

Outsourcing Payroll? IRS Guidance Helps Employers Understand Their Rights and Responsibilities

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Many employers decide to outsource their payroll administration to third-party vendors. Many employers who decide to hire a third-party vendor anticipate that the vendor understands how to fill out the forms necessary to the reporting of income and employment taxes; comply with the Patient Protection and **Affordable Care Act** reporting obligations; and to properly calculate and timely pay over to the IRS withheld employee income tax and the employer and employee's respective share of employment taxes. Most employers anticipate that if they pay income taxes and employment taxes into a vendor's account, or give a vendor authorization to withdraw income taxes and employment taxes from the employer's accounts, that the income and employment taxes will be paid over to the United States Treasury.

Unfortunately, there are all too many circumstances where actual vendor performance does not meet employer expectations. Worse, there are too many circumstances where the employer finds that money set aside from employee income tax withholdings, and the employer and employee share of payroll taxes, does not get paid over to the Treasury. Worse still, such an employer will often be shocked to discover that the employer, not the vendor, is completely liable to the U.S. Treasury for unpaid income and employment taxes, even though the taxes were paid to the vendor or removed from the employer's accounts by the vendor.

Recently, the IRS published guidance for employers entitled *Outsourcing Payroll*. The primary purpose of the guidance is to help employers understand which of the three potential types of relationships may exist with respect to third-party payroll vendors under IRS rules. Perhaps more importantly, the guidance informs employers which of the outsourcing relationships leave the employer solely liable for unpaid income and employment taxes, and penalties associated with failing to file payroll reports, if the vendor does not perform as promised.

There is only one kind of relationship that imposes joint and several liability upon a third-party payroll vendor and employer for taxes and penalties that may arise with respect to the reporting and payment of income and employment taxes. The relationship is called a "Section 3504 Agent" relationship and it is formed only when the employer and agent complete and sign an IRS Form 2678. A vendor that executes the Form 2678 is essentially standing in the shoes of the employer for purposes of reporting and paying over employment taxes and withheld income taxes. A special schedule, called "Schedule R" gives the IRS notice that the vendor is processing payroll under a

Form 2678 agreement. A special feature of this kind of agency relationship is that the Section 3504 Agent has the authority to verify whether an employee's tax identification number for payroll purposes matches the IRS' records.

Contrastingly, a "Reporting Agent" relationship is created when the employer and vendor execute a Form 8655. With this Form, the employer is essentially giving the vendor a power of attorney to act on the employer's behalf with regard to income tax and payroll tax reporting on the employer's payroll. However, the employer remains completely and utterly responsible for the reporting, calculation and tax payment functions if the vendor makes an error or, more serious, takes the employer's money that is designated for income and employment taxes and diverts the money for other uses.

Finally, a "Payroll Service Provider" is a third-party that assists with the employer's reporting and payroll deposit functions, but does not stand in the shoes of the employer or act on behalf of the employer before the IRS. This type of relationship, like the Reporting Agent relationship, leaves the employer solely liable for correct and timely filing of payroll-related reports and for payments of income and employment taxes.

So what should an employer who desires to outsource payroll do? First, identify what kind of relationship the vendor proposes to create in its contract with the employer. Obviously, the Section 3504 Agent relationship is the most protective of the employer's interests and finances. The employer should consider the risks and benefits of entering into a relationship with a vendor that proposes a different arrangement. Second, the employer should demand that the vendor produce evidence of, and maintain a bond (insurance) sufficient to cover the aggregate of the vendor's payroll payment liability (for the payroll of all clients) for at least three quarters—long enough for the employer to receive notice from the IRS that income and employment taxes have not been paid and take appropriate responsive action.

Finally, employers should monitor, quarterly, the performance of any third-party payroll administrator to make sure that all money provided to that vendor for tax payments is actually paid over to the Treasury. The employer should establish independent verification processes with the bank or financial institution that is holding and transmitting income and employment tax payments. This will help protect the employer from any diversion of funds by a payroll vendor and the consequential "double-loss" of money that is set aside for income and payroll taxes never paid to the Treasury, and the IRS assessment and collection of money that the Treasury never received.

This article was written by Kathleen Barrow.

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