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Simplifying Payroll Tax Deposit Rules

Statement of  
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Before the  
Subcommittee on Taxation  
Committee on Finance  
United States Senate



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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 and S.1610 would simplify these rules by requiring employers to deposit their payroll taxes on either the Tuesday or Friday following each payday. The bills would exempt small employers from this Tuesday/Friday rule and would instead allow them to make deposits less often.

GAO believes that changes to the deposit rules are urgently needed. These bills would make it easier for employers to understand the deposit requirements and to comply with the deposit rules. Both bills contain 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. The bills substantially fulfill the recommendation GAO made in a 1990 report on this subject.

However, S.1610 differs in several respects from H.R.2775. GAO believes that the S.1610 provisions are generally preferable to those in H.R.2775. S.1610 has a higher deposit threshold at which small employers would be exempted from the Tuesday/Friday deposit rule. H.R.2775 exempts employers with \$3,500 or less in quarterly liability from making deposits on Tuesday or Friday. The S.1610 exemption level is \$18,000. This higher exemption level would reduce the number of small employers who would be required to make deposits on Tuesday or Friday by over 1.4 million. Furthermore, even though the Senate bill increases the exemption, it would nevertheless have a positive effect on federal revenues because many employers' deposits would be made faster under the Tuesday/Friday rule than they are currently.

S.1610 also has a different look back provision. Under H.R.2775, employers can qualify for the exemption if they remained below the \$3,500 threshold for eight consecutive quarters. Therefore, all employers would have to review eight quarters of deposit history each and every quarter--those who exceed the threshold in one quarter would have to wait at least two years before again qualifying for an exemption. The S.1610 provision looks back for only four quarters. GAO believes that the shorter look back provision would be less burdensome, would enable small employers to return to the slower deposit schedule more quickly, and would still achieve certainty in advance about which deposit rules apply during a given quarter.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here to comment on H.R.2775 and S.1610-- bills which would simplify the payroll tax deposit system.

Currently, five rules determine when employers must deposit their payroll taxes. In a report issued in 1990, we said that the deposit rules are difficult to understand and comply with because employers can be subject to more than one deposit rule during a given tax period.<sup>1</sup> Up to one-third of the nation's employers are penalized each year for failure to follow these complex rules.

H.R.2775 and S.1610 would simplify these rules by requiring employers to deposit their taxes on the Tuesday or Friday following each payday. Both bills contain an exception to this Tuesday/Friday rule that allows less frequent deposits for small employers. H.R.2775 would allow quarterly deposits for 2.3 million small employers who have quarterly payroll tax liabilities of \$3,500 or less. The small employer exception under S.1610 would allow 3.7 million employers who have quarterly payroll tax liabilities of less than \$18,000 to deposit once a month.

We believe that changes to the deposit rules are urgently needed and that both proposed simplification measures will ease the

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

employers' tasks of understanding and complying with their payroll tax deposit responsibilities. The proposals will also reduce the number of deposits that some employers will have to make. However, we believe that the S.1610 proposal would be the least 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 based on the voluntary compliance of over 5 million small, medium, and large businesses, is distinctly unfriendly to the employers who must make the 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 in causing this high penalty rate.

Complexity arises when employers must determine the frequency of deposits and the specific dates that 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. Under the current deposit rules specified by Treasury regulations, employers pay their employment taxes either quarterly, monthly, or within 3 banking days following the end of one of eight deposit periods within each month. A statutory deposit rule also requires employers with \$100,000 or more in employment tax liabilities each payday to deposit within 1 banking day of a payday.

