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Simplifying Payroll Tax Deposit Rules

Statement of
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SIMPLIFYING PAYROLL
TAX DEPOSIT RULES

SUMMARY OF STATEMENT BY
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The rules for depositing payroll taxes are complex and make it difficult for employers to predict with certainty when to make their payroll tax deposits. About one-third of the Nation's employers are penalized annually because they do not comply with these complex rules. H.R. 2775 would simplify these rules by requiring employers to deposit their payroll taxes on the Tuesday or Friday following their payday. The bill would except small employers with quarterly tax liabilities of \$3,500 or less from this Tuesday/Friday Rule and instead allow them to make quarterly deposits.

GAO believes that changes to the deposit rules are urgently needed. This bill would make it easier for employers to understand the deposit requirements and to comply with the deposit rules. The bill includes a "look back" provision which for the first time would permit employers to know with certainty what their deposit requirement will be for the forthcoming quarter. Thus the bill substantially fulfills the recommendation GAO made in a 1990 report on the subject.

GAO believes several modifications would strengthen the bill. The bill would increase the number of deposits. Over 900,000 employers who currently pay employment taxes monthly would have to pay the Tuesday or Friday following each payday. To reduce the number of employers so affected, the proposed Tuesday/Friday Rule could be modified to except more employers and have them deposit monthly. This could be done without adversely affecting federal revenues.

Improvements could also be made to the "look back" provision of H.R. 2775. Under this provision employers qualify for the exception if they were below the \$3,500 threshold for eight consecutive quarters. Therefore, all employers would have to review 8 quarters of deposit history each and every quarter-- those who exceed the threshold in one quarter would have to wait at least 2 years before they can qualify for an exception. GAO believes a look back based on fewer quarters, perhaps 4, may be more appropriate and that an exception could apply for a full year. This would reduce the administrative burden and the delay before small employers could escape the Tuesday/Friday Rule, while still achieving certainty in advance as to the employer's deposit requirement in a forthcoming quarter.

Mr. Chairman and Members of the Committee

We are pleased to be here to comment on the provisions in H.R. 2775 to simplify the payroll tax deposit system. Currently, there are five deposit rules for determining when employers must deposit their payroll taxes. In a report we issued in 1990, we found that the deposit rules are difficult to understand and to comply with because employers can be subject to more than one deposit rule during a tax period.¹ Up to one-third of the nation's employers are penalized each year for failure to follow these complex rules.

H.R. 2775 would simplify these rules by requiring most employers to deposit their taxes on the Tuesday or Friday following their payday. The bill also contains an exception to this Tuesday/Friday Rule that allows quarterly deposits for the 1.7 million small employers who have quarterly payroll tax liabilities of between \$500 and \$3,500.

We believe that changes to the deposit rules are urgently needed and that the proposed simplification measure will ease employers' task of understanding and complying with their payroll tax deposit responsibilities. The proposal will also reduce the number of deposits some employers will have to make. However, we

¹ Tax Policy: Federal Tax Deposit Requirements Should Be Simplified (GAO/GGD-90-102, July 31, 1990).

believe some modification would make it less burdensome to smaller employers.

BACKGROUND

The routine deposit of federal payroll taxes is the linchpin of the federal tax system. In fiscal year 1989, over 5 million employers deposited \$679 billion in withheld income and social security taxes, which represented 67 percent of all revenues collected by IRS that year.

But the current payroll deposit system, which is predicated on the voluntary compliance of over 5 million small, medium, and large businesses, is distinctly unfriendly to the employers who must make deposits. About one-third of the nation's employers are assessed at least one payroll deposit penalty annually and total payroll deposit penalties amounted to \$2.8 billion in 1989. According to IRS data, in 1988 approximately 70 percent of the payroll deposit penalties were assessed against relatively small employers. We believe that the complexity of the deposit rules is a major factor causing this high penalty rate.

Employers who withhold income and social security taxes are required to deposit these employment taxes under the Federal Tax Deposit system. Employers deposit their tax payments with about 15,000 financial institutions and are to simultaneously submit

deposit coupons (Form 8109) showing the deposit amount and the quarterly tax period that the deposit should be applied against. Employers are also to submit to IRS a Quarterly Federal Tax Return (Form 941) that shows when their paydays occurred and the amount of employment tax liabilities they had each payday.

