



*Improvements Have Been Made to Monitor
Employers That Use Professional Employer
Organizations, but More Can Be Done*

September 19, 2007

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

Redaction Legend:

1 = Tax Return/Return Information

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

September 19, 2007

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – Improvements Have Been Made to Monitor
Employers That Use Professional Employer Organizations, but More
Can Be Done (Audit # 200630027)

This report presents the results of our review of the efforts the Internal Revenue Service (IRS) is making to address compliance of Professional Employer Organizations (hereafter referred to as a PEO or an Organization). The overall objectives of the review were to determine the steps the IRS is taking to address PEOs that default on paying employment taxes and to determine what can be done to improve compliance tracking for those businesses that terminate their use of these Organizations.

Impact on the Taxpayer

A PEO may enter into contracts with numerous companies (clients) and is responsible for paying employment taxes on wages paid to leased employees. If the Organization fails to pay these employment taxes, large tax underpayments can occur in a short time span because of the large number of employees that are affected. If the Organization defaults on paying the employment taxes, it usually does not have significant assets to collect against because it is only a service company. The IRS' only recourse may be to collect the amounts due from clients of the Organizations, which could result in significant additional expense for the clients who paid fees to the Organizations to cover the costs of payroll taxes and subsequently must pay again.

Synopsis

Current regulations do not protect clients when PEOs default on paying employment taxes. In many States, these Organizations provide a financial instrument to protect the State and the



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client against loss; 22 States have requirements for the PEOs to be bonded. However, the Federal Government currently does not require bonding of PEOs.

In March 2006, the House of Representatives proposed in H.R. 4985,¹ certain requirements for PEOs to become certified. Besides requiring the posting of a bond, this bill proposed that an independent certified public accountant review the Federal employment tax payments of each Organization to ensure it had withheld and made deposits of all taxes. Once a year, the certified public accountant would also report whether the certified Organization's financial statements are presented fairly, in accordance with Generally Accepted Accounting Principles. Without regulations such as these, clients of PEOs and the Federal Government are both at increased risk. Instances of Organizations defrauding their clients are becoming more prevalent. The following are recent examples:

- On December 7, 2004, the Chief Executive Officer of a large PEO pled guilty to conspiring to defraud the United States by underreporting and underpaying in excess of \$51 million in Federal employment taxes to the IRS. On January 7, 2005, the former Chief Operating Officer also pled guilty to the same charges. The objective was to avoid alerting the IRS to the multimillion dollar underpayment of Federal employment taxes by filing fraudulent quarterly employment tax returns.
- The *New York Law Journal*, dated July 17, 2003, discusses the prosecution of the president of a PEO that, during a period of fewer than 2 years, failed to pay over to the IRS more than \$13 million in payroll taxes for more than 6,000 employees leased to over 100 businesses.²

At the beginning of this review, the IRS was unable to specifically link businesses with their PEOs. As a result, it could not differentiate between employers that had become noncompliant and were not paying their employment taxes and those that had begun using an Organization.

In 2005, the Office of Taxpayer Burden Reduction of the Small Business/Self-Employed Division convened a task force to study the use of Employer/Payer Appointment of Agent (Form 2678).³ The task force determined Form 2678 was not being used to its full potential and recommended changes to the way the Form is processed. It implemented improvements in the way Form 2678 is designed and processed subsequent to our review. We agree with the

¹ Small Business Efficiency Act of 2006, 109th Congress (March 16, 2006).

² The *New York Law Journal*, Volume 230—NO. 12; Thursday, July 17, 2003.

³ Application for authorization as an agent to perform acts required of an employer should be (1) made in writing by the agent to the IRS campus with whom the agent will file returns upon approval of the application and (2) accompanied by Form 2678. The employer should submit the properly executed Form 2678 to the agent, who will transmit it to the IRS with a written request for authority to act as the agent of such employer. The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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corrective actions taken by the task force; they are an important step in getting this compliance issue under control.

Recommendations

We recommended the Commissioner, Small Business/Self-Employed Division, and the IRS Office of Chief Counsel work with the Office of Tax Policy in the Department of the Treasury to (1) consider a legislative proposal requiring all current and future PEOs to become certified, which would include posting a bond for payment of taxes; and (2) explore all options, including use of the revised Form 2678, to establish accurate links between the PEOs and their clients. The Commissioner, Small Business/Self-Employed Division, should also fully implement the changes proposed by the task force requiring the Employer's QUARTERLY Federal Tax Return (Form 941) to list clients, and ensure outreach efforts are adequate to sufficiently inform taxpayers of the potential risks of using a PEO, which include remaining liable for employment taxes left unpaid by the PEOs for employees used by the taxpayer.

