd
1992	3rd
1993	1st
1994	1st

(Pending legislative proposals could modify this schedule for years after 1990.)

The Act provides that for calendar year 1995 and thereafter, the Secretary shall prescribe regulations with respect to the date on which deposits of such taxes will be made in order to minimize the unevenness in the revenue effects of the new acceleration provision.

B. CHANGE IN DEPOSIT PENALTY

In subtitle G (section 7742) of the Act, Congress revised the penalty provisions under section 6656 of the Code for the failure to make deposits, effective with respect to failures made after December 31, 1989.

Under revised section 6656 of the Code, the penalty rate is 2 percent of the underdeposit if the failure is for not more than 5 days, 5 percent if the failure is for more than 5 days but not more than 15 days, and 10 percent if the failure is for more than 15 days. The penalty rate increases to 15 percent if the tax is not deposited on or before the earlier of (i) the day 10 days after the date of the first delinquency notice to the taxpayer under section 6303, or (ii) the day on which notice and demand for immediate payment is given under section 6861 or 6862 or the last sentence of section 6331(a).

III. PURPOSE

The Service will be developing regulations reflecting the changes made by Congress in the Act with respect to the federal tax deposit rules and failure-to-deposit penalty. Until further guidance is issued, this notice may be relied upon by those persons making deposits of withheld income tax (including backup withholding) and FICA taxes.

IV. APPLICATION OF DEPOSIT RULES

A. EFFECTIVE DATE - NEW SECTION 6302(g)

The Internal Revenue Service will apply the new provision to amounts required to be deposited with respect to eighth-monthly deposit periods beginning after July 31, 1990. Thus, the new provision will not apply to amounts due in August 1990 with respect to deposit periods ending before August 1, 1990.

B. APPLICATION OF SECTION 6302(g) "ACCELERATION" PROVISION

Under section 31.6302(c)-1(a)(1)(i) of the regulations, an employer who has undeposited taxes of $3,000 or more on hand at the close of an eighth-monthly period is required to deposit those taxes in a Federal Reserve Bank or authorized financial institution within 3 banking days after the close of such eighth-monthly period. "Eighth-monthly period" is defined as the first 3 days of a calendar month, days 4 through 7, 8 through 11, 12 through 15, 16 through 19, 20 through 22, 23 through 25, and the remainder of the calendar month following the 25th day.

The regulations under section 6302 of the Code provide that an employer depositing on an eighth-monthly basis generally is considered to be in compliance if a deposit for an eighth-monthly period is at least 95 percent of the amount required to be deposited and, if the eighth-monthly period is in the first or second month of the quarter, the underdeposit is remitted with the first deposit otherwise required after the 15th day of the next month. If the eighth-monthly period is in the last month of the quarter, the underdeposit must be remitted by the last day of the first month following the close of the quarter. This provision is the so-called "safe-haven" rule.

New section 6302(g) of the Code provides a special rule for persons depositing taxes on the basis of eighth-monthly periods. If, on any day, such a person has on hand, with respect to any eighth-monthly period, $100,000 or more of the taxes imposed by chapters 21 (FICA tax) and 24 (income tax withheld including backup withholding) for deposit, then that person must deposit those taxes by the close of the "applicable banking day" after such day, as provided by section 7632 of the Act. From August 1, 1990, through December 31, 1990, the applicable banking day is the first banking day.

Until further guidance is issued, the Service will apply new section 6302(g) of the Code as follows. If, during an eighth-monthly period, a person required to make deposits on an eighth-monthly basis has on hand for deposit at least $100,000 with respect to that eighth-monthly period, then that amount must be deposited by the close of the next banking day. If, by the end of the same eighth-monthly period, that same person has accumulated at least $3,000 but less than $100,000 in additional taxes for deposit with respect to that eighth-monthly period, then that amount must be deposited within three banking days after the end of the eighth-monthly period, under the general rule of section 31.6302(c)-1(a)(1)(i) of the regulations.

If, at the end of an eighth-monthly period, a depositor has on hand a sufficient undeposited amount to give rise to a deposit obligation with respect to that amount, then that deposit obligation is fixed, and that amount is not taken into account in determining whether on any succeeding day the $100,000 threshold amount in section 6302(g) of the Code has been reached. However, as in the past, if amounts on hand at the end of an eighth-monthly period are less than $3,000 and thus not subject to a deposit obligation, those amounts will be taken into account in determining amounts on hand in the succeeding eighth-monthly period. Finally, the 95 percent "safe-haven" rule will be applicable to deposits required to be made on an accelerated basis under section 6302(g).

The following examples illustrate how the new section 6302(g) "acceleration" provision applies:

Example 1: At the close of business on Thursday, August 2, 1990, Employer *A*'s payroll date, *A* has on hand $105,000 in FICA tax and income tax withheld. Notwithstanding section 31.6302(c)1(a)(1)(i) of the regulations, *A*, pursuant to section 6302(g) of the Code, must deposit that amount by Friday, August 3, 1990, the next banking day after August 2, in order to prevent assertion of the failure-to-deposit penalty under section 6656.

Example 2: The facts are the same as in Example 1, except that on Friday, August 3, 1990, the close of an eighth-monthly period, A made a payroll payment that gave rise to an additional $10,000 in undeposited taxes. *A* must deposit the $10,000 by Wednesday, August 8, 1990, three banking days after the close of the eighth-monthly period, under the general rule of section 31.6302(c)-1(a)(1)(i) of the regulations. Because the $105,000 obligation described in Example 1 was fixed as of the close of business on Thursday, August 2, the $10,000 withheld on August 3 is the beginning of a separate and distinct deposit obligation.