Complexity arises when employers must determine how often deposits must be made and the specific dates when deposits are due. Employers accumulate their employment tax liabilities from payday to payday until a deposit rule is triggered, unless they qualify for an exception to a rule. The deposit rules vary according to how much tax has been withheld and how often paydays occur.

Rule 1-- If the total accumulated employment taxes are less than \$500 in a calendar quarter, no deposit is required. Instead, taxes can be paid directly to IRS when a business files its quarterly federal tax return, which is due 1 month after the end of the calendar quarter.

Rule 2-- If the total accumulated undeposited employment taxes are less than \$500 at the end of any month, the taxes can be carried over to the following month within the quarter and added to that month's

taxes until one of the deposit requirements in Rule 3 or 4 is triggered.

Rule 3-- 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-- 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. These periods were established to assure a continuous flow of funds from larger employers.

In addition to these four rules established by the Secretary of the Treasury, 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.

CURRENT DEPOSIT RULES ARE COMPLEX

In our review of the payroll deposit system, we found that many employers are assessed failure to deposit penalties because they have difficulties in understanding the complex requirements of the deposit system. We developed a penalty data base which showed the rate at which all employers were penalized. We also reviewed a random sample of 150 federal tax deposit penalty actions from three IRS service centers, reviewed IRS guidance and administrative procedures, and discussed the deposit requirements with IRS and Treasury officials.

Because deposit rules specify different deposit dates depending upon the amount of accumulated undeposited taxes and some employers' payrolls fluctuate over time, it is difficult for many employers to predict with certainty when their payroll deposits are due. Further, because the eight monthly deposit periods vary in length from 3 to 6 days, 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, employers must monitor undeposited employment taxes from payday to payday, compare the undeposited amounts to the deposit rules, determine whether an earlier deposit requirement has been

triggered, and, if an eighth-monthly deposit applies, determine the next such deadline.

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 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.

Perhaps an even more telling indicator of how confusing these complex requirements can be is IRS' error rate when applying deposit rules to determine whether penalties are warranted. 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.²

To address these problems, we recommended that the Secretary of the Treasury abandon the complicated eighth-monthly deposit rule and adopt a simplified single deposit rule for all employers not affected by the statutory 1-banking-day requirement. We suggested that the complex multi-tiered set of exceptions be replaced with a simplified exception rule for smaller employers. We illustrated four alternative deposit thresholds for

² For deposits made after January 1, 1990, the Omnibus Budget Reconciliation Act of 1989 changed the deposit penalty from a flat rate to a four-tier, time-sensitive penalty.

determining which employers would be excepted from regular deposits, ranging from \$3,000 to \$30,000 in quarterly tax liabilities. Significantly, each of these options would, in concert with our recommended deposit rule, have reduced federal borrowing costs. In addition, we recommended that regardless of whether any other changes were made, the Secretary should establish a look back rule whereby all employers could know their deposit requirements before the start of a quarter.

ANALYSIS OF PROPOSED CHANGES

TO THE PAYROLL TAX DEPOSIT RULES

In assessing the individual provisions in H.R. 2775, we applied four criteria that we consider particularly important. Would the burden experienced by employers, particularly smaller employers, be reduced? Are the proposed requirements simple to understand? Would IRS' administrative burden be manageable? Would the current cash flow of the government be maintained?

Based on our assessment, we believe that H.R. 2775 represents a commendable approach to bringing fairness and predictability to the federal payroll deposit system. The proposed changes would make it easier for employers to understand the deposit requirements and to comply with the deposit rules. Thus, this bill would undoubtedly reduce the number of penalties that well-

meaning employers receive because they cannot understand the current complex deposit requirements.

The bill would: (1) replace the current eighth-monthly system with a system that requires deposits to be made on Tuesdays and Fridays, (2) permit small employers with quarterly tax liabilities of \$3,500 or less and new businesses to deposit quarterly instead of following the Tuesday/Friday Rule, and (3) provide a look back rule for employers to use in establishing the deposit requirement to follow at the outset of each quarter.

