PAYROLL SERVICE PROVIDER REGULATION & BUSINESS AND EMPLOYEE PROTECTIONS

A REPORT ON THE PAYROLL SERVICE PROVIDER INDUSTRY IN NEW YORK, PURSUANT TO CHAPTER 186 OF THE LAWS OF 2022

SEPTEMBER 8, 2022

Introduction

Adrienne A. Harris, the Superintendent of Financial Services, respectfully submits this report, prepared in consultation with the New York State Department of Taxation and Finance, on the findings of its study performed pursuant to Chapter 186 of the Laws of 2022 of the makeup of the payroll services industry in New York and the adequacy of employee protections and small business employer protections in the payroll services industry. The New York State Department of Labor also contributed essential data for this report. Chapter 186 of 2022 directs that this report be submitted within 120 days of its enactment, which took place on May 6, 2022.

In accordance with Chapter 186 of the Laws of 2022, this report provides information about the size and number of payroll service providers in New York, the number and size of businesses in New York that use payroll service providers, the incidence of fraud or misappropriation of payroll funds in the payroll services industry, whether it is feasible and advisable to require payroll service providers to obtain bonds or insurance to address the potential for misappropriation of wages by a payroll service provider, and whether it would be advisable and feasible for the Department of Financial Services ("DFS") to supervise and regulate payroll service providers.

I. The Department of Financial Services, The Department of Taxation and Finance, and the Department of Labor.

DFS is New York's banking, insurance, and financial services regulator, established in 2011 by the Legislature which consolidated the New York Banking Department and Insurance Department and authorized the resulting agency to oversee a broader array of financial products and services, with the goal of modernizing regulation. DFS now supervises and regulates the activities of nearly 3,000 financial institutions with total assets of more than $8.4 trillion, including more than 1,700 insurance companies and 1,200 banking and other financial institutions. DFS seeks to build an equitable, transparent, and resilient financial system that benefits individuals and supports business. DFS and its employees are responsible for empowering consumers and protecting them from financial harm; ensuring the health of regulated entities; driving economic growth in New York through responsible innovation; and preserving the stability of the global financial system.

The Financial Services Law tasks DFS with, among other things, "provid[ing] for the effective and efficient enforcement of the banking and insurance laws," "promot[ing] the reduction and elimination of fraud, criminal abuse and unethical conduct by, and with respect to, banking, insurance and other financial services institutions and their customers," and "educat[ing] and protect[ing] users of banking, insurance, and financial services products and services through the provision of timely and understandable information." DFS's Banking Division supervises bank and non-bank service providers, including money transmitters. DFS also houses a Consumer Protection and Financial Enforcement Division ("CPFED") which fights consumer fraud, ensures that regulated entities comply with related New York and federal law, and educates consumers about financial services.[1]

The mission of the New York State Department of Taxation and Finance ("Tax Department") is to collect tax revenues efficiently in support of State services and programs while acting with integrity and fairness in the administration of the tax laws of New York State. The Tax Department administers more than 40 state and local taxes and fees, processing over 29 million returns annually. It also oversees the administration of more than $50 billion in property taxes annually and works directly with nearly 1,000 local governments. Payroll service providers making deposits of tax owed to New York State file form NY45 with the Tax Department in addition to depositing the funds.

The Department of Labor ("DOL") provides services to workers, businesses, and the unemployed across New York State. The Department helps New Yorkers find careers they love by connecting them to employment, training, and upskilling opportunities. DOL builds and supports New York's businesses, helping them find qualified workers and connecting them to tools and incentives to make their businesses thrive. It also empowers and protects New York's workers by ensuring all workers have a safe workplace where they receive a fair wage. DOL assists New Yorkers who have lost their jobs through no fault of their own with Unemployment Insurance and works to help them regain employment as quickly as possible. The Department is also New York State's premier source for economic data, both current and historical, including with respect to Unemployment Insurance.

II. Background

Payroll service providers ("PSPs") are companies that administer payroll for other businesses. PSPs manage the issuance of wages (electronically or in the form of paychecks) to their clients' employees with appropriate withholdings and make required deposits. The payroll services industry is made up of large, medium, and small businesses. Some PSPs offer additional services, such as filing other taxes on behalf of their clients, ensuring compliance with tax and wage laws, and handling human resources functions. In managing payroll, they collect from their clients the necessary funds, which are held temporarily in PSPs' accounts. The PSPs determine the amounts from those lump sums that must be directed to tax authorities, unemployment insurance contributions, and their clients' employees' paychecks, and transmit them accordingly, typically electronically, via automated clearing house ("ACH") funds transfers. PSPs are not required to be registered with or licensed by DFS, DOL, or the Tax Department.

