

**MSP
#21****OFFERS IN COMPROMISE: The IRS Does Not Comply with the Law Regarding Victims of Payroll Service Provider Failure****RESPONSIBLE OFFICIAL**

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DEFINITION OF PROBLEM

Outsourcing payroll and related tax duties to third-party payroll service providers (PSPs) is a common business practice, especially for small business owners. PSPs can help employers meet filing deadlines and deposit requirements by withholding, reporting, and depositing employment taxes with state and federal authorities on behalf of the employer. If a PSP mismanages or embezzles funds that should have been paid to the IRS or state tax agency, the client employer remains responsible for unpaid tax, interest, and penalties. PSP incompetence or fraud often results in significant hardship for the business, which (from its perspective) must pay the tax twice—once to the failed PSP, and again to the IRS.

For the past decade, the National Taxpayer Advocate has recommended numerous administrative and legislative actions to assist victims of PSP failure.¹ Congress recently enacted legislation that incorporates two of these recommendations. The Consolidated Appropriations Act of 2014 requires the IRS to:

1. Issue dual address change notices related to an employer making employment tax payments (with one notice sent to both the employer's former and new address); and
2. Give special consideration to an offer in compromise (OIC) request from a victim of fraud or bankruptcy by a third-party payroll tax preparer.²

Notwithstanding significant improvements to the IRS's approach to these taxpayers, the National Taxpayer Advocate has the following concerns with the IRS response to this congressional mandate:

- While the IRS has stated its intention to start issuing dual address change notices by January 2015, it is unclear whether the IRS will meet this commitment.
- The IRS has not embraced its effective tax administration (ETA) OIC authority as a viable collection alternative and has consistently underutilized this tool to provide relief to victims.
- The proposed interim guidance on offers is inadequate.

1 See National Taxpayer Advocate 2012 Annual Report to Congress 426-44 (Most Serious Problem: *Early Intervention, Offers in Compromise, and Proactive Outreach Can Help Victims of Failed Payroll Service Providers and Increase Employment Tax Compliance*); National Taxpayer Advocate 2012 Annual Report to Congress 553-59 (Legislative Recommendation: *Protect Taxpayers and the Public Fisc from Third-Party Misappropriation of Payroll Taxes*); National Taxpayer Advocate 2007 Annual Report to Congress 337-54 (Most Serious Problem: *Third Party Payers*); National Taxpayer Advocate 2007 Annual Report to Congress 538-44 (Legislative Recommendation: *Taxpayer Protection From Third Party Payer Failures*); National Taxpayer Advocate 2004 Annual Report to Congress 394-99 (Legislative Recommendation: *Protection from Payroll Service Provider Misappropriation*).

2 Consolidated Appropriations Act, Pub. L. No. 113-76, Division E, Title I, § 106 (2014).

ANALYSIS OF PROBLEM

Dual Address Change Notices Can Alert Employers of Potential PSP Fraud.

Unscrupulous PSPs may wish to change their clients' addresses of record with the IRS without their clients' knowledge, which could keep an employer from learning it has delinquent tax deposits for months or even years. To prevent such an occurrence, the National Taxpayer Advocate recommended in her 2012 Annual Report to Congress that the IRS promptly issue dual address change notices to alert employers when a PSP initiates a change.³ The address change notice would be sent to the taxpayer's new and old address, giving the employer an opportunity to contact the IRS if it did not initiate the change of address. That way, the employer will receive IRS correspondence about any penalties and interest that result from the PSP failing to make timely payments.