Tuesday/Friday Rule

The bill would change all but the statutory \$100,000 deposit rule and require employers with quarterly tax liabilities of more than \$3,500 to deposit taxes on (1) the Tuesday following paydays that occur on a Wednesday, Thursday, or Friday, or (2) the Friday following paydays that occur on a Saturday, Sunday, Monday or Tuesday.

We believe that this Tuesday/Friday Rule is a significant improvement over the current eighth-monthly deposit rules. Employers, especially those whose deposit requirements change during a quarter, should have little problem determining when to deposit their payroll taxes. This added certainty should also lead to a substantial reduction in the amount of IRS and

taxpayer correspondence that is associated with failure-to-deposit penalties. Many of these penalties occur because employers are uncertain or confused as to when their deposits are due. We estimate that between 20 and 25 percent of the correspondence IRS has with businesses deals with failure to deposit penalty assessments and abatements.

Exception for small employers

The bill also provides an exception to the Tuesday/Friday Rule for small depositors so that they will not be burdened with having to make deposits after each payday. Under the bill, small depositors are defined as employers with quarterly tax liabilities of between \$500 and \$3,500--an estimated 1.7 million employers, or 38 percent of employers paying employment taxes. Under the current deposit rules these employers are required to make from one to three deposits over the course of the quarter. The bill would in effect reduce their deposit burden by allowing these employers to deposit their taxes quarterly.³ The bill continues to allow small depositors with quarterly liabilities of less than \$500 to avoid making deposits and instead pay their taxes with their quarterly employment tax returns.

³ Our estimate of the number of employers making deposits, number of deposits made, and potential revenue effects are based on (1) the first quarter 1989 IRS data on the number of Forms 941 filed and the employment tax liability for these returns, and (2) unpublished Bureau of Labor Statistics data on employers' payroll frequency.

We endorse excepting small employers from making frequent deposits. The small depositor rule in H.R. 2775 relieves certain small employers from the inherent complexities of the current deposit rules and from increasing the number of deposits they would have to make under the Tuesday/Friday Rule. However, the bill would speed up deposits for those employers with \$3,500 to \$9,000 in quarterly tax liabilities who now deposit monthly. They would have to deposit on the Tuesday or Friday following their paydays. This could affect about 906,000 employers who would have to make an additional 25 million deposits annually. This has prompted concern on the part of the small business community. We think the exception level could be modified to address their concerns.

We understand that raising the threshold higher than \$3,500 has the disadvantage of reducing federal receipts in the initial fiscal year. Reduced receipts would stem from delaying the final quarter's deposits, now received monthly, into the next fiscal year because these deposits now would be made quarterly. However, we believe that more employers can be excepted from the Tuesday/Friday Rule without adversely affecting current federal revenues. This can be achieved as long as excepted employers are required to deposit monthly, as they do now, rather than quarterly as the bill provides.

Accordingly, we suggest that you consider adopting a monthly, rather than quarterly payment schedule for excepted employers whose liabilities are between \$500 and \$9,000 a quarter. This would permit almost all employers currently paying monthly to continue to do so. The smallest employers--those with less than \$500 per quarter in tax liability--could be permitted to continue paying quarterly as the bill provides. Ideally, we would like to see one exception rule for all small businesses. However, two levels of exceptions for small businesses may be necessary to minimize the burden for the greatest number of employers without jeopardizing federal revenues.

We estimate that a provision requiring monthly payments by those having from \$500 to \$9,000 in quarterly tax liability would exempt 2.6 million employers, or 59 percent of all employers from making Tuesday/Friday deposits. Compared to current rules, federal borrowing costs would, however, be less. This would result first because payments under our suggested rule would be made on the first Tuesday or Friday at the beginning of the month whereas these depositors currently are required to pay 15 days after the end of the month. This speeds up deposits. Second, the number of tax deposits also would increase for employers whose tax liabilities exceed \$9,000 since they would follow the H.R. 2775 Tuesday/Friday Rule, which is faster than the current eighth-monthly system. For example, for employers with liabilities just over \$9,000, their payment frequency could

increase from about 4 deposits per quarter to 13. This increased federal cash flow would result in lower federal borrowing costs.

