

Understanding the ‘Aha!’ Of ACH Payments

By Jim Ford and Mark Cox

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In this article, Ford and Cox examine the pros and cons of using different types of automated clearinghouse payments when sending them to a tax authority, and they explain how one method can make accounting and reconciling much easier.

Automated clearinghouse (ACH) payments are not new to tax departments. They were initiated by the ACH Network, which has become one of the largest, safest, and most efficient payment systems in the world since it began in 1974. By 1978 it was possible for two financial institutions located anywhere in the United States to exchange ACH payments under a common set of rules and procedures. Today, the nonprofit association NACHA manages the ACH Network and transfers trillions of dollars annually between financial institutions.

Taxing authorities are always eager to receive their payments in a timely and efficient manner. Beginning in the 1990s, they began implementing legislative changes that required the electronic payment of taxes due from taxpayers making frequent or large payments. As time progressed, taxing authorities began lowering the thresholds for mandatory electronic payments as well as requiring additional types of tax to be paid in electronic form.

Two Payment Options, What’s Best for You?

There are two ways to make an ACH payment from a taxpayer’s perspective: ACH debit and ACH credit. ACH debit is simple — most people have

used this type even if they didn’t realize it. ACH debit is when we authorize a third party to take payment from an account we own. This is usually as simple as providing a routing number, account number, and account type at the third party’s request. The online application we are using then executes an ACH debit payment that transfers funds from our account to theirs. ACH debits are authorized by the sender but then executed by the receiver of the funds. Because the receiver knows who the funds are from and the amount he needs to collect, the receiver pulls the funds from the account and applies payment to whatever liability existed. The authorizer then sees the payment in his account within one to two business days.

In the ACH credit method, the sender executes the transaction, not the receiver. The receiver provides the sender with information about their account including: routing number, account number, and addenda record format. The sender then prepares an ACH credit batch with their financial institution that transfers the funds from their account to the receiver’s. The transaction arrives with an addenda record that identifies (1) who the sender is and (2) what the payment is for. Once the receiver decodes the addenda record, payment is applied to the appropriate liability, indicated by the sender.

Both methods have advantages and disadvantages. At face value, ACH debit seems simple. But it is a manual process that involves researching many taxing authorities’ websites, setting up accounts, adding bank account details, and then manually logging in each time a payment is due. Manual steps are subject to human error (for example, keystroke mistakes), account lockouts on due dates, and debit blocks on accounts.

ACH credit requires some initial effort and know-how but is easy to execute once it is set up. To get started with ACH credit, first think about how you want to create your batches. There are several options, including:

- third-party ACH origination software;
- banking application ACH (or cash management) module; and
- Microsoft Excel templates.

It starts with your bank. Investigate what capabilities your bank has for making ACH credit payments to taxing authorities. Almost all banking applications today include a module for creating ACH payments. The modules vary by bank but are

often similar in that they allow companies to create vendors (that is, taxing authorities), and templates for each type of batch needed. The templates include the taxing authorities' routing and account numbers and addenda records. Many banking applications may also include the ability to upload a file to create batches from outside the system.

Third-party ACH origination software allows companies to organize vendors, set up templates, and define addenda record formats by taxing authorities. Then it's just a matter of importing the current payments to create ACH batches that can be sent or uploaded to the bank. The software may help in automating the creation of the addenda records and ensure that once an initial template is set up, it will work each time until the taxing authority changes its accounts or addenda record format.

Not sure which option is best for you? Ask peers about their experiences. We asked Michael Gallagher, tax manager at Draeger Medical Inc., North America, who switched from ACH debit to ACH credit for making sales and use tax payments a few years ago. He hasn't looked back since the switch. "Tracking and reconciling hundreds of payments was always a challenge with ACH debit," Gallagher said. "Now, with ACH credit, we make lump sum payments with detail that break out the payments by state, separate discounts from tax, identify prepayments, and adjustments upfront. This makes the accounting and reconciling dramatically easier."

The How-To of ACH Credit

After deciding on the organization's preferred technique for ACH batches, follow these steps to execute ACH credit payments:

- decide which payments and tax types to send via ACH credit;
- contact the taxing authority to determine if ACH credit is an option;
- execute an ACH agreement with the taxing authority;
- review addenda record formats and program guidelines;
- set up the new payee and addenda record in the system; and
- send a prenote transaction.