Response

IRS management agreed with the recommendations and will work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal applicable to PEOs addressing certification and bonding requirements and other requirements such as reviews of quarterly tax payments and annual financial reviews. The IRS will also work with the Department of the Treasury to explore all options to establish links between PEOs and their clients. The Director, Specialty Programs, Small Business/Self-Employed Division, will explore a proposal for PEOs to provide a list of every client whose wages the organization is reporting to the IRS and will work to develop a mechanism requiring this information. The Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division, will develop an outreach initiative to small business/industry groups that addresses employment tax obligations when the services of a PEO are used. Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8500.



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*Improvements Have Been Made to Monitor Employers That Use
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Abbreviations

IRS

Internal Revenue Service

PEO

Professional Employer Organization



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Background

Tax compliance by Professional Employer Organizations (hereafter referred to as a PEO or an Organization) is a growing area of risk. These Organizations began operating in the early 1980s. In this industry, PEOs (also called employee leasing companies) contract with client companies to handle the management of critical human resources and assume some of the employment responsibilities normally handled by their client companies. This includes hiring some or all of the client companies' employees whose services are then leased back to the client companies (Figure 1 presents the graphical relationship).

According to the National Association of Professional Employer Organizations:

The Professional Employer Organization relationship involves a contractual allocation and sharing of employer responsibilities between the Professional Employer Organization and the client. This shared employment relationship is called co-employment . . . When evaluating the employer role of either the Professional Employer Organization or the client, the facts and circumstances of each employer obligation should be examined separately, because neither party alone is responsible for performing all of the obligations of employment. Each party will be solely responsible for certain obligations of employment, while both parties will share responsibility for other obligations.

Figure 1: Relationship of the Professional Employer Organizations, Clients, and Employees



Source: The National Association of Professional Employer Organizations web site.¹

¹ www.NAPEO.org.



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A PEO may enter into contracts with numerous companies and is responsible for paying employment taxes on all the leased employees. If the Organization fails to pay employment taxes on these leased employees, large tax underpayments can occur in a short time span because of the large number of employees that are affected. If the Organization defaults on paying the employment taxes, it usually does not have significant assets to collect against because it is only a service company. One criminal investigation determined an Organization owed the Federal Government approximately \$50 million in unpaid taxes.

Revenue Procedure 70-6² established procedures to be followed by the Internal Revenue Service (IRS) and taxpayers in applying for authorization to perform acts required of employers under the Federal employment tax statutes. Application for authorization as an agent to perform acts required of an employer should be (1) made in writing by the agent to the IRS campus³ with whom the agent will file returns upon approval of the application, (2) accompanied by an Employer/Payer Appointment of Agent (Form 2678), and (3) executed by each employer for whom the agent is to act. The employer should submit the properly executed Form 2678 to the agent, who will transmit it to the IRS with a written request for authority to act as the agent of such employer.

This review was conducted at the Small Business/Self-Employed Division in Lanham, Maryland, during the period April 2006 through January 2007. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

² 1970-1 C.B. 420; 1970 IRB LEXIS 772. A Revenue Procedure is an official statement by the IRS about the practices and procedures to be followed by taxpayers or by the IRS.

³ The campuses are the data processing arm of the IRS. They process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.



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Results of Review

Current Regulations Do Not Protect Clients When Professional Employer Organizations Default on Paying Employment Taxes

Discussions with IRS personnel and review of current regulations indicate the IRS may attempt to collect employment taxes from the clients of PEOs if the Organizations default on paying the employment taxes. To get an indication of noncompliance by Organizations, we obtained data from the Division of Occupational and Professional Licensing from 1 State, which indicated 3,118 client companies had ended their associations with 93 Organizations. We reviewed a statistically valid sample of 64 tax records for 27 of these Organizations and determined 8 Organizations were not fully compliant in paying employment taxes. These 8 PEOs owed approximately \$38.4 million, and 1 [REDACTED]

In the event a PEO defaults on paying the employment taxes, it usually does not have significant assets to collect against because it is only a service company. The IRS' only recourse may often be to collect the amounts due from clients of the Organization. Unfortunately, this could result in significant additional expense for the clients who pay their payroll taxes to the IRS in addition to already paying fees to the Organization intended to cover those costs.