Another possible advantage of retaining monthly depositing, rather than the proposed quarterly exception, has to do with the burgeoning accounts receivable--which totaled \$96 billion in 1990, 31 percent of which is due to employment tax delinquencies. As previously noted, about 1.7 million employers have quarterly tax liabilities between \$500 and \$3,500. Under H.R. 2775, we estimate that about 1 million of the 1.7 million employers would shift from making deposits monthly to making one deposit per quarter. However, small employers who face cash flow difficulties often become delinquent in their taxes because they spend withheld tax monies. Increasing the time that small employers can retain employment taxes may exacerbate this problem.

Look Back Provisions

We believe that a look back provision is essential to reducing confusion and penalties under the federal payroll deposit system. Such a provision eliminates the need for employers to continually monitor their tax liabilities to determine their next required deposit date.

H.R. 2775 includes such a provision. Under the bill, employers whose quarterly tax liability did not exceed \$3,500 in any one of eight prior quarters would make quarterly deposits rather than follow the Tuesday/Friday deposit schedule.⁴ Employers would have to make this determination for each quarter. Once an employer who qualifies for the exception exceeds the \$3,500 threshold in one quarter, the employer would have to again build 8 consecutive quarters of tax liability under \$3,500 before again being excepted from the Tuesday/Friday Rule.

We question whether the eight quarter look-back provision may be too long. We believe that seasonal variations in business taxes can be captured with a shorter look back period. Also, as proposed, the provision would mean that employers would have to review eight quarters of their tax deposit history before the beginning of every quarter. We believe that business's paperwork requirements could be lessened and their deposit rules made more stable by applying the look back rule for a full year.


Therefore, we suggest revising the look back to require employers to review fewer quarters of deposit history, perhaps four, to determine the exception and for the exception to apply for a full year. A shorter look-back provision would be less burdensome, would enable small employers to return to the slower deposit

⁴ To qualify as a small depositor, an employer must have quarterly tax liabilities of \$3,500 or less in each of the eight calendar quarters ending with the second quarter preceding the quarter for which deposit requirements are being determined.

schedule more quickly, and would still achieve certainty in advance regarding which deposit rules the employer will fall under during the quarter.

Safe Harbor Provision

Under current regulations, Treasury has an exception to the deposit rules, known as the safe harbor, which allows employers required to make eighth-monthly deposits to deposit 95 percent of their accumulated taxes within 3 banking days of the end of an eighth-monthly deposit period. The remaining 5 percent can be deposited with the first deposit that is otherwise required after the 15th of the following month. The current safe harbor provision exists 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.



In our report, we recommended that the 95 percent safe harbor be eliminated because IRS studies show that less than one-half of one percent of the employers use it. Further, some studies indicate that some employers use the safe harbor not because they are unable to pay the exact amount of taxes, but rather to delay depositing their full tax liability. For example, one IRS study showed that 25 percent of the businesses that used the safe harbor consistently deposited exactly 95 percent of their tax liability. For these employers, the safe harbor represents a

maximum payment target rather than a means to ease legitimate payment calculation problems.

H.R. 2775 provides a statutory safe harbor for deposit shortfalls. Under the bill an employer is considered to have deposited required taxes if a shortfall does not exceed the greater of \$150 or 2 percent of the employment taxes that were required to be deposited.

The proposed statutory safe harbor provision is better than the current safe harbor because the tolerance is lower, i.e., 2 percent instead of 5 percent. However, raising the safe harbor from 95 percent to 98 percent only reduces the amount of taxes employers can delay depositing; it does not eliminate the potential for abuse. We believe that 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, IRS could grant waivers to depositing the full payroll tax liability to those employers who submit evidence that they could not accurately calculate their entire employment tax liability.

CONCLUSIONS

Mr. Chairman, we believe that passage of H.R. 2775 would achieve a major simplification of tax rules for our nation's employers. It would lessen the burden experienced by employers, particularly smaller employers; be simple to understand; result in fewer penalties for IRS to administer; and would maintain the federal government's current cash flow. While we support the bill, we believe some minor refinements could improve the balance among simplification, the shifts in burden that occur when new rules are introduced, and maximizing future compliance.

This concludes my testimony. I would be happy to answer any questions you may have.