#### CURRENT DEPOSIT RULES ARE COMPLEX

In our review of the payroll deposit system, we found that many employers were assessed failure-to-deposit penalties because they had difficulties in understanding the complex requirements of the deposit system.<sup>2</sup> Because deposit rules specify different deposit dates--depending on the amount of accumulated

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<sup>2</sup> We developed a penalty data base that showed the rate at which all employers were penalized. We reviewed a random sample of 150 federal tax deposit penalty actions that were taken in fiscal year 1987 at 3 IRS service centers. The sample cases consisted of 25 manual assessments and 25 manual abatements for each service center. We also reviewed IRS guidance and administrative procedures, and discussed the deposit requirements with IRS and Treasury officials.

undeposited taxes--and because some employers' payrolls fluctuate over time, many employers struggle to predict with certainty when their payroll deposits are due. Furthermore, 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 on the length of the deposit period as well as where in an eighth-monthly period the payday falls. To comply, employers must monitor undeposited employment taxes from payday to payday, compare the undeposited amounts to those in 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 a given 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, thus triggering a different deposit requirement.

Perhaps an even more telling indicator of how confusing these complex requirements can be is IRS' error rate for 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.<sup>3</sup>

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 also 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 determining which employers would be excepted from regular deposits, ranging in size from \$3,000 to \$30,000 in quarterly tax liabilities. In addition, we recommended--regardless of any other changes made--that the Secretary should establish a look back rule, whereby all employers could know their deposit requirements before the start of a quarter. Finally, we said that changes to the deposit rules should include repealing the safe haven provision, which permits employers to delay depositing 5 percent of the taxes that are due because some employers have difficulty in calculating the precise amount. We recommended repealing the safe haven because for some employers it represents a maximum payment target rather than a means to ease legitimate payment calculation problems and because

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<sup>3</sup> 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.

alternative means are available to IRS to address legitimate payment problems.

ANALYSIS OF PROPOSED CHANGES  
TO THE PAYROLL TAX DEPOSIT RULES

In assessing the reforms proposed in the House simplification bill, H.R.2775, and the bill introduced in the Senate, S.1610, 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 cash flow of the government be maintained?

Based on our assessment, we believe that both H.R.2775 and S.1610 represent commendable approaches 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, these bills would undoubtedly reduce the number of penalties that well-meaning employers receive because they cannot understand the current complex deposit requirements.

Both bills would: (1) replace the current eighth-monthly system with a system that requires deposits to be made on Tuesdays or Fridays, (2) permit small employers to deposit less frequently



than required under the Tuesday/Friday rule, (3) provide a look back rule for employers to use at the outset of each new quarter for establishing the deposit requirement that they would follow, and (4) increase the amount of taxes an employer must deposit under the safe haven provision.

### Tuesday/Friday Rule

The bills would change all but the statutory \$100,000 deposit rule and would require employers 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 that IRS has with businesses deals with failure-to-deposit penalty assessments and abatements.

## Exception for Small Employers

Each bill also provides an exception to the Tuesday/Friday rule for small employers, so that they will not be burdened with having to make deposits after each payday. Under H.R.2775, small employers with quarterly tax liabilities of \$3,500 and under--an estimated 2.3 million employers, or 52 percent of employers paying employment taxes--would be allowed to deposit quarterly.<sup>4</sup> Under the current deposit rules, most of these employers are required to make from one to three deposits over the course of the quarter. H.R.2775 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.

We endorse exempting 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

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<sup>4</sup> Our estimates of the number of employers making deposits, the number of deposits made, and the change in federal revenues 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. 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, leaving about 4.5 million making deposits.

bill would speed up deposits for some employers. For example, those with \$3,500 to \$9,000 in quarterly tax liabilities who now deposit monthly would have to deposit on the Tuesday or Friday following their paydays. This change could affect about 906,000 employers who would have to make an additional 25 million deposits annually. This increase has prompted concern on the part of the small business community.

The small employer exemption in S.1610 addresses these concerns. This bill would exempt employers with quarterly tax liabilities of less than \$18,000 from the Tuesday/Friday rule. Instead, these employers would be allowed to deposit by the 15th day of the month following the month in which the tax liability was incurred. This threshold would permit all employers currently paying monthly to continue doing so. We estimate that S.1610 would exempt 3.7 million employers, or 83 percent of all employers from making the Tuesday/Friday deposits.