Although employee leasing is a legitimate practice, it is subject to abuse, sometimes on a significant scale, when a PEO fails to remit payroll taxes to the IRS.

In many States, PEOs provide a financial instrument to protect the State and the client against loss; currently, 22 States have requirements for Organizations to be bonded. According to *PEO Insider* (a professional magazine for these Organizations), dated November 2003:⁴

Surety bonds, irrevocable bank letters of credit and certificates of deposit are used in the PEO industry to meet state registration and licensing requirements, to provide workers' compensation policy collateral, to guarantee PEO performance of employer responsibilities, and for clients to guarantee payment of service fees. . . . The most common use of surety bonds by PEOs continues to be to meet various state regulatory requirements. Sometimes these bonds are compliance in nature, meaning the PEO must adhere to the states' registration or licensing requirements. In other instances,

⁴ *PEO Insider*, "PEO Financial Assurance Options Update," November 2003.



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unemployment taxes. In still other instances, the bonds are “deficiency bonds,” meaning the bond is required due to the PEO’s failure to pay certain taxes on time, poor financial performance, or failure to provide financial statements demonstrating certain equity levels. . . . Qualifying for these bonds is not typically difficult . . .

The Federal Government currently does not require bonding of PEOs. However, it does require bonding of some other types of taxpayers. For example, the Employee Retirement Income Security Act of 1974⁵ establishes a comprehensive scheme of fiduciary⁶ duties and responsibilities that are designed to protect the benefits of the pension plan participants and their beneficiaries and to prescribe standards that may be enforced. The fiduciaries have a duty to protect the pension plan assets and to administer and manage the plan and trust in a manner that protects the interests of the plan participants and beneficiaries. Every fiduciary and every person who handles pension plan funds must be bonded. The bonding rules are set forth in Department of Labor Reg. Sections 2580.412-1 through 2580.412-36.⁷

The duties of a PEO are similar to those of a fiduciary in many ways. The Organization accepts from clients payments that are intended to cover employee wages, employer and employee portions of Federal income taxes, Social Security taxes, State taxes when applicable, and fringe benefits that may be offered through the Organization (e.g., a retirement plan). The Organization is to control these funds and remit appropriate amounts to the Federal and State Governments.

In March 2006, the House of Representatives proposed in H.R. 4985⁸ certain requirements for PEOs to become certified. Two of the requirements involved having the Organization post a bond for the payment of taxes and consent to having quarterly tax payment reviews as well as annual financial reviews. Besides requiring the posting of a bond, this bill proposed that an independent certified public accountant review the Federal employment tax payments of each Organization to ensure it had withheld and made deposits of all taxes. Once a year, the certified public accountant would also report whether the certified Organization’s financial statements are presented fairly, in accordance with Generally Accepted Accounting Principles.

According to the *New York Law Journal*, dated July 2003, “In addition to prosecuting the operators of employee leasing companies who abscond with payroll taxes, the IRS has recently

⁵ Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.). This Federal law sets minimum standards for pension plans in private industry.

⁶ A fiduciary is one often in a position of authority who obligates himself or herself to act on behalf of another (as in managing money or property) and assumes a duty to act in good faith and with care, candor, and loyalty in fulfilling the obligation; one (as an agent) having a fiduciary duty to another, *Merriam-Webster’s Dictionary of Law*, 1996.

⁷ These regulations were originally issued under Section 13 of the Welfare and Pension Plans Disclosure Act of 1958 (72 Statute 997, August 28, 1958), which was superseded by the Employee Retirement Income Security Act of 1974. The Department of Labor simply reissued its Regulations under Employee Retirement Income Security Act of 1974 Section 412.

⁸ Small Business Efficiency Act of 2006, 109th Congress (March 16, 2006).