The Legislature enacted Chapter 186 of the Laws of 2022 in response to the multimillion-dollar bank fraud scheme perpetrated by the CEO of MyPayrollHR.com, LLC, a PSP that was a

[1] The other DFS divisions include Insurance; Cybersecurity; Research and Innovation; Capital Markets; and Climate. The Cybersecurity Division protects consumers of financial services and the financial services industry from cyber threats by improving cybersecurity in the financial services industry and conducting cybersecurity-related enforcement investigations in cooperation with CPFED. The Research and Innovation Division concentrates on financial services innovation. Capital Markets houses the Department's expertise in complex financial products, enterprise risk management, financial analysis, internal controls and audit, research, fiduciary controls, and regulatory accounting. Lastly, the Climate Division was stood up in 2021 to ensure that climate risks are integrated into the governance frameworks, business strategies, and risk management processes of regulated institutions.

subsidiary of the ValueWise Corporation, which the CEO also operated (and which had other subsidiary payroll companies as well). The companies were based in Clifton Park, New York, and provided payroll services to hundreds of businesses with thousands of employees in New York and across the U.S. The CEO took advantage of the money his company was supposed to be holding for taxes and paychecks to effectuate his fraud, misappropriating millions of dollars in funds of client companies to perpetrate a scheme to obtain business loans on false premises. When the scheme unraveled in late 2019, his clients' employees did not receive their paychecks on time, impeding their ability to buy necessities and pay bills. Tax liabilities also went unpaid, putting clients in danger of penalties.[2] The CEO pleaded guilty to federal conspiracy and fraud crimes and was sentenced to 12 years in prison. He was also ordered to forfeit assets of $14 million plus shares in Pioneer Bank, where he kept accounts used in his crimes, and to pay more than $100 million in restitution to victims. DFS's investigation of Pioneer Bank, initiated immediately following the revelation of the fraud, is ongoing.

In 2020 and 2021, the New York State Legislature introduced but did not pass a number of bills relating to PSPs, including bills that would have made a PSP liable directly to employees of a company that contracted with the PSP for "intentionally and without good cause prevent[ing] the remittance of taxes or payment of wages pursuant to the contract with the employer," and would have additionally permitted an action by employees to recover damages for such failures to be maintained as a class action.[3]

III. DFS's Study

Chapter 186 of the Laws of 2022 directs DFS to examine the following items, and they are addressed in this report in the following order:

- The number and size of PSPs in New York;
- The number of small businesses in New York that use PSPs;
- The incidence of fraud or misappropriation of payroll funds in the payroll services industry;
- Specific causal or facilitative facts regarding instances of fraud or misappropriation by PSPs;
- The present state of employee protections in the payroll services industry;
- The present state of small business employer protections in the payroll services industry;
- The feasibility and advisability of requiring PSPs to obtain insurance, post bonds, or utilize other risk management tools to address potential situations in which payroll monies owed to employees on behalf of businesses are stolen, misappropriated, or otherwise rendered unavailable after being transmitted from an employer to a PSP or an affiliated entity; and

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[2] *See, e.g.,* Press Release, *ValueWise CEO Michael Mann Sentenced to 144 Months in Prison for $100 Million Fraud*, U.S. Dep't of Justice, U.S. Attorney's Office, Northern Dist. of N.Y., Aug. 4, 2021; Larry Rulison, *Michael Mann Sentenced to 12 Years in Prison in MyPayrollHR Scam,* TIMES UNION, Aug. 4, 2021; Larry Rulison, *Victims of MyPayrollHR Collapse Reveal Pain and Suffering*, TIMES UNION, Aug. 4, 2021; Michael Williams, *Shuttering of Clifton Park Payroll Company MyPayrollHR Sends Businesses Scrambling*, TIMES UNION, Sep. 6, 2019.
[3] S.6727-B/No same-as of 2020; S.761/A.3478 of 2021.

- The feasibility and advisability of the department of financial services having regulatory oversight over third-party PSPs.

A. The number and size of PSPs in New York and number of small businesses in New York that use PSPs

As noted above, PSPs are not required to register or be licensed in New York to do business in the state, so it was not possible for DFS to generate exact numbers based on records already in its or other State agencies' possession. However, U.S. Census Bureau data, businesses' Unemployment Insurance ("UI") filings with DOL, and reports from industry associations were used to estimate the number and size of PSPs operating in New York and the number of small businesses in New York that use PSPs.

1. Census data

The U.S. Census Bureau collects data on all U.S. businesses with paid employees for its Statistics of U.S. Businesses ("SUSB") annual series.[4] The most recent available SUSB data, from 2019, shows 8,099 New York firms classified as "accounting, tax preparation, bookkeeping, and payroll services" (NAICS[5] code 54121). This classification "comprises establishments primarily engaged in providing services, such as auditing of accounting records, designing accounting systems, preparing financial statements, developing budgets, preparing tax returns, processing payrolls, bookkeeping, and billing," for example, accountants' offices, payroll processing services, bookkeeping services, and tax return preparation services.[6] Not all of these businesses necessarily provide payroll services, but some accountants, bookkeeping businesses, and tax preparers do provide payroll services. They may serve clients in New York, outside New York, or both. Additionally, the 2019 SUSB shows 5,548 businesses classified as "administrative management and general management consulting services businesses" (NAICS code 541611). This classification "comprises establishments primarily engaged in providing operating advice and assistance to businesses and other organizations on administrative management issues, such as financial planning and budgeting, equity and asset management, records management, office planning, strategic and organizational planning, site selection, new business start-up, and business process improvement, [as well as] establishments of general management consultants that provide a full range of administrative, human resource, marketing, process, physical distribution, logistics, or other management consulting services to clients." Some of these businesses may also act as PSPs, and they also may serve New York clients, out-of-state clients, or both. Below is a breakdown by size of the aggregate number of accounting, tax preparation, bookkeeping, and payroll services businesses (NAICS 54121) and administrative management and general management consulting services businesses (NAICS 541611) in New York:

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[4] The SUSB data provides details of, among other things, business establishments' location, industry, and size. https://www.census.gov/programs-surveys/susb/about.html.
[5] NAICS, the North American Industry Classification System, is the classification system the Census Bureau uses to classify U.S. businesses. https://www.census.gov/naics/.
[6] https://www.census.gov/naics/?input=54&chart=2017&details=54121.

Accounting, Tax Preparation, Bookkeeping, and Payroll Services Businesses and Administrative Management and General Management Consulting Services Businesses in New York by Size		
Firm Size	Number of Firms	Percent of Total
<5 employees	10,569	77%
5-9 employees	1,592	12%
10-19 employees	709	5%
20-99 employees	485	4%
100-499 employees	142	1%
500+ employees	105	0.1%

The SUSB 2019 data show approximately[7] 332 firms classified specifically as "Payroll Services" businesses (NAICS code 541214) in New York. The NAICS definition of payroll services businesses is, "establishments (except offices of CPAs) engaged in the following without also providing accounting, bookkeeping, or billing services: (1) collecting information on hours worked, pay rates, deductions, and other payroll-related data from their clients and (2) using that information to generate paychecks, payroll reports, and tax filings. These establishments may use data processing and tabulating techniques as part of providing their services."[8] This group of businesses is a subset of the accounting, tax preparation, bookkeeping, and payroll services businesses (NAICS 54121) discussed above. Although they range in size from very small to large, the majority of New York payroll services businesses employ 19 or fewer staff. They may serve New York clients, clients in other states, or both. Businesses classified as payroll services businesses (NAICS code 541214) in New York have employment counts as follows[9]:

Payroll Services Businesses in New York by Size		
Firm Size	Number of Firms	Percent of Total
<5 employees	126	38%
5-9 employees	58	18%
10-19 employees	34	10%
20-99 employees	60	18%
100-499 employees	28	8%
500+ employees	26	8%

For context and comparison, according to the 2019 SUSB data, nationwide, there are about 4,312 payroll services businesses, 114,687 accounting, tax preparation, bookkeeping, and payroll services businesses, and 80,226 administrative management and general management consulting services businesses.[10] Below is a comparison of the national total of payroll services businesses and New York total of payroll services businesses broken down by size:

[7] *See* "Protecting Confidentiality" and "Noise Infusion" at https://www.census.gov/programs-surveys/susb/technical-documentation/methodology.html#:~:text=The%20flag%20for%20'low%20noise,changed%205%20percent%20or%20more.
[8] https://www.census.gov/naics/?input=54&chart=2017&details=541214.
[9] https://www.census.gov/data/tables/2019/econ/susb/2019-susb-annual.html.
[10] *Id.*

Comparison of U.S. and New York Payroll Services Industry Makeup				
Firm Size	Number of Firms in U.S.	Percent of Total, U.S.	Number of Firms in New York	Percent of Total, New York
<5 employees	1,861	43%	126	38%
5-9 employees	642	15%	58	18%
10-19 employees	505	12%	34	10%
20-99 employees	792	18%	60	18%
100-499 employees	311	7%	28	8%
500+ employees	201	5%	26	8%

2. New York State Department of Labor data

DOL's Unemployment Insurance Division receives UI data filings[11] from all businesses in New York State that are covered by UI. Because almost all employers have unemployment insurance liability and therefore must make UI contributions, the count of employers making UI contributions is a good estimate of the total number of employers operating in New York. Like the Census Bureau, DOL categorizes employers using NAICS codes. DOL's records also indicate the number of employees that have worked at the businesses each month and whether the data were reported, and UI contributions paid over, by an agent, such as a PSP (but also, potentially, a tax preparer, CPA, or business consultant, for example), on the business's behalf. Thus, DOL's UI data shows the size of businesses in New York making UI contributions and the number of businesses that use an agent to submit their UI contributions. The data does not, however, distinguish among agents; it does not show whether the agent is a standalone PSP or another type of firm that may provide such services. Additionally, this data does not show whether the agents reporting data and submitting UI contributions on behalf of business are New York-based. In the following charts, the number of firms is based on DOL's 2021 Quarter 1 data, and firm size is based on the annual average employment of the firms for 2021 (employment numbers vary somewhat over the course of the year).

DOL data show a total of 416 payroll services businesses (NAICS 541214) making UI contributions in New York, 84 more than counted by the Census Bureau. This difference may be explained in part by coding differences (DOL and the Census Bureau may apply a different NAICS code to the same employer, as they apply codes based on information the employer submits to the agency).