In addressing the concerns of small businesses, S.1610 will nevertheless increase federal revenues, although not as much as the House bill. On the basis of data from the first quarter of 1989, which is the most recent data available to us, we estimate that H.R.2775 would raise \$1.4 billion in the initial year. This sum would result principally from accelerating the payments of employers with \$3,500 to \$9,000 in quarterly tax liabilities who currently pay monthly and would now pay under the Tuesday/Friday

rule. In contrast, we estimate that S.1610 would raise \$300 million in the initial year. Although more employers would pay less frequently than they do now, the revenue effect would still be positive because the Tuesday/Friday rule would accelerate payments for certain employers exceeding the \$18,000 threshold.

Another possible advantage of retaining monthly depositing, compared to the quarterly deposits proposed under H.R.2775, has to do with the burgeoning accounts receivable inventory--which totaled \$96 billion in 1990, 31 percent of which was due to employment tax delinquencies. As previously noted, about 2.3 million employers have quarterly tax liabilities of \$3,500 or less. Under H.R.2775, we estimate that about 1 million of the 2.3 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 money. 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.

Both H.R.2775 and S.1610 include such a provision. Under H.R.2775, employers whose quarterly tax liability did not exceed \$3,500 in any one of the eight preceding quarters would make quarterly deposits rather than follow the Tuesday/Friday deposit schedule.<sup>5</sup> Employers would have to make this determination for each quarter. Once an employer who qualifies for the exemption exceeds the \$3,500 threshold in one quarter, the employer would have to again build eight consecutive quarters of tax liability under \$3,500 before again being exempted from the Tuesday/Friday rule.

S.1610 has a similar look back provision for exempting employers with quarterly tax liability of less than \$18,000 from the Tuesday/Friday rule. Under S.1610, before each quarter, employers would use four prior quarters' liabilities to determine if they can be exempted from the Tuesday/Friday rule. We believe that seasonal variations in business taxes can be captured just as well with a four quarter look back period as under an eight quarter period. However, we believe that businesses' paperwork requirements could be lessened, and their deposit rules made more

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<sup>5</sup> 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.

stable, by applying the look back rule for a full year. A four quarter look back provision that exempts employers for a full year would be less burdensome, would enable small employers to return to the slower deposit schedule more quickly, and would still achieve certainty in advance about which deposit rules the employer will fall under during the quarter.

### Safe Haven Provision

Under current regulations, Treasury has an exemption to the deposit rules, known as the safe haven, which allows employers, who are 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 haven 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 haven be eliminated because IRS studies show that less than one-half of one percent of the employers use it. Furthermore, studies by IRS and the Railroad Retirement Board indicate that some employers use the safe haven, 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 haven consistently deposited exactly 95 percent of their tax liability. For these employers, the safe haven represents a maximum payment target rather than a means to ease legitimate payment calculation problems.

Both H.R.2775 and S.1610 provide a statutory safe haven for deposit shortfalls. Under H.R.2775, an employer is considered to have deposited the 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 S.1610 safe haven is the same exempt the \$150 shortfall limit is increased to \$250.

In general, both proposed statutory safe haven provisions are better than the current safe haven because the tolerance is lower (i.e., 2 percent instead of 5 percent). However, raising the safe haven from 95 percent to 98 percent only reduces the amount of taxes that employers can delay depositing; it does not eliminate the potential for abuse. We believe that other administrative procedures that are less prone to abuse could be established, thus providing the needed flexibility to accommodate genuine cases where employers cannot accurately determine their tax liability. For example, IRS could grant waivers for 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 both H.R.2775 and S.1610 would achieve a major simplification of tax rules for our nation's employers. They would lessen the burden experienced by employers, particularly smaller employers; be simpler than the present rules to understand; would not reduce the federal government's cash flow compared to current rules; and should result in fewer penalties for IRS to administer. We support the basic framework set forth in H.R.2775, but we believe that S.1610 would improve this framework by further reducing the burdens experienced by the small business community.

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



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