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begun to seek and obtain civil injunctive relief against such companies, placing them into receivership, freezing their assets and prohibiting their owners from operating similar services.”⁹

However, without regulations such as those discussed above, clients of PEOs and the Federal Government are both at increased risk. Instances of Organizations defrauding their clients are becoming more prevalent. The following are recent examples:

- On December 7, 2004, the Chief Executive Officer of a large PEO pled guilty to conspiring to defraud the United States by underreporting and underpaying in excess of \$51 million in Federal employment taxes to the IRS. On January 7, 2005, the former Chief Operating Officer also pled guilty to the same charges. The objective was to avoid alerting the IRS to the multimillion dollar underpayment of Federal employment taxes by filing fraudulent quarterly employment tax returns.
- The *New York Law Journal*, dated July 17, 2003, discusses the prosecution of the president of a PEO that, during a period of fewer than 2 years, failed to pay over to the IRS more than \$13 million in payroll taxes for more than 6,000 employees leased to over 100 businesses.

Recommendation

Recommendation 1: The Commissioner, Small Business/Self-Employed Division, and the IRS Office of Chief Counsel, should work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal requiring all current and future PEOs to meet the requirements for becoming “certified,” which would include posting a bond for the payment of taxes and may include some of the other requirements outlined in H.R. 4985, such as independent quarterly tax payment reviews as well as annual financial reviews.

Management’s Response: IRS management agreed with this recommendation and will work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal applicable to PEOs, including certification and bonding requirements, and other requirements such as reviews of quarterly tax payments and annual financial reviews.

The Internal Revenue Service Is Taking Actions to Improve Tracking of Employers That Use the Services of a Professional Employer Organization

We identified 761 corporations that had (1) filed income tax returns for fiscal years ending between February 2003 and March 2006 with significantly large amounts of income and/or

⁹The *New York Law Journal*, Volume 230—NO. 12; Thursday, July 17, 2003.



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wages, (2) stopped filing employment taxes, and (3) continued to file income tax returns.¹⁰ We selected a random sample of 59 of these taxpayer entities and reviewed their tax records to determine if the businesses had indications that employment tax returns should have been filed.

Our review showed 34 (58 percent) of these 59 taxpayer entities reported significant salaries and/or wages during the period of our review, indicating the businesses potentially should have filed Federal employment tax returns. It is possible these businesses used the services of a PEO. However, at the time of our review, IRS recordkeeping did not indicate such a relationship existed.

To administer employment tax laws and to effectively use scarce compliance resources, the IRS needs to be able to identify businesses that begin using the services of a PEO, as well as when businesses terminate the use of those services. Without this ability, the IRS may not take appropriate actions against businesses that do not pay employment taxes or may unnecessarily burden taxpayers that are paying through an Organization.

The IRS has taken actions to improve the tracking of businesses that use the services of a PEO. However, it is still unable to identify all Organizations and the businesses that use them. Currently, the IRS uses Form 2678 to record an employer's (business') use of third-party employment companies and receives approximately 30,000 of these Forms per year. It stores these Forms at two IRS campuses; however, prior to January 2007, these Forms were not transcribed or stored in a searchable order.

In 2005, the Office of Taxpayer Burden Reduction of the Small Business/Self-Employed Division convened a task force to study the use of Form 2678; it determined the Form was not being used to its full potential and recommended changes to the way the Form is processed. The task force implemented improvements in the way Form 2678 is designed and processed subsequent to our review, including:

- Designating specific action codes¹¹ to show receipt of Form 2678 by the IRS and the relationship between the parties (i.e., establishment of an authorization or termination).
- Redesigning Form 2678 (effective May 2007) using a "plain language" format for simplicity. The new Form 2678 requires both parties to sign (see Appendix IV).
- Proposing that a specific schedule be attached to the Employer's QUARTERLY Federal Tax Returns (Form 941) filed by each PEO. The schedule is to be filed by the PEO with the Forms 941 and must list every taxpayer on whose behalf the PEO is filing (see Appendix V).

¹⁰ From a population of taxpayers filing 1,895,085 Employer's QUARTERLY Federal Tax Returns (Form 941) containing indicators that this was the business' final return, we identified 761 taxpayers that had filed a U.S. Corporation Income Tax Return (Form 1120) and reported net income and/or salary or wages greater than \$1,000,000. (This amount was determined by the audit team as significant but represents no IRS tolerance.)

¹¹ Action codes are used to designate an action to be taken on a taxpayer account.



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- Implementing a process to prevent Employer's Annual Federal Unemployment (FUTA) Tax Returns (Form 940) filed by a PEO for individual clients from "opening" an erroneous Form 941 filing requirement for each client (this requirement is satisfied by the PEO's filing of an aggregate Form 941 for all its clients) and burdening clients with erroneous Form 941 Tax Delinquency Investigation notices.