[11] DOL administers New York's unemployment insurance program. Employers covered by UI must make UI contributions and they must report their payroll to DOL using the Quarterly Combined Withholding, Wage Reporting and Unemployment Insurance Return (Form NYS-45). *See* https://dol.ny.gov/nys-45-quarterly-reporting. UI contributions fund benefits paid to unemployed workers.

Payroll Services Businesses (NAICS 541214) Operating in New York in 2021, by Size		
Firm Size	Number of Firms	Percent of Total
<5 employees	215	51.7%
5-9 employees	57	13.7%
10-19 employees	58	13.9%
20-99 employees	65	15.6%
100+ employees	21	5.0%
All sizes	416	100.0%

DOL data also show 14,106 total accounting, tax preparation, bookkeeping and payroll services businesses (NAICS 54121) and administrative management and general management consulting services businesses (NAICS 541611) in New York. The chart below breaks down this group by size.

Accounting, Tax Preparation, Bookkeeping and Payroll Services Businesses and Administrative Management and General Management Consulting Services Businesses Operating in New York in 2021, by Size		
Firm Size	Number of Firms	Percent of Total
<5 employees	11,327	80.3%
5-9 employees	1,540	10.9%
10-19 employees	641	4.5%
20-99 employees	471	3.3%
100+ employees	127	0.9%
All sizes	14,106	100.0%

Finally, according to DOL data, 267,691 businesses used agents, including but not limited to those that could be identified as payroll service businesses (NAICS 541214), to handle their UI contributions in 2021. Nearly 60% of those 267,691 businesses had fewer than five employees, and nearly 97% had fewer than 100 employees. Further detail is provided in the chart below:

Businesses in New York That Used Agents in 2021, by Size			
Firm Size	Number of Firms	Percent of Total Using Agents	Percent of Total UI Contributors
<5 employees	159,811	59.7%	27.1%
5-9 employees	43,835	16.4%	7.4%
10-19 employees	29,467	11.0%	5.0%
20-99 employees	27,302	10.2%	4.6%
100+ employees	7,276	2.7%	1.2%
All sizes	267,691	100%	45.4%

3. Data provided by the PSP industry

In conducting its study, the Department met with several trade groups representing the industry to learn more about PSPs' work, how many of their members have offices in New York or serve New York businesses, and what types of businesses their membership serves. The Independent Payroll Providers Association, the National Payroll Reporting Consortium, and The Payroll Group together also submitted a short report to the Department ("Industry Association Report"). The representatives were able to provide approximate membership numbers, but they were not able to supply granular data that would allow DFS to reach an exact number of PSPs doing business in New York or to determine the number and size of New York businesses they serve. The organizations' membership does not include all PSPs, and their membership does not reflect the overall size of the industry in New York or nationally. DFS obtained the following information from the PSP industry representatives:

- One industry association estimated its membership to be about 100 PSPs nationwide, serving companies with an aggregate of approximately 300,000 employees. All of the PSPs in the association are small, independent businesses that provide services to small- and medium-sized businesses. Twelve of their members are located in New York State.
- Another industry association estimated its membership to be about 200 small- and mid-sized PSPs nationally, including 12 PSPs headquartered in New York State. The membership serves about 200,000 companies in all, issuing paychecks for 10 million people.
- The Industry Association Report states that more than 28,000 reporting agents, which together provide services to 3 million employers, are registered with the IRS. Reporting agents register their authorization with the IRS to deposit employment taxes, electronically sign and file employment tax returns, and exchange confidential information with the IRS on their client companies' behalf.[12] According to the Internal Revenue Manual, "a reporting agent is a type of PSP,"[13] but individual income tax preparers, accounting firms, and similar businesses all may register as reporting agents to perform these services.[14] Per the Industry Association Report, reporting agents tend to be small businesses, with 57% having fewer than 10 clients, 83% having fewer than 40 clients, 6.5% having more than 100 clients, and 0.6% having more than 1,000 clients.[15]

B. The incidence of fraud or misappropriation of payroll funds in the payroll services industry and specific causal or facilitative facts regarding instances of fraud or misappropriation by payroll service providers

There are no existing data sources that would allow for a complete assessment of the scope of fraud or misappropriation in the PSP industry. However, DFS was able to determine that the MyPayrollHR fraud, though not unique, was distinguishable from other PSP-related

[12] Industry Association Report at 1-2.
[13] Internal Revenue Manual 5.1.24.4.3(1). Note that the Census Bureau/NAICS classification differs.
[14] Internal Revenue Manual 5.1.24.4.3(2).
[15] Industry Association Report at 1-2.

frauds in the way it affected employees of MyPayrollHR's clients. Reports of PSP-related fraud and prosecutions have diminished in recent years, and DFS's Consumer Assistance Unit's records of consumer complaints regarding PSPs show that the only complaints relating to possible PSP fraud that the Department has received in recent years were complaints about MyPayrollHR.