The IRS website recommends that the employer not change its address of record to that of the PSP.⁴ However, the IRS has not yet adopted the National Taxpayer Advocate's recommendation to issue dual notices, despite the mandate from Congress to do so. As noted above, the Consolidated Appropriations Act of 2014 *requires* the IRS to issue a notice of confirmation of any address change relating to an employer making employment tax payments, and send such notice to both the employer's former and new addresses.⁵

On May 8, 2014, the IRS Commissioner sent a letter to the House and Senate appropriations committees, which stated that "dual notice language has been drafted and a programming change has been submitted" to allow notices to go to the old and new addresses, to be implemented by January 2015.⁶ While the National Taxpayer Advocate commends the IRS for its initial steps to respond to this mandate, she will monitor the process to ensure that the IRS is on track to issue dual notices by the date promised.

The IRS Should Embrace Its Authority to Compromise the Tax Liability of Victims of PSP Failure, Based on Effective Tax Administration.

Employers remain liable for unpaid payroll taxes when a PSP diverts employers' funds without paying the IRS the taxes due. When this occurs, employers may suffer a severe financial toll. Though they have complied with the tax laws by paying withholding and payroll taxes to their PSPs, these employers will be required, through no fault of their own, to pay the taxes a second time, along with interest and penalties. Some small businesses may be unable to recover from such a setback and be forced to shut down and lay off employees.

³ National Taxpayer Advocate 2012 Annual Report to Congress 444 ("establish ascertainable timeframes for beginning the use of dual address change letters alerting employers that a PSP has initiated a change of address, including email or text message notifications to taxpayers who so consent in a special field on employment tax returns"). See also National Taxpayer Advocate 2007 Annual Report to Congress 341 ("establish a procedure to send duplicate notices to the employer and the third party payer" and "notify affected employers when it becomes aware of a defunct third party payer").

⁴ See IRS, *Outsourcing Payroll Duties*, available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Outsourcing-Payroll-Duties> (last visited Nov. 18, 2014).

⁵ Consolidated Appropriations Act, Pub. L. No. 113-76, Division E, Title I, § 106 (2014).

⁶ Letter from John A. Koskinen, IRS Commissioner, to U.S. Senate and House Committees on Appropriations (May 8, 2014). See also IRS, Unified Work Request 99807 (Dec. 30, 2013) (setting scheduled implementation for January 23, 2015). On January 2, 2015, the IRS issued SERP Alert 15A0001, *Dual Notices of Address Change*, stating that: "Beginning Jan. 23, 2015, when an address change occurs on an EIN reflecting Employment Tax FRCs (Form 94X series), a CP 148A will generate to the taxpayer's new address and a CP 148B will generate to the taxpayer's previous address."

In March 2013, the press widely reported that AccuPay, a Maryland-based payroll service provider, failed to remit taxes it collected from 500 to 600 clients.⁷ AccuPay filed for Chapter 7 federal bankruptcy protection after clients claimed in lawsuits that some \$465,000 entrusted with AccuPay was not remitted to tax authorities.⁸ TAS worked to alert former AccuPay clients of potential IRS collection action, and how to deal with the IRS regarding unpaid payroll taxes and unfiled returns.

TAS also coordinated with the IRS to forestall collection activity on the accounts of the affected clients while TAS works with the taxpayers to resolve their individual issues. The IRS designated a specific Criminal Investigations agent to deal with inquiries from victims of AccuPay.⁹ In many cases, TAS successfully advocated to abate penalties for failing to timely deposit payroll taxes and accept installment agreements to pay the tax liability over time. However, TAS has been less successful in working with the IRS to compromise the underlying tax liability.

Authority to Accept Offers in Compromise Based upon Effective Tax Administration

Under the Taxpayer Bill of Rights (TBOR), taxpayers have the *right to a fair and just tax system*. That is, taxpayers have the right to expect the system to consider facts and circumstances that might affect their underlying liabilities, ability to pay, or ability to provide information timely. In recognition of this important taxpayer right, the IRS Restructuring and Reform Act of 1998 (RRA 98) introduced the concept of accepting OICs based on effective tax administration (ETA).¹⁰ The Conference Report accompanying RRA 98 provides this additional guidance:

[T]he conferees believe that the *IRS should be flexible* in finding ways to work with taxpayers who are sincerely trying to meet their obligations and remain in the tax system. Accordingly, the conferees believe that the IRS should make it easier for taxpayers to enter into offer in compromise agreements, and should do more to educate the taxpaying public about the availability of such agreements.¹¹ (emphasis added)

Offers in compromise based on ETA provide the IRS the flexibility to consider all of the circumstances that led to a delinquency. The IRS can accept ETA offers even if it could achieve full collection when such collection would create an economic hardship for the taxpayer or when “compelling public policy or equity considerations” are identified by the taxpayer.¹²

In her 2012 Annual Report to Congress, the National Taxpayer Advocate reiterated her recommendation that the IRS promote the use of offers in compromise as a viable collection alternative for victims of failed PSPs, including compromising the amount of tax in appropriate instances.¹³ In practice, the IRS has

⁷ See Lorraine Mirabella, *Payroll Firm Accupay Is Investigated for Allegedly Stealing Clients' Tax Payments*, BALTIMORE SUN, Mar. 4, 2013, available at http://articles.baltimoresun.com/2013-03-04/business/bs-bz-accupay-investigation-20130304_1_tax-payments-tax-collectors-potential-victims; Angus Loten, *Tax Surprises Can Follow When Payroll Firms Implode*, WALL ST. J., Apr. 24, 2013, available at <http://online.wsj.com/news/articles/SB10001424127887324743704578442901672516758>.

⁸ *Id.*

⁹ IRS, SERP Alert 13A0213, *Contact Regarding AccuPay* (May 14, 2013).

¹⁰ For an in-depth discussion of the IRS's OIC authority, see Most Serious Problem: OFFERS IN COMPROMISE: Despite Congressional Actions, the IRS Has Failed to Realize the Potential of Offers in Compromise, *supra*.

¹¹ H.R. CONF. REP. NO. 105-599, at 289 (1998).

¹² See Treas. Reg. § 301.7122-1(b)(3)(ii).

¹³ National Taxpayer Advocate 2012 Annual Report to Congress 444 (“revise the IRM and training materials to promote the use of ETA OICs as a viable collection alternative for victims of failed PSPs, including compromising the amount of tax in appropriate instances”). See also National Taxpayer Advocate 2007 Annual Report to Congress 342 (“interim guidance regarding the use of the ETA authority should do more to encourage IRS personnel to compromise tax liability in these situations”).

The IRS does not track the number of Payroll Service Provider victims, but even considering only the approximately 500 to 600 employers impacted by the AccuPay bankruptcy, accepting 54 non-economic hardship Effective Tax Administration offers over the past two years is hardly the “flexible” use that Congress intended.

not embraced its ETA OIC authority and has consistently underutilized this tool to provide relief to victims. For example, in fiscal years (FYs) 2013 and 2014, the IRS accepted only 54 non-economic hardship ETA offers submitted by victims of PSPs.¹⁴ The IRS does not track the number of PSP victims, but even considering only the approximately 500 to 600 employers impacted by the AccuPay bankruptcy, accepting 54 non-economic hardship ETA offers over the past two years is hardly the “flexible” use that Congress intended.

Unsatisfied with the lack of the IRS’s interest in the use of its ETA OIC authority for victims of PSPs, Congress included language in the Consolidated Appropriations Act of 2014 specifically mandating that the IRS “shall give special consideration to an offer in compromise from a taxpayer who has been the victim of fraud by a third party payroll tax preparer.”¹⁵ It is clear that Congress wants the IRS to do more to assist victims of PSP failure.

Yet in its response to this congressional directive, the IRS fails to even acknowledge these taxpayers as victims who need special assistance. The Commissioner’s May 2014 letter simply states that an “employer’s use of a PSP does not relieve the employer of its employment tax obligations or liability for employment taxes.” The IRS does not acknowledge that the taxpayers’ specific facts and circumstances may warrant a compromise of those obligations or liabilities, as Congress directed the IRS to do and as the TBOR promises.