We agree that the corrective actions taken by this task force are an important step in improving internal controls over this compliance issue.

Recommendations

Recommendation 2: The Commissioner, Small Business/Self-Employed Division, and the Office of Chief Counsel should work with the Department of the Treasury to explore all options, including use of the revised Form 2678, to establish accurate links between the PEOs and their clients.

Management's Response: IRS management agreed with this recommendation and will work with the Department of the Treasury to explore all options, including use of the revised Form 2678 or a similar form, to establish accurate links between the PEOs and their clients.

Recommendation 3: The Commissioner, Small Business/Self-Employed Division, should fully implement the proposal that Form 941 require attachment of a specific schedule filed by a PEO that will list every taxpayer on whose behalf the Organization is filing.

Management's Response: IRS management agreed with this recommendation. The Director, Specialty Programs, Small Business/Self-Employed Division, will explore a proposal to list every client whose wages the Organization is reporting and will work to develop a mechanism requiring this information.

Recommendation 4: The Commissioner, Small Business/Self-Employed Division, should ensure outreach efforts are adequate to sufficiently inform clients of the potential risks of using a PEO, which include remaining liable for payment of employment taxes left unpaid by the PEO on employees used by the client.

Management's Response: IRS management agreed with this recommendation. The Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division, will develop an outreach initiative to small business/industry groups which provides a key message and talking points to address employment tax obligations when the services of a PEO are used.



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Appendix I

Detailed Objectives, Scope, and Methodology

The overall objectives of the review were to determine the steps the IRS is taking to address PEOs (also referred to as an Organization) that default on paying employment taxes and to determine what can be done to improve compliance tracking for those businesses that terminate their use of these Organizations. To accomplish our objectives, we:

- I. Determined efforts underway by the IRS, the Department of the Treasury, and Congress to address problems with certain third-party payers of employment taxes, such as PEOs.
 - A. Contacted the Treasury Inspector General for Tax Administration Congressional/Media Liaison to identify pending changes in the Internal Revenue Code covering liability of taxes owed by these Organizations.
 - B. Analyzed pending legislation to determine whether liability is clearly stated between the Organization and employee-leasing client.
 - C. Reviewed IRS efforts to improve the functionality of Employer/Payer Appointment of Agent (Form 2678).
 - D. Reviewed IRS efforts to improve the recording of Organization clients using Employer's QUARTERLY Federal Tax Return (Form 941).
- II. Identified employers that may have hired PEOs to lease employees.
 - A. Prepared computer requests to identify taxpayers that have stopped filing Forms 941, or whose wages paid are significantly reduced, and are still in business.
 1. From the Data Center Warehouse,¹ identified the population of 761 taxpayers who filed Form 941 that had stopped submitting the Forms by extracting those taxpayers who had used Computer Condition Code "F," indicating the filing of the final return and had income and/or wages of \$1 million or more. (This amount was determined by the audit team as significant, but represents no IRS tolerance.)
 2. From the Data Center Warehouse, identified the population of 24,935 taxpayers whose "Total Compensation" had decreased by 50 percent for any period between the first and fourth quarters of Calendar Year 2005.

¹ The Data Center Warehouse is a Treasury Inspector General for Tax Administration repository of IRS data used for analysis.



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3. Sampled the returns identified in the computer requests for Steps II.A.1. and II.A.2. to assess the accuracy of the data.²
 4. We validated the reliability of the data identified in Step II.A.1. by reviewing a randomly selected sample of 59 cases to ensure the required filing requirements matched the tax returns filed by the taxpayers.
 5. We validated the reliability of the data identified in Step II.A.2. by reviewing a sample of 62 cases selected to ensure proper calculations were performed.
- III. Evaluated the filing and paying compliance of employers identified in Step II by selecting a statistically valid sample of 59 employers from a population of 761 and determining whether there was a compliance problem indicated.
- A. Analyzed the sample selected and determined whether all required tax returns had been timely submitted to the IRS for processing. The required returns were determined from the forms indicated on the employer's entity module.³
 - B. Analyzed the same sample and determined whether all required payments had been made and made on time.
 - C. Determined what efforts, if any, the IRS could take to reduce the identified compliance problems.
- IV. Used PEO data supplied by the Division of Occupational and Professional Licensing for one State. The State providing the data used in this Step was selected because no cost was associated with obtaining the data. Another State was also contacted for data; however, the cost of the data would have been significant. We received data showing a total of 3,118 employers had ended their relationships with 93 Organizations. We reviewed a randomly chosen statistically valid sample of 64 tax records for 27 of the Organizations.⁴
- A. Identified the Organization name by using the Integrated Data Retrieval System.⁵

² We used a statistically valid sample of 59 from a population of 761 in expectation of estimating the number of taxpayers in our population that had stopped filing their employment returns because they were possibly using a PEO. We used a 95 percent confidence level, an expected error rate of 20 percent, and a precision level of ± 10 percent.