According to research by the Conference of State Bank Supervisors and analysis by DFS, during the period from 2010 to 2019[16], at least 28 PSP-related fraud cases (including the MyPayrollHR case) were prosecuted nationwide (some with underlying conduct occurring before this period), with losses ranging from about $200,000 to $130 million spread over several client companies, and sometimes over a period of several years. In addition to the MyPayrollHR case, the three cases described below involved PSPs based in New York, though not all three affected clients and employees in New York. (As noted above, PSPs may have clients outside the states where they are based.) These cases are similar in that executives of PSPs diverted tax withholdings to improper purposes and covered up that malfeasance with false filings to the IRS or misleading reports to clients, leaving their clients with unpaid tax liabilities and at risk of penalties. Of the 28 cases DFS reviewed, news reports, court filings, and law enforcement press releases suggest that only one did not involve the misuse of funds intended for tax payments. At least two involved PSPs that either handled or had a related company handle other HR matters, allowing them access to flexible spending, insurance premium, and retirement savings funds that they also misused. Industry representatives asserted that it is rare that PSP fraud causes employee pay losses or tax penalties.[17] This was generally borne out by the cases DFS reviewed. Of the 28, it appears that only two scams, those associated with MyPayrollHR and Accupay in Maryland[18], caused interruption in payment of wages. In both instances, the PSP's failure to properly issue paychecks alerted clients to the frauds, ending the schemes.

Ingentra HR Services, Inc./Humanic Solutions, Inc.

From 2005 to 2010, two executives of Ingentra HR Services, Inc. (FKA Humanic Solutions, Inc.), a PSP based on Long Island, engaged in a scheme to defraud a county government in California and two corporations of funds intended for tax payments. The PSP collected the correct amount of money for tax withholdings from its clients but, in false filings to the IRS, underreported the amount owed by the clients and directed the difference to the PSP's operating accounts for its own use. The scheme diverted about $20 million to improper purposes. Both defendants pleaded guilty to wire fraud, received prison sentences, and were ordered to pay nearly $20 million in restitution.[19]

[16] DFS was not able to find public reports of incidents of fraud from later than 2019.
[17] Industry Association Report at 1.
[18] Press Release, *Payroll Service Company Owner Admits to Stealing Money Set Aside by Clients to Pay Federal and State Taxes*, U.S. Dep't of Justice, U.S. Attorney's Office, Dist. of Md., Jan. 11, 2016.
[19] Press Release, Comptroller of New York Payroll Services Company Sentenced for $20 Million Fraud Involving Sacramento County, U.S. Department of Justice, U.S. Attorney's Office, Eastern District of California, Apr. 12, 2013.

Paybooks, Inc.

From approximately 2008 to 2009, the president of Paybooks, a PSP based in Rochester, New York, used client funds intended for tax payments to pay the company's operating costs and the company president's personal expenses. The Paybooks president also withdrew money from some clients' accounts to cover tax deficits of others. The president repeatedly misled his clients, which comprised about 1,100 small businesses (seven or fewer employees) in the Rochester area, regarding the status of their taxes. Paybooks's clients as a result faced penalties and interest from tax authorities. The New York Attorney General obtained a judgment of $2.2 million in restitution against Paybooks and permanently barred the company and its president from the payroll services industry. According to a press release from the Attorney General's office, state and federal tax authorities agreed to provide special assistance to the businesses that were victims of the fraud, and on a case-by-case basis would consider waiving certain penalties and interest payments.[20]

Total Time Solutions

From 2002 to 2005, executives and an employee of a New York PSP and an affiliated accounting firm diverted several million dollars meant to pay taxes on behalf of clients to the PSP's operating accounts. The PSP's accountant, who pleaded guilty to wire fraud, hid the misappropriation from clients by sending them false reports that their taxes had been paid.[21]

C. The present state of employee protections in the payroll services industry and present state of small business employer protections in the payroll services industry

Currently, the need for protection for employees and small business employers from frauds perpetrated by PSPs is addressed by a combination of law, transparency measures that rely on employer diligence, and public information campaigns by tax authorities. Additionally, Nacha, the governing body for the ACH network, promulgates rules and standards that apply to the payments system used for direct deposits and may impose sanctions on violators. According to Nacha, 96% of American workers are paid by direct deposit.[22]

[20] Press Release, Attorney General Cuomo Stops Rochester Payroll Company's Scheme That Scammed Hundreds Of Area Businesses, New York State Attorney General, Jun. 23, 2009; Press Release, Attorney General Cuomo Obtains $2.2 Million Judgment Against Rochester Payroll Company For Scamming Hundreds Of Area Businesses, New York State Attorney General, May 15, 2010.

[21] Press Release, New York Accounting Firm Employee Admits Defrauding Clients of Payroll Services Company of Over $ 3 Million in Tax Money U.S. Dep't of Justice, U.S. Attorney's Office, Dist. of N.J. (undated); Press Release, Jury Convicts One of The Owners of Former New York Payroll Company, Total Time Solutions, LLC, of Wire Fraud, U.S. Dep't of Justice, U.S. Attorney's Office, Dist. of N.J., Aug. 29, 2011.

[22] https://www.nacha.org/content/what-is-ach.

