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TIGTA Wants Your Opinion of IRS's 'Lock-In Letter' Process

The Treasury Inspector General for Tax Administration (TIGTA) is asking APA for feedback on the withholding compliance program IRS put into place in April 2005. TIGTA wants to hear our concerns and complaints and get our perspective on the program's effectiveness. Send your comments to Scott Mezistrano, CPP, APA's Senior Manager of Government Relations, at smezistrano@americanpayroll.org.

What is the withholding compliance program?

IRS reviews all Forms W-2 and personal income tax returns, looking for anyone who generally does not have enough tax withheld from wages. For each of those taxpayers, IRS sends to the employer: a tentative "lock-in letter," specifying a maximum number of withholding allowances permitted for that employee. The employer also receives a notice to give the employee, who then has 30 days to justify his or her current W-4 filing status to the IRS. Unless the lock-in letter is revoked or updated by IRS, the employer must put it into effect with the first pay period beginning after a date specified on the letter – no earlier and no later – or be subject to a penalty for failure to withhold.

When the new program was established in 2005, APA made many suggestions for improvement via written comments to the IRS and oral testimony at a U.S. Treasury Department hearing. Most of our suggestions were implemented when final regulations were issued in July 2007 (see "Inside Washington" for August 2007).

How could it be made easier on you?

Here are reminders of a couple of our suggestions that weren't implemented.

- **Electronic delivery to employers, by e-mail or via a web portal, of the lock-in letter, the accompanying employee notice, and any subsequent communications.** This would ensure timely delivery, as the documents could be sent to the e-mail address the payroll office provides with its annual filing of Forms W-2, instead of to the employer's "address of record" with the IRS, which could be out-of-state, the address of a service provider, or even "off-shore." We suggested requesting an e-mail address on Form 941, filed quarterly, to maintain more current information. Alternatively, these communications could be posted to a website accessible only when a piece of data from a recently filed Form 941 is provided. In our oral testimony, we recommended that IRS partner with SSA and deliver this information using SSA's Business Services Online. Delivering these documents electronically would allow the

employer to quickly forward the employee copy and would provide an electronic way for the employer to notify the IRS if the individual was no longer employed.

- **Follow-up communication from IRS, instead of having employers "warehouse" the potential lock-in status.** APA offered an alternative: Currently, IRS sends the initial notice to the individual taxpayer and to the taxpayer's employer. Under APA's alternative, the employer would forward a copy to the employee, but would not be required to warehouse or implement the proposed W-4 status. The taxpayer would have 30 days to reply to the IRS. Any final lock-in letter would be sent by the IRS to the taxpayer and to the taxpayer's employer, to take effect with the next payroll processing. Under the current system, which is based on "perform these steps, unless you hear otherwise," there are bound to be some "lock-in release" or "lock-in modification" notices mailed by the IRS that just never make it to the employer, and the employer has no way of knowing that it is missing something.

Effective tax policy?

Some APA members felt that telling employees that "questionable W-4s" would be forwarded to the IRS (under a procedure eliminated in April 2005) made many employees reconsider submitting a W-4 that may have been completed merely to avoid withholding on a bonus or to bring home some extra cash. Without this leverage, some APA members fear that more employees are "playing with their W-4 status," resulting in more underwithholding, more lock-in letters, more tax levies, and more taxpayers who don't file a personal income tax return, simply because they are so underwithheld that they can't possibly pay the balance that would be due.

To combat this, we recommended that the language on the W-4 specifically state that IRS will analyze the amount of withholding relative to the amount of wages and may instruct the employer to invalidate an "exempt" status and/or adjust the number of withholding allowances. The language was updated, but perhaps it could be stronger. It says, "Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS." In addition, the W-4 could refer taxpayers to specific IRS guidance on who is entitled to claim exemption from withholding (see Publication 505, *Tax Withholding and Estimated Tax*). ■

APA Answers House Subcommittee Questions on H.R. 3359

APA member Dee Nelson, CPP, followed up her recent testimony before the House Judiciary Committee's Subcommittee on Commercial and Administrative Law (see "[Inside Washington](#)" for November 2007) with more information on H.R. 3359, the Mobile Workforce State Income Tax Fairness and Simplification Act. (To read Nelson's original testimony, as well as all of the follow-up questions and answers discussed here, visit the APA website at www.payroll.org/i4a/pages/index.cfm?pageid=151.)