³ The entity module will provide name, address, and other entity information from the input of the Taxpayer Identification Number.

⁴ We used a statistically valid sample of 64 from a population of 3,118 in expectation of estimating the number of PEOs in our population that were not fully compliant in paying employment taxes. We used a 95 percent confidence level, an expected error rate of 20 percent, and a precision level of ± 10 percent.

⁵ The IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer's account records.



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- B. Identified the clients that have ended their relationship with the Organization by finding those taxpayers who had a date indicating the end of the Organization relationship in the data received.
- C. Determined the Employer Identification Number of the client by using the Integrated Data Retrieval System.
- D. Determined the filing requirements of the taxpayers identified in Step IV. B. using the Integrated Data Retrieval System. We also determined whether the tax returns may have been filed by a parent company.
- E. From the Organization data supplied by the State, quantified the number of taxpayers, the number of Organizations, the number of taxpayers ending their relationship with the Organization, and the number of clients that had began the use of another Organization.



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Appendix II

Major Contributors to This Report

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Appendix III

Report Distribution List

Acting Commissioner C
Office of the Commissioner – Attn: Acting Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Small Business/Self-Employed Division SE:S
Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Taxpayer Burden Reduction SE:S:TBR
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaison: Commissioner, Small Business/Self-Employed Division SE:S



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Appendix IV

Revised Employer/Payer Appointment of Agent (Form 2678)

Form 2678 Employer/Payer Appointment of Agent (Rev. May 2007) Department of the Treasury — Internal Revenue Service OMB No. 1545-0748

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

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

Note: This appointment is not effective until we approve your request. See the instructions for your reporting, deposit, and payment requirements while we are processing your request.

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



Part 1: Why you are filing this form...

(Check one)

- You want to appoint an agent for tax reporting, depositing, and paying.
You want to revoke an existing appointment.

Part 2: Employer or Payer Information: If you want to appoint an agent or revoke an appointment, complete this part.

1 Employer identification number (EIN)
2 Employer's or payer's name (not your trade name)
3 Trade name (if any)
4 Address (Number, Street, Suite or room number, City, State, ZIP code)

Table with 3 columns: Form type, For ALL employees/payees, For SOME employees/payees. Rows include Form 941, 943, 944, 945, 1042, CT-1, CT-2.

Note: You may NOT appoint an agent to report, deposit, and pay taxes reported on Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return.

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

Sign your name here (with X), Print your name here, Print your title here, Date, Best daytime phone

Now give this form to the agent to complete.



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Form 2678 (Rev. 5-2007)

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

6 Agent's employer identification number (EIN) -

7 Agent's name (not trade name)

8 Trade name (if any)

9 Address

<input type="text"/>	<input type="text"/>	<input type="text"/>
Number	Street	Suite or room number
<input type="text"/>	<input type="text"/>	<input type="text"/>
City	State	ZIP code

Check here if the employer is a disabled individual or other welfare recipient receiving home-care services through a state or local program

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

X Sign your name here Print your name here

Print your title here

Date / / Best daytime phone () -

Form **2678** (Rev. 5-2007)



Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done

Form 2678 (Rev. 5-2007)

Page **3**

Instructions for Form 2678

Section references are to the Internal Revenue Code.

Use this form if you want to request approval to have an agent file returns and make deposits or payments of employment or other withholding taxes or if you want to revoke an existing appointment. You cannot use a prior version of this form. All prior versions are obsolete and will not be accepted.

- If you want to appoint an agent, check the box in Part 1 that says, "You want to **appoint** an agent for tax reporting, depositing, and paying," and complete Part 2.

- If you are an agent and you want to accept an appointment, complete Part 3. If you are a corporate officer, partner, or tax matters partner, you must have the authority to execute this appointment of agent.