1. Protection from fraud

a. Federal and state law

Generally, federal and state law require employers to deduct and withhold taxes from their employees' wages, and both the Internal Revenue Code and New York State Tax Law protect employees from being liable for unpaid taxes and associated penalties when the person or entity responsible for collecting or paying over their employment taxes fails to do so.[23] This includes when a PSP fails to do so on behalf of a client. In circumstances where a PSP represents to a client employer and its employees that taxes were properly withheld and paid, and the PSP does not actually send the funds to the tax authority, the employees would not be responsible for amounts the PSP did not pay over.[24]

Employers are liable under law for employment taxes they are obligated to collect and pay on behalf of their employees (and of course, they are liable for wages owed to their employees), but even though PSPs are not liable for their clients' employment taxes, and an employer's use of a PSP does not change an employer's employment tax obligations or its liability for such taxes,[25] an employer may have legal recourse (e.g., breach of contract action, conversion action) against a PSP that mishandles payroll and tax funds. PSPs may have insurance policies that will compensate their clients in the event of malfeasance[26], and client businesses may carry insurance policies against theft as well.

Legal deterrents also protect employers and employees. PSPs, as registered reporting agents, may be suspended by the IRS for failing to follow required procedures set forth in Internal Revenue Procedure 2012-32 or if the IRS receives "significant complaints about the reporting agent's performance."[27] And, as demonstrated by the cases described above, anyone who uses a PSP to commit fraud could be subject to criminal prosecution and imprisonment for theft, false filings, or any other crimes committed as part of the scheme and be ordered to pay restitution. Such persons could also be subject to civil fines and penalties.

In 2014, Congress enacted legislation intended to mitigate PSP fraud, including a provision requiring that when an employer notifies the IRS of an address change, the IRS must send a confirmation of address change to both the former and new addresses.[28] This reduces the chance that a PSP changes a client's contact information with the IRS without the client's

[23] 26 U.S.C.S. §§ 3102, 3402 (Lexis 2022), N.Y. Tax Law § 671 (Consol. 2022); 26 U.S.C.S. § 6672 (Lexis 2022). Employers are liable for withholding amounts regardless of whether the employer makes the deductions from their employees' pay. 26 U.S.C.S. § 3403 (Lexis 2022), Internal Revenue Manual 5.19.11.1.2(10), N.Y. Tax Law § 675 (Consol. 2022), Form NYS-50 Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax, Rev. Dec. 2021 at 34.
[24] *Id.*
[25] *See* Internal Revenue Manual 5.1.24.4.2(3), (4), Form NYS-50 Employer's Guide to Unemployment Insurance, Wage Reporting, and Withholding Tax, Rev. Dec. 2021 at 34, IRS Third Party Arrangement Chart.
[26] *See, e.g.,* Kim Christensen, *Payroll Firm's Clients to Get Payouts*, Los Angeles Times, Mar. 18, 2014.
[27] Internal Revenue Proc. 2012-32.
[28] Consolidated Appropriations Act of 2014, Public Law No. 113-76 § 106, 128 Stat. 190 (2014), Cong. Rec. H903-904 (Jan. 15, 2014) (statement of Rep. Rogers). https://www.irs.gov/faqs/irs-procedures/address-changes/address-changes, https://www.irs.gov/individuals/understanding-your-cp148a-notice, https://www.irs.gov/individuals/understanding-your-cp148b-notice.

knowledge, as such a change could prevent the client from receiving communications from the IRS that could alert the client to its PSP's malfeasance, such as notices about late payments or unpaid taxes.[29]

b. Employer diligence

Employers can protect themselves and their employees by checking their own tax records through a federal online system provided for free by the Department of the Treasury. The Electronic Federal Tax Payment System ("EFTPS")[30] offers an employer visibility into payments made by its PSP to ensure that its PSP is in fact paying taxes on its behalf on time and in the right amounts. EFTPS is primarily for making tax payments, but even if an employer's PSP handles all of the employer's tax payments, the employer can enroll and review its account. The IRS recommends that employers use EFTPS for this purpose.[31] Further, a PSP must, as a reporting agent, upon entering into a contract for services with a taxpayer client, (1) inform the taxpayer that the taxpayer is ultimately responsible for timely and accurate filing, and for this reason, the IRS advises enrollment in EFTPS to monitor its account, and (2) provide the taxpayer information on how to enroll. The PSP must provide this information at least quarterly thereafter while the PSP is providing services to the client.[32]

The Tax Department maintains its Online Services system[33] that employers can use for the same verification purpose. Like EFTPS, Online Services allows users to transact business with the Tax Department electronically, but even if an employer is a client of a PSP and therefore does not use Online Services to send tax payments, the employer can log in to view its account to verify that its PSP has been making payments on time and in the right amounts. Through Online Services, employers can see the payment dates and amounts for all withholding payments.

c. Public information

The IRS periodically reminds employers to check their PSPs' work to prevent and stop fraud. In May 2022, for example, the IRS published a Tax Tip advising employers of the importance of a trustworthy PSP and ensuring that their payroll taxes are submitted on time and in the correct amount, offering advice on how to select a PSP, and reminding employers that even if they send funds to their PSP for tax payments, if the PSP does not perform as promised, the employer will still owe tax.[34] A 2019 press release informs employers that they can verify