Example 3: On Monday, August 13, 1990, Employer *B* accumulates $105,000 in income tax withheld and FICA taxes. Pursuant to section 6302(g) of the Code, *B* deposits that amount on Tuesday, August 14, 1990. At the close of business on Wednesday, August 15, 1990, the close of an eighth-monthly period, B has on hand an additional $2,500 in income tax withheld and FICA taxes. Under section 31.6302(c)-1(a)(1)(i) of the regulations, B is not required to make an additional deposit with respect to that eighth-monthly period since the amount on hand is less than $3,000. The undeposited $2,500 is carried forward to the next eighth-monthly period. On Thursday, August 16, 1990, *B* accumulates an additional $98,000 in withheld income tax and FICA taxes. Accordingly, on that date, *B* has on hand $100,500 in undeposited taxes. *B* is required to deposit that amount by the next banking day, Friday, August 17, 1990, under section 6302(g).

Example 4: At the close of business on Wednesday, August 15, 1990, the close of an eighth-monthly period, Employer *C* has on hand $50,000 of income tax withheld and FICA taxes. Pursuant to section 31.6302(c)-1(a)(1)(i) of the regulations, the $50,000 must be deposited within three banking days after August 15 in order to prevent assertion of the failure-to-deposit penalty. On Thursday, August 16, *C* has on hand an additional $60,000 of income tax withheld and FICA taxes. The acceleration provision of section 6302(g) does not require payment by the next banking day even though *C* has on hand $110,000 ($50,000 + $60,000) of FICA tax and income tax withheld, because the obligation to deposit the $50,000 was fixed as of the close of business on Wednesday, August 15, and that amount is not to be taken into account for purposes of the acceleration provisions of section 6302(g). The $50,000 must be deposited by Monday, August 20, 1990, three banking days after Wednesday, August 15th. The determination of the date by which the $60,000 must be deposited depends on what additional amounts, if any, are accumulated during the August 16-19 eighth-monthly period.

Example 5: The facts are the same as in Example 4 except the additional amount on hand on Thursday, August 16, is $105,000, not $60,000. The $105,000 must be deposited by Friday, August 17, 1990, pursuant to the provisions of section 6302(g) of the Code.

Example 6: On Thursday, August 23, 1990, Employer D's payroll date, *D* estimated that it had on hand $2 million in FICA tax and income tax withheld. Pursuant to section 6302(g) of the Code, *D* deposited that amount by the close of the next banking day, Friday, August 24, 1990. On Monday, August 27, *D* determined that the actual FICA tax and income tax withheld for the August 23 payroll date was $2.1 million. Provided that the undeposited $100,000 is deposited with the first deposit otherwise required after September 15, 1990, *D* is deemed, under section 31.6302(c)-1(a)(1)(i) of the regulations, to be in compliance with section 6302 because at least 95% (95.24% in this case) was deposited. Under these circumstances, the $100,000 in undeposited taxes is not subject to the acceleration rule of section 6302(g) of the Code but the general rule of section 31.6302(c)-1(a)(1)(i) of the regulations.

C. REQUEST FOR COMMENTS

The taxes imposed by chapter 24 of the Code include amounts subject to the backup withholding provisions of section 3406 of the Code. The Service invites comments on whether amounts subject to backup withholding should continue to be taken into account in determining amounts subject to the deposit rules of section 6302(g) of the Code and section 31.6302(c)-1(a)(1)(i) of the regulations.

The Service is considering possible changes to the existing rules for the deposit of the taxes imposed by chapters 21 and 24, including but not limited to (a) the need for the 95 percent "safe-haven" exception in section 31.6302(c)-1(a)(1)(i) of the regulations, and (b) the possibility of replacing the eighth-monthly system with a less complex deposit system, such as one based on employers' payroll dates. The Service invites comments on these matters, including suggested alternatives to the current rules. Note, however, that alternatives should not significantly lengthen the time before payroll taxes are deposited.

V. PAYMENT OF UNDEPOSITED AMOUNTS AFTER NOTICE AND DEMAND

If the total employment tax liability for the quarterly return period has not been fully deposited by the due date of the quarterly Form 941, the Service will issue a notice and demand for the unpaid tax and the resulting penalties. As noted in Section II.B above, if the outstanding taxes are not paid by the tenth day following the date on which the notice was issued, the applicable failure-to-deposit penalty imposed by section 6656 of the Code rises to fifteen percent. To ensure that payment is properly credited to your account and to prevent the additional penalty charge, employers should follow these steps:

1. Submit a check or money order for the full amount billed;
2. Make the check or money order payable to Internal Revenue Service;
3. Attach the payment stub portion of the delinquency notice to the check or money order;
4. Use the envelope provided; and
5. Mail the payment within 10 days of the date on the notice.

VI. SUBMISSION OF COMMENTS

The Service invites comments with respect to matters discussed in this notice. Comments should be addressed to the Assistant Chief Counsel (Income Tax & Accounting) Internal Revenue Service, 1111 Constitution Ave., N.W., Room 5134, Washington, D.C. 20224. Comments should be received by July 20, 1990, in order to ensure that they will receive full consideration.

VII. DRAFTING INFORMATION

The principal author of this notice is Vincent Surabian of the Office of Assistant Chief Counsel (Income Tax & Accounting). For further information regarding this notice, call (202) 566-5985 (not a toll-free number).

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