Note: If the employer/payer will be making payments not covered by the appointment, the employer/payer must file all related returns and deposit and pay taxes for those payments. When completing line 5, check the box(es) "For SOME employees/payees."

- If you are an employer, payer, or agent and you want to revoke an existing appointment of an agent, check the box in Part 1 that says, "You want to **revoke** an existing appointment," and complete Parts 2 and 3. However, only one signature is required. If an existing appointment is revoked, the IRS cannot disclose confidential tax information to anyone other than the employer/payer for periods after the appointment is revoked.

What are the reporting, deposit, and payment requirements while we are processing the request?

Send Form 2678 to us 60 days before the date when you want the appointment to become effective. This appointment is not effective until we approve your request. We will send a letter with the effective date to the agent after we have approved the request. Until we approve the request, the employer/payer must continue to file all tax returns and make all deposits and payments.

What are the reporting, deposit, and payment requirements after the IRS approves the appointment?

Agents must follow the procedures in Revenue Procedure 70-6 for employment taxes (unless you are a sub-agent for a state agent under Notice 2003-70) and Revenue Procedure 84-33 for backup withholding. Agents for employers who are receiving home-care services through a state or local program are often referred to as "fiscal agents" and "household employer agents." All agents, employers, and payers remain liable for filing all returns and making all tax deposits and payments while this appointment is in effect. If an agent contracts with a third party, such as a reporting agent or certified public accountant, to prepare or file the returns covered by this appointment or to make any required tax deposits or payments and the third party fails to do so, the agent, employer, and payer remain liable.

Where to send this form if you are in ...

Send your form to ...

Connecticut	Maryland	Pennsylvania	IRS
Delaware	Massachusetts	Rhode Island	Cincinnati, OH
District of Columbia	Michigan	South Carolina	45999-0046
Illinois	New Hampshire	Vermont	
Indiana	New Jersey	Virginia	
Kentucky	New York	West Virginia	
Maine	North Carolina	Wisconsin	
	Ohio		
Alabama	Iowa	North Dakota	IRS
Alaska	Kansas	Oklahoma	Ogden, UT
Arizona	Louisiana	Oregon	84201-0046
Arkansas	Minnesota	South Dakota	
California	Mississippi	Tennessee	
Colorado	Missouri	Texas	
Florida	Montana	Utah	
Georgia	Nebraska	Washington	
Hawaii	Nevada	Wyoming	
Idaho	New Mexico		
No legal residence or place of business in any state			IRS Ogden, UT 84201-0046

Privacy Act and Paperwork Reduction Act Notice: We ask for this information to carry out the Internal Revenue laws of the United States. We need it to figure and collect the right amount of tax. You do not have to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number.

Generally, tax returns and return information are confidential, as required by section 6103. However, section 6103 allows or requires the IRS to disclose or give the information shown on this form to others as described in the Code. For example, we may disclose your tax information to the Department of Justice for civil and criminal litigation, and to cities, states, and the District of Columbia for use in administering their tax laws. We may also disclose this information to other countries under a tax treaty, to federal and state agencies to enforce federal nontax criminal laws, or to federal law enforcement and intelligence agencies to combat terrorism.

The time needed to complete and file Form 2678 will vary depending on individual circumstances. The estimated average time is 30 minutes. If you have comments concerning the accuracy of this time estimate or suggestions for making Form 2678 simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave., NW, IR-6406, Washington, DC 20224. DO NOT send Form 2678 to this address. Instead, send it to the Internal Revenue Service at the address indicated in the table above.



Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done

Appendix VI

Management's Response to the Draft Report



COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

RECEIVED
AUG 24 2007

AUG 23 2007

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kathy K. Petronchak 
Commissioner, Small Business/Self-Employed Division

SUBJECT: Audit Report – Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations but More Can Be Done (Audit # 200630027)

We have reviewed your report, "Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations but More Can Be Done," and agree with your recommendations.

The report states that we implemented improvements in the way the Form 2678, "Employer/Payer Appointment of Agent," is designed and processed. Your recognition that the corrective actions taken were an important step in improving internal controls over our compliance issues is greatly appreciated.

We agree to work with the Office of Chief Counsel and the Department of the Treasury to explore guidance and consider legislative proposals in the area of third party payer reporting. We also agree to include a message on the use of Professional Employer Organizations (PEOs) in our educational plans.