[29] This tactic was used, for example, by the owner of Accent Payroll Services, to prevent a client from learning that the PSP had paid only part of the taxes owed by the client. Press Release, Johnson County Tax Preparer Sentenced for Filing False Tax Return, Wire Fraud, FBI, Jan. 27, 2015.
[30] https://fiscal.treasury.gov/eftps/.
[31] IRS Publication 966, Electronic Federal Tax Payment System, A Guide to Getting Started at 4.
[32] Internal Revenue Proc. 2012-32 5.05.
[33] https://www.tax.ny.gov/online/.
[34] IRS Tax Tip 2022-73, Employers should choose their third-party payroll service provider wisely to prevent fraud ("Most payroll service providers give quality service. However, there are a few who don't submit their client's payroll taxes and close abruptly. The damage hits their unsuspecting clients hard. Typically, these clients remain legally responsible for paying the taxes due, even if the employer sent funds to the payroll service provider for required deposits or payments."), May 11, 2022.

payments using EFTPS, that missed or late payments are red flags, and that an employer concerned about possible improper or fraudulent activity by their PSP with respect to the employer's taxes and returns can file a complaint with the IRS using a designated form, and such complaints "receive expedited handling and investigation."[35]

2. Nacha response to MyPayrollHR

As discussed above, the MyPayrollHR fraud, unlike most other PSP frauds, directly affected employee pay. The fraud proceeded for some time without impacting paychecks (employees would have noticed otherwise, revealing the malfeasance). However, when the CEO's banks froze his accounts based on suspicious activity, funds for payroll could not be accessed. When the ACH processor for MyPayrollHR processed payments for the first time following the account freeze, it discovered that funds were not available, and it attempted to reverse the transactions. In some cases, not only did some employees have their pay rescinded, but also, some employee accounts were debited twice in the amount of their paychecks. In response to this event, Nacha revised its rule on reversals to make reversals improper where a third-party sender or originator fails to provide funding.[36]

D. The feasibility and advisability of requiring payroll service providers to obtain insurance, post bonds, or utilize other risk management tools to address potential situations in which payroll monies owed to employees on behalf of businesses are stolen, misappropriated, or otherwise rendered unavailable after being transmitted from an employer to a payroll service provider or an affiliated entity

As discussed above, payroll monies owed to employees on behalf of businesses typically have not been affected in PSP fraud schemes. Generally, the misused funds were employment taxes required to be paid to tax authorities by the employer, payments for which, as discussed above, the employer is primarily liable. The PSP industry is composed mostly of small businesses, and based on conversations with industry and evidence from other states, they will find the costs of protecting against a rare occurrence burdensome, and potentially a deterrent to doing business in the State. While even one delayed paycheck can be an enormous burden on an individual, evidence gathered in this survey suggests the likelihood of this occurring as a result of PSP fraud is low. Bonding or insurance can be required to mitigate the risk to consumers, but feasibility for PSPs should be carefully considered against the low likelihood of these events and the existing protections that are in place.

1. Bonding requirements

Bonding and insurance requirements for PSPs are not common in the U.S. Based on DFS's research, it appears that only one state, Maine, requires PSPs to be bonded, and the bonds are generally meant to compensate employers for losses of funds intended for tax payments and UI contributions, not wages. Maine's Bureau of Consumer Credit Protection, within its

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[35] Press Release, IRS reminds employers about the benefits of EFTPS, IR-2019-171, Oct. 18, 2019.
[36] Industry Association Report at 6. https://eb-us.com/wp-content/uploads/2020/12/Supplement-3-2020-dec-1-2020.pdf

Department of Professional and Financial Regulation, licenses PSPs doing business in Maine and requires an applicant for a license to provide proof of a surety bond, "in an amount equal to the total of all local, state and federal tax payments and unemployment insurance premiums processed by the payroll processor on behalf of employers in this State in the 3-consecutive-month period of highest volume during the previous calendar year or $50,000, whichever is greater, but not to exceed $500,000."[37] Such bonds are required to designate the Superintendent of Consumer Credit Protection as payee, and it "may be used for the purposes of the administrator and for the benefit of any employer who may have a cause of action against the [PSP]." Soon after Maine first enacted its bonding law in 2004, it reduced the minimum bond amount to $50,000 from $100,000 to make it possible for small businesses to afford a bond.[38] Payroll service associations assert that in Maine, small PSPs could not obtain surety bonds on the market, and the state stepped in to issue the bonds.[39] Maine also created an alternative for PSPs that allowed a smaller bond plus assessments directed to a state-administered Payroll Processor Recovery Fund "for employers injured by a payroll processor's failure to pay taxes or unemployment insurance premiums."[40]

The Maryland Commission to Study the Regulation of Payroll Services, established by the Maryland General Assembly in the wake of the Accupay fraud, considered but declined to endorse bonding requirements on the premise that they would be "prohibitively expensive and would drive small payroll service companies out of business and create a barrier to entry for new payroll service companies."[41]

DFS expects that bonding to cover some portion of employee wages in addition to employment tax amounts and UI contributions would be significantly more expensive than bonding covering only tax and UI contributions, and that these costs would be passed on to PSP clients, most of which are small businesses themselves.