First, start by deciding which payments make sense. Recurring monthly or weekly payments generally work best as they can easily be templated and then reused each cycle with minimal changes.

Next, find out if the taxing authority accepts ACH credit payments for this type of tax. The vast majority do; however, a few holdouts or states may have special requirements for receiving ACH credit payments.

To make payments via ACH credit in most states, it's necessary to execute a form with the taxing authority, letting it know that you will be making payments via ACH credit in the future. Usually these are executed with the state's electronic funds transfer division.

ACH Credit: Addenda Records

Once the agreement is executed with the state, the taxing authority will send along the program guidelines and addenda record format. Specific addenda records will vary by taxing jurisdiction but generally they are all looking for the same pieces of information: taxpayer ID, tax period, tax type, and amount.

There are many pieces to a NACHA file, but don't worry, most of this will be transparent. Your bank application or ACH software will create the file automatically. Simply supply the data, including accounts, routing numbers, and amounts. The addenda records format may need to be set up, but it is similar from tax to tax and state to state.

The standard tax payment (TXP) format uses an asterisk as a record separator. Your taxpayer ID is included as well. Each taxing authority will indicate the format of the taxpayer ID and things like spaces and dashes that typically appear in the identifier and should be included. Some states will issue a specific ACH taxpayer ID to be used in lieu of the actual taxpayer ID for ACH credit payments. Tax periods are included in the format "YYYYMMDD." Each taxing authority will publish a list of tax type codes that correspond to tax types of the ACH credit payments they receive. Amounts in addenda records are shown without the decimal places, so a payment of \$123.45 would be represented as 12345 in the addenda record.

A typical record looks like this:

TXP*[TaxPayerID]*[TaxPeriodEnding]*
[TaxTypeCode]*[Amount]

Example: TXP*123456*20160331*0345*456789

This example denotes a payment of \$4,567.89, taxpayer account number: 123456, the period ending 03/31/2016, and tax type 0345 indicates consumers use tax. After registering for ACH credit, taxing authorities will supply their specific record formats and tax type codes. Many bank applications and ACH software will allow companies to define addenda formats once and update data only when needed.

If your bank allows uploadable payments into a batch, use basic Excel concatenation formulas to make an addenda record creator. Update the spreadsheet with amounts and tax period and then save the tax type codes and format in a formula that creates the record on the fly, as noted in the following chart.

A6		A	B	C	D	E	F
1	Return	Taxpayer ID	Period	Tax Type Code	Amount	Addenda Record for ACH Credit	
2	State Sales and Use Tax	123456	3/31/2016	375	\$4,354.23	TXP*123456*20160331*0375*435423	

Here is the formula for column F that uses simple concatenate and text formatting functions to transform the data in the sheet into an addenda record:

```
= "TXP*" & B2 & "*" & YEAR(C2) &
TEXT(MONTH(C2), "00") &
TEXT(DAY(C2), "00") & "*" & D2 & "*" &
(E2*100)
```

After the batches are prepared, it's sometimes necessary to send a prenote transaction. A prenote is a special transaction that includes a zero dollar transmission and acts as a test to verify the bank account, routing, and addenda record formats. Not every taxing authority requires prenotes but it is a good practice to request the test as a fail-safe, especially the first time you execute the process. Remember, because you execute the payment, any mistakes are your (the sender's) responsibility. Thus, prenotes are always good even when not required.

Once the prenote is accepted, it's done. Update the payment amounts each month. Upload the file

and release the batches in your preferred back-office application to send them along the NACHA network in batch format.

The benefits? Your bank account will no longer be littered with hundreds of payments. The batch will appear in a lump sum amount on the bank statement. And, the detail used to create the batch becomes the detail used for journal entries, reconciliation, and more — saving time and effort long term.

Work Smarter, Not Harder

No matter how small or infrequent the payments, tax departments are required to make electronic payments to taxing authorities. With fewer resources, tax departments must work smarter to balance everyday fundamental activities (such as payments) with new technology, rising costs, and regulatory complexity. Take the time to look at long-term and more efficient solutions to automate and better execute tax department processes. ■