In addition, as stated in the report, "Revenue Procedure 70-6 establishes procedures to be followed by the IRS and taxpayers in applying for authorization to perform acts required of employers under the Federal employment tax statutes." Revenue Procedure 70-6 requires a taxpayer to apply for this authorization by filing Form 2678. The report assumes that this Revenue Procedure applies to PEOs. While we are in agreement with your recommendation that the Service should explore all options to establish the linkage between the PEO and its clients, it is generally not the business practice of a PEO to require its clients to complete a Form 2678. Nor under current law and regulations can the IRS require a PEO to use the Form 2678.

Since the existing laws are unclear for PEOs, the Administration's FY 2007 and 2008 Revenue Proposals include a proposal for setting standards for holding employee leasing companies responsible for federal employment taxes.



Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done

Our response to your recommendations is attached. If you any have questions or concerns, please contact me at (202) 622-0600 or Bill Conlon, Director, Specialty Programs at (202) 283-6874.

Attachment



Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done

Attachment

RECOMMENDATION 1:

The Commissioner, Small Business/Self-Employed Division and the Office of Chief Counsel should work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal requiring all current and future PEOs to meet the requirements for becoming "certified," which would include posting a bond for the payment of taxes, and may include some of the other requirements outlined in S. 2913¹ and H.R. 4985 such as independent quarterly tax payment reviews as well as annual financial reviews.

CORRECTIVE ACTION:

We agree with your recommendation. We will work with the Office of Tax Policy in the Department of the Treasury to consider a legislative proposal applicable to PEOs, including certification and bonding requirements, and other requirements such as reviews of quarterly tax payments and annual financial reviews.

IMPLEMENTATION DATE:

September 15, 2008

RESPONSIBLE OFFICIAL:

The Director, Specialty Programs, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:

Chief, Employment Tax Operations will advise the Director, Specialty Programs of any delays in accomplishing this planned action.

RECOMMENDATION 2:

The Commissioner, Small Business/Self-Employed Division, and the Office of Chief Counsel should work with the Department of the Treasury to explore all options, including use of the revised Form 2678, to establish accurate links between the PEOs and their clients.

CORRECTIVE ACTION:

We agree with your recommendation. We will work with the Department of the Treasury to explore all options to establish accurate links between PEOs and their clients. This may include use of the revised Form 2678 or a similar form and/or a request for additional guidance in the area of information reporting.

IMPLEMENTATION DATE:

September 15, 2008

RESPONSIBLE OFFICIAL:

The Director, Specialty Programs, Small Business/Self-Employed Division

¹ Small Business Efficiency Act of 2006, 109th Congress (dated May 19, 2006).



Improvements Have Been Made to Monitor Employers That Use Professional Employer Organizations, but More Can Be Done

CORRECTIVE ACTION(S) MONITORING PLAN:

Chief, Employment Tax Operations will advise the Director, Specialty Programs of any delays in accomplishing this planned action.

RECOMMENDATION 3:

The Commissioner, Small Business/Self-Employed Division, should fully implement the proposal that Form 941 require attachment of a specific schedule filed by a PEO that will list every taxpayer on whose behalf the Organization is filing.

CORRECTIVE ACTION:

We agree with your recommendation. We will explore a proposal for PEOs to list every client whose wages the organization is reporting. We will work to develop a mechanism requiring this information.

IMPLEMENTATION DATE:

January 15, 2010

RESPONSIBLE OFFICIAL:

The Director, Specialty Programs, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:

Chief, Employment Tax Operations will advise the Director, Specialty Programs of any delays in accomplishing this planned action.

RECOMMENDATION 4:

The Commissioner, Small Business/Self-Employed Division should ensure outreach efforts are adequate to sufficiently inform clients of the potential risks of using a PEO, which include remaining liable for payment of employment taxes left unpaid by the organization on employees used by the client.

CORRECTIVE ACTION:

We agree with your recommendation. As a FY 2008 outreach initiative to small business/industry groups, we will provide a key message and talking points which address employment tax obligations when the services of a PEO are used.

IMPLEMENTATION DATE:

September 15, 2008

RESPONSIBLE OFFICIAL:

The Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division

CORRECTIVE ACTION(S) MONITORING PLAN:

The Director, Communications will advise the Director, Communications, Liaison and Disclosure of any delays in accomplishing this planned action.