Under this legislation, wages paid to an employee who performs duties in more than one state or locality would be subject to the income tax laws of the state or locality of the employee's residence and any state or locality in which the employee is physically present and performing duties for more than 60 days during the calendar year. Professional athletes, professional entertainers, and nationally prominent public figures would not be covered by this legislation.

Most importantly, from APA's point of view, is that "it will be much easier to comply with a single standard across all the states and localities compared with the patchwork of laws in the 41 states and thousands of localities with income tax withholding. Employers will be able to avoid the expensive process of withholding taxes and filing Forms W-2 for multiple states in which an employee will spend only a short amount of time," Nelson declared.

"To the extent that a business's employees perform services in a particular state, but no single employee spends enough time in that state to exceed the threshold, the business will never be faced with the costs of registering for a withholding tax account in that state, setting up that state's withholding tables in its payroll system, learning that state's withholding tax laws and regulations (e.g., Which benefits are taxable wages? What are the depositing and filing due dates?), withholding that state's tax, depositing those taxes, filing employment tax returns, or filing Forms W-2 with that state."

Should we rely on employer or employee records of time and place?

The committee chair posed this challenge to Nelson: "H.R. 3359 allows an employer to rely on an employee's determination of time in a state to determine whether an employee is subject to a withholding requirement and tax liability. H.R. 3359 seems to place the onus on employees and not employers. What is the difficulty in employers keeping track of where their employees work? Do not technology or payroll systems do this already, and, if not, why not?"

Nelson's responded that, "... not all employers utilize such systems and some employers don't use them for all employees, as they can be costly and/or they can be impractical for tracking certain employees. For example, if an employer has a system on which an employee can 'sign in' via the Internet, it may not be practical for an employee who travels from state to state repairing equipment at client sites and doesn't always have access to the Internet. The time and location of such an employee's work will probably be determined via the employer's record of the employee's assignments, a summary the employee will periodically submit, or both."

"Do you get involved in an employee's filing of income tax returns?"

When the committee asked whether payroll managers offer tax advice or tax preparation services for their employees with multiple returns to file, Nelson made it clear that that would be crossing an almost sacrosanct line. However, she explained that, "... when our employees have questions about their paychecks, including the taxes withheld from those checks and the ramifications of those taxes, they come to me!"

In addition, she outlined the burden imposed by those questions. "My staff and I spend a great deal of time explaining to employees, sometimes over their protests, why we are required to withhold the tax of the state in which they were on temporary assignment, why we are sometimes required to also withhold the tax of their resident state from those same wages, and that they will have personal income tax filing responsibilities in multiple states. We provide them the withholding allowance certificates and tax tables of whichever states they go to, and we point them to the websites of state revenue agencies so they can find forms and instructions for filing those nonresident personal income tax returns."

"Can you quantify the dollar cost to your company ...?"

In response to the committee's inquiry about her employer's expense under the current laws, Nelson said, "The cost to our company can vary from year to year, depending on the number of employees we have in our mobile workforce. For tax year 2006, it cost our company approximately \$50,000 for tax preparation assistance provided to employees and approximately \$60,000 in salary for time spent by payroll and human resource staff for the special handling of our mobile workforce." ■

Submit Your Payroll Questions for the 2008 Federal Forum

One of the most popular workshops at the APA's Annual Congress is the *Forum on Federal Payroll Issues*, which features a panel of representatives from six federal agencies answering challenging payroll questions posed by our members. The questions are provided to the panelists about a month in advance, so they can do any necessary research and deliver complete answers.

If you have a question about a federal payroll law or regulation, or how it should be applied in your particular setting, please send it by March 14 to smezistrano@americanpayroll.org. You may pose a question to the Internal

Revenue Service, the Social Security Administration, the Office of Child Support Enforcement, the Department of Labor, U.S. Citizenship and Immigration Services, or Immigration and Customs Enforcement.

In addition to being presented at the Congress workshop, many of the questions and answers will be transcribed for publication in future issues of PAYROLL CURRENTLY. Last year's Congress Q&A appeared in Issue Nos. 13, 14, 15.

APA's 26th Annual Congress will be held May 13-17 in Austin, Texas. For more information, visit www.americanpayroll.org/congress. ■