Interim Guidance in Response to Congressional Directive

During the summer of 2014, TAS worked with the IRS to develop an interim guidance memorandum (IGM) that supplements its Internal Revenue Manual (IRM) section on OIC.¹⁶ Its stated objective is to:

allow the offer specialist to investigate and process offers submitted by taxpayers impacted by the fraudulent acts of a PSP in the most expeditious manner possible. The attached procedures require taxpayers to submit the least amount of documentation necessary to complete the offer investigation and allow for a resolution which is in the interest of both the taxpayer and the government.¹⁷

Though skeptical of the term “expeditious” and noting that it is often interpreted as “most convenient for the IRS” rather than “effective” or “correct,” the National Taxpayer Advocate is generally pleased with the additional guidance. While there is no “silver bullet” solution for this problem, this IGM provides Collection employees much more flexibility to use ETA authority in these cases.

14 See IRS response to TAS information request (Aug. 8, 2014); IRS response to TAS information request (Aug. 11, 2014); IRS response to fact check (Dec. 8, 2014). While the IRS does not systemically track the number of OICs submitted by victims of PSPs, it stated that it knew of 33 such offers received in FY 2013 and 57 in FY 2014. See IRS response to fact check (Nov. 26, 2014).

15 Consolidated Appropriations Act, Pub. L. No. 113-76, Division E, Title I, § 106 (2014).

16 Memorandum from Rocco A. Steco, Acting Director, Collection Policy, *Interim Guidance on Offers in Compromise from Taxpayers When Payroll Service Provider Issues Are Present* (Sept. 16, 2014). This guidance supplements the procedures found in IRM 5.8.11.2.2.1, *Public Policy or Equity Compelling Factors* (Sept. 23, 2008), IRM 5.8.11.5, *Documentation and Verification* (Sept. 23, 2008), IRM 5.8.4.22.1, *Trust Fund Liabilities* (May 10, 2013), and IRM 5.8.8.4, *Closing a Case as an Acceptance* (Aug. 8, 2014), and will be incorporated into the next revision of these IRM sections.

17 *Id.*

From the outset, the IGM acknowledges that these taxpayers are victims of a crime. This is the perspective that the National Taxpayer Advocate believes Congress intended the IRS adopt. The IGM takes a more taxpayer-favorable approach than before in discussing how to determine if the victims acted in a reasonable manner in selecting a PSP. For example, whether the PSP was licensed and bonded is just one of many factors to consider, not a dispositive factor.

Most significantly, Collection has backed away from requiring full payment of the outstanding tax balance (exclusive of penalty and interest), as the minimum offer amount. In other words, the IRS will compromise tax under certain conditions—which shows a significant commitment to treating taxpayers harmed by PSPs as victims. Furthermore, the guidance allows for acceptance of an ETA OIC without financial analysis if the taxpayer can and will agree to offer the tax balance (exclusive of penalty and interest).

Once the Collection employee has determined the PSP victim acted reasonably and its failure to comply is directly due to the actions of a third party, the IGM provides an expanded set of factors to consider in determining a reasonable offer amount in these cases. For example:

- Will payment of the full reasonable collection potential (RCP) or the remaining tax balance (exclusive of penalty and interest):
 - Negatively impact the ability of the taxpayer to pay current and future expenses in a timely manner?
 - Potentially result in the need for the taxpayer to lay off employees?
 - Reduce the goods or services provided to the community?
 - Impair the ability of the taxpayer business to remain operational?
 - Negatively impact the local economy if the business fails?
- Will payment of less than the calculated RCP or the remaining tax balance (exclusive of penalty and interest):
 - Result in providing a financial gain for the taxpayer?
 - Be generally perceived within the community as a fair and equitable solution?