DFS also notes that although employees of MyPayrollHR's clients did not receive their paychecks on time and suffered the consequences of erroneous direct deposit reversals, they did receive their wages within a relatively short period. A bond would not necessarily have provided funds more quickly but would have added expense.

2. Additional consideration: protection of employees from PSP error

The Tax Department indicates the most frequent problem it encounters with respect to PSPs that directly affects employees is filings with inaccurate information that impede the Tax Department's ability to verify the return. An "exception" is triggered at the Tax Department when a return shows the withholding reported to a taxpayer employee is different from the withholding reported to the Tax Department by the PSP, or when PSP reporting to the Tax Department relating to the taxpayer lacks necessary information or has inaccurate information, such as a missing or incorrect Social Security number for an employee. Compounding the problem is the difficulty of determining whether the source of the error is the PSP or the PSP's

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[37] Me. Rev. Stat. Ann. §§ 1493-E(1), 1493-D (Lexis 2022).
[38] P.L. 2004, Ch. 668; P.L. 2005, Ch. 278 (emergency, effective June 2, 2005). The text of the amendment states that it was enacted "to help prevent small payroll companies from going out of business."
[39] Industry Association Report at 8.
[40] P.L. 2006, c. 500, Me. Rev. Stat. Ann. §§ 1493-E(2-A) (Lexis 2022).
[41] https://msa.maryland.gov/megafile/msa/speccol/

client, who may have supplied erroneous information or failed to supply necessary employee data. However, the Tax Department suggested, if an employer makes withholding errors, employees are likely to notice the error on their paycheck or paystubs, whereas if a PSP makes the error in processing withholdings, employees may not realize until tax time that incorrect tax payments were made on their behalf unless their employer is monitoring its accounts.

When the Tax Department cannot validate the information on a New York taxpayer's personal income tax return because of inaccurate or missing information, it must hand-verify the return, a process that can add 6 to 12 weeks to the time it usually takes for a taxpayer to receive a refund because it includes sending the taxpayer a Request for Information[42] and/or a request for copy of the individual's W-2. If the Tax Department doesn't receive a response that resolves the issue, it will send a letter informing the taxpayer of their adjusted refund or tax bill.

Improved accuracy in filings from PSPs could prevent thousands of delayed refunds to New York taxpayers, spare those taxpayers unnecessary correspondence with the Tax Department, and reduce the Tax Department's expenditure of resources on correcting PSP and employer errors. This year, the Tax Department held approximately 625,000 returns (individual and joint) for review because of errors or missing information, and based on data from 2019, the Tax Department estimates that 75% of holds result from data errors in withholding records. About 63% of withholding records come to the Tax Department from a PSP, and about 73% of exceptions are for taxpayers whose withholding records came from PSPs. The exception rate for filers whose payroll was handled by the largest payroll service providers was 10%, which is higher than the rate for those filers whose employers did not have a professional company filing on their behalf (5.7%) and higher than the overall exception rate of 7.8%. The exception rates for filers whose payroll is handled by PSPs, by PSP size, are as follows:

Exception Rate by Size of PSP	
PSP Size by Number of Clients	Exception Rate
2,500 or more	10.00%
250 to 2,499	5.10%
25 to 249	4.80%
5 to 24	5.80%
4 or fewer	6.30%

The Tax Department suggests that a requirement for PSPs report to their clients their error rate, the exception rate on returns filed by employees of their clients overall, and the exception rate on returns filed by the client's employees may offer an incentive for greater accuracy, as could penalties for errors.

The Tax Department also pointed out that it is possible for PSPs to verify Social Security numbers before submitting withholdings to tax authorities. Furthermore, closer collaboration between PSPs and their clients could also improve accuracy of their submissions, and validation of client employee data ahead of submission could also help prevent delayed refunds and reduce taxpayers' interaction with tax authorities. According to industry representatives, Social Security

[42] *See* https://content.govdelivery.com/accounts/NYTAX/bulletins/2ca2362.

number verification is not widely used, but they are currently advocating for access to information that would allow PSPs to verify TINs.

E. The feasibility and advisability of the Department of Financial Services having regulatory oversight of third-party PSPs

The Census and DOL data show that between approximately 400 and 14,000 entities are performing payroll services in New York. For context, in 2021, the Department's Licensed Financial Services Unit regulated 118 money transmitters, 89 sales finance companies, 28 budget planners, 93 check cashers, 21 licensed lenders, and 34 premium finance agencies. The PSP industry may be orders of magnitude larger than Licensed Financial Services. Administering a licensing or registration program and conducting examinations would require a new business unit at the Department with significant new staffing and resources.

As outlined in this report, the few instances of malfeasance in this in industry have primarily been addressed through existing tax and fraud laws, and, based on decreased reports of payroll service provider fraud, preventative initiatives of recent years appear to have been effective. While this report provides the information and analysis required by Chapter 186 of the Laws of 2022, DFS looks forward to continuing this dialogue with the New York State Legislature to support appropriate policy recommendations to ensure New Yorkers' wages are protected.