The National Taxpayer Advocate believes the inquiry of whether the offer amount will result in a financial gain for the taxpayer is irrelevant to offer acceptance. This factor indicates that the IRS is still thinking that somehow, by relieving a PSP victim of the employment tax liability, the taxpayer will obtain some economic advantage over its competitors. Yet the very fact that the taxpayer has already paid the PSP the amount of the tax means that the taxpayer will be economically *disadvantaged*, vis-à-vis its competitors, by paying the amount twice.

Given this underlying emphasis on enforcement, the National Taxpayer Advocate is concerned that the IRS is not comfortable with making an objective assessment of whether an accepted offer would be perceived as fair and equitable by the community. One possible solution to this concern is for the National

Taxpayer Advocate, as the voice of the taxpayer within the IRS, to make this assessment.¹⁸ The relevant inquiries are:

- Whether the taxpayer exercised good judgment in utilizing this particular PSP;
- Whether the taxpayer timely paid the payroll taxes and withholding to the PSP; and
- Whether the taxpayer took appropriate steps to mitigate its loss (including paying over any insurance proceeds received as a result of the loss).

The National Taxpayer Advocate continues to have concerns about both the substance and implementation of the new guidance, as discussed above. After decades of treating ETA OICs as a rare occurrence—recall that the IRS accepted only 54 OICs based on ETA from victims of PSPs in FYs 2013 and 2014—it will be a challenge to change the culture of the organization to provide special consideration of OICs for victims of PSPs. This message should be reiterated by top-level executive communications from Small Business/Self-Employed Division (SB/SE) leadership.

Once the IRS has revised its guidance and approach, it must develop and deliver comprehensive training to its staff, including all Revenue Officers and Centralized OIC employees. Revenue Officers must be directed to forward OICs submitted by victims of PSP failure for ETA consideration as soon as they are identified. Without the appropriate training to supplement the revised guidance, it will be difficult to achieve the culture change.

The guidance in this IGM will be the basis for a new section of IRM 5.8.11 that specifically addresses the PSP issue. In addition, the IRS should update IRM 5.7, *Trust Fund Compliance*, to include a discussion of the use of ETA OICs in these cases. IRM 5.7 should direct Revenue Officers to assist PSP victims in submitting OICs, and getting them to the Centralized OIC group without delay.

Finally, SB/SE executives must continue to monitor activity in this area to ensure that employees actually follow the new guidance. For example, if the IRS accepts only a few dozen ETA OICs on this issue in FY 2015, we would be concerned that the IRS is only giving lip service to Congress with respect to victims of PSP malfeasance.

CONCLUSION

Many small businesses rely upon payroll service providers to meet their employment tax reporting and payment obligations. Unfortunately, there have been many instances where PSPs have failed to remit the proper amount of tax deposits on behalf of their clients. The IRS has been reluctant to take steps to (1) reduce the likelihood of the fraud by issuing dual notices whenever an address change is requested, and (2) exercise the full extent of its authority to accept offers in compromise based upon effective tax administration principles. Unsatisfied with the lack of IRS action, Congress mandated in January 2014 that the IRS issue dual notices for address changes and give special consideration to OICs submitted by victims of PSP fraud. The IRS Commissioner assured Congress that the IRS would comply with the mandate. The National Taxpayer Advocate will continue to work with the IRS to ensure it addresses both mandates.

¹⁸ See Legislative Recommendation: *OFFERS IN COMPROMISE: Authorize the National Taxpayer Advocate to Determine Whether an Offer in Compromise Submitted by a Victim of Payroll Service Provider Fraud Is “Fair and Equitable,”* *infra.*.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that SB/SE:

1. Amend its interim guidance and IRM to incorporate the changes suggested by the National Taxpayer Advocate.
2. Develop and deliver comprehensive training to all Revenue Officers and Centralized OIC employees on the new guidance for reviewing and processing ETA OICs submitted by victims of PSP failure.
3. Update IRM 5.7, *Trust Fund Compliance*, instructing Revenue Officers to pass on OICs submitted by PSP victims to the centralized OIC group without delay.